2011

The Chinese Socio-Cultural Influence on the Legal System of the People’s Republic of China and Its Implications for Foreign Investment: A Critical Analysis

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Recommended Citation

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The Chinese Socio-Cultural Influence on the Legal System of the People’s Republic of China and Its Implications for Foreign Investment: A Critical Analysis

A thesis submitted in fulfilment of the requirements for the award of the degree

DOCTOR OF PHILOSOPHY

from

UNIVERSITY OF WOLLONGONG

by

Ying Lin
LLB (ShenZhen), LLM (Wollongong)

FACULTY OF LAW

2011
I, Ying Lin, declare that this thesis, submitted in fulfilment of the requirements for the award of Doctor of Philosophy, in the Faculty of Law, University of Wollongong, is wholly my own work unless otherwise referenced or acknowledged. The document has not been submitted for qualifications at any other academic institution.

Signature ........................................
Ying Lin

Date ..............................................
THESIS DECLARATION

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Abstract

China’s dramatically increasing economic development has established a major presence in the global market since the commencement of its ‘Open Door’ policy in December 1978. An important result of this policy’s implementation was the involvement of foreign direct investment in China’s economic reform. Undoubtedly, foreign investors have begun to play a significant role in the course of China’s economic development. However, foreign investors in the People’s Republic of China (PRC) must deal with a different legal environment to that of their home country and find that the law is different both in appearance and in practice. In this research social and legal issues relating to foreign investors operating in China are used as a starting point to identify the nature and development of the PRC legal system. From a historical and cultural point of view, the reasons for those issues are explored. The study reveals that a feudal political system and the dominance of Confucian culture in China have had a significant effect on the Chinese legal system. The different implications for the concepts of law, and its standing in society are the effects of these factors on the application of law. To comprehend the PRC legal system for foreign investors doing business in China, it will be suggested that it is important to understand Chinese history and culture originating in the particular region. The social standing of law and the nature of its enforcement in practice reflect the PRC legal culture.

This thesis begins with issues affecting foreign investors operating in China, accompanied by an analysis of the influence of historical and cultural factors, such as political power and Confucian concepts of law in society. It reveals an important interaction between law and culture affecting the Chinese legal system today. The research includes a
survey illustrating how foreign-investment enterprises in the PRC are dealing with the shock of a different legal system and caused by cross-cultural phenomena. Even though legal reform has been undertaken in developing a legal system in China, clearly it is the attitude towards law that has been a primary tool for facilitation of a utilitarian reception of foreign legal institutions. A survey referring to these issues for existing foreign investors has been conducted and the results analysed to explore the relations between cultural and social factors and the development of the legal system in China. It illustrates the interaction between law and culture in the evolution of China’s history. It reveals that is important to have a rational and practical attitude to law in China involving an understanding of the effects of Confucian culture and legalism on the legal system in the course of its evolution. This is a vital ingredient not only for an entry strategy for foreign investment but also for continued operations in China.

These issues have illustrated the fact that the function and standing of law are uncertain as a result of different needs of development. This can be traced to Chinese history and the acknowledgement of the place of law in society.

The Chinese legal tradition developed from both Confucianism (with its emphasis upon morality) and Legalism (which emphasised the rule of law), and the legal system is characterised by the influence of these two influential and adversarial schools of thought. The Confucian ideology provided the fundamentals for the substance of traditional law and the Legalist school constructed the important framework of the traditional legal system. Although the legalist school and Confucianism were adversarial philosophies in terms of their political ideologies of how Chinese society should be ruled, they certainly shared some important ideas, such as the emperor’s power over all facets of life, including law. However, Chinese imperial law bears a strong Confucian moral character. Confucian
morality and imperial law were two parallel behavioural codes that combined to order social conduct in Chinese society.

The features of law in a society and at a particular historical stage are shaped not only by the prevailing environment but also by the cultural heritage of that society, even though the role of culture and tradition in shaping the law may be muted, implicit and even unconscious. The emphasis on the emperor’s superior power under the teaching of Confucius is a major tradition in political power in China. A good government is based on virtue and morality but not by law. Certain fundamental features of the traditional legal culture clearly persist in the contemporary legal system and social attitudes towards law. Thus, a legal system must be assessed within its historical and cultural context.

This research examines how law in China is created in the light of cultural and historical dimensions. The patriarchal relationship and behavioural norms within the extended family or clan were not only reflected in the power structure of officialdom but also formed the basic foundation and standards for social conformity. Foreign investor operations in China must meet the challenge posed by differences in legal culture and tradition because they will continue to significantly influence the future shaping of the PRC legal system.
Acknowledgements

I am most grateful to my supervisors Dr Sheikh Solaiman, Professor Natalie Stoianoff and Professor Warwick Gullett, of the Faculty of Law, University of Wollongong. They have been most helpful in providing constructive guidance and comments on successive drafts of this thesis. For final proof-reading of the thesis, I sincerely thank Elaine Newby.

During my years of study in the Wollongong University Faculty of Law, many friends and faculty and library staff have given me invaluable assistance and moral support. I express my sincere thanks to them all.

I give special thanks to my husband William Preece, who has been giving me complete and wonderful support and encouragement of my pursuit of academic study.

Last, but not least, I express my deep gratitude to my parents. Without their love and encouragement, life would have been intolerable.
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List of Abbreviations

ALNG: Australian Liquefied Natural Gas
AMC: American Motor Corporation
CKD: Completely Knocked Down
CNAIC: China National Automotive Industrial Corporation
CPC: Communist Party of China
CJV: Cooperative Joint Venture
ECL: Economic Contract Law
EJV: Equity Joint Venture
ETDZs: Economic Technology Development Zones
FAW: First Auto Works
FDI: Foreign Direct Investment
FECL: Foreign Economic Contract Law
FTA: Free Trade Agreement
GATT: General Agreement on Tariffs and Trade
GDP: Gross Domestic Product
GIPA: Global Investment Prospects Assessment
GPCL: General Principles of the Civil Law
ICSID: International Centre for Settlement of Investment Disputes
IMF: International Monetary Fund
MOFCOM: Ministry of Commerce
MOFTEC: Ministry of Foreign Trade and Economic Cooperation
NPC: National People’s Congress
PLA: People’s Liberation Army
PRC: People’s Republic of China
R&D: Research and Development
RMB: Ren Min Bi – Chinese Currency
SAIC: State Administration for Industry and Commerce
<table>
<thead>
<tr>
<th>Acronym</th>
<th>Full Form</th>
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<tbody>
<tr>
<td>SAIC</td>
<td>Shanghai Automotive Industrial Corporation</td>
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<tr>
<td>SDPC</td>
<td>State Development and Planning Commission</td>
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<tr>
<td>SETC</td>
<td>State Economic and Trade Commission</td>
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<tr>
<td>SEZ</td>
<td>Special Economic Zone</td>
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<tr>
<td>SOE</td>
<td>State Owned Enterprise</td>
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<td>SVW</td>
<td>Shanghai Volkswagen</td>
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<td>TCL</td>
<td>Technology Contract Law</td>
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<td>TRIPs</td>
<td>Trade Related Aspects of Intellectual Property Rights</td>
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<td>UCL</td>
<td>Uniform Contract Law</td>
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<tr>
<td>UNCTAD</td>
<td>United Nations Conference on Trade and Development</td>
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<tr>
<td>WFOE</td>
<td>Wholly Foreign Owned Enterprise</td>
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<td>WTO</td>
<td>World Trade Organisation</td>
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2. Copy of Human Research Ethics Committee amendments approval letter for the thesis survey in respect of the use of audio tape recording in interviews (‘AMENDMENTS APPROVAL’)
3. Copy of renewal of Human Research Ethics Committee approval letter for the thesis survey (‘RENEWAL APPROVED’)
4. Copy of Survey questionnaire (‘QUESTIONNAIRE FOR AUSTRALIAN ENTERPRISES OPERATING IN CHINA’)
5. Copy of questions for follow–up interviews (‘INTERVIEW QUESTIONS’)
6. Copy of Participant Information letter for survey participants inviting their participation in ‘follow–up’ interviews (‘INFORMATION LETTER’)
7. Copy of blank interview consent form for participation in a follow–up interview including advice of audio recording of the interview (‘CONSENT FORM’)
8. Copy of letter from Researcher to those accepting the invitation to participate in a follow–up interview (‘INTERVIEW LETTER’)

Chapter 1

General Introduction

1.1 Introduction

Law as a discipline is concerned with elaboration of the practical art of government through rules.\(^1\) Also, law embodies important cultural assumptions which constitute a central aspect of its influence in society.\(^2\) Law’s relationship with social conditions is a significant element in any study of perceived problems in the application of laws.

In the case of China, its social and economic conditions have been rapidly changing in the last 30 years as a result of the commencement of economic reforms.\(^3\) Since 1978, China has consistently pursued what has been termed an ‘Open Door’\(^4\) policy to international trade and investment. This chapter introduces the environment existing in China in the late 1970s and the decision-making that set China on a new path that would see it grow into one of the largest of the world’s economies.

In this chapter, section 1.1 introduces the subject area of the research. It includes an outline of the remaining 9 chapters of the study and discusses the policy changes that began China’s massive drive towards becoming a sophisticated world economic power. Section 1.2 indicates the aims, objectives and intended contribution of this research.

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\(^2\) Ibid 26.
\(^3\) At the Third Full Meeting of the Central Committee of the Eleventh Term of the China Communist Party in December 1978, the Four Modernisations (agriculture, industry, defence, and science and technology) were added to the Revised Rules and New Constitution of the Communist Party. To achieve these modernisations, China engaged in economic reform centred on the introduction of an open market economy.
\(^4\) The report on the Third Full Meeting states that its purpose, which is founded on a philosophy of self-reliance, is to actively seek to develop mutually beneficial economic cooperation with other world countries, to work for the introduction of advanced technology and facilities from foreign countries and to put effort into science and education projects necessary for the realisation of modernisation.
paper and its conceptual basis. Section 1.3 provides a background to the economic growth of China and the legal reform that accompanied that growth and includes an outline of the scale of foreign enterprises operating in China and some substantial issues for those investors. Section 1.4 commences analysis of the legal regime for foreign investors in the People’s Republic of China (PRC) while section 1.5 discusses the proposition that ‘interaction’ and ‘networks’ are matters of vital importance to foreign investors. Section 1.6 introduces the link between economic development and legal reforms in the PRC and section 1.7 commences the analysis of the existing legal environment for foreign investors. Section 1.8 examines historical and social influences in the areas of morality and social order and suggests that these have a central place in the modern legal environment in China. Section 1.9 discusses the intersection of philosophy and political power in the PRC. Section 1.10 summarises and concludes the chapter.

1.1.1 A Brief Outline of the Following Chapters of the Research

In Chapter 2, features of the current legal system of China are explained. These include the law-making bodies, the executive branch, sources of law, the judiciary and the interpretation of law.

Chapter 3 includes an examination of the traditional roots of Chinese law and the intersection of philosophy and political power. Chinese world views in their social and legal context are analysed and explained by reference to Confucian and legalist theories.

Chapter 4 further analyses the evolution and development of the current legal system in China and the roles of Government and the Communist Party of China (CPC).
The chapter reflects upon historical and social influences upon the existing legal environment for foreign investors.

Chapter 5 gives an introduction on foreign investment and the development of foreign investment laws in China including the background to the ‘Open Door’ policy regarding foreign investment, the establishment and development of foreign investment laws and the legal sources of Chinese foreign investment law.

Chapter 6 includes an analysis of some substantive practical issues for foreign investors. These include issues concerning the implementation of law and its administration, such as: the dilemma of national laws versus local regulations, the discretionary power of the administration, and the enforcement of contract. Some feedback from a survey in Australia is elaborated.

Chapter 7 includes detail of the development of contract law in the foreign investment field and examines features of administrative operation in the current legal system.

Chapter 8 further analyses the outcomes of a survey of Australian enterprises conducting business in China, and discusses the importance of relationships between foreign investors, such as those surveyed and/or interviewed and their Chinese business partners.

Chapter 9 contains some insights into major issues for foreign investors, such as: social and legal aspects, business and culture, ‘Guanxi’, and a comparative examination of the experiences of two major joint venture investors (the German Volkswagen Group and the American Motor Corporation). The chapter also deals with legal uncertainty, property rights, contract law, and conflict of laws.

Chapter 10 concludes the study and draws together important practical outcomes of the ramifications of law in China evolving from Chinese culture.
1.1.2 The Genesis of an Economic Revolution

Deng Xiaoping (1904–1997) is rightfully called the main inspirer and initiator of market reforms in China.\(^5\) Deng was one of the principal leaders of the PRC’s socialist reform, opening its economy to the international market and modernisation.\(^6\) He was the founder and chief architect of Deng Xiaoping Theory.\(^7\) When the ‘Cultural Revolution’ began in China in 1966, Deng lost all his leadership positions.\(^8\) In October 1976 the ‘Gang of four’ was smashed and the Cultural Revolution ended.\(^9\) In July 1977, the Third Plenary Session of the 10th National Congress of the CPC reinstated Deng Xiaoping to his former duties as military and political leader.\(^10\) In August 1977, convening the 11th

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\(^5\) 决定：关于同意邓小平同志辞去中共中央军事委员会主席职务的决定 [Decision Concerning Deng Xiaoping’s Resignation of Chairmanship of the Central Military Commission of the Communist Party of China at the Fifth Plenary Session Meeting of the Thirteenth Central Committee of the Communist Party of China] Central Committee of the Communist Party of China, 9 November 1989. The Central People’s Government of the People’s Republic of China [http://www.gov.cn/test/2008-07/02/content_1033721.htm]. Deng Xiaoping’s contribution to China’s economic reform was recognised in this official document and for the first time Deng was officially regarded as the chief architect of China’s economic reform.

\(^6\) Ibid.

\(^7\) 杨德山 [Yang Deshan], ‘邓小平理论’ [Deng Xiaoping Theory], 中国共产党新闻网 [News of the Communist Party of China] [http://cpc.people.com.cn/GB/64162/64171/4527683.html]. Deng Xiaoping Theory may be briefly summarised as ‘building socialism with Chinese characteristics’ and primarily includes: an admission that China is still in the early stages of socialism; that China should have an attitude of seeking the truth from the facts rather than blindly transplanting any foreign model of a socialist system; and that China’s socialist model must be based upon China’s national conditions. The theory includes the need for China to shift its focus from a political movement to emphasis upon economic construction including opening China’s door to the outside world and accomplishing the ‘Four Modernisations’ including:- industrial modernisation, agricultural modernisation, military modernisation, and technology modernisation. Additionally the theory emphasises the upholding of four cardinal principles, namely: the basic spirit of Communism; the Peoples democratic centralised political system; leadership by the Communist Party; and Marxism-Leninism and Mao Zedong Thought.

\(^8\) ‘Deng Xiaoping’, News of the Communist Party of China, 23 August 2004 [http://english.cpc.people.com.cn/66485/66495/66496/4533662.html]. In 1966 Deng Xiaoping was criticised by, and lost all his posts within, the Communist Party of China thus experiencing the most arduous period during his revolutionary career.


National Congress of the CPC, Deng was elected vice-chairman of the CPC Central Committee.\textsuperscript{11}

In March 1978 Deng was elected to the Fifth (CPC) National Committee. Deng began by promoting an ideological line to set things right against the earlier policy mistakes.\textsuperscript{12} He undertook leadership and support in the discussion of the criterion that the truth put forward must be based upon a complete and accurate understanding of Mao Zedong thought.\textsuperscript{13} He also proposed to shift the focus of the party’s work as soon as possible to economic construction.\textsuperscript{14} When the Third Plenary Session of the 11\textsuperscript{th} National Congress of the CPC was held in December 1978, China commenced reform and to open its market to the outside world and focus efforts on a new socialist modernisation.\textsuperscript{15}


\textsuperscript{13} <<关于建国以来党的若干历史问题的决议>> [Resolution on Certain Questions in the History of Our Party since the Founding of the People’s Republic of China] (People’s Republic of China) Central Committee of Communist Party of China, 27 June 1981, [27]; ‘Comments and Historical Solution’ in Mao’s 110\textsuperscript{th} Anniversary News of the Communist Party of China, 14 June 2006 <http://english.cpc.people.com.cn/66095/4471924.html>. The Chinese Communists, with Mao Zedong as their chief representative, conducted a theoretical synthesis of China’s unique experience in its protracted revolution in accordance with the basic principles of Marxism-Leninism. This synthesis contributed a scientific system of guidelines befitting China’s conditions, and it is this synthesis which is Mao Zedong Thought, the product of the integration of the universal principles of Marxism-Leninism with the concrete practice of the Chinese revolution.

\textsuperscript{14} Ibid [32].

\textsuperscript{15} 邓小平 [Deng Xiaoping], ‘关于经济工作的几点意见’ [Some Comments on the Economic Work] in <<邓小平文选第二集>> [Selected Works of Deng Xiaoping vol. 2] (人民出版社 [People’s Publishing House], 4 October 1979) [2].
Deng Xiaoping was at this meeting on the history of the policy changes in the CPC and played a decisive role. After the Third Plenary Session of the 11th National Congress of the CPC, he insisted upon emancipating the mind and seeking truth from facts and the creation of a theory of ‘building socialism with Chinese characteristics’. This theory scientifically clarified the nature of socialism, and provided the first relatively systematic answers to the question of how to address China’s position as an economically and culturally backward country while continuing to build on socialism and explore how best to consolidate and develop utilising a series of basic questions of socialism.

According to his ideas, it was imperative for the 13th National Congress of the CPC (having achieved the most developed primary stage of socialism), to adopt economic construction as its central element. He pointed out that the fundamental task of socialism is to develop productive forces and that the Party must wholeheartedly engage in modernisation and achieve it. He believed that modernisation of science and technology was the key; that science and technology were primary productive forces; and that education is the most fundamental goal for a nation. The CPC decided to...
establish a socialist market economy system with reform goals as a theoretical basis. Deng’s initiative — to set up special economic zones, open 14 coastal cities as well as opening up Shanghai’s Pudong New Area development — was the proper pattern to adopt in promoting China’s full economic awakening. He actively pushed forward the political system, emphasising the development of a socialist democracy and improving the socialist legal system in the building process. In November 1989 at the Fifth Plenary Session of the 13th National Congress of the CPC, Deng resigned from his last job as Chairman of the Central Military Commission.

After retiring, he remained concerned about the Party and state enterprises. He conducted inspections in 1992 in Southern China’s Wuchang, Shenzhen, Zhuhai, Shanghai and other places and delivered an important speech, summing up the basic experience of reform and economic ‘opening up’ from a theoretical perspective in order to present solutions to a number of major problems. The 15th National Congress of the CPC held in 1997 discussed the theory of building socialism with Chinese
characteristics and described it as Deng Xiaoping Theory. It was pointed out that this theory is the Marxism of contemporary China, that is, China’s development of Marxism to a new stage. The Constitution clearly stipulated that the CPC takes Marxism-Leninism, Mao Zedong Thought and Deng Xiaoping Theory as its guide to action. Implementation of the late Deng Xiaoping’s discrete programme of economic reform has clearly brought about significant changes in China’s economy, politics and culture.

The PRC, a country with a rich five thousand year history of civilisation, has been moving towards becoming a capitalist and market economy. The economic system is moving away from the heavy hand of centralised state planning toward a system marked by greater openness, competitiveness, and flexibility. The Anti-Monopoly Law of the People’s Republic of China 2007 (Anti-Monopoly Law) came into force on 1 August 2008. The new law sets out a broader definition of monopolistic conduct and creates a commission to oversee this area. The passing of a unified, anti-monopoly law applying to both domestic and foreign businesses represents a significant milestone for the PRC. The new legislation adopts and expands on a number of competition law

concepts that are used in Western jurisdictions, and sets tougher penalties for those that engage in monopolistic conduct.\textsuperscript{32}

Anti-Monopoly Law has provided restraints upon the predominance of the monopolistic state owned enterprises. In the context of China’s political, economic and legal development the Anti-Monopoly Law is nevertheless a very significant achievement.\textsuperscript{33}

Law, in particular, has become highly significant in terms of its functions and application to economic development in China. Since the mid-1990s a series of steps have been taken for legal reform, including: changes in the legislative process; the implementation of legislation via the interpretive practices of courts and administrative agencies as well as through the enforcement of civil judgments; the addition of legal advisers to personnel within the system; developments in criminal law and human rights; key changes in laws relating to foreign trade and investment law; and, finally alterations to China’s place and role in the international legal order.\textsuperscript{34}

1.2 Aims, Objectives and Contribution of the Research

China’s dramatic economic development has established a major presence in the global market in the last 30 years. An important result of its implementation of economic development has been the inevitable involvement of foreign companies in China’s trade and development. Foreign investors have begun to play a significant role in the course of China’s economic development. A core question of this research is how foreign investors in the PRC can be assisted to deal with a system of law that is different both in

\textsuperscript{32} Ibid arts 46–54.
appearance and in practice to that of their home country, and to better equip them to work effectively with outcomes that may be confusing and sometimes incomprehensible.

1.2.1 Aims of the Research

The aims of this research are twofold. On the one hand it aims to provide an enhanced understanding of the socio-legal environment in China for those who wish to become involved in business activity in that country and to better prepare such investors to avoid the pitfalls experienced by others who have preceded them.

Secondly, the research will map the development of laws in the PRC for the period during which the country has become a significant player in the global market economy and, in particular, examine the social, historical and cultural factors that, in the view of this researcher, underpin the nature of those laws. The research will also analyse the nature of the implementation of relevant laws including reference to some inherent flexibility in their interpretation — and thus their implementation — with the purpose of assisting foreign investors to gain an understanding of the practical effects of laws applying to them as foreign investors.

1.2.2 Objectives of the Research

The development of laws related to matters of market economics is central to this study. An objective of the research is to raise the level of understanding of the historical and cultural background of Chinese society and the extent to which these have had and continue to have an influence upon the nature of modern laws in China. A further objective is to provide the reader with knowledge that can shed light upon the ways in
1.2.3 Significance of the Study

In this research legal issues relating to foreign investors operating in China are used as a means to identify the nature and development of the PRC legal system, particularly in its appearance and practice. Those issues are explored from historical and cultural perspectives. The exploration reveals that a feudal political system and the dominance of Confucian culture in China have had a significant effect on the Chinese legal system. The different implications of concepts of law and its standing in society are the effects of these factors on the application of law. To comprehend the PRC legal system for foreign investors doing business in China, it will be suggested that it is important to understand Chinese history and culture relevant to the particular region.

1.2.4 Contribution of the Study

This research will assert that there are issues arising for the operations of foreign investors that illustrate the effects of social and cultural factors on the legal environment in China in which the investors must operate. A sample group of foreign investors was surveyed, referring to these issues for existing foreign investors, and an analysis of the outcomes shed light upon the relationships between cultural and social factors and development of the legal system in China. The analysis illustrated the relevance of the interaction between law and culture in the evolution of China’s history.

This research examines three specific aspects related to the legal environment in China that foreign investors will encounter in the course of their business operations. These aspects are: legal requirements (laws, regulations and policies) for foreign
investors; communication with the Chinese government (commencing with assessment and approval procedures for foreign investment projects); and relationships with Chinese partners. These aspects are generally associated with foreign investors’ commercial interests as well as being a reflection of features of the legal system of the PRC in reality. The role of law is to serve policies of economic change.\footnote{欧阳涛 [OuYang Tao], ‘法律工作要准确地为经济建设服务’ [Legal Works Should Serve Economic Construction Accurately] (1993) 77 法学杂志 [Journal of Legal Study] 2, 2.}

For the Chinese, in the process of resolving disputes, litigation is to be avoided and mediation is preferred.\footnote{Kuihua Wang, Chinese Commercial Law (Oxford University Press, 2000) 307.} Networks between foreign investors and their Chinese partners and government officials are commonly built up in social activities. Exploration of Confucian and feudal history in China reveals that there was a non-litigious tradition in both Confucian teaching and centralised political power in feudal society.\footnote{刘晴辉 [Liu Qinghui], ‘中国诉讼机制的近现代变迁及思考’ [Evolution of China’s Modern Judicial System and Some Consideration] (2005) 4 社会科学研究 [Social Science Research] 1, 1.} Confucius (551–479BC) promoted the use of ‘\(Li\)’(virtue) to control the country and the people.\footnote{崔永东 [Cui Yongdong], <<中国法律思想史>> [History of Chinese Legal Thoughts] (北京大学出版社 [Beijing University Press], 2004) 13–4.} According to the ‘Confucian Analect’, ‘Good and just government depends upon the moral and cultural qualities of the ruler and its officials.’ Emperors were exhorted to control common people mainly by using moral rules rather than laws as most laws were a means of punishment for criminal activity. Moral rules should be primary and punishment should be secondary. To achieve social harmony the human race has to find and practice the principles of ‘\(Li\).’\footnote{Ibid 15–7.} The teaching of Confucius became the official creed of the governing elite in China until the late 19th century. Confucius did not draw a sharp distinction between ethics, morality, propriety and law. His teaching sought to identify a moral method rather than a moral code.\footnote{Fung Yu-lan, A Short History of Chinese Philosophy (MacMillan, 1950) 46.}
Feudal society in China from the dynasties of Zhou (1134BC) to that of Qing (1911) lasted about 3000 years. It strengthened state administration following a rigid hierarchical system with law mainly being used to preserve social stability. Centralised political power was supreme. Therefore, the role of law and the Chinese approach to law today can be shown to have their roots in Confucian and feudal history.

This study seeks to create an enhanced understanding of the significance of these deeply entrenched aspects and to emphasise that the value of social connection involved in every aspect of legal activities can, and does play a pivotal role in the relationships between foreign investors in the PRC and their local partners and local agencies.

Rapid economic development and increasing involvement with economic globalisation have demanded and facilitated legal reform in China. In reality the questions of the role of law in China and how law is applied within the process of economic reform have become the subjects of significant debate. There have been many studies of Chinese law and China’s economic developments. This thesis examines the economic transformation that has led China into a market economy from the perspective of whether the traditional social and historical conditions have continued to have relevance to any significant role in the development of the legal system and social environment in the course of this rapid economic reform. As Fishman suggests:

At any given time since China started on the capitalist road, opinions about its prospects have figuratively, and literally, been all over the map. The present mood is a combustible mix of euphoria, fear, admiration, and cynicism.44

This research examines foreign direct investment (FDI) in a Chinese legal cultural context from an interdisciplinary45 point of view. In this research legal issues relating to foreign investors operating in China provide a window to view and identify the nature and development of the PRC legal system, particularly in regard to its appearance and practice. Those issues are explored from an historical and cultural point of view. The study will analyse whether a previously feudal political system and the dominance of Confucian culture in China have had significant effects upon the Chinese legal system. It will examine the unique nature of a communist regime entering into a capitalist market economy and how the different local concepts of law and its standing in society affect the application of law in China today.

The research will focus upon how law in China impacts upon foreign investors in the PRC and the ways that foreign investors comprehend the PRC legal system whilst doing business in China. It will also address the question of whether an understanding of Chinese history and culture originating in the particular region is relevant to the newly arrived or existing foreign investor. This study will explore how law and its practice are contained in China’s institutions, in the system of departmental assessment of proposed enterprises, and implementation procedures concerning foreign investment practice in China today. This researcher commences the study with a conceptual

44 Ted C Fishman, China, Inc. How the Rise of the Next Superpower Challenges America and the World (Scribner, 2005) 16.
45 This research studies roles and functions of law in practice. Foreign direct investment is chosen as a window through which both legal and social aspects can be examined in order to explain legal practice in reality in China today.
framework that accords with Chen’s view, that an understanding of the nature of laws requires an understanding of the social environment in which those laws exist.\textsuperscript{46}

Australian enterprises operating in China were surveyed for this research and their views and accounts of actual experiences provided some practical insights into the issues facing multi-national foreign investment in the business environment of China.

\subsection*{1.2.5 A Survey Conducted for This Study}

A survey was conducted in the course of this research. It was conducted between June 2004 and March 2005, and was based on written questionnaires sent to 200 Australian enterprises operating in China and 7 follow-up interviews. A sample group of 200 Australian enterprises with business operations in China was selected in New South Wales, Australia.

Participants in the survey were asked to respond to questions concerning general company information; market entry issues; operating issues in China including the legal environment and administrative environment; and cultural issues and cross-cultural management issues based on their experience of doing business in or with China. The participants’ perceptions of problems varied depending on the size of their business, its period of operation, the nature of the operation and the scope of the business.

Generally, China’s large market is the motivation for an enterprise’s entry to China, and it was evident that partner selection and geographical location are the major concerns regarding the entry strategy.\textsuperscript{47} Most of the businesses surveyed for this study


rated negotiation as the preferred form of dispute resolution as far as the industrial relations aspect of the legal environment was concerned. Respondents generally agreed that the relationship with the relevant government authority is very important and that networking played a significant role in the successful operation of their business. The different understanding of law and attitudes towards disputes were rated as the main issues. Also, differences linked to cultural backgrounds were evident in management issues within joint ventures.

Amongst the questionnaire participants, 16 of them agreed to participate in a follow-up interview and 7 participants actually undertook the interview. In answering expanded questions based on the questionnaire, the interviewees generally agreed that their business must function within a relatively new and incomplete legal system. The research showed that bureaucratic factors in the administrative system are still a major concern for foreigners doing business in China. A more detailed analysis of the findings of the survey is contained in Chapter 8.

1.2.6 Methods and Methodology of the Research

This study examines legal, social and cultural aspects of foreign investment in China as a means to explore the extent to which cultural and historical factors are relevant or important in terms of the ways in which laws are developed in the PRC. It also addresses the matter of the extent of the influence of those factors in terms of their practical effects on day to day business practice, particularly for foreign investors.

The methods adopted in this research include a literature review to ascertain existing views on the various aspects relevant to the research question, an historical analysis of law and its development in China, a survey of a sample group of players in
the activities central to the research, and case studies of the experiences of some substantial foreign investors in China.

The nature of this study has required the adoption of a multi-disciplinary approach in analysing the Chinese regulatory structures related to foreign direct investment. In addition to the study of Chinese legal history and an analysis of the current national legal framework on foreign investment, as well as procedural administrative law and non-foreign investment laws, issues of social conditions and culture are central to this thesis. The overall approach is based on traditional legal methods, such as the analysis of legal provisions, combined with insight from other disciplines, including the use of comparative and historical methodologies. This overall approach allows a suitable method to be applied to a specific area of the analysis where that technique is the most relevant. Each research strategy has its limitations and no single strategy is adequate for the complete analysis undertaken.

The research sources used for this thesis include primary legal sources, secondary sources, policies and formal reports. Secondary legal sources include texts, journal articles, research theses, news reports and governmental speeches. Presidential decrees, ministerial decrees and provisions, governmental reports and policy, and relevant data are not always easily or publicly accessible. Often, the sources are not stored in written form, but found only in official speeches. The literature references have dealt with areas such as: foreign investment in China, the Chinese legal system, Confucian philosophy and history, Chinese history, and business management.

Research methods in this study have included: a survey in the form of questionnaires; individual interviews with persons actively involved as foreign investors
in the PRC; and case study comparisons [German Volkswagen Group and American Motor Corporation].

The survey, in the form of a written questionnaire, was conducted in Australia. Participants were a sample group of Australian enterprises conducting business in China. The questionnaire consisted of four main sections designed to collect data relevant to entry strategies, operating issues and management issues. The analysis of the responses provided information relevant to the research question. This method was chosen as it was thought to be a useful means to collect primary data to illustrate the experiences of foreign investors in China. Questions about cultural issues were included in order to collect data about foreign investors’ communication with Chinese governments and Chinese partners. Information from this part of the research methodology elicited those foreign investors’ impressions (in 2005) about Chinese negotiation and communication styles and demonstrated links to cultural factors relevant to Confucian influences in modes of Chinese communication. It is suggested that the same probably holds true today whilst accepting that there may have been a degree of ‘westernisation’ in the attitude of the Chinese parties’ negotiation and communication styles due to the ongoing exposure to Western influence.48

In this thesis, it has been important to understand several points: firstly, China is a country based on the civil law tradition, and because of that no Chinese legal cases are quoted to support the thesis; secondly, since the majority of Chinese legal materials, including laws and regulations, have not always been officially translated into English, some materials have had to be translated into English by the present researcher; thirdly,

the changing nature and progressive development of international arrangements governing foreign direct investment to some extent affects national policy and, accordingly, updates of some material and data in this thesis has been required. Considering the fact that policy changes are not always published, the analysis of the updated materials is based primarily upon the official news and speeches available on the official government websites. The statistics quoted are all from publicly available, reliable and authoritative sources, and the fact that they counter commonly held perceptions could be due to the fallibility of the latter. However, the researcher concedes that statistics only present part of the picture, and that it is necessary to take into account the whole picture that eventually emerges, rather than just the statistical glimpse presented at a particular time.

1.2.7 Scope of the Study and Difficulties Experienced in the Research

In inter-disciplinary studies such as socio-legal research, it is important to establish the causal relationships between social phenomena and legal practices so as to allow the production of an analysis that is both accurate in its description of social reality and significant to the study of law. One of the difficulties for this research was that the Chinese system of law cannot yet be said to have a clear theoretical framework, particularly in the area of foreign investment.

In the study of relations between culture and law, the term ‘culture’ has been used in its widest sense. In sociological writing it refers to beliefs, attitudes, cognitive ideas, values and modes of reasoning, and perception.49 In this research, the term ‘legal culture’ is used to suggest the whole range of ideas, which exists in particular societies, about law and its place in the social order. These ideas will indicate legal practices,

people’s attitudes to law and their willingness or unwillingness to litigate. Accordingly, the relative significance of law in indicating wider trends of thought and behaviour reflect the specific practices and forms of discourse associated with legal institutions.\footnote{Ibid.}

This research, which is centrally concerned with Chinese law and its cultural aspects, was somewhat limited by the shortage of primary sources on the evolution of Chinese law, the Chinese legal system and historical literature in either English or Chinese languages. Some primary sources are not available for public access. For example, most judicial decisions are difficult to access, particularly those involving judgments made by the Judicial Committee. The Chinese government’s concern with national security appears to be the reason for the withholding of such information.

1.3 Background of Economic Growth and Legal Reform in China

1.3.1 An Overview

China’s dramatically increasing economic development has established a major presence in the global market since the commencement of its ‘Open Door’ policy in December 1978. This policy of concentration upon economic development has undoubtedly been a great success in terms of both national economic growth and increasing international economic and political influence. A United Nations Conference on Trade and Development (UNCTAD) report in 2009, incorporating a survey and assessment of global investment prospects, stated:

One of the striking features of FDI flows to the region during the past few years has been the steadily growing importance of China and India as host economies. With its inflows surging to a historic high ($108 billion) in 2008, China became the third largest FDI recipient country (after the United States and France) in the world. And these two largest emerging economies ranked numbers one and three, respectively, as the most

According to the Ministry of Commerce, the Department of Foreign Investment Administration statistics of utilisation of foreign investment from January to February 2010 show an increase of 14.56 per cent from the same period in the previous year, that is, from USD2.761 billion\footnote{‘billion’ used here refers to US billion, i.e. 1000 million.} to USD3.163 billion.\footnote{Department of Foreign Investment Administration, ‘Statistics about Utilisation of Foreign Investment in China from Jan to Feb 2010’ (12 March 2010) Ministry of Commerce of the PRC <http://www.fdi.gov.cn/pub/FDI_EN/Statistics/FDISTatistics/StatisticsofForeignInvestment/t20100312_119132.htm>.} This shows that foreign investment in China is still very active and has performed strongly despite the effects of the global economic recession.

China has then, by virtue of its size and dynamism, become a powerful economic presence in Asia and globally in the new millennium.\footnote{Calla Wiemer, ‘Introduction: China’s Economic Presence’ in Calla Wiemer and Heping Cao (eds), \textit{Asian Economic Cooperation in the New Millennium: China’s Economic Presence} (World Scientific Publishing, 2004) 1, 1.} An important result of the implementation of the ‘Open Door’ policy was the involvement of foreign companies in China’s economic transformation. China needed to attract not only foreign technology and foreign capital, but also foreign management expertise, marketing experience and marketing networks.\footnote{Jianfu Chen, \textit{Chinese Law} above n 46, 318–9.} On 17 January 1979, Deng Xiaoping, when meeting with the leaders in industrial and business communities, formally declared that:

More channels should be utilised to forge ahead our development, for instance, through utilisation of foreign capitals and technologies, and through the factories run by the returned overseas Chinese or people of Chinese origin … The absorption of foreign capital should be launched by means of complementary trade, or joint ventures.\footnote{Department of Foreign Investment Administration, ‘The First Speech Related to Absorption of Foreign Capital’ (4 December 2008) Ministry of Commerce of the PRC.
Commenting upon the degree of foreign direct investment (FDI) in China, Wei and Dutta suggest that:

When comparing borrowing from abroad to foreign direct investment (FDI), the latter is an advantageous approach in terms of importing capital, goods, plant and equipment, and technology. Under the FDI system, foreign investors directly share the risk of investment. They stand to share profits or losses. Accordingly, as an economic plan for accelerated industrialisation and thus accelerated growth of GDP.\(^{57}\)

It is clear that the FDI sector has contributed significantly to China’s economic growth since the late 1970s. As the country attracting the most FDI among the countries of the developing world for consecutive years, China not only expanded the scale of FDI but also optimised its structure. Companies with foreign investment in China are playing an increasingly important role in China’s national economic growth, industrial and technological advancement, export expansion and generation of job opportunities.\(^{58}\)

1.3.2 Foreign Enterprises Operating in China

Absorption of foreign capital is an important component of China’s basic state policy of opening up to the outside world.\(^{59}\) In the period from January to December 2010, the number of newly established foreign investment companies in China was 27,406 — a growth of 16.94 per cent compared to the same period in 2009.\(^{60}\) The level of utilised foreign investment in China was USD105.7354 billion in 2010, comprising a 17.44 per

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cent increase compared to the same period in 2009. According to the UNCTAD Global Investment Prospects Assessment (GIPA) and based on a joint survey conducted by UNCTAD in Geneva and Corporate Location Magazine in London, China was then ranked in the top three foreign investment hot spots for the following four years, ahead of India and the United States.

China’s continuous economic growth provides massive opportunities globally to business participants. In May 2005, the Asian headquarters of International Paper, the largest paper and forestry product’s company in the world, moved from Hong Kong to Shanghai. In July 2007, Coca Cola Amatil planned to build a global innovation and technology centre along with its China headquarters in Shanghai. Trans-national corporations have continued to set up their Research and Development (R&D) centres in China. A total of 490 of the world’s top 500 companies have invested in China and they have established more than 1160 R&D centres. It is not surprising that Australian enterprises also desired to participate in this enormous economic market. On 24 October 2003 Australia and China signed the Australia-China Trade and Economic Framework. The Australian Department of Foreign Affairs and Trade stated:

The Trade and Economic Framework set the direction for the future development of the strong and rapidly expanding trade and economic relationship between Australia and China. The practical measures and co-operative activities contained in this Framework

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61 Ibid.
64 Ibid 2.
will make it easier to do business with China and provides for closer government, business-business and people-people linkages.66

Until its recent slowdown, China had experienced a sustained period of rapid economic expansion, with GDP growth averaging 11.2 per cent between 2006 and 2010.67 Although growth in 2008 slowed to a seven year low of 9 per cent, and to 7.7 per cent in the first nine months of 2009, these growth rates remain very high by international standards and China remains the single largest contributor to global growth.68

China has continued efforts to reform and expand its economy regardless of the recent international economic recession conditions. During the Tenth Five Year Plan period, foreign investment of USD383 billion was actually used, including about USD286 billion as FDI.69 China has become increasingly more outward looking and active internationally and has become a favourite investment destination for foreign capital and multi-national corporations; however, the investment environment in China is still under development, including the construction of the legal system, perfection of the market economy system, establishment and implementation of relevant policies, and further measures to encourage foreign investment. The Chinese government has not only already promulgated and revised relevant laws, regulations and policy documents according to the requirements of a market economy and undertaken to join the World

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Trade Organisation (WTO),\textsuperscript{70} it has also made the establishment of laws, regulations and policies more open, fair, standardised and transparent. Foreign investors expect that the combination of the transformation of governmental functions, along with improvement to the efficiency of services, will reduce the number of steps in the assessment and approval of foreign investment proposals.

1.3.3 Some Substantive Practical Issues for Foreign Investors

The nature of the legal and business environments in China has been of great importance to those enterprises that have been operating in China as well as to potential foreign investors. Some practical problems of compliance with laws relating to foreign investment enterprises and issues of performance of joint ventures are common experiences of the foreign investor in the PRC.\textsuperscript{71} Among the many issues that are important and indispensable to a potential foreign investor wishing to do business in and with China are an understanding of Chinese political and legal systems and sensitivity to Chinese social and cultural issues.

Once the complete setup of a foreign business is achieved, many aspects of domestic law will be applicable to its operation. For example, amongst the laws and regulations that apply to Co-operative Joint Ventures (CJVs)\textsuperscript{72} are the \textit{Law of the PRC}

\begin{itemize}
  \item \textsuperscript{70} Guojun Pan et al, ‘China’s Accession to WTO’ \textit{The People’s Daily Overseas Edition}, 11 November 2001, 1. The Fourth Ministerial Conference of WTO held in the capital of Qatar, Doha, with the consensus decision supporting China’s accession to the WTO on 10 November 2001.
  \item \textsuperscript{71} Matthew Stephenson, \textit{A Trojan Horse in China} (Harvard Law School, 2006) 191. Laws seem opaque, unpredictable, and unfair. Legal institutions are inefficient, inaccessible to ordinary people, and subject to corruption and political interference.
  \item \textsuperscript{72} A Co-operative Joint Venture is a type of joint venture into which foreign investors and Chinese parties insert every aspect of their arrangements into a written contract and the parties share profits and risks. A co-operative enterprise can also obtain the status of a ‘Chinese legal person’ if it complies with the provisions of Chinese law for a legal person.
\end{itemize}
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on Chinese-Foreign Cooperative Joint Ventures 1988 \(^{73}\) the Detailed Rules for the Implementation of the Law of the PRC on Chinese-Foreign Cooperative Joint Ventures 1995 \(^{74}\) and the Interpretation of the Implementation of Certain Articles of the Detailed Rules for the Implementation of the Law of the PRC on Chinese-Foreign Cooperative Joint Ventures 1996. \(^{75}\) These are specific laws and regulations governing any CJV. Additionally, the general national laws are applicable. For instance, the Contract Law of the PRC 1999 \(^{76}\) and the General Principles of Civil Law of the PRC 1986 \(^{77}\) also regulate CJVs.

However, there are major issues of practical concern regarding ambiguities and loopholes within and between the laws as well as the impact of government policy on foreign investors’ operations. These include issues of compliance with China’s company laws and laws for enterprises involving foreign investment in relation to limited liability companies under both of those sets of laws. \(^{78}\)


\(^{76}\) [Contract Law of the People’s Republic of China] (People’s Republic of China) National People’s Congress, Order No 15, 1 October 1999. It was passed on 15 March at the 2nd Session of the 9th National People’s Congress and was effective from 1 October 1999.


\(^{78}\) Owen D Nee, ‘The Forms of Foreign Investment in the People’s Republic of China’ in Dennis Campbell and Arthur Wolff (eds), Legal Aspects of Business Transactions and Investment in the Far East, (Kluwer Publishing, 1988) 219, 221. The difficulty of understanding China’s laws governing foreign investment is complicated by the fact that China has two separate legal systems, rather than one. China’s foreign investment laws not only establish the procedures and conditions under which foreign investment is permitted, they also stipulate the form of enterprise created and have specific laws to
Additionally, the unsettled legal environment resulting from an instrumental approach to law is another factor of concern for foreign investors. This is so because the central government makes policy decisions tied to the development of the economy. Wang, referring to the policy emphasis on economic development observes that ‘… the Party’s tolerance towards economic freedom decides the scope or usefulness of law in the PRC.’ These issues illustrate the fact that the function and standing of law are uncertain as a result of the perceptions of the different needs of development. This research will suggest that this uncertainty can be linked to Chinese history and its acknowledgement of the place of law in society.

1.4 A Specific Legal Regime for Foreign Investors in the PRC

Today, law in China serves as a means both to consolidate the achievements of economic reform and to promote further development of economic reform by way of standardising and institutionalising changes in the economic system. Deng Xiaoping said, in the Communiqué of the Third Plenary Session of the Eleventh Central Committee of the CPC, that law must be used to establish stability and order for economic development.

In China, Party policy decides the direction of economic reform and development. Chen Shouyi, a prominent scholar in China, suggests that law is the fixing

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regulate foreign exchange, tax, labour matters and a large number of other issues that would normally be governed by general laws.


80 Donald C Clark, ‘Legisлатing for a Market Economy in China’ in Donald C Clark (ed), *China’s Legal System: New Developments, New Challenges* (Cambridge University, 2008) 13, 13. In either the state-driven or market-driven model development in China, the goal is to serve the needs of the market economy.


and codification of policy and that it is necessary to stabilise, in legal form, Party policies that in practice have repeatedly proven their effectiveness and whose implementation should be continued.\textsuperscript{83} Therefore, law is a better tool than policy, as it is capable of securing and institutionalising policies in a more universal manner, and providing stability and order through the harnessing of state coercive forces for economic development, and defining rights and duties in relation to the state as represented by various administrative authorities.\textsuperscript{84}

Competition among local authorities, to attract foreign investment by offering preferential treatment and concessions (other than those granted or approved by the central government), generated the possibility of conflict between central and local authorities.\textsuperscript{85} The Chinese Constitution does not expressly give any exclusive powers to the central government as it allows local government at the provincial level to make local regulations and rules, provided that these regulations and rules do not contravene the Constitution, or the law and administrative rules and regulations issued by the central government.\textsuperscript{86} Therefore, it remains unclear whether locally granted preferential treatments and concessions are legally valid, particularly when central government policies change.

As in other areas of economic activities, various forms of foreign investment developed and were often permitted by ad hoc policies ahead of legislative sanctions. However, as foreign investment increased in China, so did the volume of Chinese laws

\textsuperscript{85} 王一帆 [Wang Yifan], <<吸引外资中的地方政府横向竞争战略分析>> [Competition for Foreign Investment between Local Governments: A Strategy Analysis ] (苏州大学[Suzhou University], 2006) 18.
\textsuperscript{86} <<中华人民共和国宪法>> [Constitution of the People’s Republic of China] (People’s Republic of China) National People’s Congress, 4 December 1982, art 100.
and regulations both at the central and local levels. These laws and regulations have resulted in a special legal regime for foreign investment enterprises. A unique feature of these laws and regulations is that they deal with specific types and specific aspects of foreign investment. There is no unified code for foreign investment. The trend appears to be towards uniformity while allowing certain special concessions for foreign investment in order to attract foreign technologies and capital.

1.5 Economic Development and Legal Reforms

The application of ‘Open Door’ policy and FDI practice facilitated the link between China and other nations not only at the economic level but also in other social aspects such as political awareness and the most significant aspect — the nature and effects of legal reform. The year 1978 is seen by Chinese scholars as the beginning of a new epoch in modern Chinese history and a turning point in legal development in China. Under these historically important circumstances, Chinese legal practice becomes the most important element of the foreign business person’s experience in their dealings in China.

These experiences may start from the beginning of the investment project approval procedure and extend to everyday business operations such as communicating with various governments' administrative departments. For example, the establishment of a joint venture is subject to certain procedural requirements. The parties need preliminary approval from the relevant government authority or local government.

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88 Ibid 150. A legal system was declared a necessity for socialist modernisation. Party leaders also repeatedly emphasised the importance of law for providing a social order conducive to economic development.
before formally applying for approval. However, foreign investors encounter a somewhat unpredictable investment environment as a result of China’s rapid transition from a centrally controlled national economy to a market-oriented economic model. Chinese laws related to foreign business and its interests have been developed separately and have been largely insulated from the development of domestic laws. At the same time foreign investors are witnesses to an unprecedented commitment to the modernisation of laws and the Chinese legal system as a whole.

Meanwhile, in addition to national economic reform, China is engaging in more and more global business activities with other countries. As a result, the Chinese economy and economic reform are increasingly linked to and affected by not only its ‘Open Door’ policy but by the broader process of globalisation, wider contact with other countries and a deepening understanding of international experience and practice. However, there are major issues concerned with doing business in and/or with China that involve the local legal environment. Foreign companies in China must deal with a different legal system to that of their home country, and find that the law is different in both appearance and practice. An understanding of legal practice and its application in business is becoming significant for any foreign business people in China. As Xin Ren suggests:

Understanding the penetration of law and social control in Chinese society has been as difficult for scholars in the fields of legal and social studies as actually establishing social control has been for China’s leaders. However, the distribution and penetration of

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90 Ibid 319.
92 The perceived needs for foreign investment change from time to time. Such needs are reflected in state industrial policies and local guidelines, issued often on an ad hoc basis, and foreign investment is then guided into high priority areas. These policy documents also serve the purpose of transparency by dividing and defining areas or projects into those encouraged, restricted and prohibited. Foreign investment projects that do not meet these needs will have difficulties obtaining approval from Chinese authorities. See Jianfu Chen, *Chinese Law* (Kluwer Law International, 1999) 319.
the state’s power into the social fabric are far more subtle and complicated than understanding institutional reorganisation and legislative stipulation.  

Additionally, concerns about problems in the investment environment (such as lack of predictability and unclear dispute processing) continue to be significant. These are continuing, and possibly inevitable, hurdles arising from China’s economic evolution. Appelbaum, Felstiner and Gessner observed that:

Business transactions are embedded in an environment of culture, practice and rule. The construction and fate of business relationships within a nation-state may encounter differences, for example, in modes of negotiation, enforcement of contract, and in dispute processing where nation-state control and support are weak or absent, and where the legal system and legal-cultural backgrounds of participants may diverge considerably.

For foreign investors, China’s huge market is, on the one hand, a place where their business can expand enormously and they feel that they cannot afford to miss the opportunity. On the other hand, China’s legal system is difficult to become accustomed to because it is not only operating in a complicated Communist social system but is also permeated by a long history of traditions. It is apparent that China’s economic openness and privatisation have not changed many of its bureaucratic traditions and lack of democratic processes in its State-commanded, social control mechanisms. So, although China has made every effort to attract foreign investment, foreign related business is subject to a strict, multi-dimensional assessment and approval system.

96 Ibid 350.
1.6 The Existing Legal Environment for Foreign Investors

In this research the laws relating to business entities and foreign investment are examined together with the practical manifestations of those laws as they affect current business activities. Instead of a uniform legal framework for business entities, different enterprises in China have been subject to various individual laws and regulations for specific forms of enterprises operating in the PRC. These legal frameworks include a fundamental law — the Constitution of 1982,\(^ {97}\) a basic civil law — the General Principles of the Civil Law of the PRC 1986 (GPCL)\(^ {98}\) and the basic corporations statute — Company Law of the PRC 2005.\(^ {99}\) These laws have effectively established a system of legal persons in which economic entities are differentiated and accorded different legal status and legal capacities in accordance with such variable factors as forms of ownership and departmental and regional subordination relations.\(^ {100}\) The establishment of the civil law institution of legal personality was meant to provide formal legal status to economic entities and to establish a uniform legal framework for all economic entities.\(^ {101}\)

Within a particular type of ownership, economic and business entities are further differentiated. They are subject to different individual statutes and administrative regulations in accordance with administrative subordination relations, the regional

\(^{97}\) The current Constitution of the People’s Republic of China was adopted at the Fifth Session of the Fifth National People’s Congress (NPC) and promulgated on 4 December 1982. China had three Constitutions (adopted in 1954, 1975 and 1978) prior to Constitution 1982. This Constitution has been amended four times, namely in 1988, in 1993, 1999 and 2004.

\(^{98}\) [General Principles of Civil Law of the People’s Republic of China] (People’s Republic of China) National People’s Congress, 12 April 1986. It was promulgated in 12 April 1986 at the Fourth Session of the Sixth NPC.

\(^{99}\) [Company Law of the People’s Republic of China] (People’s Republic of China) National People’s Congress, Order No 42, 1 January 2006. It was passed on 29 December 1993. This was amended in 2005 with the new Company Law of the PRC taking effect from 1 January 2006.

\(^{100}\) [General Principles of Civil Law of the People’s Republic of China] (People’s Republic of China) National People’s Congress, 12 April 1986, art 2–4. Economic equal treatment for all business entities was formally written into this legislation.

\(^{101}\) Jianfu Chen, Chinese Law above n 46, 287.
locations of enterprises concerned, forms of foreign investment and even the size of the business. These statutes and administrative regulations prescribe not only governing organisational structures but also provide, together with many other administrative measures and regulations, detailed rights and duties as well as advantageous or discriminatory treatment. This results in a number of difficulties including:

i) ambiguous legal status of many economic entities,

ii) lack of an abstract and general approach towards the legal status of economic entities, and

iii) creation of an unequal and unfair environment for economic competition among different economic entities.

Discussing these problems, Corne has asked why law on its face does not or cannot connect with reality, why it is haphazard and inconsistent in its implementation, and why there is an absence of legal autonomy. He suggests that these problems result from what might be termed as the ‘administratisation’ of law rather than the legalisation of administration. Corne observes:

Law is basically regulatory in its functions but lacking in a sufficient state or social structure on which to ground application. There has been, as a result of recent social and political changes and adaptations — both western and Marxist — a normative dislocation which creates an enormous and persistent gap between the law and the reality in which it operates or is intended to operate.

Initially there was no legal framework for FDI in China. As foreign investment proliferated the volume of Chinese laws and regulations grew at both at the central and local levels. These laws and regulations have established a special legal regime for foreign investment enterprises. A unique feature of these laws and regulations is that


103 Ibid 256.
they deal with specific types and specific aspects of foreign investment, there being no unified code encompassing all foreign investment.

Complications in the economic transition from a planned economy to a market-oriented system appear to stem from the legal system not keeping pace with the rapid economic development. China’s enormous population makes it nearly the largest market ever. Multi-national corporations (such as Citibank, Disney, Nokia, GE, Toyota and Microsoft) have been successful in expanding their operations to China in order to broaden their markets. However, barriers in the investment environment have caused difficulties or even failure for investors’ further involvement. According to the authors of an International Monetary Fund policy discussion paper, Tseng and Zebregs:

Corruption and legal environment are two important factors that have been found significant in explaining FDI to many countries. In the case of China, many foreign investors perceive the legal system as ambiguous, and legal disputes often are settled through personal contacts rather than formal contracts that are enforced by the court. The ambiguity in law has, in turn, contributed to corruption … this situation has deterred foreign investment from Europe and the United States more than investment from Hong Kong SAR and Taiwan Province of China. Familiarity with the local culture helps in passing bureaucratic hurdles and that is one of the reasons why investors from Europe and the United States have often sought local counterparts.\(^\text{104}\)

Furthermore, during the process of the ‘Open Door’ policy reforms many problems became apparent. A number were related to policy formulation and implementation procedures but a significant proportion of problems were (and are) institutional, caused by inherent contradictions within the Chinese political and economic systems.\(^\text{105}\) However, it seems inevitable for China, undergoing a rapid economic transition within a short period of time, to have systematic problems such as those between formulation of its policies’ and the legal framework. In addition to complex legal practice, the underlying social conditions also have a powerful influence.


in practical terms. Hardly any business deal or company set up is concluded in China without the help of personal connections and the ubiquitous business networks.\textsuperscript{106} Business networks extend far beyond family structures and include seemingly unrelated business activities as well as local administrations.\textsuperscript{107} In this regard Chen states:

\begin{quote}
The features of law in a given society and at a particular historical stage are shaped not only by the prevailing environment of that time, but also by the cultural heritage of that society, though the role of culture and tradition in shaping the law may be muted, implicit and even unconscious. Thus a study of current Chinese law requires some basic understanding of legal traditions in China.\textsuperscript{108}
\end{quote}

In these circumstances it is not surprising that China’s legal system today is a result of the effects of historical and cultural factors. To expand on Jianfu Chen’s point, the understanding of legal traditions in China must also extend to those foreign investors in China who are directly involved with the practical effects of current laws relevant to their business activities. It is suggested here that such an understanding will greatly assist in the set up and operation of their projects, not simply in understanding the meanings of the laws and regulations but, more importantly, knowing more about how their Chinese partners are going to respond to those laws and regulatory processes and to the systems and procedures sought to be introduced by their foreign investor partners.

\section*{1.7 Reflections upon Historical and Social Influences}

This aspect of the research constitutes a further examination of the proposition that the development of the Chinese legal tradition was greatly influenced by both


\textsuperscript{108} Jianfu Chen, \textit{Chinese Law} above n 46, 3.
Confucianism and Legalism and suggests that Confucianism has had a stronger influence on society than has Legalism. In support of this Chen, argued:

Traditional Chinese conceptions of law have been largely influenced by writings of traditional schools of philosophy. Of these, three have had a particular influence, namely, Run Jail (Confucianism); Fa Jia (Legalism); and Yin-Yang Jia, with Confucianism being the dominant force since the Han Dynasty (206 B.C.)

In this period the promotion of morality (Li), virtue (De), rightness (Yi), and benevolence (Ren) was the basis of a government’s activities. They were used to regulate social relations, to curb the natural desires of human beings, and to cultivate moral habits. Confucianists opposed the replacement of moral influence by punishment and the improper application of punishment. This was because Confucianists believed that human beings, whether their nature be good or bad, are able to be educated. Thus moral education and influence should be the first priority in maintaining an ideal social order. Moral self-cultivation and self-control (reinforced through socialisation within the family, clan, guild and other social institutions) were other important social control agents in Chinese society. The individual’s internal ability to control his or her behaviour was regarded as one of the greatest qualities of human virtue.

109 Ibid 7.
113 任继愈 [Ren Jiyu], <<中国哲学史>> [History of Chinese Philosophy] (人民出版社 [People’s Publishing House], 1997) 93.
115 崔永东 [Cui Yongdong], above n 38, 16–7.
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Historically, local units such as the lineage (tsu or zu), rather than the formal legal system, handled much of the work of resolving disputes and maintaining order.\(^\text{116}\) In terms of the official governmental structure, a magistrate was appointed to govern a county-size area (Hsien or Xian).\(^\text{117}\) There was no idea of separation of powers; the magistrate was responsible for almost everything going on within his territory.\(^\text{118}\) He was assisted by a small personal staff and by a larger group of local constabulary.\(^\text{119}\) Magistrates were usually transferred every three years mainly to prevent the building of power bases by local officials.\(^\text{120}\) However, the short tenure in each area also meant that a magistrate would have difficulty learning about local conditions and penetrating local social and other networks.\(^\text{121}\)

This research considers the extent to which local units continue to perform similar functions today.\(^\text{122}\) It has become obvious during this study that many of the questions regarding Chinese law and social control may not be answered solely on the basis of a study of the rule of law. This research suggests the additional need for an examination of culture, customs, traditions, and people’s attitudes toward law and authorities.\(^\text{123}\) This section of the research concludes that the legal tradition in China was constituted by (and the fundamental governance of society was based upon) the primary education of morality not on the rule of law and that the significance of that distinction is highly relevant today.

\(^{116}\)任继愈 [Ren Jiyu], above n 113, 80.
\(^{117}\)马志冰 [Ma Zhibing], above n 41, 57.
\(^{118}\) Ibid.
\(^{119}\) Ibid 58.
\(^{120}\) Ibid 202.
\(^{123}\) Xin Ren, Tradition of the Law above n 93, 3.
This study explores Chinese legal tradition with respect to the function of law and morality. The Chinese legal tradition in respect of both Confucianism (that emphasised morality) and Legalism (that emphasised the rule of law) has resulted in the current legal system being characterised by the influence of these two influential, and often adversarial, schools of thought.

The Confucianist ideology provided the fundamentals for the substance of traditional law and the Legalist school constructed the important framework of the traditional legal system.\footnote{朱勇 [Zhu Yong] (Translated), Derk Bodde and Clarence Morris, <<中华帝国的法律>> [Law in Imperial China] (江苏人民出版社 [Jiangsu People’s Press], 2003) 17.} Although the Legalist school and Confucianism were adversarial philosophies in terms of their political ideologies as to how Chinese society should be ruled, they shared some important ideas, including that of the emperor’s power over all facets of life — including law.\footnote{Tongzu Qu, Law and Society in Traditional China (Mouton, 1961) 150–2.} However, Chinese imperial law bears a strong, Confucian moral character.\footnote{朱勇 [Zhu Yong], above n 124, 11.} From the traditional point of view, Chinese society has highly valued self-sufficiency and self-reliance through internal restraint and discipline.\footnote{徐祥民， 刘笃才， 马建红 [Xu Xiaming, Liu Ducai, Ma Jianhong], <<中国法律思想史>> [History of Chinese Legal Thoughts] (北京大学出版社 [Beijing University Press], 2004) 60.} Societal reliance on external control through formal legal procedure, codified law and official social control agencies was regarded as morally inferior to internalised self-constraint and seen as virtually a form of dehumanisation.\footnote{Ibid 31.} Confucian morality and imperial law were two parallel behavioural codes that combined to order social conduct in Chinese society.\footnote{马志冰 [Ma Zhibing], above n 41, 6.}
1.8 The Intersection of Philosophy and Political Power in China

The emphasis on the emperor’s superior power under the teaching of Confucius is a major tradition in political power in China. The test of good government was based on virtue and morality but not by law. Chen observed, ‘Law increasingly became an administrative tool for determining and maintaining social order with the state at the centre.’ Certain fundamental features of the traditional legal culture clearly persist in the contemporary legal system and social attitudes towards law.

No discussion of law in the PRC would be complete without examining the relationship between the Communist Party and the legal system. The CPC has a central role in China’s domestic and foreign policies and in any forecast of China’s future. Chinese law must conform to Party policies, and Party policies still remain at the heart of all laws. The CPC plays an important role in implementing policy through the legislative process. The Party’s role in dealing with the judiciary has three dimensions. Firstly, it conducts education programs to explain its ideology and the maintenance of the Party line by the judiciary. Secondly, it selects a number of able cadres to run the judicial organs. Thirdly, it constantly observes whether or not the judicial systems strictly implement the law. Through these mechanisms, the Party becomes the guardian of the law.

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1.9 Prospective Development of the Rule of Law in China

As a result of the rapid and large scale transition from a socialist planned economy to a market economy, the nature of the reconstruction of the legal system in the PRC has become significant in relation to economic development within China and in respect of external concerns about China’s future political direction. These matters have been the subject of significant study and debate. Studies of China’s current legal system and its development and reform have involved both Chinese and western scholars. Chen points out:

There are vibrant debates on key issues relevant to the future development of Chinese law. Examples of these issues include (1) the pathway of legal modernisation in China, (2) the relationship between traditional Chinese legal culture and the quest for legal modernisation, (3) faith in law, (4) civil society and legal development, (5) judicial reform, and (6) the contextual approach to legal research.\(^\text{133}\)

Chen studied the work of Professor Zhu Suli, Dean of Beijing University Law School and one of the most outstanding legal socialists in contemporary China. Chen observed Zhu’s views on legal development in China including Zhu’s cautionary view that while most Chinese jurists assume that legal modernisation is legal westernisation, Western norms and practices are not necessarily universally valid and applicable. While most Chinese jurists believe in the use of legislation to promote social and economic transformation, Zhu points out that the spontaneous order and customary practices that emerge from the rational choice of countless individuals cannot be easily dictated to by the State’s legislative decrees. While most Chinese jurists advocate the Rule of Law, judicial independence and the protection of people’s rights on an abstract and philosophical level, Zhu calls attention to the social reality and the living conditions of

the people.\textsuperscript{134} While most Chinese jurists presuppose that enlightened legal ideas constitute one of the most powerful forces behind legal and institutional progress, Zhu relies on Marxist historical materialism in arguing that what ultimately matters are the material and social conditions in which people live, and that the ‘modern’ rule of law is a response to the commercialisation, industrialisation and urbanisation of society rather than a liberation from despotism and authoritarianism.\textsuperscript{135}

On the other hand, Jianfu Chen argues that there is indeed a home-grown Chinese conception of the rule of law that has been promoted and practised in the last twenty years or so. For many years, the proclamation that there must be laws for people to follow and that these laws must be observed, that their enforcement must be strict, and that law-breakers must be dealt with, has been held by party and government officials to be the essence of, or a basic requirement for, the rule of law. This notion of the rule of law is, however, vague and ambiguous.\textsuperscript{136} There are no requirements as to how laws are to be made, whether the rulers are to observe the law, whether the enforcement must also be impartial and independent, or how law-breakers are to be dealt with (other than strictly).\textsuperscript{137}

In his study of Chinese law, Peerenboom discusses the rule of law from the perspective of a philosophical pragmatism that balances ‘thick’ and ‘thin’ theories on

\textsuperscript{135} Albert H Y Chen, ‘Socio-legal Thought’ above n 133, 246.
\textsuperscript{137} Albert H Y Chen, ‘Socio-legal Thought’ above n 133, 270.
the rule of law. Recognising that concepts of law are unavoidably contentious and embedded in the context of local culture, Peerenboom suggests that despite the many problems and contradictions inherent in development of law in China during the post-Mao period, this process can indeed be described as moving toward a rule of law system. While Peerenboom acknowledges numerous obstacles (including the dilemma of party rule, the institutional frailty of legal institutions, and the obstacles of path dependency, he suggests, nonetheless, that China’s economic reforms make some form of rule of law inevitable. Peerenboom views the development of China’s legal system as an historical process of socio-economic change that makes unavoidable the gradual progression toward a system which, while not necessarily matching the models of Europe or North America, nonetheless qualifies as a rule of law system.

Peerenboom notes that while China’s leaders have officially endorsed the rule of law, they have not sanctioned the liberal democratic version. Accordingly, to gain an understanding of the likely path of development of China’s legal system and the reasons for differences in its institutions, rules, practices and outcomes in particular cases, it will be necessary to rethink the rule of law. The rule of law can be theorised in ways that do not assume a liberal democratic framework and that include an exploration of alternative conceptions of the rule of law that are consistent with China’s circumstances. To that end, Peerenboom refers to four competing ‘thick’ conceptions of rule of law namely: Statist Socialist, Neo-Authoritarian, Communitarian and Liberal.

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Democratic. Peerenboom’s conclusions about the potential for the emergence of the rule of law in China draw on his assessment of the interplay between law and economic development. He asserts that law has played a central role in Chinese economic development and will continue to do so. He suggests that law may play a yet greater role in supporting political reform, particularly as the economy develops and Chinese people seek expanded legal rights. Peerenboom sees changing attitudes among China’s population, driven in part by economic growth and in part by increased exposure to international ideas, as demanding increased reliance on law and legal procedures in the exercise of governance. Peerenboom’s is a hopeful projection, that changing attitudes among the Chinese people will constrain the state to rely increasingly on law and legal procedure.

From another perspective, Cao suggests an examination of Chinese legal language in terms of the ‘rule of law’ or ‘rule by law’ debate in contemporary China. She observes that one of the most commonly used phrases in China today is fazhi. Fazhi can be translated into English as both ‘rule of law’ and ‘rule by law’. In the Chinese language, no convenient and easy distinction can be made between ‘rule of law’ and ‘rule by law’ as is possible in English. The rule of law in China has always been a topic of academic and pragmatic interest. Its renewed interest has been highlighted by the incorporation of Fazhi in the Chinese Constitution. In March 1999, the National People’s Congress (NPC) of the People’s Republic of China adopted an amendment to the Chinese Constitution, incorporating in Article 5 Yi fa zhi guo (governing the country

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143 Randall Peerenboom, China’s Long March above n 139, 450.
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in accordance with law) and Jianshe shehui zhuyi fazhi guojia (building a socialist rule of law state). Prior to this, CPC in 1996 and 1998 set the aforementioned as part of its policy for government. The Legislation Law of the PRC 2000 also includes Jianshe shehui zhuyi fazhi (building a socialist rule of law).147

The emphasis upon Fazhi, in particular its inclusion in the Constitution, has been viewed in legal circles in China as a major step forward in its modern legal development.148 However, Cao suggests that Fazhi could also be seen as simply another political slogan used by the Chinese government that does not carry any substantive meaning — a kind of ‘semantic law’ — as is, she asserts, is the case with many constitutional guarantees regarding the rights of Chinese citizens.149 Language can influence people’s world view and their construction of reality. Also, Cao asserts, it is unprecedented that such prominence has been accorded to law and Fazhi, politically, legislatively, and academically.150 Due to the lack of legal definition of Fazhi or Yi fa zhi guo (a variant expression), a diverse range of opinions has been offered by Chinese legal scholars, debating what Fazhi means or should mean.151 Cao argues that in contemporary China, Fazhi is still largely an ideal that is being debated and in the process of finding a foothold whilst drawing upon western thinking along the way.152 It might be instructive to those with similar views to those expressed by Cao to examine

149 Randall Peerenboom, ‘Rule of Law’ above n 142, 36.
150 ‘王家福依法治国学术思想研讨会’ [Wang Jiafu, Rule of Law Academic Research Forum] was held in Beijing on 7 October 2010. This forum was organised by Chinese Academy of Social Science Legal Research Division and conducted a research discussion on the rule of law in China. There were more than 150 influential legal academic scholars and state government officials attending this event. They include Hu Kangsheng, director of Legal Committee of National People’s Congress, Professor Jiang Ping of University of Politics and Law of China, Professor Tong Rou of People’s University of China and Professor Wei Zhenying of Beijing University.
152 Ibid 40.
the many Constitutions and laws of western countries that contain lofty ideals that are not realised in practice. The institutional aspect of Fazhi, its elevated status and legitimacy in the Constitution and the continued development and strengthening of the legal machinery is noteworthy. It may be flawed and in need of improvement, but Chinese law and legal processes have displayed or begun to display some of the essential attributes of rule of law under the ‘thin’ theory.\(^{153}\)

China’s legal reform has attracted attention from scholars, politicians and international lawyers, who are interested in Chinese economic development and its significant role on the international stage. Issues in relation to the Chinese legal system, political reform and the application of the rule of law in China have attracted the attention of numerous researchers. Those studies have contributed significant and helpful projections or suggestions in regard to China’s legal evolution over the long term. Nevertheless, it is this researcher’s view that, in the course of China’s current legal reform, attention also should be paid to the effects of traditional embedded customs that are still operating within the legal system in subtle ways. Careful consideration of the social conditions within which the legal system is operating are, this researcher suggests, worthy of significant attention for analysing the prospects of an efficient and successful outcome of legal reform in China today.

This study examines how law in China has evolved in the light of cultural and historical factors. Chinese law was indigenously developed from the secular philosophies of social morality, namely Legalism and Confucianism. The patriarchal relationships and behavioural norms within the extended family or clan were not only reflected in the power structure of officialdom but also formed the basic foundation and

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standards for social conformity.\textsuperscript{154} Law everywhere is evolutionary and this quality seems to be even more evident in China in terms of its relationships with the international community. Foreign investors’ activities in China must meet the challenge posed by differences of legal culture and tradition because those differences will, according to the findings of this research, continue to provide significant influence in the future shaping of the legal system of the PRC. It is axiomatic that all legal development is based upon the development of society and that such development demonstrates that people and their relationships constantly change and develop over the course of time.\textsuperscript{155}

Some observers express concerns about legal-political development in China. Alleged development of Chinese ‘economic nationalism’ is of concern to Françoise Nicolas.\textsuperscript{156} Nicolas suggests that there is something dangerous about China’s apparent recent exercise of more control over foreign investors. It appears that China is reluctant to let foreign investors dominate or monopolise some sectors of the Chinese economy.\textsuperscript{157} From the perspective of those who believe that the ‘market’ should be the arbiter of everything, it seems that for a sovereign nation to decide to impose some controls over the ‘market’, and in particular the market’s activities within that sovereign state, is some sort of dangerous and radical behaviour. Nicolas also suggests that China is seeking to reduce its dependence upon foreign investors. More constructively, James Zimmerman provides valuable and very extensive information resources to any

\textsuperscript{154} 马志冰 [Ma Zhibing], <<中国法制史>> [History of the Chinese] above n 41.
\textsuperscript{156} Françoise Nicolas, ‘China and Foreign Investors: the End of a Beautiful Relationship’ (April 2008), \textit{Institute Fran ais des Relations Internationals} 1, 32.
researcher on Chinese law, systems and policies as well as expanded discussion on some of the matters raised in this study.¹⁵⁸

John Mo brings to the examination of Chinese law a wide experience in the study of international commercial law in particular and provides an excellent source of comparative research.¹⁵⁹ Mo carefully explores Chinese law and practice relating to foreign investment and makes it clear that China’s legal system will become more transparent, fairer and more desirable as China’s market becomes more mature and more open.¹⁶⁰

On the question of the existence or otherwise of a rational set of laws in China in earlier times, according to Kenneth Winston, the conventional view of early Chinese law — being essentially that the rules made by the emperors were of low quality and solely for the purpose of maintaining power with the ruler being all powerful — oversimplifies and possibly debases the idea of the existence of an effective and respected system of laws. He argues that these laws were more sophisticated and more principled than is often recognised, a view shared by this researcher.¹⁶¹

1.10 Conclusions

Another revolution occurred in China in the late 1970s after the end of the Cultural Revolution. That revolution was the way that China, led by Deng Xiaoping, re-stated

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and re-organised its attitudes to economics and trade both internally and with the western world. It has led to massive economic growth in China and such a lift in its international trading status that it has become the leading economic power in the world. This chapter has analysed the nature and extent of foreign investment in the PRC and begun to introduce the legal regime that confronts foreign investors.

China’s systems of law were not well prepared for the onslaught of foreign investors at the early stages of the ‘Open Door’ policy. These foreign investors were generally accustomed to sets of laws that were quite consistent and predictable and allowed them to conduct their business with confidence. However, Chinese laws often appeared to be inconsistent — for example: in respect of the location of the foreign business venture (hence the group of administrators performing regulatory functions); the binding value (or otherwise) of the terms of a contract; or how dispute situations were to be dealt with — and these uncertainties, coupled with the unique nature of a communist regime with a ‘market economy’ policy, comprised a particularly challenging situation for both existing or potential foreign investors and their Chinese business partners.

This study will reflect upon those challenges, examine the way in which law has evolved in China, and analyse how western law interacts with modern Chinese law. It will be based upon the practical ways that laws related to economic activity are interpreted by Chinese participants and seek to explain why those interpretations are sometimes confusing to western foreign investors.

This chapter has introduced two very important aspects of the social and cultural background of Chinese business people. These are the aspects of interaction and networks. Chinese management characteristics are analysed in order to identify how
those aspects are related to the experiences of foreign investors in the PRC. Additionally, the chapter has begun the analysis of the importance of historical and cultural factors in the make-up and practical manifestation of Chinese laws, particularly in the areas of investment and contract law.

The following chapter discusses the ways in which the political and legal structures of China have developed into their current form. The structure of the court systems in China and their modes of operation are also discussed as are the roles of the various dispute resolution mechanisms that operate in China’s legal system. The chapter also commences an analysis of the sources of the laws that form the Chinese legal system.
Chapter 2

Political and Legal Systems in China

2.1 Introduction

The legal history of the People’s Republic of China (PRC) began in 1949. The socialist elements of the Chinese legal system came primarily from Soviet sources. China started to absorb the Soviet experience in every aspect of its socialist society from 1949. However, the present legal system is mainly a product of the legal reform and development efforts in the 1980s and 1990s. The current legal system operates as part of five-tiered governmental structure including central, provincial, municipal, county and village levels. The various political, legislative, governmental, administrative, judicial and prosecutorial structures and institutions of the PRC are set up in accordance with these five levels.

To study and comprehend China’s foreign investment law and its application in the prevailing social conditions, it is necessary to understand some important aspects of the current legal and political systems of China, including the political party, law-making bodies, governmental institutions and the court system, and the interpretation of laws and sources of judicial information.

This chapter sets out the legal and political structures in the PRC and some of the historical background of those systems. Section 2.2 outlines developments in the period from the late 19th century the early 20th century leading to the establishment of

2 Ibid 31.
3 Ibid 13.
the Communist Party of China (CPC) and the subsequent formation of the Peoples Republic of China (PRC). Section 2.3 details the political structure of the CPA and its hierarchy. The law making institutions of the PRC and their manner of operation are described in detail in section 2.4. Section 2.4.1 presents details of the Executive structure and the roles of the members of the Executive and the Executive institutions. Section 2.5 examines the sources of law in the PRC commencing with the 1982 Constitution of the PRC, and includes explanations of the roles of the National People’s Congress (NPC) and its Standing Committee, the PRC’s relationship with international treaties and the role of case law. Section 2.6 provides a detailed description of the Court system in the PRC. Section 2.7 examines the role of equity in Chinese law and its emphasis within the conciliation processes in the Chinese legal system. Section 2.8 comprises a detailed analysis of the People’s Procuratorate — an office of public prosecutors but with greatly extended powers within the court and judicial systems, including supervision of the legal activities of the People’s Courts, the execution of judgments, and the activities of prisons. Section 2.9 provides an analysis of the means by which laws are interpreted in the PRC which is complemented by a discussion in section 2.10 of the sources of judicial information. Section 2.11 discusses the dispute and resolution processes in the PRC and uses a hypothetical dispute to illustrate some of these processes. Section 2.12 provides a brief outline of the conciliation, arbitration and appeal processes in Chinese law and section 2.13 summarises and concludes the chapter.
2.2 Modern China–Preceding 1949

Efforts to modernise the legal system were instituted by the Qing Empire in the earliest part of the 20th century.\(^4\) It had become apparent that some aspects of the legal system, such as the harshness of criminal procedure and the lack of commercial law, rendered China’s law primitive in comparison to legal systems of other nations. One initiative was the creation of a Law Reform Bureau in 1904, instilled with the task of translating foreign codes and drafting new laws.\(^5\) Another move in the direction of modernisation was the promulgation of an Imperial Constitutional Outline in 1908.\(^6\) However, before any of the drafted laws were implemented the Qing Empire was overthrown in 1911. Nevertheless, successive governments adopted some laws that were partly based on the draft laws of the Qing reform movement.\(^7\)

The CPC was established on 1 July 1921. Shortly afterwards, a politically tumultuous period (referred to as the ‘New Democratic Revolution’) ensued, encompassing three important struggles in which the CPC engaged. Included in this period were the Second Revolutionary Civil War (1927–37), the War of Resistance

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\(^4\) Between 1890 and 1910, legal reform was advocated by the Emperor and some leading scholars with the intention of modernising the Chinese traditional legal system. The adoption of a Western-style code marked a significant turning point in Chinese legal history as China, for the first time, moved away from traditional Chinese society and Confucian philosophy. Kuihua Wang, *Chinese Commercial Law* (Oxford University Press, 2000) 8 cited in P R Luney Jr, ‘Traditions and Foreign Influences: Systems of Law in China and Japan’ *Law and Contemporary Problems* (Duke University, 1989) 52 (2), 131.

\(^5\) In May 1904, a Law Codification Commission was established (法律编撰馆) — an event seen by a former Chinese judge at the Permanent Court of International Justice, Tien-His Cheng, as the commencement of a new era. Shen Jiaben and Wu Tingfang were appointed commissioners to the Commission.

\(^6\) In 1907, a constitutional committee, named the Committee for Investigating and Drawing up Regulations of Constitutional Government (宪政编查馆) was established. In the following years until the final collapse of the Qing Dynasty in 1912, a series of edicts concerning the establishment of a constitutional government and a series of constitutional projects and documents was issued by the Throne.

\(^7\) 《暂行新刑律施行细则》 [New Interim Provisional Details on the Criminal Code] (Republic of China) 12 September 1912. This provision was enacted by the Republic of China in 1912. It adopted some advanced principles from the legal reform during the Qing dynasty with the aim of resolving some problems in legal practice during the implementation of the new Criminal Code; 马志冰 [Ma Zhibing], <<中国法制史>> [History of the Chinese Legal System] (北京大学出版社 [Beijing University Press], 2004) 262.
against Japan (1937–45), and the Third Revolutionary Civil War (1945–49). In 1949 the CPC founded the PRC.

The origin of the current legal system can be traced to the period of the Chinese Soviet Republic in the revolutionary period prior to the establishment of the PRC.\(^8\) The first formal piece of legislation was the Common Programme of the Chinese People’s Political Consultative Conference (promulgated in 1949), which laid down the essential principles of the Constitution which was subsequently adopted in 1954.\(^9\)

### 2.3. The Communist Party of China

The CPC is the only formal political organisation with power in China.\(^10\) There are three levels of the CPC in descending hierarchical order include: the National People’s Congress; the People’s Congresses at the provincial level; autonomous regions; and four municipalities\(^11\) directly under the Central Government (State Council) and People’s Congresses at the level of municipalities other than those mentioned above. There also are branches at local county levels or in some organisations such as State Owned

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\(^8\) In the beginning of the PRC era from 1949, law-making mainly consisted of translating and borrowing from Soviet Law. The connection between Soviet Law and the civil law system is that the civil law system operated in Russia before the ‘October Revolution’ led by Lenin in 1917. See Kuihua Wang, *Chinese Commercial Law* (Oxford University Press, 2000) 9–10.

\(^9\) The ‘Instruction of Central Committee of the CPC to Abolish the Kuomintang Six Codes and to define the Judicial Principles for the Liberated Areas’ was issued in February 1949. This ‘Instruction’ was issued as an opinion of the Central Committee of the CPC to governments at different levels and to judicial cadres for further discussions. Opinions and conclusions were sought, but the ‘Instruction’ was immediately implemented in March 1949 by an ‘Order of the North China People’s Government to Abolish the Six Codes and All Reactionary Laws’. This Order was identical to the ‘Instruction’. In September 1949, it was further implemented by the Common Programme of the Chinese People’s Political Consultative Conference, a document which served as a provisional constitution until the first constitution of the PRC was promulgated in 1954.

\(^10\) There are eight other parties in China including the Revolutionary Committee of the Kuomintang, China Democratic League, China Democratic National Construction Association, China Association for Promoting Democracy, China Peasants and Workers’ Democratic Party, China Zhi Gong Dang, Jiu San Society and Taiwan Democratic Self-government League. They are all under the leadership of the CPC. The CPC claims this political system of ‘multi-party’ cooperation and political consultation operates under the leadership of the CPC as China’s basic political system. See <<中华人民共和国宪法>> [Constitution of the People’s Republic of China] (People’s Republic of China) National People’s Congress, 20 September 1954, Preamble.

\(^11\) These four municipalities are Beijing, Tianjin, Shanghai and Chongqing.
Enterprises, universities, schools, the army and village farming co-operative teams. The Standing Committee of the Political Bureau of the Central Committee of the CPC has important decision-making power. Zhao, of the Chinese Academy of Social Sciences, examined the CPC Central Committee’s decisions-making on policies concerning all major issues related to China’s economic and social development. According to the structure of the State, the Chinese Government separates powers among different organisations. For example, the administrative power is held by the State Council and the various local governments; legislative power is exercised by the NPC and local People’s Congresses; judicial power is dispensed by the Supreme People’s Courts and other People’s Courts at various levels.

However, the separation of power has been weakened as a result of the fact that the CPC is an omnipotent political party in China and that most of the senior government officials and representatives of the People’s Congresses at various levels are held by the CPC members. Thus the CPC effectively has control of the legislative and administrative systems.

2.4. The Law-making Institutions

The NPC is the highest organ of State power and, together with its permanent body, the Standing Committee of the NPC, exercises the legislative power of the State. With 3000 members the NPC now convenes a meeting each year which lasts for about two weeks. In theory, the NPC has the power to amend the Constitution and to enact and amend basic laws governing criminal offences, civil affairs, the state organs and other

13 Kuihua Wang, Chinese Commercial Law above n 1, 16.  
matters. In practice however, the NPC has neither the ability nor adequate time to consider draft bills for enactment. On the other hand, the Standing Committee of the NPC is much smaller in size and meets every two months. Many of its members serve on a full-time basis. To entrust the NPC Standing Committee with the legislative power is a demonstration of China’s willingness to allow the NPC to exercise its legislative power in the true sense. Compared with the legislative power of the NPC, the Standing Committee may not amend the Constitution. However the Standing Committee is authorised to:

(1) interpret the Constitution and supervise its enforcement;
(2) enact and amend laws, with the exception of those which should be enacted by the NPC;
(3) partially supplement and amend, when the NPC is not in session, laws enacted by the NPC provided that the basic principles of these laws are not contravened;
(4) interpret laws;
(5) annul those administrative rules and regulations, decisions or orders of the State Council that contravene the Constitution or the law;
(6) annul those local regulations or decisions of the organs of state power of provinces, autonomous regions, and municipalities directly under Central Government that contravene the Constitution, the law or the administrative rules and regulations. 

From the above provisions, it is clear that not only the NPC and its Standing Committee have legislative power, but also the State Council and Local governments. In regard to the law-making power of local government, such power may be exercised only by the People’s Congresses of provinces, autonomous regions and municipalities directly under Central Government control. The People’s Congresses of cities where provincial and autonomous regional people’s governments are located and the People’s

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15 Ibid art 62.
16 Ibid art 3.
17 Ibid art 67.
18 Ibid art 89.
Ch 2: Political and Legal Systems in China

Congress of relatively large cities, with State Council approval, may also formulate local regulations, which must not contravene the local regulations of their respective provinces or autonomous regions or contravene the Constitution, the law and administrative rules and regulations. Likewise, the People’s Congresses of the provinces, autonomous regions and cities may not formulate any local regulations contrary to the provisions of the Constitution, the law, and administrative rules and regulations. At the same time, local regulations must be adopted in light of the specific conditions and actual needs of the respective administrative areas.

Starting from the early 1990s all the Special Economic Zones (SEZs) in China gradually acquired the power to enact local regulation.\(^{19}\) As provided in the Constitution, the administrative rules and regulations created by the State Council must not contravene the Constitution or the laws; otherwise the NPC Standing Committee may declare such administrative rules and regulations null and void.\(^{20}\)

In terms of the hierarchy of law-making power, Chinese law can be divided into four categories:

1. the Constitution;
2. laws adopted by the NPC and its Standing Committee;
3. administrative regulations adopted by the State Council;

\(^{19}\) <<全国人民代表大会常务委员会关于授权深圳市人民代表大会及其常务委员会和深圳市人民政府分别制定法规和规章在深圳经济特区实施的决定>> [Decision of the Standing Committee of the NPC on Authorising the People’s Congress of the Shenzhen City and its Standing Committee and the People’s Government of Shenzhen City to Formulate Regulations and Rules Respectively for Implementation in the Shenzhen Special Economic Zone] (People’s Republic of China) National People’s Congress Standing Committee, 1 July 1992.

(4) local regulations by the People’s Congresses of provinces, autonomous regions and cities.

As provided by the Constitution, the legal superiority descends according to the level of law-making authority. The Constitution governs the social, economic and political sectors of the country. It is the fundamental law of China and has the highest legal binding power. It states the country’s fundamental system and tasks.\(^\text{21}\) No laws, administrative regulations or local decrees may contravene the Constitution.\(^\text{22}\)

The laws adopted by the NPC and its Standing Committee are the second level. They are general in nature and therefore usually supplemented by more detailed rules at the third (State Council) level. Rules and regulations enacted by the State Council or other relevant ministries deal with specific matters, particularly economic activities, and are applied nationwide. For example, the *Law on Chinese-foreign Equity Joint Ventures of the People’s Republic of China* was enacted on 1 July 1979.\(^\text{23}\) Later, the State Council promulgated *Provisions on the Labour Administration of the Enterprises of Foreign Investment* and its *Regulations in respect of the Registration of Joint Ventures in the People’s Republic of China 1994*.\(^\text{24}\) Three years after the adoption of the 1979 Equity Joint Venture Law, the State Council adopted *Regulations for the Implementation of the Law on Equity Joint Ventures of the People’s Republic of China*

\(^{21}\) Ibid last paragraph of the Preface.

\(^{22}\) Ibid art 5.

\(^{23}\) <<中华人民共和国中外合资经营企业法>> [Law of the People’s Republic of China on Chinese-foreign Equity Joint Ventures] (People’s Republic of China) National People’s Congress Standing Committee, Order No 48, 15 March 2001. The EJV Law was adopted on 1 July at the 2nd Session of the 5th NPC. It was amended twice: on 4 April 1999 at the 3rd Session of the 7th NPC and recently in March 2001.

which provide more detailed provisions for the establishment and management of equity joint ventures using Chinese and foreign investment.

Over the last two decades, the State Council’s legislative power has been increased. In April 1984, the NPC Standing Committee passed a resolution requiring its working committee to co-operate with the State Council and various ministries to research and draft legislation for the implementation of the economic policies of China.

Ministerial provisions are more limited in nature and their application is generally within the sphere of the function of the ministry in question. Very often, the ministerial provisions are intended to supplement and implement regulations adopted by the State Council. For example, immediately after the State Council promulgated the *Provisions for the Encouragement of Foreign Investment* in October 1986, the Ministry of Foreign Trade and Economic Co-operation, the People’s Bank of China and the Ministry of Finance issued implementing rules covering such areas as examination and confirmation of export-oriented enterprises and technologically advanced enterprises with foreign investment, import and export licences, loans in Chinese currency, and taxation. These ministerial provisions have a nationwide application and may be supplemented by local legislation which takes into account the conditions and circumstances of the local area.


27 *<<鼓励外商投资高新技术产品目录>>* [Catalogue of Encouraging Foreign Investment in High Technology Products 2006] (People’s Republic of China) Ministry of Commerce and Ministry of Science and Technology, Order No 652, 31 December 2006. In order to encourage foreign investment in advanced technology and manufacturing advanced equipment and parts, foreign invested enterprises were exempted from import duty and associated added value tax.
Local congresses and governments at various levels are permitted to enact laws suitable to local conditions provided that such laws and regulations do not contravene the Constitution or the laws or regulations adopted by Central Government. In effect, local governments may promulgate laws which vary slightly from those enacted by the Central Government. These local laws are valid provided that they are in conformity with the general principles and policies of the legislation enacted by the Central Government. For example, as soon as the State Council passed provisions for the encouragement of foreign investment in October 1986, many provincial and local governments promulgated similar regulations to give foreign investors more incentives in comparison to the incentives offered by their local counterparts. These local provisions carry a step further the standards adopted by the Central Government but are still within the general principles of encouraging foreign investment involving advanced technology or for the production of export-oriented goods. They are, therefore, valid laws in so far as they are implemented in their respective localities.

The Constitution stipulates that law includes the administrative rules and regulations enacted by the State Council which have nationwide applications. Accordingly, such rules and regulations may be referred to by the court when dealing with relevant cases. The question then arises, what constitutes administrative rules and regulations of the State Council? It is true that the Constitution mentions both administrative rules and regulations, but they are stipulated in the same category of orders and decisions of the State Council. The logical interpretation is, therefore, that all

the provisions and measures adopted by the State Council, regardless of their form or title, have the same effect and should be regarded as administrative regulations.

The Legislation Law of the People’s Republic of China 2000 (Legislation Law 2000) was passed by the National People’s Congress (NPC) in March 2000. According to Paler’s study, this law ‘represents an attempt by the NPC to rationalise China’s legal system, establish a uniform legislative hierarchy and consolidate its authority over other important lawmaking institutions.’

The passage of the Legislation Law 2000 offered a unique opportunity to glimpse the institutional power struggles among major law-making institutions as they engaged in arguments and reached compromises over fundamental issues of their authority, purposes and responsibilities within an evolving legislative system. The Legislation Law 2000 should be recognised as an attempt by the NPC to strengthen its authority against that of the State Council and local government by addressing the myriad of conflicts that jeopardised the coherence of China’s entire legal system and challenged the NPC’s ability to play a unifying role in that system. The NPC succeeded to some extent in reining in the discretion of the local authorities, but it made little progress in establishing mechanisms to control the departmental protectionism rampant.
within the State Council. While many debates that emerged during the drafting of the Legislation Law 2000 revealed a genuine recognition of the problems and resulted in some innovative proposals, particularly on supervision, the extreme sensitivity and volatility of the issues at hand meant the carving away of the draft Law’s most substantive portions. Thus, while the Legislation Law 2000 documents the ideal of a uniform legal hierarchy, it is likely to become a victim of the system it was intended to reshape without more thorough structural reform. The Legislation Law 2000 has some potential, however, if China’s leadership views it as a necessary stepping-stone on the path to the creation of a better legal system, increasingly seen as necessary for China’s international economic integration and even the Party’s legitimacy.

To some degree, NPC officials who have invoked the Law in the name of more procedurally transparent and publicly consultative legislation have already demonstrated its use in such a manner. For example, Legislation Law article 88 gives power to the NPC, NPC standing Committee, State Council, people’s congresses of provincial governments and autonomous regional governments to revoke regulations, departmental rules and local government regulations. In judicial practice the Supreme People’s Court issues guidelines to direct the people’s courts in dealing with administrative dispute cases.

35 Laura Paler, ‘China’s Legislation Law’ above n 32, 310.
2.4.1 The Executive Branch

The positions and powers of the President and the Vice President are established in Articles 79–84 in the *Constitution 1982*. The NPC elects individuals to fill these positions for a term of five years with a limit of two consecutive terms. Some of the powers entrusted to the President are the promulgation of statutes, the appointment and removal of various State Council members, the issue of pardons, proclamations of martial law and states of war, as well as receiving foreign diplomats and ratifying or abrogating treaties with foreign nations. The Vice President is to aid the President in carrying out his duties, and may carry out presidential functions delegated by the President.

Section 3 of Chapter 3 of the *Constitution 1982* deals with the State Council. The State Council is the Central Government in China. The State Council is the government of the PRC under the authority of Articles 85–98. It is the highest organ of state power and of state administration. The State Council consists of the Premiers, Vice-Premiers, State Councillors, Ministers in charge of ministries, Ministers in charge of commissions, the Auditor-General, and the Secretary-General. The State Council’s term of office is five years. The State Council is given a number of functions and powers including, but not limited to: the adoption of administrative measures, rules and orders; submission of proposals to the NPC; the creation and execution of a plan for national economic and social development; conducting foreign affairs and concluding

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38 Ibid arts 80–81.
39 Ibid art 82.
40 Ibid art 85.
41 Ibid art 86.
treaties and agreements with foreign nations; the protection of the rights of Chinese nationals abroad; and exercising any other functions that the NPC may delegate to it.\textsuperscript{42}

Under China’s socialist political and economic system, the government was explicitly responsible for planning and managing the national economy. The State Constitution of 1982 specifies that the state is to guide the country’s economic development and that the State Council is to direct its subordinate bodies in the State Council’s drawing up and carrying out the national economic plan and the state budget.\textsuperscript{43}

Although the NPC and its Standing Committee have the legislative power in China, the State Council is empowered to perform the following legislative activities:

(1) to adopt administrative measures, enact administrative rules and regulations and make decisions and orders in accordance with the Constitution and the law,

(2) to submit proposals to the NPC or its Standing Committee,

(3) to issue rules governing administrative affairs in respect of national economic and social development, the state budget, urban and rural development, education, science, culture, public health, sports, population control, internal affairs, public security, judicial administration and national defence,

(4) to alter or annul inappropriate orders, directives and regulations issued by the Ministries or Commissions.\textsuperscript{44}

Regulations of the State Council must be based upon the PRC Constitution and its related statutes and must not be contradictory to them. At the same time the State Council, as the highest state administrative organ, is responsible for leading and managing administrative work in China. Therefore, the State Council guides local

\textsuperscript{42} Ibid art 89.
\textsuperscript{43} Ibid Framework, ch 10.
\textsuperscript{44} Ibid art 89.
governments in their formulation of local rules and regulations as well as the enactment of such regulations by local governments. Local ordinances, and local rules and regulations of local governments must accord with the rules and regulations administered by the State Council.

The figure below describes the hierarchical political, legislative, governmental, administrative, judicial and prosecutorial structures and institutions in the PRC with Courts and geographical locations highlighted. It can be seen that the CPC’s organisational hierarchy is very much integrated into the hierarchy of the administrative, legal and governmental or congressional structure of the PRC.

It is clear that of the various executive, legislative and regulatory levels, the State Council is very much at the centre of day to day administration and implementation of law in China and whilst it does not occupy the highest nominal level of power in the country, it seems to be the practical source of the major proportion of decision-making in China today.

45 Kuihua Wang, *Chinese Commercial Law* above n 1, 14.
### Figure 2.1: Location Guide to Political, Government Institutions and Judicial Structures in the PRC

#### Central Level

<table>
<thead>
<tr>
<th>Political Institution</th>
<th>Legislative Institution</th>
<th>Government</th>
<th>Judicial Institution</th>
<th>Prosecutorial Institution</th>
</tr>
</thead>
<tbody>
<tr>
<td>Central CPC Congress</td>
<td>NPC and its Standing Committee</td>
<td>State Council</td>
<td>Supreme People’s Court</td>
<td>Supreme People’s Procuratorate</td>
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</tbody>
</table>

#### Provincial Level

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<tr>
<th>Political Institution</th>
<th>Legislative Institution</th>
<th>Government</th>
<th>Judicial Institution</th>
<th>Prosecutorial Institution</th>
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</thead>
<tbody>
<tr>
<td>Provincial CPC Congress</td>
<td>Provincial People’s Congress</td>
<td>Provincial Government</td>
<td>Higher People’s Court</td>
<td>Higher People’s Procuratorate</td>
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#### Municipal Level

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<tr>
<th>Political Institution</th>
<th>Legislative Institution</th>
<th>Government</th>
<th>Judicial Institution</th>
<th>Prosecutorial Institution</th>
</tr>
</thead>
<tbody>
<tr>
<td>Municipal CPC Congress</td>
<td>Municipal People’s Congress</td>
<td>Municipal Government</td>
<td>Intermediate People’s Court *</td>
<td>Intermediate People’s Procuratorate</td>
</tr>
</tbody>
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#### County Level

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<tr>
<th>Political Institution</th>
<th>Legislative Institution</th>
<th>Government</th>
<th>Judicial Institution</th>
<th>Prosecutorial Institution</th>
</tr>
</thead>
<tbody>
<tr>
<td>Grass Roots CPC Branches</td>
<td></td>
<td>Basic People’s Court *</td>
<td>Basic People’s Procuratorate</td>
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#### Village Level

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<thead>
<tr>
<th>Political Institution</th>
<th>Legislative Institution</th>
<th>Government</th>
<th>Judicial Institution</th>
<th>Prosecutorial Institution</th>
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<tr>
<td>Grass Roots CPC Branches</td>
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<td>Basic People’s Court *</td>
<td>Basic People’s Procuratorate</td>
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</tbody>
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Abbreviations: CPC = Communist Party of China; NPC = National People’s Congress; * Collectively known as Local People’s Court
2.5 **Sources of Law**

2.5.1 **1982 Constitution of the PRC**

The current Constitution of the PRC, adopted in 1982, is the highest source of law in the country. As previously noted, the Constitution establishes the framework of the government, in addition to codifying the general principles of government and society and listing the fundamental rights and duties of the people of China. Three prior constitutions of 1954, 1975 and 1978 partially contribute to the composition of the current Constitution.

The Preamble to the Constitution states some fundamental principles:

Both the victory in China’s New-Democratic Revolution and the successes in its socialist cause have been achieved by the Chinese people of all nationalities, under the leadership of the Communist Party of China and the guidance of Marxism-Leninism and ‘Mao Zedong Thought’, by upholding truth, correcting errors and surmounting numerous difficulties and hardships. The basic task of the nation in the years to come is to concentrate its effort on socialist modernisation. Under the leadership of the Communist Party of China and the guidance of Marxism-Leninism and ‘Mao Zedong Thought’, the Chinese people of all nationalities will continue to adhere to the people’s democratic dictatorship and the socialist road, steadily improve socialist institutions, develop socialist democracy, improve the socialist legal system, and work hard and self-reliantly to modernise the country’s industry, agriculture, national defence and science and technology step by step to transform China into a socialist country with a high level of culture and democracy.46

From this passage it is clear that the leadership of the CPC is emphasised. Also, the guidance of Marxism-Leninism and ‘Mao Zedong Thought’ is regarded as the proper intellectual framework and ideology for leading the country to a socialist state under the people’s democratic dictatorship.

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Some of the general principles that are mentioned in the Articles of the 1982 Constitution include: ‘the power of the country lies with the people’, 47 ‘equality of all nationalities in China’, 48 ‘the principle of the rule of law, binding on the state as well as all others’, 49 and ‘state involvement in the economy’. 50 As mentioned, the Constitution also lists fundamental rights and duties, for example: ‘equality of citizens’ 51 ‘freedom of speech, press, assembly, association, procession and demonstration’, 52 ‘the right to personal dignity’, 53 ‘the right to criticise state organs’, 54 ‘the duty and right to receive an education’, 55 ‘the duty to practise family planning’, 56 and ‘the duty to pay taxes’. 57

2.5.2 NPC Statutory Law and Other Legislative Enactments

Law that is to have general impact is enacted by the NPC or its Standing Committee. The Standing Committee also enacts regulations, decisions and resolutions. Administrative regulations are one type of legislative enactment by the State Council. The State Council and its ministries or commissions can also make rules. At the local level the People’s Congresses can enact local regulations and the local people’s governments can make local administrative rules. As to the national autonomous regions, they are permitted to enact autonomy regulations and specific regulations. A novel concept, the Basic Law, was developed for dealing with specific areas such as Hong Kong which had a legal system of its own prior to its return to China. In these
areas, known as Special Administrative Regions, the basic law of the former system is maintained provided that the laws comport with the PRC Constitution.

### 2.5.3 International Treaties

The Constitution 1982 does not specify the relationship of international law to the laws of the PRC. In practice, however, the legislative approach has been to automatically incorporate international law as part of PRC law. However, if the PRC has made a reservation to a provision of a treaty, this aspect or provision of the treaty is not implemented in the law.

### 2.5.4 Case Law

Unlike common law jurisdictions such as the United States or the United Kingdom, there is no strict precedent concept for case law. In theory, each case stands as its own decision and will not bind another court. In practice, however, judges in lower People’s Courts (that may be the Higher People’s Court, Intermediate People’s Court, or Basic People’s Courts) often attempt to follow the interpretations of the laws decided by the Supreme People’s Court. Moreover, higher level courts can use the finality of their judgments on appeals as having a binding effect on the lower court that issued the first judgment or order.

In China, not all court decisions or cases are published and available to the public. In fact, the large majority remain unavailable, although the system of justice has

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become more transparent in recent years with the publishing of more legal materials. China’s legal system is based on civil law, with heavy influence from traditional Chinese law, modern Japanese law, and German law. With no system of precedents, interpretation of the applicable law is usually done on an individual basis by the judge hearing the case.

The Supreme People’s Court and the Standing Committee of the National People’s Congress will, on occasion, provide interpretations of various laws in which ambiguities have become evident, or for which clarification is deemed necessary by the Communist Party leadership. These interpretations are much less common that one would expect of higher courts in common law jurisdictions, such as Australia, the United States, or the United Kingdom.

In addition, judgments themselves and the publishing of cases are highly political processes, and the courts really lack the autonomy necessary to render unbiased decisions that might conflict with Communist Party policy, values and, of course, current laws. However, in recent years various judicial reform programs have supplied cases as guidance for future court decision. For instance, the Supreme People’s Court case guidance system advocated by the judicial reform movement indicates the future direction of judicial reform in China.
Ongoing discussions on the importance of a guidance system for cases are taking place.\(^6^4\)

In May 2011, Judge Gong Pixiang discussed what kind of cases should be the guiding or precedent cases and argues that establishing a clear case guidance system must be the primary aim.\(^6^5\)

Sometimes a case will be chosen for publication in order to make a point, or set an example for the public and build confidence in the justice system. At other times, cases will be published to demonstrate the ‘rule of law’ to foreigners, or to set forth new policies regarding foreign investment, or the activities of foreigners in China. A labour dispute case published on the Supreme People’s Court case guidance website in 2009 details a Court decision and interpretation on whether an agency agreement forms a labour relationship between an individual and a company (16 December 2003, China Unicom Ltd Suqian Branch (China Unicom) and Chen Liangqin).\(^6^6\)

It is generally accepted knowledge that the Government of China exerts strong pressure on the courts in cases where they believe there is a national policy interest at stake, or which it deems to be politically sensitive.\(^6^7\) Despite China’s recent revisions of criminal law and criminal procedure, and civil law and civil procedure, trials are often closed. They can be conducted days after charges are filed, or even months or years later. Lawyers have been known to have been restricted from seeing their clients or even

\(^6^7\) "中华人民共和国民事诉讼法" [Civil Procedure Law of the People’s Republic of China] (People’s Republic of China) National People’s Congress Standing Committee, Order No 75, 1 April 2008, art 120.
refused permission\textsuperscript{68} to attend politically sensitive trials altogether. Intimidation is also known to play a role, and many lawyers are unwilling to take on clients involved in trials considered sensitive, in order to protect their legal careers.\textsuperscript{69}

These are some of the reasons why individual cases decided by courts in China have much less significance than in other common law or civil law jurisdictions. It should also be mentioned that cases in China also play an important role as a tool of the Ministry of Propaganda, not only in its decisions as to what is to be published, but more importantly, as to what is not to be published. It is known that all such decisions convey some message to the public at large, however subtle it may be. This may be regarded as a result of a legal system without the measure of independence that might be found (or claimed to be in existence) in some Western judicial democracies. In China, publication (or not) of cases is often used as a ‘tool’ to convey messages or to reinforce a policy, rather than simply to illustrate or provide guidance for the implementation of justice.

2.6 The Judicial System of the PRC

2.6.1 The Court Hierarchy System

There is a hierarchy within the court structure consisting of the Supreme People’s Courts at the national level, the Higher People’s Courts at the provincial level, the

\textsuperscript{68} <<罗秋林诉衡阳市公安局行政复议案>> [Qiuli n Luo v Hengyang Municipal Bureau of Public Security – Administrative Reconsideration Appeal] 衡阳市公安局 [Hengyang Municipal Bureau of Public Security] 衡复决字 2005-5 号 [Administrative Reconsideration Appeal No 2005-5]. This was the first successful challenge by a solicitor whose application for interview with his client (who was in custody) had been refused. Solicitor Luo initiated an administrative reconsideration appeal to the Bureau of Public Security after being refused permission (on four occasions) to interview his client in a criminal matter. His appeal was upheld and this case became the first case of a solicitor taking action against authorities as a result of official denial of his lawful right to interview client.

\textsuperscript{69} <<关于加强对律师办理重大，敏感，群体性案件指导监督的意见(试行)>> [Opinions Concerning Strengthening Supervision and Guidance of Lawyers Dealing with Influential, Sensitive and Class Cases (Trial)] (People’s Republic of China) 三门峡市司法局 [Sanmenxia Municipal Bureau of Justice], 28 March 2006.
Intermediate People’s Courts at the municipal level, and the Basic People’s Courts at the county or district level.\textsuperscript{70} The Basic People’s Courts are comprised of more than 3,000 courts at county level, which are further subdivided into about 20,000 smaller units referred to as People’s Tribunals located in towns and villages.\textsuperscript{71} There are 376 Intermediate People’s Courts and 31 Higher People’s Courts located in the provinces.\textsuperscript{72} Additionally, there are a number of specialised courts, including those dealing with railway transportation, forest affairs, the People’s Liberation Army (PLA), and maritime matters. Jurisdiction is allocated partly through the Constitution, the *Organic Law of the People’s Courts 2007*,\textsuperscript{73} the *Criminal Procedure Law of the People’s Republic of China 1996*,\textsuperscript{74} the *Law of Civil Procedure 2008*,\textsuperscript{75} and the *Administrative Procedure Law of the People’s Republic of China 1989*.\textsuperscript{76}

Litigants are generally limited to one appeal, on the theory of finality of judgment by two trials.\textsuperscript{77} Cases of second instance are often reviewed ‘de novo’ as to both law and facts.\textsuperscript{78} Requests for appellate review take the form of appeals and protests (in criminal cases). Appeals may be lodged by parties to the case either directly

\textsuperscript{74} <<中华人民共和国刑事诉讼法>> [Criminal Procedure Law of the People’s Republic of China] (People’s Republic of China) National People’s Congress, Order No 64, 17 March 1996.
\textsuperscript{75} <<中华人民共和国民事诉讼法>> [Civil Procedure Law of the People’s Republic of China] (People’s Republic of China) National People’s Congress Standing Committee, Order No 75, 1 April 2008.
\textsuperscript{78} Ibid art 153.
or through private lawyers. Protests are filed by the Procuratorate (which has functions that include those of a Public Prosecutor (see section 2.8 below)) in criminal cases when it is believed that an error has occurred in the law or facts as determined by the judgment or order of the Court of first instance. In civil cases the Procuratorate does not possess a right to file a direct protest, but it can initiate ‘adjudication supervision’ via a protest. ‘Adjudication supervision’ refers to a type of discretionary ‘post-final decision’ review, which may occur in certain situations in criminal and re-trial in civil cases.

Under the Chinese Constitution, the People’s Courts of the PRC are the judicial organs of the State. The People’s Procuratorates are the State organs for legal supervision. The judicial and the procuratorial organs of the State are created by the People’s Congresses to which they are responsible and by which they are supervised. Being organs of the State, the judiciary and Procuratorate must apply the principle of democratic centralism. The first Organic Law of the People’s Court was adopted in

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82 Ibid arts 129, 133.
83 <<中华人民共和国宪法>> [Constitution of the People’s Republic of China] (People’s Republic of China) National People’s Congress, 4 December 1982, art 3; 师霞 [Xia Shi], ‘什么是党的民主集中制原则？’ [What are the Principles of the Party’s System of Democratic Centralism?] (July 2011) 中国共产党新闻网 [News of Communist Party of China] <http://cpc.people.com.cn/GB/64156/64157/4418487.html>; ‘Building of Political Democracy in China’ (White Paper, October 2005, Beijing, Information Office of the State Council of the People’s Republic of China). The white paper states that China’s democracy is a democracy with democratic centralism as the basic organisational principle and mode of operation. Democratic centralism is the fundamental principle of organisation and leadership of state power in China. The Constitution of the CPC proposed six basic principles of democratic centralism. They are: individual members complying with the Party organisation; minority complying with majority; lower level organisation complying with higher level organisation; every organisation of the Party and every member of the Party complying with the Party’s National Congress and the Central Committee; each level of the leadership of the Party must be elected; the Party’s National Congress and Central Committee are the highest levels of leadership and should listen to lower
1954, and was amended in 1979, 1983 and 2007 respectively. Under the Organic Law of the People’s Court, the judicial power is exercised by the Courts at four levels:

**Figure 2.2: The Court Hierarchy System in the People’s Republic of China**

- **Supreme People’s Court**
  Original Jurisdiction over cases that have been assigned to it by law, or over cases that it decides it should try. It has jurisdiction over appeals or protests from the Higher People’s Court and Special People’s Courts.

- **Higher People’s Court**
  Jurisdiction in the first instance in cases assigned by law, or transferred from lower courts; or with major criminal cases which impact the entire province. Courts also hear cases of appeals or protests against judgments and orders of lower courts.

- **Intermediate People’s Court**
  First instance jurisdiction in some cases, including those transferred to it from basic People’s Courts; major cases dealing with foreign parties; counter-revolutionary cases, criminal cases subject to sentence of life imprisonment or death; cases where foreigners committed crimes. Also hears appeals and protests.

- **Basic People’s Courts**
  Local level courts adjudicate criminal and civil cases of first instance. Excluded from jurisdiction are criminal cases carrying penalty of death or life imprisonment, as well as certain foreign civil cases. The courts can request that more important cases be transferred to a higher court.

(Note: the arrows indicate paths of appeal but only one appeal to the next highest Court from the initial hearing of a matter—see 6.1.5 below)
2.6.2 The Basic People’s Courts

The Basic People’s Courts, Intermediate People’s Courts and Higher People’s Courts are generally referred to as ‘Local People’s Courts’. The Basic People’s Courts are established at the county and district level. A Basic People’s Court is comprised of a president, vice-presidents and judges. Every Basic People’s Court is divided into divisions: criminal, civil, economic, and enforcement. Each division has a chief judge and associate chief judges. Tribunals may also be set up in accordance with local conditions and populations.

2.6.3 The Intermediate People’s Courts

Local People’s Courts at various levels are responsible to the organs of state power that created them. Cases involving foreign elements are heard in the Intermediate People’s Court or above.

2.6.4 The Higher People’s Courts

The Higher People’s Courts include Higher People’s Courts of provinces, autonomous regions, and municipalities directly under supervision of the Central Government. The Higher People’s Courts’ jurisdiction includes first instance matters as required by regulations; first instance cases transferred by the local people’s courts; appeal cases

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and cases under the supervision process of the people’s procuratorate. Recently the Supreme People’s Court reported details of the top ten intellectual property cases involving foreign parties that had been submitted by the Higher People’s Courts.

### 2.6.5 The Supreme People’s Courts

The Supreme People’s Court is the highest judicial organ and as the highest level in the hierarchy of the People’s Courts, it supervises the administration of justice by the People’s Courts at various levels and by the Special People’s Courts. The Supreme People’s Court is responsible to the NPC and its Standing Committee, and is situated in Beijing. The President of the Court cannot serve more than two consecutive terms and each term is of five years. The NPC elects the president of the Supreme People’s Court.

The Supreme People’s Court has three responsibilities:

1. handling cases that are of the greatest influence, appeals against judgments and orders of Higher People’s Courts and deemed by the government that it should try,

2. supervising the administration of justice by Local People’s Courts and Special People’s Courts at all levels, overruling incorrect judgment of inferior courts and reviewing those cases itself or directing the lower-level courts to conduct a retrial, and

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91 Ibid art 17.
92 Ibid art 124.
2.6.6 Special Courts

Besides the general court system, the government has also set up other Special courts.\textsuperscript{94} The special Courts are Military Courts, Maritime Courts, Railway Courts and Forest Courts.

Under the current system, the jurisdiction of each Court is assigned by the law.\textsuperscript{95} In general, the jurisdiction of Courts is subdivided both hierarchically and geographically. Hierarchical jurisdiction refers to the principle that Courts should exercise jurisdiction in accordance with the authorisation stipulated by law. This requires that important cases be handled by Courts of a higher level such as the Higher People’s Court and the Supreme People’s Court. Under the Civil Procedure Law\textsuperscript{2008}, Basic People’s Courts, subject to Articles 18–21 of the Civil Procedure Law, hear all civil cases as courts of first instance. Prior to the adoption of the Civil Procedure Law\textsuperscript{2008}, all cases involving foreign interests had to be heard by an Intermediate People’s Court as the Court of first instance.\textsuperscript{96} The delegation of jurisdiction to the Basic People’s Courts over cases involving foreign interests is a sign of gradual perfecting of economic tribunals in China. It appears to be the case that with growing economic exchanges with foreign countries there is an increasing need for the Basic People’s Courts to share the caseload of Intermediate People’s Courts. Although the Higher

\textsuperscript{93} <<中华人民共和国宪法>> [Constitution of the People’s Republic of China] (People’s Republic of China) National People’s Congress, 4 December 1982, art 32.
\textsuperscript{94} Ibid art 31.
\textsuperscript{95} Ibid arts 21, 22, 25, 28, 32.
\textsuperscript{96} <<中华人民共和国民事诉讼法(试行)>> [Civil Procedure Law of the People’s Republic of China (Trial Implementation)] (People’s Republic of China) National People’s Congress, 1 October 1982, art 17(1), repealed on 9 April 1991.
People’s Court and the Supreme People’s Court may serve as the court of first instance for important cases in the relevant region or for the whole country respectively, they basically serve as the courts of appeal.

### 2.7 The Position of Equity in the Chinese Legal System

In addition to the provisions of law, and similar to equitable principles in common law jurisdictions, Chinese Courts also attach importance to fairness when deciding a case. In practice in civil cases Chinese Courts always encourage out-of-court settlement. Whilst the conciliation process is generally regarded as a reasonable form of alternative dispute resolution it may appear to some to be against the principle of justice and fairness by reason of the fact that one or both parties in dispute may be persuaded to retreat to some extent from a strongly held belief in the correctness of their position. The people’s courts argue that it is important for courts to uphold the principle of mutual consent when conciliation is chosen by parties as a dispute resolution. Courts play an important role in the conciliation process to ensure parties’ interests and rights being fairly protected.  

The parties concerned may, with the Court’s assistance, have their dispute resolved through conciliation. Article 85 of the *Civil Procedure Law 2008* explicitly stipulates:

> In conducting civil proceedings, the People’s Court shall distinguish right from wrong on the basis of clear facts and conduct conciliation between the parties on a voluntary basis.

Article 91 of the *Civil Procedure Law 2008* further states that:

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If no agreement is reached through conciliation or if either party backs out of the settlement agreement before a conciliation statement is served, the People’s Court shall render a judgment without delay.  

Conciliation may occur informally between the parties but can also be conducted by other bodies such as grass-roots governments and by neighbourhood committees. Such conciliation committees are required to follow the directives of the local government and the People’s Court in the locality. It has been estimated that in 1993 there were about 950,000 conciliation committees with 6,000,000 conciliators in China. In 1986, more than 7,370,000 disputes were settled through conciliation. They involved marriage, inheritance, maintenance, alimony, debts, real property, production and management, tortious acts, and other civil and commercial disputes and minor criminal cases.

2.8 The People’s Procuratorate

The judicial system of the PRC is established under Articles 123–135 of the Constitution, and consists of the People’s Courts, the Supreme People’s Court, the People’s Procuratorates, the Supreme People’s Procuratorate, Military Procuratorates and other Special People’s Procuratorates. Article 129 refers to the People’s Procuratorates as ‘state organs for legal supervision.’ In 1983, the NPC amended the Organic Law of the People’s Procuratorates, which included an enumeration of the powers and functions of the procuratorates. The powers and functions of the People’s Procuratorates create an organisation which initially performs functions similar to a public prosecutor in the West, in that it oversees investigations by the public security organs and decides which cases will be prosecuted. However, the oversight of the procuratorates extends beyond investigation and trial, into the supervision of the legal...
activities of the People’s Courts, the execution of judgments, and the activities of prisons.\footnote{中华人民共和国人民检察院组织法 \cite*[Organic Law of the People’s Procuratorates of the People’s Republic of China] (People’s Republic of China) National People’s Congress, 2 September 1983, arts 21–24.} Strictly speaking, China’s judicial system only refers to the People’s Court system.

According to \textit{Criminal Procedure Law of the PRC 1996}, during a criminal proceeding a People’s Court, People’s Procuratorate and public security organ shall perform their tasks in accordance with their individual responsibilities as well as cooperatively.\footnote{中华人民共和国刑事诉讼法 \cite*[Criminal Procedure Law of the People’s Republic of China] (People’s Republic of China) National People’s Congress, Order No 64, 17 March 1996, arts 3, 7.} Hence, the People’s Procuratorate and public security organ both execute judicial power, although their judicial functions are limited to a relatively narrow scope. Thus broadly speaking, China’s judicial system is institutionally comprised of three parts: the People’s Court system, the People’s Procuratorate system, and the Public Security system (police). Corresponding to this, the judicial structure in the broad Chinese sense not only refers to Courts, but also to the Procuratorates and the Public Security system.

The presidents of Courts and the procurator-generals of Procuratorates are selected and appointed by the People’s Congresses on the same levels. The judges and procurators are selected and appointed by the standing committees of the respective People’s Congresses, and assistant judges and assistant procurators are appointed by the respective Courts and Procuratorates.\footnote{中华人民共和国人民法院组织法 \cite*[Organic Law of the People’s Courts of the People’s Republic of China] (People’s Republic of China) National People’s Congress Standing Committee, 1 January 2007, arts 11, 35, 37; \textit{中华人民共和国人民检察院组织法} \cite*[Organic Law of the People’s Procuratorates of the People’s Republic of China] (People’s Republic of China) National People’s Congress, 2 September 1983, arts 21–24.}
2.9 Interpretation of Law

With a civil law tradition, China adopts the principle of legislative interpretation. The Constitution entrusts the NPC Standing Committee with the power to interpret the Constitution and laws. It issues interpretations of a law when the stipulations of a law require clearer and more specific meaning or when a new situation arises after the promulgation of the law which requires clarification of the rationale or basis for its application. The State Council and People’s Congresses at various levels may enact administrative regulations and local regulations respectively. The basis of legislative interpretation is that those who make the law know the meaning of the law and are in the best position to interpret it. According to this theory, in addition to the NPC and its Standing committee, other law-making bodies, including the State Council and the standing committees of local congresses should also have the power to interpret the law. All departments under the State Council and the people’s governments of provinces, autonomous regions and municipalities directly under the Central Government may make requests to the State Council for interpretation of administrative regulations.

In China, judicial interpretation is described as the interpretation of the national supreme judicial authorities on questions relating to specific application of laws in their judicial practices according to the authorisation of the NPC. The Supreme People’s Court and the Supreme People’s Procuratorate, by virtue of the relevant decrees adopted

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by the NPC, both hold the power of formulating judicial interpretations.\textsuperscript{108} The Supreme People’s Court is much more active in providing judicial interpretations, and has become “the most frequent and important” form of interpretation of the law.\textsuperscript{109}

Judicial interpretation has an extensive history in modern China, dating back to 1954 (shortly after the founding of the People’s Republic of China). Judicial interpretation appeared along with the rapid progress in the fields of economic construction and growth in national legislation after the first Constitution was promulgated. It was a matter of urgency for the national supreme judicial authorities to strengthen the interpretative work on the application of law in order to cope with the problems that arose in handling cases.\textsuperscript{110} For this reason the Standing Committee of the NPC passed the \textit{Decision on Interpretation of Law} in 1955 which provided that those questions connected with the specific application of laws and decrees should be interpreted by the Supreme People’s Court.\textsuperscript{111} Thus the highest organ of State power had, for the first time, formally conferred upon the supreme judicial organ the power of enacting judicial interpretation from that time forward. This power was also confirmed by subsequent legislation such as the \textit{Organic Law of People’s Court of the People’s Republic of China} in 1979. Furthermore, the Standing Committee of the 5\textsuperscript{th} NPC at its 19\textsuperscript{th} session adopted a resolution on improvement in the explanation of the workings of the law that provided:

An interpretation of questions involving the specific application of laws and decrees in court trials shall be provided by the Supreme People’s Court; and an interpretation of

\textsuperscript{108} The authority of judicial interpretation derives from the \textit{Organic Law of the People’s Courts of the PRC}. It was adopted at the Second Session of the Standing Committee of the Fifth National People’s Congress on 1 July 1979 and amended on 2 September 1983 and 31 October 2006.
\textsuperscript{110} <<最高人民法院关于案例指导工作的规定>> [Provisions Concerning Case Guidance of the Supreme People’s Court] (People’s Republic of China) Supreme People’s Court, Order No 51, 26 November 2010.
problems concerning the concrete application of laws and decrees in procuratorial practices shall be prescribed by the Supreme People’s Procuratorate. If there is any difference in principle between them, it should be delivered to the Standing Committee of the NPC for interpretation or decision.  

This Resolution stresses not only the power of judicial interpretation by the Supreme People’s Court but also bestows the same power upon the Supreme People’s Procuratorate. Thus judicial interpretation has been considered as a formal source of law. According to judicial statistical data, there were about 4000 judicial interpretations by the Supreme People’s Court alone or jointly with the Supreme People’s Procuratorate recorded in the period from 1949 to 2000. Shen explains:

Chinese jurisprudence commonly divides authoritative interpretation into three categories: legislative, administrative and judicial. Generally speaking, legislative interpretation means interpretation given by legislative authorities on laws and rules issued by themselves; administrative interpretation refers to interpretations given by administrative authorities on these rules and regulations; and judicial interpretations are those issued by the Supreme People’s Court and the Supreme People’s Procuratorate in their judicial and procuratorial work.

The theory of legislative interpretation requires restraints on the power of the judiciary in relation to interpreting laws. The Court, in its primary role of implementation needs an interpretive mechanism. Without ascertaining the meaning of law, the power of implementation cannot be reasonably exercised. In this regard, the more detailed an interpretation (ascertaining meaning) that is given by the legislature, the easier it becomes for the Court to implement. As China’s legal reforms and enactments of laws began without adequately qualified legal professionals associated with law-making bodies, detailed interpretation by such bodies has not been possible. As a result, the system has instituted what is, in fact, a shared interpretative power. The

112 Ibid.
113 Ibid.
Resolution of the NPC Standing Committee on *Strengthening of Legal Interpretative Work 1981*, adopted on 10 June 1981,\(^{115}\) prescribed:

1. all articles in laws requiring further definition or supplementary stipulations shall be interpreted or stipulated by law by the NPC Standing Committee;
2. all questions arising from court trials concerning the specific application of laws and decrees shall be interpreted by the Supreme People’s Court. All questions relating to the specific application of laws and decrees in the procuratorial work of the procuratorate shall be interpreted by the Supreme People’s Procuratorate. In the case that there is a difference in principle between the interpretations of the Supreme People’s Court and the Supreme People’s Procuratorate, the NPC Standing Committee shall be asked to give an interpretation or decision;
3. all questions on the application of laws or decrees that do not come under judicial or procuratorate work shall be interpreted by the State Council and the responsible department;
4. all articles of law of local character requiring further definition or supplementary stipulations shall be interpreted or stipulated by the respective standing committees of provinces, autonomous regions and municipalities that formulated those regulations. All questions concerning the specific application of laws and regulations of a local character shall be interpreted by responsible departments under the people’s governments of provinces, autonomous regions and municipalities.\(^ {116}\)

In practice, the NPC Standing Committee has not yet given any formal interpretation of any law. The lack of action on the part of the NPC Standing Committee in relation to law interpretation has left room for the Court to perform the function. The Court, unlike the legislature, must hear cases and apply the law. Whilst without instructions from the legislature, and with the authorisation of the 1981 Resolution discussed above, the Supreme People’s Court has issued thousands of pieces of judicial

\(^ {115}\) <<全国人民代表大会常务委员会关于加强法律解释工作的决议>> [Resolution of the NPC Standing Committee on Strengthening of Legal Interpretive Work] (People’s Republic of China) National People’s Congress Standing Committee, 10 June 1981. It was adopted on 10 June 1981 by the 19\(^\text{th}\) Meeting of the Standing Committee of the 5\(^\text{th}\) National People’s Congress.

interpretation to guide the lower courts.\textsuperscript{117} Such judicial interpretations have binding force on all the courts in China and cover almost every aspect of the legal system and thus play an important role in the enforcement of law in China.\textsuperscript{118} The scope of judicial interpretation is so vast that the function of the Court regarding interpretation of law can hardly be said to be different from its counterparts in other countries. However, the status of judicial interpretation is still not the same as legislative interpretation. On numerous occasions, the Supreme People’s Court announced invalidations of its previous interpretations on the ground that they contravened laws subsequently adopted. For example, the Supreme People’s Court and Supreme People’s procurator jointly announced in May and November 2010 that 37 previous interpretations had been invalidated.\textsuperscript{119} The \textit{Notification of the Supreme People’s Court and the Supreme People’s Procuratorate Concerning Trial of Re-trial Cases in Public} adopted in 1988 was invalidated as a result of the detailed interpretation concerning criminal procedure of re-trial cases has been issued by the Supreme Court in 1998.\textsuperscript{120}

The Chinese legal system has undergone substantial changes over the last three decades.\textsuperscript{121} Before the policy of opening to the outside world and the introduction of domestic economic reforms in the late 1970s, the Chinese legal system was essentially based upon a planned economy and Marxist theory. Since then, the Chinese government

\begin{footnotesize}

\footnote{Dayun Xiong, ‘Legal System and Rule of Law in Contemporary China’ (Akashi Shoten) 124 cited in Patricia Blazey and Kay-Wah Chan (eds), \textit{The Chinese Commercial Legal System} (Lawbook, 2008) 104.}

\footnote{\textit{最高人民法院关于案例指导工作的规定} [Provisions Concerning Case Guidance of the Supreme People’s Court] (People’s Republic of China) Supreme People’s Court, Order No 51, 26 November 2010, art 7.}

\footnote{\textit{最高人民法院最高人民检察院关于废止部分司法解释和规范性文件的决定} [Supreme People’s Court, Supreme People’s Procuratorate, Decision on Abolishing Some Judicial Interpretations and Regulatory Documents] (People’s Republic of China) Supreme People’s Court, Supreme People’s Procuratorate, 22 December 2010.}

\footnote{\textit{最高人民法院关于执行<中华人民共和国刑事诉讼法>若干问题的解释} [Interpretations of the People’s Supreme Court Concerning Enforcement of Criminal Procedure Law] (People’s Republic of China) Supreme People’s Court, Order No 23, 29 June 1998.}

\footnote{1978 is seen by Chinese scholars as commencing a new epoch in modern Chinese history and a turning point in legal development in China. In that year, the Third Plenary Session of the Eleventh Central Committee of the CPC declared that large scale nationwide mass political movements should be stopped and the emphasis of the Party’s work should be shifted to socialist modernisation as of 1979.}

\end{footnotesize}
has been learning from the experiences of foreign jurisdictions particularly in relation to commercial law.\textsuperscript{122}

With the inflow of foreign capital and technology as well as foreign commercial concepts, the Chinese economic system changed from a purely planned economy to an essentially market-oriented economy.\textsuperscript{123} In order to cope with the requirement of further opening the domestic market and enlarging economic co-operation with foreign countries, the pace of legal reform has quickened over recent years.\textsuperscript{124} A number of laws were adopted, not only in the area of commerce, but in the field of public interest. For instance, China passed its first \textit{Company Law of the PRC} on 29 December 1993.\textsuperscript{125} The law has its basis in China’s joint venture laws and the experience derived from the operation of the company laws in Shenzhen and Shanghai. It provides limited liability protection that did not exist under joint venture laws.\textsuperscript{126} Also, the \textit{Labour Law of the People’s Republic of China} was promulgated on 5 July 1994 and the \textit{Labour Contract Law of the People’s Republic of China} was passed on 29 June 2007.\textsuperscript{127} The latter law provides a legal ground for employees’ rights and their protection. The trend has been that China will make its laws — at least the commercial laws — compatible with the

\textsuperscript{123} In 1993, amendments of the Constitution of 1982 were adopted at the First Session of the Eighth NPC and promulgated on 29 March. The concept of socialist market economy was introduced to replace planned economy. The amendment was made to Article 15 of the Constitution.
\textsuperscript{124} In 1993, amendments were adopted and the term socialism with Chinese characteristics and the phrase persevere in reform and opening to the outside world were added to the seventh paragraph of the Preamble. A provision was added to state the PRC governs the country according to law and makes it a socialist country under rule of law. The provision was added as an additional paragraph in Article 5.
\textsuperscript{125} [Company Law of the People’s Republic of China] (People’s Republic of China) National People’s Congress, Order No 42, 1 January 2006. This law was amended in 2005 with the new \textit{Company Law of the PRC} taking effect from 1 January 2006.
\textsuperscript{127} [Labour Law of the People’s Republic of China] (People’s Republic of China) National People’s Congress Standing Committee, Order No 65, 1 January 2008. The Labour Law of the PRC was adopted at the 28\textsuperscript{th} Session of the Standing Committee of the Tenth National People’s Congress. It became effective on 1 January 2008. It aims at offering better protection to employees in China.
laws prevailing internationally and in conformity with international practice. Such a development will inevitably affect the internal public law-making and enforcement of laws by the courts and other bodies. Thus with China’s market becoming more mature and more open, it is very likely that its legal system will become more transparent, fairer and more desirable. However, the underlying philosophy of the system in practice can be traced back at least two thousand years as a result of significant parts of the culture matching the style and needs of the current Communist regime.

2.10 Sources of Judicial Information

Judicial information can be divided into two categories in the light of subject of issuance. Their titles also vary and include circulars, replies to questions, instructions, opinions, and so on. The categories are;

i) The Supreme People’s Court

ii) Official Gazette

The Gazette of the Supreme People’s Court of the People’s Republic of China commenced in 1985. It is the sole official publication of law. Published four times each year, it carries the important national legislation, official documents, judicial interpretation and typical cases involving civil, criminal, economic, marine and administrative matters discussed and adopted by the Judicial Committee of the Supreme People’s Court. As part of its content, the judicial interpretations are, pursuant to the provisions of the Supreme People’s Court, the authoritative statements and can be cited in judicial documents and Court decisions. For example, there are two bound volumes of the gazette: ‘A Complete Compilation of the Gazette of the Supreme

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2.10.1 General Compilation of the Supreme People’s Court’s Decisions

Judicial interpretations prior to 1985 can be traced in another publication entitled, ‘A Collected Edition of Judicial Interpretation of the Supreme People’s Court of the People’s Republic of China: 1949–1993’. This historical collection, compiled by the research department of the Supreme People’s Court, contains seven parts involving: general provisions, criminal law, criminal procedure law, civil law (including general principles of civil law, marriage law, succession law and copyright law), economic law, maritime law, civil procedure law, and administrative procedure law. It consists of around 2200 judicial interpretations issued solely by the Supreme People’s Court or jointly with other central state organs from October 1949 to June 1993, and is a very useful archival source of early judicial interpretations.

In addition to the official publications mentioned above, a commercial collection deserving of mention is: ‘A Complete Collection of Judicial Interpretations of New China: October 1949 – June 1990’ and its enlarged edition, June 1990 – June 1992. This collection, dividing judicial documents into several parts covering criminal and civil affairs, criminal and civil procedures, administrative law, lawyers and notarisation,
and judiciary involving foreign interests, records a great many judicial documents issued by the Supreme People’s Court and the Supreme People’s Procuratorate as well as other normative documents such as legislative interpretation, law, policy, circulars, and replies that have been adopted or promulgated by NPC, the State Council and Ministries and Commissions concerned. Additionally, there is an English list of legislative enactments and judicial documents issued from June 1990 to June 1992, in the end of the enlarged edition which may prove useful to foreign readers.

As Chen has pointed out, ‘As Chinese laws are mostly made in general and vague terms, their interpretation by various authorities effectively forms an important source of law.’ Judicial interpretations by the Supreme People’s Court have binding force on local People’s Courts at all levels and special People’s Courts. In practice, it has the same effect as laws and forms an important component of the legal system in China.

2.11 The Dispute Resolution Process

2.11.1 A Hypothetical Dispute Involving a Foreign Investor

To unravel some of the complexities of the legal system it may be instructive to take a hypothetical example of a dispute occurring between a foreign investor — ABC (Australia) Pty Limited (ABC) and its Chinese business partner — Sheng Wah Industries Co (SWI) and to work through some possible legal processes available to the parties in their attempts to resolve the issue between them.

134 Jianfu Chen, Chinese Law above n 122, 106.
136 Ibid.
137 The names used and the circumstances referred to in this hypothetical scenario are imaginary and bear no resemblance to any persons, organisations or circumstances known to the writer. The same is so in the case of the references to Courts and Government authorities. Any resemblance to any actual persons, circumstances, or any organisation is totally accidental.
2.11.2 The Background of the Dispute

SWI and ABC at the outset engaged in a number of meetings during which they discussed all facets of the plan to work together to produce a range of goods, designed by ABC and manufactured in China by SWI. One of the components of the final products of the production process is manufactured in Malaysia under a pre-existing contract between ABC and a Malaysian company (the imported components).

The negotiations between ABC and SWI progressed well. Registration processes were commenced and a contract was drafted (with Chinese and English versions) to express the terms agreed by the parties. The contract was signed by the parties and all registration requirements were properly executed. The manufacture and marketing of the products commenced.

For the purpose of this exercise the contract between ABC and SWI formed another company SWAB Equity Joint Venture Co, a company that was registered under the terms of the \textit{Equity Joint Ventures Law of the People’s Republic of China 2001}^{138} (EJV law) as an Equity Joint Venture (EJV).^{139} The registration application of SWAB Equity Joint Venture Co and all manufacturing, safety standards and environmental requirements also satisfied all regulations and other approval requirements of the local Municipal Government, which had given approval for the commencement of the operation.

The contract between the parties was based upon the standard contract form as appeared in the EJV Law. There was no provision in the contract that specifically addressed the means by which equity values, that is, monetary equivalents of assets and

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139 Note: Substantial details in respect of specific Chinese laws relating to foreign direct investment matters are contained in the following chapter.
so on brought to the venture by a party, were assessed other than that this was left to the parties to negotiate and agree.

In this example, the equity of the partners was agreed between the parties in the contract and included both actual monetary amounts contributed by each party and the monetary value attributed to the manufacturing costs in the case of SWI and the monetary value of the product designs and the imported components supply in the case of ABC. The parties were to jointly share the costs of marketing and distribution of the products. The business commenced operations and in six months was already selling its product in China and overseas.

2.11.3 The Dispute

A dispute arose when SWI subsequently complained that ABC had over-valued the Malaysian manufactured components, and it demanded that equity levels between the parties be adjusted according to a new, and lower, value of the imported components as suggested by SWI. Negotiations on this issue failed to reach a solution. SWI then began paying ABC a lower level of profit payments according to SWI's re-calculation of the equity contribution by ABC.

Under the law and the contract, three methods of resolving the impasse were available to the parties, comprising semi-formal conciliation, formal arbitration and litigation. ABC refused to engage in conciliation or arbitration as it was entitled to do under the contract and commenced a claim against SWI for breach of contract. SWI countered by claiming misrepresentation at the contract formation stage.
2.11.4 Referral to the Court

The dispute was notified to the Court and was heard in the Basic People’s Court in the first instance. In the result ABC failed in its claim of breach of contract by SWI on the basis that SWI had continued to fulfill its obligations under the contract. SWI was successful in its counter claim, as ABC was found by the Court to have inflated the costs of the imported components on the basis of a purported independent opinion as to their value, which was supplied to the Court by SWI. The Court ordered a re-valuation of the imported components for the purpose of the equity input and profit sharing provisions of the contract.

In its deliberations the Court examined the question of whether any laws (other than the EJV Law) applied to the dispute and in doing so satisfied itself that the operations of SWAB Equity Joint Venture Co were not in breach of any other laws or regulations.

ABC instructed its solicitor to file an appeal against the decision. The solicitor advised ABC that only one appeal was available under Chinese law and that the matter would be concluded at the appeal. ABC arranged to acquire another independent opinion as to the value of the imported components. The papers were filed in the Intermediate People’s Court. SWI’s solicitor was provided with a copy of an independent valuation of the imported components acquired by ABC that gave a value close to, but a little less than, that originally claimed by ABC in the contract negotiations.

2.11.5 Informal Conciliation

In the period before the matter was to be heard in the Intermediate Court, the solicitor for SWI indicated that her client was prepared to negotiate on the matter of the value of
the imported components. The parties entered negotiations and subsequently agreed to a new value of the imported components. The Appeal was withdrawn and the Basic People’s Court and the Intermediate Court were notified that the dispute had been settled to the satisfaction of both parties.

In the above example it can be seen that a number of aspects of the legal system are pertinent.

2.11.6 Project Approval

In terms of the initial registration requirements of a project, there is an approval (examination) process that must be completed. The monetary values involved and the significance of the project in local, regional or national terms are some of the criteria that are assessed to conclude which of the local, regional or national levels of government are able to approve the project. In this hypothetical case the municipal government was competent to approve the project and did so once all its registration requirements were satisfied. As the Municipal Government was empowered to make local regulations it was the authority that was able to approve the project or otherwise.

2.11.7 The Court’s Jurisdiction

The Basic People’s Courts and the Intermediate Courts in municipal or regional locations are funded by the local and regional governments with judges in those Courts being appointed by the relevant local and regional governments. In Chinese law there is clearly no formal separation of powers requirement in operation to purportedly insulate judicial powers from the powers of government(s). Whilst the concept of separation of powers is a component of constitutional systems in many Western countries and is seen to be an essential element of democratic government, the degree of separation may
sometimes seem to be illusory. This is because in many cases the political party having power in the parliament appoints members of the judiciary as a matter of course. In the final analysis, the integrity of individual judges is the final test as to the independence or otherwise of their decision-making by reference to prevailing government policies.

2.11.8 The Court’s Role in the Dispute

In the above hypothetical scenario, once having been notified of a dispute the Court had a very wide authority to examine every detail of, not only the dispute factors, but also all aspects of the registration process, compliance with all operational regulatory requirements, and compliance with any other applicable laws regulating a particular industry pursuant to the court’s power under the Civil Procedure Law of the People’s Republic of China 2008.\(^\text{140}\)

In this case, having satisfied itself that the operation was properly registered and that its operations were in accordance with the law, including the Regulations for the Implementation of the Equity Joint Ventures Law of the People’s Republic of China 2001,\(^\text{141}\) it turned its attention to the details of the dispute and considered that the dispute would be decided on the basis of the parties’ compliance or otherwise with the General Principles of Civil Law of the People’s Republic of China 1987\(^\text{142}\) and the provisions of the Contract Law of the People’s Republic of China 1999.\(^\text{143}\)


\(^{143}\) [Contract Law of the People’s Republic of China] (People’s Republic of China) National People’s Congress, Order No 15, 1 October 1999. It was passed on 15 March at the 2nd Session of the 9th National People’s Congress and was effective from 1 October 1999.
2.12 Conciliation, Arbitration and Appeal Processes

It is the general case in China that when a matter is heard by a Court in the first instance, only one appeal opportunity is available to a party. A matter would be re-examined \textit{in toto} by the (appeal) Court and the resulting judgment binding upon the parties. Whilst it is possible for a question of interpretation of law arising during the appeal process to be further examined within the Court system, this is a process in which the parties would have no role. Such an investigation would be conducted on the Court’s initiative and may be referred by the Court to a higher level Court, such as the Supreme People’s Court. The outcome of such a process may ultimately be of benefit to a party in the original dispute. In such a circumstance, the Court that heard the appeal would notify the parties of the outcome of any review, modifying the judicial outcome if necessary.

In the hypothetical case outlined above, mention was made of two other dispute resolution processes available to the parties (but not mandatory). These were formal conciliation or formal arbitration, the former being conducted within the Court and the latter in an Arbitration Commission. In the conciliation process, both parties must initially sign their agreement to be bound by the Conciliation Statement resulting from such conciliation. No review process is available to the parties. Such is also the case with the formal Arbitration process with the parties being bound by the Arbitrator’s decision and with no right of appeal.\footnote{<<中华人民共和国仲裁法>> [Arbitration Law of the People’s Republic of China] (People’s Republic of China) National People’s Congress Standing Committee, Order No 31, 31 August 1994, art 52.}

The lack of availability of any further judicial consideration of the matter in either case is perhaps one reason that parties in such circumstances may choose against following those avenues of dispute resolution. However, both processes are much less
costly than litigation in terms of both time and legal expenses and are very commonly utilised in domestic dispute resolution.\textsuperscript{145} The long, drawn out and expensive litigation path can often not only damage one or both parties financially but will also often lead to an irrevocable breakdown of the parties’ relationship.\textsuperscript{146} According to the China International Economic and Trade Arbitration Commission, arbitration is a preferred dispute resolution method for foreign investors. There are currently 174 arbitration organisations.\textsuperscript{147}

It is suggested in this research that for the Chinese, the non-litigious dispute resolution pathway is a far more culturally effective means of resolving differences whilst maintaining good, or at least ongoing and workable, relationships. This ‘non-litigious’ aspect of the Chinese culture has a long-standing history and is believed, by this researcher, to constitute a central element of the differences in approach of the Chinese to business generally that has been experienced by new foreign investors in China. This aspect is further explored in Chapter 7 of this study.

\textbf{2.13 Conclusions}

Three decades ago, when China launched the country’s impressive modernisation programme, the importance of constructing a legal system commensurate with China’s new economic reform was recognised. The Chinese legal system has been developing within the changing economic, social and political environments. The legal system must fulfill many functions including provision for orderly and efficient conduct of


\textsuperscript{146} Ibid.

government not only at the central level but also at the provincial and local levels of a vast land and population. It has certainly facilitated domestic industrial and commercial development and international trade and investment. The development of law and legal institutions has contributed to a raised awareness of law as well as an improved consciousness of rights. Profound social and economic change has fostered this trend.

On first view, however, the legal and judicial system may appear to be somewhat confusing and convoluted to the newcomer. The ‘newcomer’, for the purpose of this study, is regarded as the foreign party (either an individual or a corporate entity) that has commenced or planned to commence a business operation in China in cooperation with a local Chinese person or company.

This chapter has discussed the background of the legal system in China prior to and subsequent to the CPC taking power. Then a major political change that occurred in the late 1970s saw the beginning of a new era in the Chinese legal system with radical policy changes, constitutional changes and the promulgation of new laws that, together, formed the basis of a system that enabled the PRC to expand massively on the international economic stage.

The Chinese law-making and judicial systems have been extensively discussed here and show structures with unique characteristics. Clearly, the CPC has been careful to avoid allowing slippage of its political control and continues to exercise such control by holding a tight rein upon the court system, administrative and regulatory processes and the law-making system. In terms of the activities of foreign investors, who continue to take advantage of low production costs and substantial investment subsidies, there appears to be a pragmatic acceptance of the CPC’s continuing control as the advantages seem to outweigh the disadvantages.\(^\text{148}\) This appears to have created a fairly stable

investment environment that continues to grow at a steady rate. Quantifying such
growth, Yao Jingyuan, a chief economist with the National Bureau of Statistics of
China, said that over the past decade China’s foreign direct investment reached
USD653.14 billion at a steady annual growth rate of 9.5 per cent.\textsuperscript{149} For local
enterprises without foreign partners, the sizes of the markets inside and outside of China
continue to be so enormous that their own growth into the future seems to be without
substantial risk. The inconvenience of high levels of administrative control and even
manipulation within the administrative and judicial systems in China do not appear, in
broad terms, to have adversely impacted upon either wholly local entrepreneurs or
foreign investors or combinations of the two.\textsuperscript{150}

In respect of dispute resolution — an aspect of major importance in business
relationships and activity — the existing dispute resolution procedures, with an
emphasis upon non-litigious resolution, would not normally be the natural preference
for Western business practitioners. However, in the final analysis, the conciliation
processes in the PRC have developed to such a level and fit so well with Chinese ways
that it is confidently suggested here that foreign investors in the PRC would benefit
greatly from adopting such methods as standard operating procedure rather than
instinctively looking to the formal court system for satisfaction.

Additionally, the ‘once only’ restriction in respect of appeals at the formal court
level whilst initially appearing to be overly restrictive to the Western litigant can be

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\textsuperscript{149} Ministry of Commerce of the PRC, ‘Foreign Investment Hits USD653 Billion in Decade’ (6 June
2011) Ministry of Commerce of the PRC
\textltt{http://english.mofcom.gov.cn/aarticle/newsrelease/counseloroffice/westernasiaandafricareport/201106/
20110607586735.html}.

\textsuperscript{150} See Yang Yao and Linda Yueh, ‘Law, Finance and Economic Growth in China: An Introduction’
viewed as something of a refreshing and certainly cost effective improvement upon the normal Western court process.

Ultimately it is for foreign investors to decide whether the laws and regulations controlling their proposed business activity in China are too restrictive upon them and this will nearly always be decided by the assessments they make as to the effects upon potential profits. The experience of the past 30 years shows that even with frustrations, some dissatisfaction and failed enterprises, more foreign investors are starting business with entities within the PRC and, with the continuing upgrading of foreign investment laws, such growth is unlikely to cease.\textsuperscript{151}

In China, foreign investment law is still under development. National laws, particularly dealing with foreign direct investment, are limited. No doubt foreign investors’ primary concerns are stability and the development of the Chinese legal environment. This chapter has provided some consideration of these issues. Nevertheless they are only part of the explanation. It is suggested here that a more thorough understanding of the Chinese way of thinking and doing business (that are still dominant in Chinese society today) would assist in understanding why things happen as they do.

To assist in achieving such an understanding it will be useful to further explore some historical background. The following chapter discusses aspects of Chinese history to attempt to further explain the significance of the ways the Chinese do business.


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Chapter 3

The Tradition of Chinese Law — Philosophies and Political-legal Powers

3.1 Introduction

In the study of the nature and development of legal system of China it is essential to have a fundamental understanding of China’s long history of legal culture and law. The features of law in any given society are shaped by cultural heritage.\(^1\) Although China is not a westernised democratic society, its modernisation and reform starting in the late 1970s has raised the question of whether these economic and legal developments will lead China in the direction of political democracy and economic privatisation. It is suggested in this research that in order to understand China’s legal system and economic reform today, we need to know China’s legal tradition and the role of law in the past.

The Chinese legal tradition developed from both Confucianism and Legalism, two influential schools of thought.\(^2\) This Chapter will not be able to deal with the historical legal heritage of China in extensive detail but will present a brief background of the development of legal history to provide a better understanding of the origins of the current legal system. The traditions of Confucianism and Legalism are explored to endeavour to identify the extent to which they are underlying influences in the modern Chinese legal system. Section

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3.2 presents a background of the earliest legal history of China. Confucian world views in their social and legal context are explored in section 3.3 Section 3.4 examines the scope of Confucian influence and the Confucian inheritance, and explains the feudal Imperial Examination System. The section also deals with the concepts of social stratification, and hierarchy and law and ethics. Section 3.5 analyses the main features of the Legalist philosophy, including the roles of the major players and the lack of individual rights of the people. Section 3.6 summarises the outcome of the competing philosophies of Legalism and Confucianism. Section 3.7 summarises and concludes the chapter.

### 3.2 Background of Early Chinese Legal History

China has a full and extensive history spanning several thousands of years of civilisation and different kinds of laws and legal systems have been adopted in accordance with varying social orders.\(^3\) However, one of the major misconceptions about traditional Chinese society is that there was no law in traditional China.\(^4\) On the contrary, law in China has a long history and abundant sources.\(^5\) Traditional Chinese legal history and structure can be characterised as: feudalism, imperialism, and rule under emperors.\(^6\) Legal codes also existed in traditional China, with the oldest surviving code being the Tang Code\(^7\) promulgated in the seventh century AD.\(^8\) The Tang Code constituted the foundation for the later developed codes of the Song, Yuan, Ming and Qing dynasties. These codes and statutes of law regulated matters that would be considered under criminal law in the modern

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\(^3\) Ibid 1.
\(^4\) Jianfu Chen, *Chinese Law* above n 1, 6.
\(^5\) Ibid.
\(^7\) The *Tang Code* first promulgated in 625AD, with 502 articles in total, contained not only legal provisions, but also commentaries which traced the historical origins of various provisions.
\(^8\) Ibid.
legal approach. Further, there was no jurisprudential distinction between criminal and civil law, as penal sanctions occasionally applied to acts that would today be covered by civil law. The lowest ranking local official in ancient China who represented the central government were the district magistrates. Each of these magistrates exercised all of the powers of the state in collecting taxes, providing for defence, carrying out public works, conducting religious ceremonies, supervising the local examination system for entry into the civil service, and deciding lawsuits etc. Disputes between individuals dealing with family matters or land were generally settled through mediation. Such informal resolutions were conducted by respected leaders or elders in the villages, who applied customary rules and concepts of morality to reach harmony between disgruntled individuals.

In traditional China the emperor was vested with executive, legislative and judicial powers. The state structure over which Chinese emperors presided had the continuing characteristic of being organised into three functionally differentiated hierarchies, each comprising agencies extending from the central government down to regional and local levels.

Ch 3: The Tradition of Chinese Law

The traditional legal system continued from one dynasty to another for several thousand years (see Table 8.1, 274). Traditional Chinese conceptions of law have been largely influenced by writings of traditional schools of philosophy.\textsuperscript{14} The most dominant of these was Confucianism, which had at its heart an emphasis on the educational function of morality (\textit{Li}) in governing a state.\textsuperscript{15} The traditional society and legal culture are often described as ‘Confucian’.\textsuperscript{16} Certain fundamental features of the traditional legal culture clearly persist in the contemporary legal system and social attitudes towards law.\textsuperscript{17}

From the Chinese point of view, the central element of their legal system was a body of rules promulgated by the emperor.\textsuperscript{18} Traditionally law had been used as an instrument to consolidate political power with administrative organs often having supreme power over the law as they exercised power on behalf of the emperor.\textsuperscript{19} The most striking aspect of this system was its intimate connection with the administration system of the central government. This system of government had developed in China after its unification in the third century BC. It consisted of a strong central government headed by the emperor who ruled through the highly centralised bureaucracy.\textsuperscript{20} There was no separation of power between the judiciary and administration. Social order very much relied upon the influence of education in morality.\textsuperscript{21} Confucian thought had been the major part of social education

\textsuperscript{14} Jianfu Chen, \textit{Chinese Law} above n 1, 7.
\textsuperscript{15} Ibid.
\textsuperscript{16} Ibid 4.
\textsuperscript{17} Ibid 7.
\textsuperscript{18} William C Jones, ‘Try to Understand’ above n 10, 9.
over thousands of years.\textsuperscript{22} These profound influences penetrated Chinese society in every way, and it still shows within the way people think and act.

From observations in earlier chapters of the ways in which foreign investment in China has been operating in the legal environment, it is difficult to avoid the inference that the application of law continues to be significantly impacted by social conditions and traditional customs. These informal norms appear to play a much more important role than we might imagine. Menski asserts:

Equally important in social reality, however, was the un-codified system of Chinese cultural norms, which is often subsumed under the label of morality or ‘Confucian ethics’, but is manifestly a legal force of great relevance for understanding how ancient China (and, as we shall see, modern Chinese law) actually functioned.\textsuperscript{23}

It is apparent that there is a need to consider the Chinese characteristics of law and specific cultural aspects in order to assess the nature of the modern interplay between the law and culture. Menski finds:

The Chinese characteristics of this interactive pattern, at first sight, appear to be that the domination of the official state law is a central issue, while the spheres of religion and the Chinese worldview seem far less important. But the formal structures of Chinese state law have almost always been applied in such a way that a subtle balancing act between the spheres of religion, society and state remains a core concern at all times.\textsuperscript{24}

Civilisation flourished in China for thousands of years in relative isolation from the rest of the world against the background of physical and cultural variety. There were three broadly unifying features which were interrelated: dependence on irrigated agriculture; a

\textsuperscript{24} Ibid 441.
centralised, bureaucratic administration; and a literary tradition.\textsuperscript{25} It has been said that in
China the creation of formal law is much easier than its application since informal legal
traditions continue to dominate modern, formal ones.\textsuperscript{26} The most important elements were
ethical philosophy and history.\textsuperscript{27}

In Chinese history, the fifth Han Emperor, Wu (147 BC) found Confucianism well
suited to the conditions of ancient China.\textsuperscript{28} In order to consolidate and strengthen the feudal
system, the Confucian school of thought or philosophy was adopted officially as the
prevailing orthodoxy and as a result a pattern of feudal legal thought was developed.\textsuperscript{29}
Probably the greatest traditional source of behavioural norms in Asia is Confucianism.\textsuperscript{30}

\textbf{Table 3.1: Chinese Dynastic Timeline}\textsuperscript{31}

<table>
<thead>
<tr>
<th>Dynasty</th>
<th>Years</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yellow Emperor to Five Emperors Period</td>
<td>2698 BC–2000 BC</td>
</tr>
<tr>
<td>Xia</td>
<td>2000 BC–1500 BC</td>
</tr>
<tr>
<td>Shang</td>
<td>1500 BC–1000 BC</td>
</tr>
<tr>
<td>Western Zhou</td>
<td>1000 BC–771 BC</td>
</tr>
</tbody>
</table>

\textsuperscript{26} H Patrick Glenn, \textit{Legal Traditions of the World} (Oxford University Press, 2\textsuperscript{nd} ed, 2004) 302.
\textsuperscript{27} Zhu Yong (Translated), Derke Bodde and Clarence Morris, \textit{Law in Imperial China} (Jiangsu People’s Press, 2003) 6–7.
\textsuperscript{29} Xu Xiaming, Liu Ducai, Ma Jianhong, \textit{History of Chinese Legal Thoughts} (Beijing University Press, 2004) 188.
\textsuperscript{30} Ibid 302.
\textsuperscript{31} Bodo Wiethoff, \textit{Introduction to Chinese History: From Ancient Times to 1912} (Thames and Hudson, 1975) 179.
<table>
<thead>
<tr>
<th>Period</th>
<th>Dates</th>
</tr>
</thead>
<tbody>
<tr>
<td>Eastern Zhou</td>
<td>771 BC–249 BC</td>
</tr>
<tr>
<td>Spring and Autumn Period</td>
<td>771 BC–481 BC</td>
</tr>
<tr>
<td>Time of the Warring States</td>
<td>480 BC–221 BC</td>
</tr>
<tr>
<td>Qin</td>
<td>221 BC–207 BC</td>
</tr>
<tr>
<td>Western Han</td>
<td>206 BC–AD 8</td>
</tr>
<tr>
<td>Xin</td>
<td>AD 9–AD 23</td>
</tr>
<tr>
<td>Eastern Han</td>
<td>AD 23–AD 220</td>
</tr>
<tr>
<td>Three Kingdoms</td>
<td>AD 220–AD 280</td>
</tr>
<tr>
<td>Western Jin</td>
<td>AD 265–AD 317</td>
</tr>
<tr>
<td>Eastern Jin</td>
<td>AD 317–AD 420</td>
</tr>
<tr>
<td>Southern and Northern</td>
<td>AD 420–AD 481</td>
</tr>
<tr>
<td>Sui</td>
<td>AD 481–AD 618</td>
</tr>
<tr>
<td>Tang</td>
<td>AD 618–AD 906</td>
</tr>
<tr>
<td>Five Dynasties and Ten States</td>
<td>AD 907–AD 960</td>
</tr>
<tr>
<td>Liao</td>
<td>AD 937–AD 1125</td>
</tr>
<tr>
<td>Northern Song</td>
<td>AD 960–AD 1126</td>
</tr>
<tr>
<td>Southern Song</td>
<td>AD 1127–AD 1279</td>
</tr>
<tr>
<td>Western Xia</td>
<td>AD 990–AD 1227</td>
</tr>
<tr>
<td>Jin</td>
<td>AD 1115–AD 1234</td>
</tr>
<tr>
<td>Yuan</td>
<td>AD 1260–AD 1367</td>
</tr>
<tr>
<td>Ming</td>
<td>AD 1368–AD 1644</td>
</tr>
<tr>
<td>Qing</td>
<td>AD 1644–AD 1912</td>
</tr>
</tbody>
</table>


### 3.3 Confucian World Views in Their Social and Legal Context

In any interdisciplinary legal study a consideration of intellectual, conceptual and social frameworks is important. It is particularly the case for a study of Chinese law. Several
major elements of traditional Chinese philosophy appear to be central to an understanding of the socio-legal environment of traditional Chinese law. Chinese philosophy can throw light upon the background of Chinese thinking from ancient times down to the present time.\(^{32}\) Chan suggests:

> If one word could characterise the entire history of Chinese philosophy, that word would be humanism – not the humanism that denies or slights a Supreme Power, but one that professes the unity of man and heaven.\(^ {33}\)

Confucianism is based primarily on the great books, all written or edited by disciples of Confucius.\(^ {34}\) Confucius was the first person in Chinese history to teach large numbers of students. He was accompanied by such students during his travels in different states.\(^ {35}\) There is no question that he was a very influential teacher and, what is more important and unique, China’s first private teacher.\(^ {36}\) His ideas are best known through the *Lun Yu* (or *Confucian Analects*), a collection of his scattered sayings which was compiled by some of his disciples.\(^ {37}\) It begins with the development of man’s personality and virtues through the cultivation of humane and social relations and ends with the prerequisites for government leading to the final achievement of an ideal world commonwealth. When the right relations among men are established, it was easy, Confucius felt, to achieve a harmonious family, a peaceful state, and eventually a global commonwealth.\(^ {38}\)


\(^{34}\) Confucius is the Latinised name of the person who has been known in China as K’ung Tzu or Master K’ung. He was born in 551 BC in the state of Lu, in the southern part of the present Shandong Province in eastern China.

\(^{35}\) Fung Yu-Lan, *A Short History* above n 22, 39.

\(^{36}\) Ibid.

\(^{37}\) Ibid.

It seems hard to believe that a philosophy that began 2500 years ago is still the dominant influence on a major modern power. Chinese legal tradition indigenously developed a vast bureaucracy for social control based on the philosophical teaching of Confucian moral codes that was endorsed by Chinese imperial rulers for more than two millennia.\textsuperscript{39} That is, in essence, the role that Confucianism has played in China. Confucianism affects individual morality, the roles of family members, the roles of the individual in society, as well as the manner in which government must act. In short, this ancient teaching dominated and continues its influence in almost every aspect of daily Chinese life.

Confucius’ central beliefs in government tie directly into the traditional Chinese belief in the Mandate of Heaven. When a new dynasty claimed power, it was said to have claimed the Mandate of Heaven.\textsuperscript{40} However, Confucius did not comment on religion.

The Han was not the only dynasty in which the impact of Confucius was of great importance. When Confucius was still under the age of 50, he was conscious of ordinary moral values which he believed to be the most important part of a strong society. He chose students who were known for their virtue, who were gifted in art or speech, who were distinguished in government, or those who were eminent in literature. However, it is now believed that Confucius just made these ideas prominent through the teaching of them.\textsuperscript{41} It was not until he was 50 or 60 years of age that he even became aware of supra-moral values, those that deal with the ideas of heaven and spirituality beyond what one

\textsuperscript{39} Xin Ren, \textit{Tradition of the Law} above n 2, 3.
\textsuperscript{40} See John T Meskill, An Introduction to Chinese Civilisation (Columbia University Press, 1973) 556.
\textsuperscript{41} Fung Yu-Lan (Translated by Derk Bodde), \textit{A History of Chinese Philosophy: The Period of the Philosophers} (Henri Vetch, 1937) 44–5.
experiences on earth.\textsuperscript{42} From his view of the quest for individual perfection and familial and societal relationships, as well as the way in which he taught, came his view of how government should function.

Confucius sought to create, by the unification of the minds of humanity, a homogeneous community of all humanity, in which there would be general and voluntary agreement regarding the objects worthy of desire and in which the careless, the selfish, and the anti-social would be subdued by the transforming influences of good example and exhortation.\textsuperscript{43} Measured against the standard of perfection, of course, the sage’s world commonwealth remained a happy and wishful dream.\textsuperscript{44} Even so, it had far-reaching beneficial consequences for his people who for two thousand years recognised him as their ‘master teacher’.\textsuperscript{45}

The fundamental idea was that there is a cosmic order of things involving a reciprocal interaction between heaven, earth and humans.\textsuperscript{46} Heaven and earth observe invariable rules in their movement, but people are in charge of their own acts; and according to the way in which they behave, there will be order or disorder in the world.\textsuperscript{47} The traditional Chinese concept of the social order is thoroughly discussed in the \textit{Li Chi} (Book of Rites).\textsuperscript{48} \textit{Li}, as the key concept of Chinese legal philosophy, represents an ideal model of self-controlled ordering. The ideal is that laws never be applied and that the courts never render decisions; but that through exhortation and example (education and

\begin{thebibliography}{99}
\bibitem{42} Fung Yu-Lan, \textit{A Short History} above n 22, 46.
\bibitem{43} Fung Yu-Lan (Translated by Derk Bodde), \textit{A History of Chinese}, above n 41, 73–5.
\bibitem{44} John E Schrecker, \textit{The Chinese Revolution}, above n 25, 18.
\bibitem{45} Fung Yu-Lan, \textit{A Short History} above n 22, 39.
\bibitem{46} Ibid 6–7.
\bibitem{48} Clarence Burton Day, \textit{The Philosophers of China} above n 32, 38.
\end{thebibliography}
experience) right action is attained. The philosophy explains how these societal, moral and ethical values worked within the social context and begins to prepare the ground for their legal application.49

The harmony upon which the world’s balance and human happiness depends has two aspects.50 It is first of all a harmony between human beings and nature.51 Human behaviour must be co-ordinated with the order of nature. Confucius believed that there were aspects of heaven’s overwhelming power that could never be controlled by human power.52 Natural disasters, such as drought and famine, continually occurred. The unpredictable forces of nature could still destroy crops and render people destitute in spite of their efforts. In the case of our ancestors, the predominance of nature over their destiny gradually crystallised itself into a concept of an omnipotent Heaven.53 The heart of Confucius’s teaching is that the key to righteousness and welfare is the attainment and maintenance of harmony. If human beings damaged the necessary harmony between man and nature, they would fall into discord among themselves.54 Virtue and morality so conceived were thus more important qualities in administrators than any technical expertise.55

The second harmonious relationship that must exist is that between human beings. Confucianism emphasised the duties and obligations of people rather than their individual

49 Ibid 447.
50 Chenyang Li, The Philosophy of Harmony in Classical Confucianism (Central Washington University, 2008) 1.
51 James M Zimmerman, China Law Deskbook, American Bar Association, Section of International Law (Quorum Books, 1992) 32.
52 Masayuki Sato, The Confucian Quest for Order: The Origin and Formation of the Political Thought of Xun Zi (Brill, 2003) 98.
rights. The focus is more on the interests and harmony of the family, clan, or the community rather than the rights of the single person. The ideas of conciliation and consensus must be primary in social relations. All condemnations, sanctions and majority decisions must be avoided. Contestations and disputes must be dissolved rather than resolved or decided; the solution proposed must be freely accepted by each because s/he considers it to be just. No one, therefore, should come away with the feeling that they have ‘lost face’. Education and persuasion must prevail, not authority or force.

3.4 The Scope of Confucian Influence

The form of social order which for centuries represented the ideal in China was that proposed by Confucianism. Confucianism as a philosophy has performed an important role in China’s history. Kong Fu Ze, called ‘Confucius’, lived from 551 to 479 BC. He can truly be said to have moulded Chinese civilisation in general terms, yet it was more than 300 years after his death before his philosophy found acceptance.

Confucianism, with its emphasis on social rank and ethics catered admirably to the needs of a strong centralised monarchy. A centralised, hierarchical bureaucracy that identified itself with an ethical and political orthodoxy, was able to impose a ‘picture of society’ upon the governed. This was a major departure from the established social order. From the Han era (206 BC–AD 220) onward, Confucianism held a dominant position in

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56 Ibid.
57 See Fung Yu-Lan, A Short History above n 22, 41–2.
59 Wing-Tsit Chan, A Source Book above n 33, 14.
60 Ibid 444.
China.\(^61\) It performed an important role in reinforcing the centralised monarchy and shaping ideology. In AD 134 a famous Confucian scholar, Dong Zhongsu, proposed the banning of all schools of thought except the Confucian school.\(^62\) This proposal was accepted by the ruling emperor.\(^63\) It was Dong who established the Confucian patriarchal conception of ‘letting a king be a king, a minister be a minister, a father be a father, and a son be a son’.\(^64\) From this premise the three cardinal guidelines evolved. Rulers guide subjects, fathers guide sons, and husbands guide wives. The most important relationships were often said to be the three bonds: husband-wife, father-son and ruler-minister.\(^65\) Dong also established the five constant virtues; benevolence, righteousness, propriety, wisdom, and fidelity.\(^66\) Dong further advanced the theory of the integration of heaven and man. This conception asserted that the emperor, as the son of heaven, was sacred and everlasting.

Dong strengthened the centralised monarchy by providing a theoretical basis for the existence of monolithic rule.\(^67\) The philosophy of Dong Zhongshu is a mixture of theories of Confucianism.\(^68\) The administrative bureaucracy in ancient China was composed of three levels: the leading centre, the central organ, and the local organ.\(^69\) From about 150 BC until the beginning of last century, the emperor exercised supreme command in China through a well-organised administrative bureaucracy.\(^70\) This process was further reinforced by the

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\(^ {63}\) 马志冰 [Ma Zhibing], above n 19, 3.
\(^ {64}\) 徐祥民，刘笃才，马建红 [Xu Xiaming, Liu Ducai, Ma Jianhong], above n 29, 201.
\(^ {66}\) Ibid.
\(^ {68}\) Jianfu Chen, *Chinese Law* above n 1, 13.
\(^ {69}\) Laurence Jacobs et al, ‘Confucian Roots in China’ above n 67, 29.
\(^ {70}\) Ibid.
direct influence of Confucianism in the administration of justice.\textsuperscript{71} Confucianism had absorbed many ideas from other rival schools including Legalism which will be discussed later in this chapter.

Confucianism is not a religion in the strict sense, but Confucian values have historically exerted a profound and lasting influence on China (and East Asia) over a period of more than two thousand years.\textsuperscript{72} It spread to the rest of East Asia as an exemplary teaching of harmonious social and moral order. Confucianism was not an organised missionary tradition, but by the first century BC it had spread to those \textit{East Asian countries} that were under the influence of Chinese literary culture.\textsuperscript{73} For this reason, for the purpose only of comparison with western moral authorities, it may be regarded here as a religion.

In the 16\textsuperscript{th} century, the first attempt by Catholic missionaries to gain admission into China was made by the founder of the Chinese mission and also the most important figure in its whole history, Matteo Ricci.\textsuperscript{74} In 1636, within a population of about 150 million, the number of Christians in China was estimated to be 38,200.\textsuperscript{75} From his knowledge of the bureaucratic structure of Chinese society, Ricci drew the conclusion that only a close link with the ruling literary and official class, and if possible with its highest grades, could provide the missionaries with a relatively respected and assured status in China.\textsuperscript{76} In the 17\textsuperscript{th} and 18\textsuperscript{th} centuries, the philosophy of European Enlightenment challenged, under rationalistic and scientific claims, the contents of the Christian faith. It was a process of

\begin{flushleft}
\textsuperscript{71} Ibid 14.  \\
\textsuperscript{72} Wing-Tsit Chan, \textit{A Source Book} above n 33.  \\
\textsuperscript{73} Lynn Harry Nelson and Steven K Drummond, \textit{The Human Perspective: The Ancient World to the Modern Era} (Harcourt Brace College Publishers, 1997) 89.  \\
\textsuperscript{74} Wolfgang Franke (Translated by R A Wilson), \textit{China and the West} (University of South Carolina Press, 1967) 34.  \\
\textsuperscript{75} Ibid 35.  \\
\textsuperscript{76} Ibid 36.
\end{flushleft}
secularisation in which a separation of Church and state firstly occurred, leading in the end to the marginalisation of the churches. A similar process of secularisation never took place in China. Some of the reasons for that were, according to Franke:

Certain traditional Chinese customs and ways of thought were opposed to Christian teaching. In particular, the thinking of the educated class formed by Confucianism was agnostic and unfavourable to all metaphysic, and concentrated on this world and its problems, and consequently made difficult the spread of a religious doctrine largely oriented towards the next world. It also seems that in spite of adoption of the Christian religion by educated Chinese, their traditional Confucian outlook remained predominant.

This does not mean that Confucianism, as its dominant ideology, had not been criticised. It had been blamed for all the ills of the traditional Chinese society during the May 4th period (1919) and, from a social-Darwinist point of view, it was deemed responsible for China’s backwardness in terms of economic, technological, military and political development. Although criticised, it never had to go through a process of secularisation as such, because Confucianism — as a form of social and political ethics — had always been a secular way of thought. After Confucianism assumed a dominant philosophical position in the Nan Dynasty (206 BC–AD 220), the rulers attached greater importance to ethics than to law as a tool of management. They believed that laws are externally enforced while ethics are moral commitments established over time. Thus, although Confucianism as an institution disappeared with the end of imperial China, it

78 Wolfgang Franke (Translated by R A Wilson), China and the West above n 74, 53–4.
79 Pingye Li, ‘How Do Social and Psychological Needs Impact the Existence and Growth of Christianity in Modern China?’ in Miikka Ruokanen and Paulos Huang (eds), Christianity and Chinese Culture (Win B Eerdmans Publishing, 2010) 211, 217. However, the critics of Confucianism in the May Fourth Movement of 1919 changed neither the essence of Chinese cultural secularism and utilitarianism nor the priority of community over individuals. This criticism has not led to change in the way of Chinese thinking, but it has shaken the Chinese power of criticism and principle of action and morality.
82 Ibid 30.
formed and, to an extent as post-Confucianism, still forms the ethical basis of Chinese society.

3.4.1 The Confucian Inheritance

Traditional Confucian thoughts have clearly shaped much of contemporary Chinese life after it dominated education for more than two thousand years. The belief in rule by an educated and functionally unspecialised elite was reflected in the attitude to education. The Confucians not only emphasised that education rather than heredity was the basis of virtue, but they also felt that nearly everyone was capable and worthy of receiving an education and so being capable of being good. The value placed on learning and propagating an orthodox ideology that focuses on society and government, and the stress on hierarchy and the pre-eminent role of the state were all carried over from traditional society. The fundamental way in which Confucianism seeks to achieve a good society is through a hierarchical system permeated with sense of responsibility by those above and obligation from those below. Some of the more radical and extreme policies of the 1950s and 1960s, such as attacks upon intellectuals and compulsory manual labour for bureaucrats, can be understood as responses to deep-rooted traditional attitudes. The role of model

83 John E Schrecker, *The Chinese Revolution* above n 25, 17
84 Ibid 14.
85 Ibid 221. The two catastrophic events during 1950s and 1960s in China were the Great Leap Forward (1958-1961) and the Cultural Revolution (1966-1976) that are considered the highpoint of what has come to be called “Maoism”, and the era itself is commonly referred to as the “Twenty Lost Years”.
86 Ibid 229–230. The Cultural Revolution emerged in full force in the summer of 1966, when Mao encouraged high school youth, college students, and other young people to organise Red Guard units. The Red Guards who were supposed to attack and depose “all those in command taking the capitalist path,” a group that, in practice, meant Communist cadres and, more broadly, all authority figures over the age of thirty. It was a time of humiliation, beatings, killings, and suicides, and those who perished probably numbered upward of half a million. Even more people were sent to prisons and work camps.
workers and soldiers,\(^87\) as well as official concern for the content and form of popular literature and the arts can be seen in the *Resolution Concerning Direction Guideline for Construction of Socialist Spiritual Civilisation 1986*\(^88\) which promoted the upholding of socialism and the Communist party through spiritual and moral education and also reflecting characteristically Chinese themes. In the mid 1980s a number of Chinese writers and political leaders identified the lingering hold of feudal attitudes, even within the Chinese Communist Party, as a major obstacle to modernisation.\(^89\) They identified such phenomena as authoritarianism, unthinking obedience to leaders, deprecation of expert knowledge, lack of appreciation for law, and the failure to apply laws to leaders, as feudal legacies that had not been addressed in the early years of China’s revolution.\(^90\)

Throughout the centuries some 80 to 90 per cent of the Chinese population had been farmers.\(^91\) Traditional Chinese society had been reliant upon agriculture. However, despite the differences that separated Chinese from the north to the south, they shared a perception of themselves as having not only a common political system but also a common cultural


\(^{89}\) Ibid para 5.

\(^{90}\) Ibid para 10.

\(^{91}\) William T Rowe, ‘Social Stability and Social Change’ in Willard J Peterson (ed), *The Cambridge History of China Volume 9: Part One, the Ch’ing Dynasty to 1800* (Cambridge University Press, 2002) 473, 537–8. In the eighteenth century approximately 5 per cent of the population lived in urban settlements. The urbanisation rate of the Lower Yangtze region was 7.4 per cent in 1843, as compared to perhaps 10 per cent in 1200.
heritage.\textsuperscript{92} The national elite, which comprised perhaps one per cent of China’s population, had a number of distinctive features. The upper members of the local elite might well be competing for power with a county magistrate within their communities.\textsuperscript{93} They were dispersed across the country and often lived in rural areas, where they were the dominant figures on the local scene.\textsuperscript{94} Although they held land, which they rented to tenant farmers, they neither possessed large estates like European nobles nor held hereditary titles. They achieved their highest and most prestigious titles by their performance on the central government’s triennial civil service examinations.\textsuperscript{95}

These titles had to be earned by each generation, and since the examinations had strict numerical quotas, competition was fierce. Government officials were selected from those who passed the examinations, which tested for mastery of the Confucian Classics.\textsuperscript{96} The examination syllabus was largely Confucian in nature.\textsuperscript{97} Many members of the elite would have been men who held the first or second degrees but had not succeeded in passing the final metropolitan examination. The qualification gave them status in their local communities as well as exemption from some taxes and from corporal punishment.\textsuperscript{98}

At the top of the social hierarchy structure in China were still an emperor and a hereditary dynasty.\textsuperscript{99} The imperial state was staffed by a small civil bureaucracy. Civil

\textsuperscript{92} Henrietta Harrison, \textit{Inventing the Nation: China} (Hodder Arnold, 2001) 9.
\textsuperscript{93} Ibid 16.
\textsuperscript{94} Ibid.
\textsuperscript{95} Insup Taylor and M Martin Taylor, \textit{Writing and Literacy in Chinese, Korean and Japanese} (John Benjamins Publishing, 1995) 148. The Chinese examination system was a civil service recruitment method and educational system employed from the Han Dynasty until it was abolished in 1905. The concept of a state ruled by men of ability and virtue was an outgrowth of Confucian philosophy.
\textsuperscript{96} Henrietta Harrison, \textit{Inventing the Nation} above n 92, 11–2.
\textsuperscript{97} Albert E Dien, \textit{State and Society in Early Medieval China} (Stanford University Press, 1990) 2.
\textsuperscript{98} Henrietta Harrison, \textit{Inventing the Nation} above n 92, 16.
\textsuperscript{99} John E Schrecker, \textit{The Chinese Revolution} above n 25, 44.
officials were directly appointed and paid by the emperor and must have passed the civil service examinations. Since the Ming dynasty, officials were supposed to owe their primary loyalty to the emperor and did not serve in their home provinces but were generally assigned to different places for each tour of duty. Although the salary of central officials was low, the positions offered great opportunities for personal enrichment, which was one reason that families competed so fiercely to pass the examinations and then obtain an appointment. For most officials, office-holding was not a lifetime career. They served one or more tours and then returned to their home districts and families, where their wealth, prestige, and network of official contacts made them dominant figures on the local scene.

3.4.2 The Feudal Imperial Examination System

In 607, Emperor Yangli of the Sui Dynasty (AD 581–618) completed possibly his most important contribution — the imperial examination system for the selection of officials. This Chinese imperial examination system was a method to evaluate ability and select officials in dynastic China on the basis of merit rather than social position or political connections.

Four Confucian books including the Great Learning, the Doctrine of the Mean, the Analects of Confucius, and the Mencius became Chinese students’ main textbooks for more

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101 马志冰 [Ma Zhibing], above n 19, 202: Henrietta Harrison, *Inventing the Nation* above n 92, 15–6.
102 Henrietta Harrison, *Inventing the Nation* above n 92, 14.
than 2000 years until the end of the Qing Dynasty (1644–1911).

In AD 5 Confucianism received royal approval and became the guiding force in the lives and minds of Chinese people in later centuries. In the Ming Dynasty, the royal court confined examination subjects to the four Confucian classics and their commentaries, and adopted a mandatory answer format known as the ‘eight-part essay’.

This civil service recruitment method and educational system was employed from the Han dynasty until the Qing dynasty in 1905. Imperial examinations in the Yuan Dynasty (1271–1368) focused mainly on the Confucian classics annotated by the famous scholar of Zhu Xi (1130–1200) of the Song Dynasty. This remained the same in the Ming and Qing (1644–1911) dynasties. Zhu Xi’s commentaries and choice of classics became the orthodox interpretation of Confucianism, maintained by the examination system and imperial patronage. This orthodoxy remained in force for the next seven hundred years and is often the foundation used by modern Confucian scholars. Candidates were tested on how well they had memorised the Confucian classics and internalised the code of ethics embodied therein.

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105 Henrietta Harrison, *Inventing the Nation* above n 92, 11; Insup Taylor and M Martin Taylor, *Writing and Literacy* above n 95, 148.

106 Ibid.

107 Henrietta Harrison, *Inventing the Nation* above n 92, 11.


110 Lee Dian Rainey, *Confucius and Confucianism: The Essentials* (Wiley-Blackwell, 2010) 169. Zhu Xi is a prolific writer who wrote commentaries on the classics, with a focus on classics he used as the basis for his interpretation. The Analects, Mencius, the Great Learning and the Doctrine of Means were understood and commented on by Zhu Xi and reflected his theories. Zhu Xi saw them as the real foundation of Confucian thought.

The Qing Dynasty followed the imperial examination system of the Ming Dynasty on the whole, and developed it into a standardised and strict system.\textsuperscript{112} A Committee on Education was established in 1903, which in 1904 presented the throne with new policies to replace examination with schools as the road to officialdom.\textsuperscript{113} While the civil service examination system enabled the government to discover and make use of talent, it was also responsible to a large extent for keeping China backward in science. The restrictive and conservative examination syllabus bound the scholar to mainly literary studies.\textsuperscript{114} China’s civilisation had experienced contact with the west that can be traced back to Han dynasty in the western part of China with trading of silk with Rome and Britain. However, with the decline of Rome and of the Han, contact faded.\textsuperscript{115} The scientific and technological superiority of the West at the end of Ming period helped determine the relationship between China and the West and had impact on the Chinese revolutions of the nineteenth and twentieth centuries.\textsuperscript{116}

The concept of a state ruled by men of ability and virtue was an outgrowth of Confucian philosophy.\textsuperscript{117} In late imperial China, the status of local-level elites was ratified by contact with the central government, which maintained a monopoly on society’s most prestigious titles.\textsuperscript{118} The examination system and associated methods of recruitment to the

\textsuperscript{113} Benjamin A Elman, \textit{A Cultural History of Civil Examinations in Late Imperial China} (University of California Press, 2000) 603.
\textsuperscript{114} Ong Siew Chey, \textit{China Condensed: 5000 Years History and Culture} (Marshall Cavendish International Asia, 2005) 31.
\textsuperscript{115} John E Schrecker, \textit{The Chinese Revolution} above n 25, 91.
\textsuperscript{116} Ibid; Wolfgang Franke (Translated by R A Wilson), \textit{China and the West} above n 74, 92.
\textsuperscript{117} Wolfgang Franke, \textit{The Reform and Abolition of the Traditional Chinese Examination System} (Columbia Electronic Encyclopedia, 1960).
\textsuperscript{118} John T Meskill, \textit{An Introduction} above n 40, 562. Those who achieved the educational intendants’ standards were given titles certifying them as state-recognised men of talents, or literati. They were thus entitled to wear distinctive costumes, their families were granted certain tax exemptions, they were honoured
central bureaucracy were major mechanisms by which the central government captured and held the loyalty of local-level elites. Their loyalty, in turn, ensured the integration of the Chinese state and countered tendencies toward regional autonomy and the breakup of the centralised system. The civil service, in short, had become a relatively autonomous and self-perpetuating power bloc in the state system. The emperor had no choice but to share his power with it and to accept the principles on which it insisted the state must function.

The examination system distributed its prizes according to provincial and prefectural quotas, which meant that imperial officials were recruited from the whole country, in numbers roughly proportional to a province’s population. Elites all over China, even in the disadvantaged peripheral regions, had a chance at succeeding in the examinations and achieving the rewards of office-holding.

The examination system also served to maintain cultural unity and consensus on basic values. The uniformity of the content of the examinations meant that the local elite and ambitious would-be elite all across China were being indoctrinated with the same values. Even though only a small fraction of those who attempted the examinations passed them and received titles, the study, self-indoctrination, and hope of eventual success on a subsequent examination served to sustain the interest of those who undertook the exercise. According to Elman’s research, several tens thousands of Chinese competed triennially in

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119 Henrietta Harrison, *Inventing the Nation* above n 92, 11.
120 John T Meskill, *An Introduction* above n 40, 564.
the fourteen to eighteen provincial examinations (more than 150,000 in total in mid and late Ch’ing provincial examinations), yielding the final three or four thousand candidates for the triennial metropolitan and palace examinations in the capital.  

Both the general administration and censorial agencies of the traditional government were staffed chiefly with men originally selected for state service on the basis of their individual merits as demonstrated in competitive, public, written examinations. These examinations tested their grasp of classical and historical literature and, in particular, of Confucian philosophical principals and their ability to apply the precepts and precedents of the past to either timely or timeless political and ethical problems. As a result the examination syllabus was a determining factor in one’s social status. The men who had passed the exams and held official positions formed the imperial bureaucracy. Because of their long and successful training in moral texts they saw themselves as uniquely well qualified to govern. Confucianism, therefore, played many roles connected with thought, society, administration and politics in traditional China. Its influence had been pervading aspects of China’s society through political and educational activities.

In late traditional China then, education was valued in part because of its possible reward in the examination system. The overall result of the examination system and its associated study was cultural uniformity and identification of the educated with national rather than regional goals and values. This self-conscious national identity underlies the nationalism so important in China’s politics in the 20th century. Since the economic reform in the late 1970s, state planning and intervention were gradually reduced and the economy

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123 Ibid xxvii.
125 Henrietta Harrison, Inventing the Nation above n 92, 15.
126 Albert E Dien, State and Society above n 97.
was opened up to the forces of market competition. Nationalism had become part of the ideology and held a particular appeal for both the Chinese government and the population.\textsuperscript{127} However, Chinese nationalism is perceived as an international ‘China threat’ in the 21\textsuperscript{st} century as a result of its strong economic growth.\textsuperscript{128} Nonetheless, the combination probably accounts for the many ways in which China’s leaders too have continued to make use of the symbols of nationalism for their own political ends.\textsuperscript{129}

3.4.3 Social Stratification

Confucius believed that the only way to maintain order would be to arrange affairs so that the emperor would continue to be emperor, the nobles to be nobles, the ministers to be ministers, and common people to be common people.\textsuperscript{130} Traditional thought accepted social stratification as natural and considered most social groups to be organised on hierarchical principles. One way of describing the hierarchy was in terms of the social class structure in the Confucian feudal system in the Zhou dynasty. At the top are the rulers, then come peasants, then artisans, and finally merchants. This was based on the distinction between those who worked with their minds and those who worked with their hands. The former were assumed to be at the highest social level.\textsuperscript{131}

In society at large, the highest and most prestigious positions were those of political generalists, such as members of the emperor’s council or provincial governors.\textsuperscript{132} Although commerce has been a major element of Chinese life since the early imperial period and

\begin{thebibliography}{99}
\bibitem{127} Henrietta Harrison, \textit{Inventing the Nation} above n 92, 251–2.
\bibitem{129} Henrietta Harrison, \textit{Inventing the Nation} above n 92, 267.
\bibitem{130} Fung Yu-Lan (translated by Derk Bodde), \textit{A History of Chinese} above n 41, 59.
\bibitem{131} John E Schrecker, \textit{The Chinese Revolution} above n 25, 14.
\bibitem{132} Ping-ti Ho and Bingdi He, \textit{The Ladder of Success in Imperial China} (Da Capo Press, 1976) 35.
\end{thebibliography}
wealthy merchants have been major figures in Chinese cities, Confucianists disparaged merchants.\textsuperscript{133} It was from the family-oriented economic and political system that rulers from the Han dynasty onwards pursued policies encouraging agriculture and restraining commerce.\textsuperscript{134} Commercial success never won respect, and wealth based on commerce was subject to official taxes, fees, and even confiscation. For example, in the Han dynasty a poll tax was levied against merchants. This tax was double the amount other workers paid.\textsuperscript{135} Upward mobility by merchants was achieved by cultivating good relations with powerful officials and educating their sons in the hope they might become officials. Despite the fact that the sons of the majority of families had little hope of ever becoming officials, the content of the examination system dominated education.\textsuperscript{136} Although dynasties were founded by military conquest, Confucian ideology derogated military skill. Common soldiers occupied a low position in society and were recruited from its lowest ranks.\textsuperscript{137} Chinese civilisation, however, includes a significant military tradition, and generals and strategists usually were held in high esteem.\textsuperscript{138}

Most of China’s population was composed of peasant farmers, whose basic role in supporting the rulers and the rest of society was recognised as positive in Confucian ideology.\textsuperscript{139} The most basic fundamental constant is that Chinese civilisation has always rested upon an agrarian, peasant base.\textsuperscript{140} Even though officials and intellectuals were the

\textsuperscript{134} Laurence Jacobs et al, ‘Confucian Roots’ above n 67, 32.
\textsuperscript{135} Ibid 32.
\textsuperscript{136} Henrietta Harrison, \textit{Inventing the Nation} above n 92, 14.
\textsuperscript{137} John E Schrecker, \textit{The Chinese Revolution} above n 25, 14.
\textsuperscript{139} June M Grasso et al, \textit{Modernisation and Revolution in China: From the Opium Wars to Olympics} (M E Sharp, 2009) 11.
\textsuperscript{140} Ibid.
higher status rank in society ultimately it was the backbreaking labour of China’s peasant masses that created the highly productive agricultural foundation on which China’s other classes built the marvelous edifice that was Chinese civilisation.

The system by which officials were selected through regularly held imperial examinations, gave opportunities to people on the lower rungs of the social ladder to acquire power and wealth. Over the years, intellectuals in China made passing the imperial examination and becoming an official their highest ideal. As a result, in Chinese communities, the primary factor generating prestige was education. Once a Chinese intellectual achieved academic merit, there would be a bright future with fame and power that would, in turn, alter the status and future situation of his family. Another asset was an extensive personal network that permitted one to grant favours and make introductions and recommendations. There was no sharp line dividing the elite from the masses, and social mobility was possible and common.

It would be incorrect to assume that Confucianism had no problems over the past 2500 years. For example in 1911, influenced by Western Enlightenment ideas of science and democracy, many criticised the Confucian belief in supernatural powers, attributing that belief to China’s backwardness. These critics began to advocate the view that the Confucian notion of Heaven referred to the impersonal physical order of nature. It was

141 Laurence Jacobs et al, ‘Confucian Roots’ above n 67, 30.
criticised after the 1911 revolution and again after the socialist revolution of 1949. In view of Marxist dialectical materialism, Confucianism was incorrect and detrimental to social development. Confucianism was criticised for imposing a reactionary metaphysical straitjacket upon Chinese thought, and for its notion of society as well-ordered and harmonious without recognition of the realities of material and social conflict. According to Qing, the twentieth century has seen a decline in Confucian morality in mainland China due to the denigration of traditional Chinese culture. However, Chinese society is a society of ritual and norms built on the principle of benevolence. In other words, traditional Chinese society is a society grounded primarily on relationships, and is a society of the rule of man. Confucianism is so ingrained after two millennia that it cannot be ignored. It still forms the basis of most business practices in China. It manifests in China today as the embedded phenomena of influential administrative power and massive use of networking in doing business in China. These extending phases of Confucian influence have always entailed an important bi-directional influence, digging deep furrows in the influenced culture, while itself being qualitatively enriched and transformed.

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144 Karl-Heinz Pohl, Ethics for the 21st Century above n 77, 1.
146 Jiang Qing, ‘From Mind Confucianism to Political Confucianism’ in Ruiping Fan (ed), The Renaissance of Confucianism in Contemporary China (Springer, 2011) 17, 17.
3.4.4 A Strong Sense of Social Hierarchy

It is impossible to do business in China and to not feel the effects of Confucian philosophy. For example, strong feelings of a social hierarchy are still present in China. The long existence of this system has produced a strong sense of order and relationship. These concepts still permeate every sector of society including business. When a group picture is taken, the most conspicuous position should be given to the one highest in rank in the group. Any breach of the rule may offend the group leader.\(^{149}\) The Confucian ethical structure, with its lack of civil law, still influences current thinking.\(^{150}\) A strong sense of family as the basic unit of production, with its rights of inheritance and views of the extended family, still pervades much of Chinese thought.\(^{151}\) If Confucianism is officially gone, its influence is still strong. As evidenced by Cao, the Confucian influence on modern Chinese may not be as explicit and strong since Confucian thought ceased to be the orthodox state ideology, but Confucius has always maintained a strong presence in Chinese culture.\(^{152}\) It is important here to identify the aspects of Confucianism which are relevant to those seeking to understand the Chinese business environment.

The centralised monarchy dominated China for 2000 years. The long existence of an immense hierarchical system has produced a strong sense of order and relationship.

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\(^{149}\) Laurence Jacobs et al, ‘Confucian Roots’ above n 67, 30.

\(^{150}\) Ibid. After Confucianism assumed a dominant philosophical position in the Han dynasty, the rulers attached greater importance to ethics than to law as a tool of management. The mandatory texts of Confucian teaching for imperial examinations is its embodiment. These two ideas are different in that laws are stipulated in explicit terms while ethics are established through use. That is laws are externally enforced while ethics are moral commitments established over time.


\(^{152}\) Deborah Cao, *Chinese Law A Language Perspective* (Ashgate, 2004) 3.
These concepts still permeate every sector of society, including business. This sense of hierarchy was strengthened, not weakened, with the introduction of Marxism in China.\textsuperscript{153}

As explained above, Confucianism advocates \textit{Li} (rites) as a basic doctrine. By giving prominence to principle of \textit{Li}, Confucianism calls for maintaining the established social order. Accordingly, everyone has a fixed position in society and, provided each person behaves according to rank, social harmony is achieved.

Chinese have a strong devotion to their hierarchical system. Everyone has a social rank in the Chinese management culture, and all are expected to know where they fit into the hierarchy and to behave accordingly. This culture originated from Confucian teaching of \textit{Li} that represents the cement of the entire normative socio-political order and the whole network of hierarchy and authority on which the order is based. It is at the heart of Confucius’ teaching.\textsuperscript{154} There are diverse manners in which hierarchy is continually reaffirmed in Chinese business culture. As evidenced by Turley’s study, showing respect by varying our manner of communication dependent on the age, status or hierarchy of those we are dealing with, is a natural skill in China.\textsuperscript{155} Instead of social equality and individual freedom, Confucianism emphasises social hierarchy and order because social stability and harmony—the very foundation of individual right—can be realised only through everyone whole-heartedly doing their duty as defined by their position in the hierarchical society.\textsuperscript{156}

Collectivism and deference to authority have, for many centuries, been so central to life in China that the value placed upon ‘harmony-in-hierarchy’ has been suggested as the

\textsuperscript{154} Deborah Cao, \textit{Chinese Law} above n 152, 32.
\textsuperscript{155} Joan Turley, \textit{Connecting with China: Business Success through Mutual Benefit and Respect} (John Wiley and Sons, 2010) 47.
key to understanding Chinese social behaviour. A foreign business person must understand the implications of this strong sense of hierarchy to do business successfully in China. Small events, which might be irrelevant in another culture, can become important. The sense of hierarchy has several manifestations in Chinese business management. Business meetings tend to be long, especially when senior managers or officials are participating. The chairman is obliged to invite all of such managers to give their guidance on all the various matters under discussion. The course of the meeting then takes the form of a series of lengthy speeches rather than any open discussion. It often destroys the sense of participation, essential to the progress of a business. Since everybody is supposed to behave according to rank, people are reluctant to present ideas that may lead to the improvement of the business. This explains much of the inertia in Chinese business, particularly in state-owned enterprises. The Chinese favour the reserved, the implicit, and the indirect forms of communication. It is a value that can be traced deep into Chinese antiquity to the philosophy of Confucius and his fundamental concern with achieving social harmony.

3.4.5 Law and Ethics

After Confucianism assumed a dominant philosophical position in the Han Dynasty, the rulers attached greater importance to ethics than to law as a tool of management. These two ideas are different in that laws are stipulated in explicit terms while ethics are established

through use. That is, laws are externally enforced while ethics are moral commitments established over time.

Ancient Europe relied on the law because the serf system was based on contractual relations. Religious doctrines of a powerful European church were also a potent force. This combination of contracts and church support exercised effective control over people’s behaviour.\textsuperscript{161} In ancient China there were no contractual relations. The existence of contract theory has even been explicitly denied for ancient China\textsuperscript{162} Under the centralised monarchy the Chinese had a weak sense of religion. In China Neo-Confucianism prevailed over other philosophies of state and religion during the Tang dynasty.\textsuperscript{163} Unlike westerners who often prayed to their God(s), the Chinese thought of heaven only when in trouble. In ancient times, China only had criminal law and imperial decrees. In the fourth century BC at the time of Shang Yang, the statutes mainly dealt with questions of administrative and criminal law.\textsuperscript{164} Over the years, China did not produce a code of civil law akin to Roman law.\textsuperscript{165}

According to the teaching of Confucius, the fundamental social unit is the family, organised in a hierarchy under the almost absolute authority of its head. Public bodies and the state itself were patterned along the same model and refrained from interfering in the many aspects of social life reserved to the family.\textsuperscript{166} In communities and collectives of

\begin{thebibliography}{99}
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\bibitem{161} Qing Tian, \textit{A Transcultural Study of Ethical Perceptions and Judgments between Chinese and German Businessmen} (Martin Meidenbauer, 2004) 33.
\bibitem{162} Heiner Roetz, \textit{Confucian Ethics of the Axial Age: A Reconstruction under the Aspect of the Breakthrough Toward Post-conventional Thinking} (State University of New York Press, 1993) 72.
\bibitem{164} Maurizio Scarpari, \textit{Ancient China: Chinese Civilisation from the Origins to the Tang Dynasty} (Barnes and Noble, 2006) 48.
\bibitem{166} René David and John E C Brierley, \textit{Major Legal System in the World Today: An Introduction to the Comparative Study of Law} (Stevens, 1985) 521.
\end{thebibliography}
various kinds, the individual’s duty was to live according to the rite or style of life which fell to each according to his status. This is because China, throughout its long history, has been collectivist in nature. Such societies tend to be characterised by participation in intense social interaction that affords little privacy, leading to a corresponding stress on the need to maintain harmony. The observance of these rites as laid down by custom was, in China, the principle that took the place of law.

The impact of Confucianism on the modern Chinese judicial system remains evident, even though the system was founded on Marxist ideology. Wang, Zhang and Goodfellow suggest:

Confucianism maintains that the entire complex of moral convention is the cement of society. Convention can be differentiated into five major areas of importance: hierarchy, collectivism, ‘face’ protection, respect for tradition or age, egalitarianism. These values must be appreciated as central to any study of Chinese national values and their particular influence on ways of doing business today.

The ‘rule of man’ is a Confucian concept, in which Confucius argued that government officials must set a good example for the governed, that the moral goodness of a government, not the strength of the laws, is linked to the morality of the people. The most important and lasting way that Confucius envisioned the hierarchy was in ethical terms, with the most virtuous and perfected people at the top and the least virtuous, the worst, on the bottom. His primary concern was a good society based on good government and harmonious human relations. To this end he advocated a good government that rules by virtue and moral example rather than by punishment or force. Other Confucian concepts seen in the judicial system are: the importance of the people’s duties over their rights.

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170 Wing-Tsit Chan, *A Source Book* above n 33, 15.
Confucius used the rectification of names to advocate not only the establishment of a social order in which names and ranks are properly regulated, but also the correspondence of words and action or of words and actuality,\textsuperscript{171} the concept of education as a primary purpose of government — superceding punishment to prevent crime; and anti-litigiousness.\textsuperscript{172} With regard to litigation, Confucius said:

> In hearing litigations, I am like any other body. What is necessary is to cause the people to have no litigations.\textsuperscript{173}

The true aim of government was, in his view, not supposed to be brought about by rigid adherence to arbitrary laws but rather by a subtle administration of customs that are generally accepted as good and have the sanction of natural law.\textsuperscript{174}

### 3.5 The Legalism Philosophy

In the third century BC, during a turbulent period of Chinese history, the school of ‘Legalists’, basing its ideas upon man’s natural tendency towards bad behaviour, repudiated traditional theory and emphasised the need to obey prescriptions of law (government by law) rather than relying on the virtues of rulers (government by man).\textsuperscript{175} The concept of Fa, ‘law’ or ‘legal regulation’ was, however, justified with particular vigour by the school of Legalists, taking a pragmatic view in terms of the instrumentality of law, and thus clearly representative of the positivist approach to human law-making, as opposed to the

\textsuperscript{171} Wei-Bin Zhang, \textit{Confucianism and Modernisation} (Macmillan Press, 1999) 60.
\textsuperscript{173} Ibid 72.
\textsuperscript{174} Ibid 67.
\textsuperscript{175} Clarence Burton Day, \textit{The Philosophers of China} above n 32, 78. The great leader of the Legalist School Han Fei Zi expressed his firm conviction that, as all men are by nature self-seeking, they can be governed only by a system of rewards and punishments.
Confucian reliance on self-controlled order. The Legalist school was the most radical of all ancient Chinese schools. It rejected the moral standards of the Confucianists and the religious sanction of the Moists in favour of power. Its aim was political control of the state and the population, a control to be achieved through an extensive set of laws, backed by generous rewards and severe punishments. The Legalists’ theories, as expounded in the works of Han Fei Zi, stated the need for permanent laws which would be known by servants of the state and to which individuals would, without exception, be subject. On the whole, these theories express a concept of legislation and law very close to the western ideal. These theories have however, remained completely alien to the Chinese mentality in general. As Zhang observes:

Although Confucius also distinguished the rule of justice and the principles of other virtues, he held that society should be governed by virtue and regulated by propriety... It is a traditional belief in the West that social order should be maintained by law. This is a continued belief in Confucian China that society should be governed by propriety rather than by law.

The Legalists do emphasise law, but only as a means, and not the only means, of achieving their ends. Han Fei Zi said power, or force, is the only thing that counts.
Severe punishments were visited upon those who opposed the ruler’s decrees or broke the laws.\(^{183}\) However, multiplication of punishments did not always have the effect that Legalists had hoped for.\(^{184}\) Eleven years after he had consolidated the Chinese world with the advocate of Legalist notion, the first Emperor Qin Chi Huang died. Legalism, as the avowed philosophy of the Chinese state, was dead.\(^{185}\) As Menski asserted, they were too radical a departure from accepted thinking, and the Legalists had only passing success. They did not gain any general acceptance in China of the notion of permanent rules and the concept of sovereign law.\(^{186}\)

In Chinese history, Legalism (literally ‘School of Law’)\(^ {187}\) was one of the four main philosophical schools (the other three being Confucianism, Daoism\(^ {188}\) and Moism) during the Spring and Autumn Period (771 BC—481 BC) and the Warring States Period (480 BC—221 BC). This period, from 770 to 221 BC, was an era of great cultural and intellectual ferment in China, and gave rise to the important ‘hundred schools’ of thought.\(^ {189}\)

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\(^{183}\) Ibid 157.
\(^{184}\) Ibid.
\(^{185}\) Ibid 158.
\(^{186}\) Werner F Menski, *Comparative Law* above n 23, 474.
\(^{187}\) H G Creel, *Chinese Thought* above n 181, 140. The Legalists do emphasise law, but only as a means, and not the only means, of achieving their ends. The Legalists were not “legalistic” in the sense of being mainly concerned with the letter of the law and its interpretation. Fung Yu-lan points out quite correctly that it is wrong to associate the thought of the Legalist school with jurisprudence.
\(^{188}\) Daoism is one of China’s major religions indigenous to the country. The primary belief is in learning and practicing ‘The Way’ (Dao) which is the ultimate truth to the universe. Also known as Taoism, Daoism traces its roots to six century BC when Chinese philosopher Laozi wrote the iconic book *Dao De Jing* on the tenets of the Dao. Daoism believes that life is generally happy but that it should be lived with balance and virtue.
Legalism was a pragmatic political philosophy that did not address higher questions like the nature and purpose of life.\(^{190}\) Legalism refers to a way of thinking which gained acceptance toward the end of the Chou dynasty. The term ‘Legalists’ is used to denote a group of thinkers in China who promoted the notion of fa meaning ranging from model, method, technique, rule and regulation to law.\(^{191}\) It basically postulates that the inherent strengths of the people are not sufficient to prevent chaos and political corruption, and recommends law as the primary tool to amend this. Legalists’ preference for law as a tool of government was based on the conviction that a government had to be concerned, not with the few individuals in society who could discipline themselves without any outside influence, but with the greatest majority.\(^{192}\) Shang Yang (400 BC—338 BC) regarded as the father of the school of Legalism, believed that society could be governed best by means of a rigidly administered system of rewards and punishments and he drew up a code of laws to be enforced under dire threat of heavy penalties for violations.\(^{193}\) The trends that were later called Legalism have a common focus on strengthening the political power of the ruler. Law was only one part of that movement. The most important surviving texts from this tradition are the Han Fei Zi (280 BC—233 BC)\(^{194}\) and the Book of Lord Shang.\(^{195}\) Unlike Confucianism and Moism, it made no attempt to preserve or restore the customs and moral

\(^{190}\) Clarence Burton Day, The Philosophers above n 32, 75. Whereas most of schools like Taoist, Confucian, Moist, Ying-Yang discussed the principles of government from the point of view of the people, the Legalist school argued from the vantage-point of the ruler and the ruling class.


\(^{192}\) Ibid 85.

\(^{193}\) Clarence Burton Day, The Philosophers above n 32, 76.

\(^{194}\) Ibid 77. Han Fei Zi was a prince of the state of Han and lived also in the state of Qin. He was a strong advocate of the principles of the Legalists. Han Fei Zi thoroughly believed in promulgated well-defined laws and having them obeyed without question.

\(^{195}\) H G Creel, Chinese Thought above n 181, 144. A work called the Book of Lord Shang, is a compendium of writings by various Legalists authors, of considerable interest and value even though it is difficult to date them exactly.
values of the past; it professed to have no use of morality whatsoever. Legalism here has
the meaning of a political philosophy that upholds the rule of law, and is thus distinguished
from the western meaning of the word. As Creel suggests:

The legalist conception of law was in some respects much more similar to that of the West
than the Confucian one, but its objective was very different from what we commonly think
of as the objective of law. To us “the safeguards of the law” mean protection for the
individual against unlimited exactions by the government. The Legalists, however, regarded
law as an instrument for the complete control of all citizens by the government. They
wanted precise laws set forth and known to all.

Legalist theory listed three things which the ruler must employ in order to govern
the world properly. One was *Shih* which means both power and position, the second was
*Shu*, methods and the third was *Fa*, law. They show that the Legalist school was
cconcerned solely with things that are political in nature. Creel gave some illustrations of
their meaning:

i. *Shih*, power and position, was demonstrated by pointing out that even the sage emperors
were unable to make the people obey them until such time as they occupied the throne,
while even the most unworthy of rulers had secured obedience. Thus, it was concluded,
virtue and wisdom are of no account as compared with power and position.

ii. *Shu*, administrative techniques. The Legalists were on their firmest ground as opposed to
the Confucians. The Legalists recognised that as states became larger and more
centralised and economic activity became increasingly complex, the administration of
government came more and more to demand specific technical knowledge and skills.

iii. *Fa*, law. The Legalists regarded law as an instrument for the complete control of all
citizens by the government. In effect, this constituted the posting of an exact schedule of
rewards and penalties, so that citizens would know just what would happen to them if
they did wrong. Punishment should be severe and inevitable, so that the people will fear
them.

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196 Burton Watson (translated), *Basic Writing of Mo Tzu, Hsun Tzu, and Han Fei Tzu* (Columbia University
197 H G Creel, *Chinese Thought* above n 181, 153.
198 Ibid 151.
200 H G Creel, *Chinese Thought* above n 181, 151–3.
Legalist thought assumed no class distinctions. Everyone was equal before law and ruler. It insisted that law must be applicable to all. However, the Legalist way of government requires unselfishness and impartiality on the part of the ruler. According to Chan’s examination:

The important things for rulers are either laws or statecraft. A law is that which is enacted into statute books, kept in government offices, and proclaimed to the people. Statecraft is that which is harbored in the ruler’s own mind so as to fit all situations and control all ministers.

The Legalists reduced the nobles to a lower standard by discarding moral matters and placing sole reliance on rewards and punishments for all alike, hence stern punishments were necessary. Legalists stated that ‘strictness is the secret of control’. The Legalist teaching emphasised the law as a means of rewards and punishments for controlling and governing the state. Contrary to the Confucian belief of ruling by persuasion, Legalists advocated strong force and centralised control through law in order to govern the world properly. The origins and contents of Legalism are explained below.

3.5.1 Origins of Legalism

Legalism asserted that human nature is evil and it is primarily associated with the concept of punishment, indeed, severe punishment. The best known of the earliest code-makers was Shang Yang who, with a realist reform-oriented philosophy set out to turn
the state of Qin from a backward state to a powerful state stressing the importance of law.\textsuperscript{209} His scheme was based on three simple principles: a penal law written in black and white; complete confidence in the justice of the code; and strict enforcement of the law.\textsuperscript{210} Shang Yang became Prime Minister of the Qin under the rule of Duke Xiao of Qin\textsuperscript{211} and he initiated two reforms in Qin aiming at consolidating the power of the central government and enriching the state.\textsuperscript{212} The first reform was promulgated in 359 BC and Shang Yang swept away the aristocracy and implemented a meritocracy — only those who achieved highly could reach high places and birth privileges were reserved exclusively for the ruler of the state.\textsuperscript{213} The second reform was announced in 350 BC and it destroyed the economic base of nobles by breaking down the boundaries of the then prevailing land enclosures and by encouraging the people to till any uncultivated land they could find. Land possession would become public, and the state, by disclaiming ownership of land, would be contented with collecting revenues from the farmers in the form of taxes.\textsuperscript{214} Law and order was achieved through tight social regimentation and the whole state was law-abiding.\textsuperscript{215} From then on, Qin was taking its shape to become the most powerful state in China before it eventually brought all of the six other states together (Qi, Chu, Han, Yan, Zhao, and Wei).

\begin{flushleft}
\textsuperscript{208} Shang Yang (390 BC–338 BC) was an important statesman of Qin in the Warring States Period of Ancient China. With the support of Duke Xiao of Qin Yang enacted numerous reforms (in accordance with his Legalist philosophy recorded in \textit{The Book of Lord Shang}) in the state of Qin that helped to change Qin from a peripheral state into a militarily powerful and strongly centralised kingdom, changing the administration by emphasising meritocracy and devolving power from the nobility. \\
\textsuperscript{209} Wing-Tsit Chan, \textit{A Source Book above n 33, 252}. \\
\textsuperscript{210} Clarence Burton Day, \textit{The Philosophers above n 32, 76}. \\
\textsuperscript{211} Duke Xiao of Qin (381 BC–338 BC) was the ruler of the Qin state from 361 BC to 338 BC during the Warring States Period of Chinese history. Duke Xiao is best known for employing the Legalist statesman Shang Yang from the Wei state, and authorising him to conduct a series of upheaving political, military and economic reforms in Qin. Although the reforms were potentially controversial and drew violent opposition from many Qin politicians, Duke Xiao supported Shang Yang fully and reforms did help to transform Qin into a dominant superpower among the Seven Warring States. \\
\textsuperscript{212} See S Y Hsieh, \textit{‘The Legalist’ above n 191, 83}. \\
\textsuperscript{213} S Y Hsieh, \textit{‘The Legalist’ above n 191, 83}. \\
\textsuperscript{214} Ibid 84. \\
\textsuperscript{215} Ibid 85.
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under the First Emperor Qin Shi Huang\(^{216}\) (literally ‘the First Emperor’).\(^{217}\) Shang’s teaching and policies of unifying the state certainly meant a victory for the Legalist school, but such a glorification lasted only for a short while. From 207 BC onward, because of its harshness and severity, it never again won official patronage in Chinese history.\(^{218}\)

### 3.5.2 The Role of the Ruler in Legalist Philosophy

The Legalist school developed in the late centuries of the Chou dynasty when the social distinctions between the class of princely men on the one hand and small men on the other were no longer so absolutely demarcated.\(^{219}\) A government with high concentration of power was needed. It was believed that it was unnecessary for the ruler to be sage or superman.\(^{220}\) Methods were promoted by Legalists as means for rulers to obtain high concentration of power. This constituted the thought of the Legalist school.\(^{221}\) To a Legalist, neither moral influence could determine the social order, nor could the virtue of the ruler be powerful enough to transform society or create order or disorder.\(^{222}\) To him, a uniform law was the only means to govern a state, and law must be universally applicable to all.\(^{223}\) The ruler needed to use political techniques (\(Shu\)) to prevent the usual drain of power to his ministers and to employ his authority (\(Shih\))—a structural and substantive domination of others using physical power to command human resources and mobilise power—to ensure

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\(^{216}\) Qin Shi Huang (259BC–210BC), personal name Ying Zheng, was king of the Chinese State of Qin from 246BC to 221BC during the Warring States Period. He became the first emperor of a unified China in 221BC. He ruled until his death in 210BC at the age of 49. Qin Shi Huang is a pivotal figure in Chinese history. After unifying China, he and his chief advisor Li Si passed a series of major economic and political reforms.

\(^{217}\) S Y Hsieh, ‘The Legalist’ above n 191, 82.


\(^{219}\) Fung Yu-Lan, *A Short History* above n 22, 156.

\(^{220}\) Ibid 157.

\(^{221}\) Ibid.

\(^{222}\) S Y Hsieh, ‘The Legalist’ above n 191, 86.

\(^{223}\) Jianfu Chen, *Chinese Law* above n 1, 14.
his total control over the officialdom. The ruler also needed to impose law (Fa)—
rewards and punishment—not only to maintain social and political order but also to ensure
his absolute dominance of the state’s ideology and the populace’s thought. Thus,
theoretically, by cloaking both his desires and his will, the emperor checked sycophancy
and forced his subjects to heed his dictates. Han Fei Zi said the ruler should treat his
ministers like domesticated animals and that the so-called ‘wise ruler’ is he who can
domesticate his ministers. Han Fei Zi once said that it is by means of strict penalties and
heavy punishments that the affairs of state are managed. The ruler creates the law; the
ministers abide by the law; and subjects are punished by the law. Although the ruler was
expected to be paternalistic, the Legalists emphasised that being too kind would spoil the
populace and threaten the state’s internal order. As Creel’s study concluded:

The empire can be ruled only by utilising human nature. Men have likes and dislikes; thus
they can be controlled by means of rewards and punishments. On this basis prohibitions and
commands can be put in operation, and a complete system of government set up. The ruler
need only hold these handles (rewards and punishments) firmly, in order to maintain his
supremacy … These handles are the power of life and death. Force is the stuff that keeps
the masses in subjection.

Thus with law and authority, the ruler rules his people. He need have no special
ability or high virtue, nor need he, as the Confucianists maintained, set a personal example
of good conduct, or rule through personal influence.

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224 Xuezhi Guo, The Ideal Chinese Political Leader: A Historical and Cultural Perspective (Praeger
publishers, 2002) 238.
225 Ibid.
226 Zhengyuan Fu, China’s Legalists: The Earliest Totalitarians and Their Art of Ruling (M E Sharp, 1996)
97.
227 Jianfu Chen, Chinese Law above n 1, 11.
228 Ibid.
229 See H G Creel, Chinese Thought above n 181, 154–5.
230 Ibid 149.
231 Fung Yu-Lan, A Short History above n 22, 160.
3.5.3 The Role of Ministers in Legalist Thought

To aid the ruler and help prevent mis-governance, Shen Buhai (a minister from the state of Han for 15 years) formalised the concept of *shu*, or the bureaucratic model of administration that served to advance the ideal Legalist ruler’s program.\(^{232}\) In Legalism, non-activity maintains that the ruler must not let his power be seen, he must remain actionless and the system of reward and punishment is based on minister’s promises and accomplishments, not on ruler’s orders and abstract laws.\(^{233}\) Ministers should not be too wise, or they will cheat the ruler, therefore it is totally unnecessary to seek virtuous and upright men as officials.\(^{234}\) If the ruler simply makes the law uniform and overawes them with his power, they will not dare to be wicked.\(^{235}\) Han Fei Zi urged rulers to control these individuals by the two ‘methods’ of punishment and favour.\(^{236}\) ‘Holding the actualities responsible for their names’ means holding the individuals who occupy certain offices responsible for carrying out what should be ideally accomplished in these offices.\(^{237}\) A ruler should make clear the laws governing the officials and should not rely either on his own personal knowledge or deliberation or on those of his officials when discharging his duties.\(^{238}\) The functions pertaining to an office had already been defined by law and were indicated by the name given to it. Hence the ruler need not, and should not, bother about the methods used to carry out his work, so long as the work itself is done and well done.\(^{239}\)

Bishop explains that:

\(^{232}\) H G Creel, *Chinese Thought* above n 181, 141.
\(^{234}\) H G Creel, *Chinese Thought* above n 181, 155.
\(^{235}\) Ibid.
\(^{236}\) Fung Yu-Lan, *A Short History* above n 22, 162.
\(^{237}\) Ibid 161.
\(^{239}\) Fung Yu-Lan, *A Short History* above n 22, 161.
In assigning responsibilities to officials, the leader has to know the exact nature of such responsibilities as well as the capabilities of the officials involved; that ideally, there should be a close correspondence between responsibilities, symbolised by a title, and the assignee’s capabilities, concretely demonstrated by his performance; that such a correspondence is not only a measure of how successfully the problems encountered by the people are involved, but also a method of controlling the officials.\(^\text{240}\)

Thus, in Legalist theory, ministers and other officials were prevented from performing some other official’s duties and were punished if they attempted to blind the ruler with words or failed to warn the ruler of danger. This indicates that, for the purpose of political control, the Legalists emphasised the theory of the correspondence of names and actualities.\(^\text{241}\) Therefore, the way of the enlightened sovereign consists of making laws uniform and not depending upon the wisdom of men, in making statecraft firm and not yearning after faithful persons, so that the laws do not fail to function and the multitude of officials will commit neither villainy nor deception.\(^\text{242}\)

### 3.5.4 The Purposes of Law

The laws supported by the Legalists were meant to defend the state, the emperor, and his military. They were also reform-oriented and innovative. In theory, the Legalists were primarily interested in the accumulation of power, the subjugation of the individual to the state, uniformity of thought, and the use of force.\(^\text{243}\) The Legalists particularly emphasised pragmatism over precedence and custom as the basis of law. Bary, Chan and Watson’s research indicates that:

\(^{240}\) S Y Hsieh, ‘The Legalist’ above n 191, 90.
\(^{241}\) Wing-Tsit Chan, A Source Book above n 33, 257.
\(^{243}\) Wing-Tsit Chan, A Source Book above n 33, 251.
Legalism in its earliest form was probably the outgrowth of a need for more rational organisation of society and resources so as to strengthen the state against its rivals. This was to be accomplished by concentrating power in the hands of a single ruler, and by the adoption of political institutions affording greater centralised control... The state would be ordered by an exhaustive set of laws defining in detail the duties and responsibilities of all its members, which would be administered with complete regularity and impartiality. Severe punishments would restrain evil, while generous rewards would encourage what was beneficial to the strength and well-being of the state.244

Guided by Legalist thought, the first Qin emperor, Qin Shi Huang, would weaken the power of the feudal lords, divide the unified empire into 36 administrative provinces, and standardise the writing system.245 Legalists expected human law-making to establish and maintain order on earth and therefore positivist law-making should be employed and would be sufficient.246 Laws that are sufficiently stringent would no longer have to be applied because their mere existence will be enough to deter wrong-doing. Thus harsh laws, though painful in their immediate effects, lead in the long run to an actual reduction of government and to a society free from conflict and oppression.247 Objectivity was one of the primary goals of Shang Yang’s preference for law. A ruler should make clear the laws governing the officials and he should not rely either on his own personal knowledge or deliberation or on those of his officials when discharging his duties.248 Based on promoting the interests of the Qin state, the law served as a vehicle to both control the populace and eliminate dissent.

3.5.5 Legalism and Individual Autonomy

Confucianism opposed rule by force rather than by persuasion; the Legalists advocated strong centralised government which should exercise absolute power by the threat of harsh

244 Ibid 137.
245 Ibid 151.
246 Werner F Menski, *Comparative Law* above n 23, 472.
247 Ibid 473.
punishments. For a highly controlling state power the Legalist philosophers emphasised the primacy of the state over individual autonomy. The lone individual had no legitimate civil rights and any personal freedom had to strengthen the ruler. Creel notes:

The objective of the Legalists, however, was not wholly new. They sought, for the ruler of the whole state, much the same kind of absolute power over his subjects as each feudal lord had exercised in the good old days, before the people had begun to get notions about rights and freedom, or to be corrupted by having these things talked about by the Confucians.

Han Fei Zi, in particular, could be very caustic towards the concept of individual rights because he spoke from the ruler’s perspective and not from that of the people. Fundamentally, the Legalists viewed the common people as of lower class and their actions as evil and foolish. Legalists taught that every individual must be compelled to live, work, think, and on the ruler’s demand, die, wholly for the state, without any regard for his individual desires or welfare. It is wrong to associate the thought of the Legalist school with jurisprudence because in modern terms, what this school taught was the theory and method of organisation and leadership.

However, Legalism allowed the common people to progress in rank if they performed well. According to Hsieh’s study, anyone who expected to have political and social privileges had to earn them by fighting on the battleground. To kill an armed enemy soldier, for instance, would entitle a person to one grade of rank, one hundred units of land, nine units of residence, and one slave. According to Shang Yang’s The Book of

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249 H G Creel, *Chinese Thought* above n 181, 136.
250 Ibid 139.
252 H G Creel, *Chinese Thought* above n 181, 140.
255 Ibid.
Lord Shang,256 the people themselves wanted a ruler to generate order. Social cohesion in
the Legalist state mandated that the populace never escape punishment. The Qin dynasty
used the people, for example, to maintain vigilant mutual surveillance over one another
under threat of death.257 Han Fei Zi insisted that all men act from motives of selfishness and
self-profit, and so show calculating minds in their attitude toward one another.258 It is this
fact that makes the system of rewards and punishment possible.259

Compared with Confucian belief of governing a state primarily by virtue, Legalists
insisted upon two handles of the government—punishments and rewards. As Chan states:

By contrast, the Confucianists were dedicated to the cultivation of virtue, the development
of individual personality, government for the people, social harmony, and the use of moral
principles, moral examples, and moral persuasion. The Legalists were primarily interested
in the accumulation of power, the subjugation of the individual to the state, uniformity of
thought and the use of force.260

3.6  Power Politics between the Philosophies

Most Chinese philosophers and political thinkers such as Creel have had very negative
views of Legalism, blaming it for what today would be considered a totalitarian society.261

256  William Theodore De Bary et al, Sources of Chinese above n 242, 136; Jan Julius Lodewijk Duyvendak,
Yang, prime minister of Qin and the original organising genius behind that state’s long drive to imperial
power, is the first of this type to achieve historic importance. The Book of Lord Shang purportedly sets forth
the policies which he successfully employed, though there is doubt as to how much of it is authentic as an
eyary Legalist work generally attributed to the eponymous Lord Shang. It is a foundational work of that harsh
tradition. The Book of Lord Shang teaches that laws are designed to maintain the stability of the state from the
people, who are innately selfish and ignorant. There is no such thing as objective goodness or virtue; it is
obedience that is of paramount importance. The philosophy espoused in this work is quite explicitly anti-
Confucian.
258  Fung Yu-Lan (Translated by Derk Bodde), A History of Chinese, above n 41, 327.
259  Ibid.
260  Wing-Tsit Chan, A Source Book above n 33, 251.
261  H G Creel, Chinese Thought above n 181, 140.
It was a reaction against legalism that gave Chinese imperial politics its personalised and moralistic flavor rather than an emphasis on the rule of law. However, this view of the Qin may be biased, as most of the Chinese historical records were written by Confucian scholars, who had been persecuted under the Qin.\(^{262}\)

In later dynasties, Legalism was discredited and ceased to be an independent school of thought. However, according to Chen, under the traditional influence of legal and cultural heritage, law is as a tool for political, administrative, supplementary and social stability.\(^{263}\) Both ancient and modern Confucian observers of Chinese politics have argued that some Legalist ideas have merged with mainstream Confucianism and still play a major role in government. The philosophy of imperial China has been described as a Confucian exterior covering a core of Legalism.\(^{264}\) The mixing of Legalist and Confucian elements is especially evident in the Chinese traditions concerning law and justice.\(^{265}\) In other words, Confucian values are used to sugarcoat the harsh Legalist ideas that underlie the imperial system. However, Menski suggested the opposite — that it is necessary to consider to what extent classical Chinese law developed a hybrid form of legal regulation that sought to combine internalised Confucian idealism and external legalist force.\(^{266}\) It is suggested that the final stage of the conceptual development of *Li* in classical China is represented by its incorporation into the administrative and legal structures of imperial China.\(^{267}\)

\(^{262}\) Ibid 157.
\(^{264}\) 马志冰 [Ma Zhibing], above n 19, 3.
\(^{265}\) John T Meskill, *An Introduction to Chinese* above n 40, 570.
\(^{266}\) Werner F Menski, *Comparative Law* above n 23, 474–5.
\(^{267}\) Ibid 475.
Re-established as a favoured philosophy during Han dynasty, Confucianism has dominated Chinese thought ever since.\(^\text{268}\) Confucius upheld what he considered to be best in the old, and created a powerful tradition that was followed until very recent years.\(^\text{269}\) The factual co-existence of a system of formal, imperial codes with a focus on criminal laws, on the one hand, and the officially informal, but in their own way formalised, local methods of handling litigation and disputes of any kind creates a pattern of intensive interaction that is indeed unique to traditional China.\(^\text{270}\) Traditional concepts have persisted and continued to dominate the realities of Chinese life. Menski observes:

The Han empire (206 BC—220 AD) adopted all major elements from the bureaucratic structures of Qin model of governance, but did not follow legalism as a state ideology. In one of the amazing reversals of history, Confucianism replaced Legalism as the dominant ideology. Already by 100 BC Confucianism was beginning to gain recognition as the orthodoxy of the state.\(^\text{271}\)

Social relationships continued to be governed in this way, similar to the way they were in the past. No other individual in Chinese history has so deeply influenced the life and thought of people as has Confucius as a transmitter, teacher, and creative interpreter of the ancient culture and literature, and as a moulder of the Chinese mind and character.\(^\text{272}\)

The rule of law is now commonly regarded as an obligatory step to establishing China’s rightful place in the global community. Yet it is widely believed that there are no indigenous roots for the rule of law though its adoption is seen as ideal for China.\(^\text{273}\) The Chinese legal tradition developed from both Confucianism and Legalism, two influential

\(^{268}\) Shu-Hsien Liu, ‘Confucius’ above n 47, 28.
\(^{269}\) Fung Yu-Lan (Translated by Derk Bodde), *A History of Chinese*, above n 41, 48.
\(^{270}\) Werner F Menski, *Comparative Law* above n 23, 477.
\(^{271}\) Ibid 475.
schools of thought. The Confucianist ideology provided the fundamentals for the substance of traditional law. The Legalist school constructed the important framework of the traditional legal system.\textsuperscript{274} Even though Confucian and Legalist thought shared some positions, such as the insistence that the emperor had superior power over all facets of life including law, the two schools of thought had different ideas on how Chinese society should be ruled. While the Legalists believed that the Emperor had to rely on the rule of law to govern Chinese society, the Confucianists demanded that the ruler must appeal to the moral order supported by a well-behaved bureaucracy of the ‘gentry’ class.\textsuperscript{275} By the time of the Han dynasty (206 BC–AD 220), Confucianism was a popular political ideology and was adopted as the official orthodoxy of law for the years up to the end of Qing dynasty (1644–1911).

China had undergone a series social and political changes since the 20\textsuperscript{th} century began. The Qing reform began a process of westernisation of Chinese law with a focus on the area of criminal law and the reform of civil law began up to 1907.\textsuperscript{276} Fundamentally, the reforms were seen as challenging the traditional institutions and structures, ignoring the traditional values as embodied in Confucian \textit{Li}, and undermining the social function built on centuries-old social morality and customs.\textsuperscript{277} The Chinese revolution of 1911 led to the overthrow of the Qing dynasty. A Republic was established in 1912 by Sun Yat-Sen (1866–1925) who stood out as the spokesmen for nationalism and republicanism concepts.\textsuperscript{278} The Republican government, though it overthrew the Dynasty, allowed the Qing laws to continue to be used. All imperial laws formerly in force were repeatedly declared to remain

\textsuperscript{274} Xin Ren, \textit{Tradition of the Law} above n 2, 19.
\textsuperscript{275} Ibid.
\textsuperscript{276} Jianfu Chen, \textit{Chinese Law} above n 1, 21.
\textsuperscript{277} Ibid 23.
\textsuperscript{278} William Theodore De Bary et al, \textit{Sources of Chinese} above n 242, 760.
effective unless they were modified by new laws or were contrary to the principles of the
Republic. However, neither the reform of westernisation of law or modernisation of the
state was to have a utilitarian and instrumentalist approach to foreign laws and legal
systems. A specific example of the ideological difference in action was in attitudes towards
Chinese traditions and customs. It can be seen as an institutional alternative to the
traditional relationship between the rulers and the ruled. However, the breakdown of the
traditional institutions and structures does not necessarily mean the total disappearance of
the influence of traditional conceptions of law on the contemporary development of law.

The Revolution of 1911 was followed by an era of chaos without central authority;
of internal conflict; of renewed foreign pressures; and, with the Japanese invasion of the
1930s and 1940s, of full-scale war and occupation that lasted until the Communist victory
of 1949. The new government of the People’s Republic of China, facing problems of
poverty, unrepresentative and ineffective government, and national weakness since the fall
of Qing, re-established a stable political system and with comparative ease. Towards the
end of 1952 when the period for power consolidation was deemed to have passed, the
Communist party appeared to shift its focus towards economic construction. The
necessary conditions for a planned economy and a gradual transition to socialism were
deemed to have been created in 1953. Chinese Communism with a highly centralised
political system had been established.

279 Jianfu Chen, Chinese Law above n 1, 23.
280 Ibid 27.
281 Bodo Wiethoff, Introduction to Chinese History above n 31, 132.
282 Jianfu Chen, Chinese Law above n 1, 30.
284 Ibid 212–3.
285 Jianfu Chen, Chinese Law above n 1, 37.
286 Ibid.
This noteworthy achievement was partly due to political skills and a sense of organisation as well as to the long-standing Chinese tradition of political unity and to the administrative legacy. However, the Chinese were evidently aware that they could not just copy the Soviet model and knew that China’s situation was very different from that of the Soviet Union because of its enormous population and the fact that the country had historically taken a different approach to state law. Following China’s departure from Russian models in the late 1950s China underwent the political movement of the Great Leap Forward (1958–1961) and the Cultural Revolution (1966–1976). The political and economical distraction of these movements continued until 1976. China started its economic reform in late 1979 and focussed on building a socialist market economy as well as a legal system since then, as discussed in following chapters. Despite any internal problems, the CPC-led political system has proven exceedingly resilient to past and current challenges. Nevertheless, the CPC is under stress and undergoing reluctant transition. It has become necessary for the CPC to adapt to continually changing circumstances and to make compromises with other participants in the political process when it is pragmatic to do so. It is crucial for foreign investors to have a better understanding of how China’s political system functions as well as its strengths and weaknesses. However, it is also necessary to examine the role of indigenous value systems in the course of economic development and legal reform. As Menski reported, the Confucian worldview of the

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288 Werner F Menski, *Comparative Law* above n 23, 516.
common Chinese people had not just been blown away with the storm clouds of the revolution.  

3.7 Conclusions

The foregoing examination of the traditional background of the development of law in China shows some powerful underlying influences that can, it is suggested here, help to explain the nature of not only the Chinese people and the way they regard and respond to law but also the ways that laws are made by the State.

The obvious question arises about the China of today. Do these traditional attitudes persist? It is suggested here that they do and it may well be the case that Chinese people today expect that the State (replacing the emperors of the past) will rule with strength and discipline and set good examples to the people whilst, at the same time, giving respect to the inherent behavioural standards of the people themselves? If this way of thinking (and being) does apply in modern China then it would help to explain what may be described as a ‘gentle reluctance’ to take some aspects of the newly made laws — particularly those in respect of doing business — too seriously.

If this is so, and if the authorities know it to be so, where does it leave the government in its attempts to convince the international community and the WTO that it is committed to imposing a rule of law in China so that the rest of the developed world, when trading with China, can be confident of what they would describe as a ‘level playing field’.

The PRC government would want to be seen by the western free market as making strong laws and ensuring that those laws protect the latter’s interests when they are in the

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291 Werner F Menski, *Comparative Law* above n 23, 516.
role of foreign investors in China. The government also would not, it is expected, wish to appear to the Chinese people to be imposing heavy or extra burdens upon them.

It seems a reasonable observation that the PRC government recognises that there are benefits available for all parties in the exercise of foreign investment in China but that foreign investors are not going to have the unfettered access and control that their colonial predecessors often enjoyed in the ‘undeveloped’ world of past centuries. For example, the Treaty of Nanjing 1842 has been portrayed as extraordinarily significant in shaping modern Sino-foreign relations. The British consuls in the five treaty ports were only appointed to be the medium of communication between the Chinese authorities and British merchants, a formulation that was much too vague to justify a claim to consular jurisdiction involving an exemption from Chinese law under extra-territoriality. The Treaty of Nanjing was an unequal treaty as a result of British’s capitalising on its military victory and Qing China’s desire to get the menacing British forces to withdraw at almost any cost.

The following chapter explores the practical manifestations of Confucianism in the current legal system and the extent to which an understanding of these matters is important in terms of an understanding of the current Chinese economic system, particularly for foreign investors in China. The utilisation of such knowledge by foreign investors may well minimise difficulties and maximise their effectiveness in conducting their business in the PRC.

292 The Treaty of Nanjing of 1842 with its two significant annexes: the General Regulations for British Trade at the Five Ports of Canton, Amoy, Foochowfoo, Ningbo, and Shanghai; the Tariff, and the Supplementary Treaty between Her Majesty the Queen of the Great Britain and the Emperor of China.
294 Ibid.
Chapter 4

Implications of Traditional Culture for Foreign Investment

Laws in China Today

4.1 Introduction

This chapter discusses the ways in which an understanding of the role of the history of Chinese legal tradition can provide an explanation for the coherence (and sometimes a perceived lack of coherence) of the law and government in the current legal system in China. This thesis has explored the relationship between modern foreign investment in China and the laws of that country and, more specifically, the often unique application of Chinese laws to foreign investment. It is suggested that an understanding of the nature, background and influences upon Chinese law can contribute to the successful exercise of investment in or with the China of today.

4.1.1 A ‘Confucian State of Mind’ in China?

In the Confucian world view, the state was not thought of as a piece of political machinery for enforcing the law, but primarily as a means to encourage, spread, and cultivate civilised behaviour. Its ultimate aim was the realisation of the Confucian maxim that ‘all under heaven constitute one family and within the four seas all men are brothers’.\(^1\) Confucius’ primary concern was a good society based on good government and harmonious

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human relations. To this end he advocated a good government that rules by virtue and moral example rather than by punishment or force.\(^2\)

But Chinese traditions recognised only those who conformed to Confucian ethics and the civilised Chinese way of life. As a standard for his theory and a pattern for his practice, Confucius confessed to taking the customs and manners of the Kingdom of Chou, in the honest belief that they represented the best culture of the age.\(^3\) In his own personal life, he sought to exemplify those qualities that he so persistently built into his teachings on ethical character as the foundation of all true living.\(^4\) Confucious explained that the best possible way to safeguard order and harmony in society was self-controlled order, rather than government-sponsored top-down guidance.\(^5\)

According to Confucian teaching, morality, virtue, rightness and benevolence are the basic roots of government (as discussed in chapter eight). They are used to regulate social relations, to curb the natural desires of humans, and to cultivate moral habits. As evidenced by Day’s examination of Confucian teaching, if good qualities are to be practised by everybody, there must be a code of good manners, or *Li*, to include not only the rules of personal courtesy but all the best social and governmental habits.\(^6\) Confucianists opposed the replacement of moral influence by punishment and the improper application of punishment. Punishment may temporarily compel men to do what they should, but it is, at best, a poor and unreliable substitute for education.\(^7\) As Confucius said:

\(^2\) Ibid 15.
\(^4\) Ibid 34.
\(^7\) H G Creel, *Chinese Thought from Confucius to Mao Tse-tung* (The University of Chicago Press, 1953) 40.
Lead the people with governmental measures and regulate them by law and punishment, and they will avoid wrongdoing but will have no sense of honour and shame. Lead them with virtue and regulate them by the rules of propriety (Li), and they will have a sense of shame and, moreover, set themselves right.8

This is because Confucianists believed that human beings, whether their nature is good or bad, are able to be educated. As evidenced by Schrecker, the Confucianists not only emphasised that education rather than heredity was the basis of virtue, but they also felt that nearly everyone was capable and worthy of receiving an education and so, of becoming good.9 Thus moral education and influence should be the first priority in the maintenance of an ideal social order. Moral self-cultivation and self-control, reinforced through socialisation within the family, clan, guild and other social institutions, were other important social control agents in Chinese society. The underlying assumption is that man is by nature good, or at least capable of learning to be good, and therefore, society based on Li, idealised self-controlled order, will have the capacity to shape individuals into socially acceptable human beings who do the right things at the right time.10 The individual’s internal ability to control his behaviour was regarded as one of the greatest qualities of human virtue. So the fundamental governance of society is based primarily on the education in morality not on the rule of law. Chinese question whether the rule of law has been an effective tool for political stability, economic development, and the protection of human and civil rights.11 To some extent this explains that a rule of law system may not be easily adopted in China as the Chinese believe that the ultimate solution is to educate

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10 Werner F Menski, Comparative Law above n 5, 454.
people and that a harmonious society will fundamentally depend upon individual self-discipline rather than control only by reliance solely on a legal system.\footnote{Ibid.}

Section 4.1 of this chapter introduces the proposition that within the way of life of the Chinese people there is an ingrained and pervasive belief system that has resulted from centuries of acceptance of some basic principles of human behaviour. In section 4.2, some of the modern consequences of the survival of Confucian principles are explored, including consideration of the particular case of foreign investors and their relationships with Chinese partners. This section also discusses the traditionally non-litigious nature of the Chinese and their negotiating style. In section 4.3, important aspects of the individual relationships between foreign investors and their Chinese counterparts are analysed. Section 4.4 discusses aspects of dispute resolution including negotiation and conciliation processes. The existence of centralised political power in the PRC and its influence in the foreign investment system are discussed in section 4.5, with reference to the historical underpinnings of that power. Section 4.6 chronicles the role of the Communist Party in respect of law-making from the Maoist period to date. The chapter is concluded in section 4.7.

A recurring observation in this research has been the significance of Chinese history and its influence on the Chinese legal system. Menski suggests:

Equally important in social reality, however, was the uncodified system of Chinese cultural norms, which is often subsumed under the label of morality or ‘Confucian ethics’, but is manifestly a legal force of great relevance for understanding how ancient China (and, as we shall see, modern Chinese law) actually function.\footnote{Werner F Menski, \textit{Comparative Law} above n 5, 439.}
The influence has been subtle, yet so permeating to society, that it continues to have profound effects upon Chinese legal practice today. This is so despite the fact that China has experienced stages of quite radical political change and development. Its implications have been examined in several aspects in relation to foreign direct investment and the legal framework.

### 4.1.2 The Historical Consequences of Confucian Teachings

For two millennia the Chinese (following Confucian principles), presented the inspiring spectacle of a people gathered into one vast political body and united primarily not only by regimentation from above but by a community of ideas, beliefs, and traditions. Although they always represented a very large fraction of the whole human race, all Chinese wrote the same language, read the same literature, and enjoyed the same way and order of life.

Confucius’ teachings have been, without doubt, the greatest influence on Chinese society, having a monumental effect on history and culture. Chinese culture has evolved as a result of many historical influences including Confucianism to create, in modern times, a business environment that operates on developing relationships of trust.\(^\text{14}\) Menski explained that the focus on the individual conscience and requirement to ascertain for oneself what is right or wrong directs us to the social arena within which individuals act and interact that is, the social dimensions of traditional Chinese societies.\(^\text{15}\) Glenn observes:

\[\text{Guanxi} \text{ or relations are thus the key intermediaries between the individual and larger harmonious groupings, and remain so throughout Asia today. Grounded in natural human}\]


\(^\text{15}\) Werner F Menski, *Comparative Law* above n 5, 456.
affections, the entire society is meant to have a dynamic of its own, requiring little external intervention or threat of force to make it coherent.\(^\text{16}\)

There are differences between *Guanxi* and western relationship marketing. Wang demonstrates these differences by examining the construction of the two concepts:

First, it distinguishes *Guanxi* from relationship marketing in terms of the personal and particularistic nature of the relation. Second, it differentiates trust from *Xinyong*, its counterpart in Chinese, based on a comparison of their roles in relationship building and maintenance. Third, it discusses the unique meaning of *Renqing*, which is proposed as an underlying mechanism that guides behaviour norms in *Guanxi* and a mediator between trust or *Xinyong* and long-term orientation. Finally, it concludes by discussing the managerial implications for international marketers who wish to succeed in the Chinese business market and the importance of adapting Western relationship marketing principles to *Guanxi* marketing.\(^\text{17}\)

A rational and practical attitude to law in China, that involves an understanding of the effects of Confucian culture and legalism on the legal system in the course of its evolution, is thus a vital ingredient of an entry strategy for foreign investment and continued operations in China.

### 4.2 Influence of Chinese Culture on Foreign Investment

As discussed above, in essence Confucianism revolves around the concept of harmonious relationships. This manifested in subtle ways involving relationships between people and government, relationships between people at various levels of business and governmental administration. When doing business in China, establishing a local contact or agent to act as an intermediary is important. This can bring multiple benefits. The intermediary can act as a reference, be an interpreter and navigate through the bureaucracy, legal system and local business networks. One research exercise, concerning the failure of some leading Japanese


technology firms operating in China, found that to succeed in China, Japanese companies must establish local connections, networks and research centres as well as building brand equity.\textsuperscript{18} Undoubtedly, for foreign investors, differences in culture are a general problem when they do business in China. The differences may involve every aspect of an investors’ business in a joint venture, such as the relationship with Chinese parties, dispute resolution, and settlement of the relationships within the executive. As Li, Lam and Qian state:

Foreign investors can encounter problems of institutional environments which are going to influence firm behaviour and performance not only formal constraints including factors such as economic, political and judicial rules but also informal constraints such as culture and ideology in a society.\textsuperscript{19}

In practice, the successes or failures may often be the result of other factors. However, an understanding of Chinese social and cultural background by foreign investors can help them to handle the differences or difficulties encountered in Chinese society.

Professor John Child is the Chair of Commerce at the University of Birmingham and consultant for major corporations in the areas of strategic alliances, organisational design, organisational learning, and business operations in China. When asked, in relation to the difficulties of achieving international joint venture success in emerging economies such as China, what he considered the major impediments to success, he replied:

In all joint ventures, the major impediment to success is failure to achieve an adequate ‘fit’ between the two partners in two areas: strategy and culture. Strategic fit encompasses such issues as compatible objectives, adequate resourcing and potential for delivery on promises. Cultural fit covers the partners’ willingness and ability to work out a common system of

\textsuperscript{18} Donald Farquharson, ‘Companies Need Local Connection to Generate Success Within China’ \textit{Investment Week}, 23 August 2010, 1.

organisation and management and to subsume differences, or work through them, to build up trust.\(^{20}\)

In order to comprehend the Chinese social and cultural background, it is necessary to analyse the effects of these social and cultural factors in Chinese society. In this research, from the point of view of the influence of the philosophy of Confucius and the feudal regime in Chinese history, three factors – the traditional non-litigious nature of Chinese people, the importance of relationships and centralised political power - are identified and analysed as to their effects on the social and legal environment faced by foreign investors. It has been suggested above in chapter eight that the effects of these deeply rooted factors on Chinese people and society will continue to have impact on the success or failure of foreign investors.

### 4.2.1 The Traditional Non-litigious Nature of Chinese People

In the important area of dispute resolution, the Chinese style is to adopt negotiation rather than litigation. An understanding of this approach is essential in the formation of relationships with Chinese parties. A traditional non-litigious nature can be defined as a preference/propensity for negotiated settlement of disputed matters rather than the exercise of formal legal action. As Menski suggests, the nature of avoidance of the law in the Chinese cultural context, means firstly, in a wider sense, avoidance of any form of litigious activity as an indication of self awareness and as a threat to universal cosmic harmony.\(^{21}\)

This characteristic exists in Chinese people generally and reflects avoidance of disputes in Chinese cultural traditions. It originates in the philosophy of Confucius, which explains the

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\(^{21}\) Werner F Menski, *Comparative Law* above n 5, 490.
universal factors of inner and outer circles: the rules of behaviour proposed by Confucius apply to one’s inner circle, that is, to family, friends, colleagues, and acquaintances. The Chinese normally live outside or apart from the law. They do not seek out whatever rules the law contains or seek to claim their day in court, but settle their disputes and regulate their dealings with others according to their own idea of what is proper, without assertion of their rights and with conciliation and harmony as goals in mind.\textsuperscript{22} The Confucian tradition stresses that man exists through his relationships with others and that these relationships are hierarchical in nature and that social harmony rests upon honouring the obligations they entail.\textsuperscript{23} Importantly, as Menski pointed out, not only the formal legal system but in particular the informal sector have always been characterised by a certain fluidity and internal flexibility, which is conceptually required in view of the over-arching Confucian assumptions about harmony and balance.\textsuperscript{24}

\textit{Li} and surface harmony are important elements to balance inner and outer circle and seeking a state of peace is the ultimate goal. According to Bary, Chan and Watson:

For Confucius the term \textit{Li}, which basically means ‘rites’, embraced all those traditional forms which provided an objective standard of conduct. Thus, while \textit{Li} may in given instances refer to ‘rites’, ‘ceremonial’, or ‘rules of conduct’, it has the general meaning of ‘good form’ or ‘decoration’. Confucius insisted, however, that the observance of Li should be neither perfunctory nor rigid and inflexible, but should be in keeping with circumstances and also with that spirit of reverence and respect for others which the ceremonies or rules of conduct were meant to embody.\textsuperscript{25}

The \textit{Li}, in short, constitutes both the concrete institutions and accepted modes of behaviour in a civilised state.\textsuperscript{26} Proper etiquette preserves harmony and ‘face’.

\textsuperscript{22} René David and John E C Brierley, \textit{Major Legal Systems in the World Today} (Stevens and Sons, 1978) 480.
\textsuperscript{24} Werner F Menski, \textit{Comparative Law} above n 5, 478.
\textsuperscript{26} Derek Bodde and Clarence Morris, \textit{Law in Imperial China} (Harvard University Press, 1967) 19.
Therefore, the true emotions of a person do not matter as long as surface harmony is maintained. For example, a public argument, or a boss reprimanding a staff member in front of others would disturb surface harmony and cause a loss of face. This is why the Chinese often use an intermediary to deliver bad news or unpleasant messages. As Tang and Ward suggested, ‘face’ serves as the lubricant necessary to sustain harmony amongst those living in situations where moving away is not an option.27

Despite the best endeavours, conflict can still break through the surface of tranquility that the Chinese long to maintain.28 According to a survey conducted by Tang and Kirkbride, a comparison of Chinese and British attitudes towards dispute resolution confirmed that the Chinese managers, both public and private, favoured the less assertive ‘compromising’ and ‘avoiding’ solutions, in contrast with the British officials who preferred the more assertive ‘collaborating’ and ‘competing’ styles.29

This nature of avoidance of law is sustained in the Chinese legal system and it seeks to rely on internalised, self-controlled order in the first place then, if that fails, tries to keep the violation of harmony and order at the lowest possible level, given that fomenting litigation is a negative act in itself.30 These are manifestations of the moral precepts and moral teaching of Li have been an integral part of, and formed the basis of, ancient Chinese legal culture.

28 Ibid 20.
30 Werner F Menski, Comparative Law above n 5, 490.
4.2.2 The Chinese Negotiating Style

The traditional non-litigious nature of Chinese people is one of the effects of the philosophy of harmony. Building up a good long-term relationship is preferred by Chinese people to the legal obligations of the parties set out in a formal contract. Most foreign investors have experienced this Chinese negotiating style. The purpose of negotiation is often to emphasise interpersonal relations rather than a concentration upon the details of a contract. As Brahm and Li suggest:

Chinese society is process-oriented. Consequently, for the Chinese, negotiations often involve understandings and intentions not spelled out in the final contract … Because of Confucian values and the Chinese emphasis on interpersonal relations, these requests may have nothing to do with the contract terms at all.\(^{31}\)

In the case of Shanghai Volkswagen Automotive, according to the technical executive director,

Although operations began in September 1985, the negotiations process had required several years of patience dating back to 1978 … perhaps somewhat in the tradition of the Confucian Dynamism, they are willing to take the long-term view and plan for a brighter future.\(^{32}\)

So ignorance of legal details in negotiation has its root in the long history of Confucianism. As Li, Lam, and Qian noted, describing the establishment of the joint venture ‘New World’ in Wuhan City:

New World set up good ties with the government in Wuhan City and other Chinese cities. These relationships proved very helpful during later negotiations in China … they (foreign investors) often quickly establish a JV, without careful negotiation and contracting.\(^{33}\)

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\(^{33}\) Ji Li et al, ‘Does Culture Affect Behavior’ above n 19, 116.
Having a long-term perspective, successful foreign investors consider setting up JVs as the first step in building lasting relationships. They will later rely on the rapport established to solve problems resulting from issues such as lack of feasibility studies or clear contracts.

4.3 Relationships with Chinese Parties

Guanxi (or relationship) is a key to a successful undertaking in the Chinese environment. Although it is true that the need to develop relationships is not unique to China, it is understood that relationships play a much greater role in Chinese society than in a typically western society. To better grasp this need for cultural awareness, Hofstede suggests:

International managers and management theorists require a deeper understanding of the range of culture determined value systems that, in fact, exist among countries, and should be taken into account when transferring management ideas from one country to another.\(^{34}\)

It is in the tradition of Confucian Dynamism, in regard to short-term versus long-term view, that the Chinese are willing to take the long-term view and plan for a brighter future. As Myrna and Raffaele state:

In discussions with SVW expatriate management, it became obvious that the agreement to enter China was made with full consideration of China’s long-term view. A long-range plan was implemented that would cover ten, twenty or more years.\(^{35}\)

On the other hand, one important implication is that foreign firms strictly pursuing dominant control over their local JV partners may fail to gain their local


\(^{35}\) Myrna Cornett-DeVito and Raffaele DeVito, ‘Cross-border Cooperative Agreements’ above n 32, 43.
partners’ assistance for entry to a local market. As Posth (of Volkswagen Asia Pacific) explained, it was necessary for Volkswagen to build up a long-term relationship with Chinese parties, particularly with local governments. In this respect, Posth observes that:

Strategically … the Chinese respect the fact that we took a lot of risk. We made it clear that we were willing to transfer our knowledge from the beginning. Not for one week or one year, but permanently. Since then we have done a lot more than we promised in the contract. But without the help of the Chinese government and the city of Shanghai we would be a dead duck. We rely on our partners, and that is one of the simple secrets of the success of Volkswagen in China. 36

Similarly, a good working relationship must have, at its core, an understanding of different cultural norms. Child suggests:

We come back here to the question of whether the foreign partner seeks to dominate the joint venture, bringing in its own practices, corporate culture and so forth, or is prepared to work towards establishing a new culture for the joint venture, working with and learning from the local partner so that the two ‘blend’ together, adopting the best elements of both cultures. 37

It has been suggested that some Chinese partners might have political agendas that affect their attitude toward a proposed joint venture and reduce the level of reciprocity that one would normally expect. Wong, Maher, Jenner, Appell and Hebert make a controversial observation by saying that:

An important reason for this is the Chinese belief that they have not been dealt with fairly over the decades and that now is time to even the score. This has exacerbated their cultural propensity to relentlessly pursue the addition, modification, or elimination of contractual terms already agreed upon rather than focus on compliance. 38

This observation would appear to be an over-generalisation and, it is suggested, does not represent a fair or rational assessment of reality. In the final analysis, business is

about the pursuit of profit and in this respect the Chinese are no different to anyone else. The history of the last decade has shown that the assertion by Wong et al, that the popularity of foreign/Chinese joint ventures in China was declining, was incorrect as was their comment about ‘even[ing] the score.’

A strategy of co-operation with Chinese parties should be based not only on the surface level of obligation but also an understanding of (and respect for) culture. The foreign partner should expect to have to continue to depend on Chinese co-operation, or at least acquiescence.

### 4.4 Dispute Resolution

Avoidance of open conflict in dispute resolution is another effect of the traditional non-litigious nature of Chinese people, although some litigated means of resolving their conflicts or disputes is provided. China offers mechanisms such as consultation, negotiation, conciliation (or mediation), arbitration and litigation to settle disputes. Mediation has been widely used in China as an effective means of dispute resolution, and has now become embedded as an integral part of both the litigation and arbitration process. Mediation, regarded in China as commendable, is the process of facilitating agreement between two parties. Essentially, mediation seeks to resolve disputes in a way acceptable to all parties without loss of face and it is primarily a method for defusing or dispelling confrontations. Of the many forms of dispute resolution, litigation has never been a popular mechanism. Less formalistic ways of resolving disputes are preferred in

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39 Ibid.
China. According to Wang, ‘in recent years, these traditional non-litigious methods have often been accepted in foreign-related civil and commercial disputes.’ For instance, it is common to insert an arbitration clause in a joint venture contract. Such a clause directs that if a dispute arises between the joint venture parties, the parties agree to take the case to an arbitration commission for resolution rather than seeking to solve the problem in the People’s Courts. This practice has become popular among foreign investors for three reasons, namely the reduction of legal costs, the maintenance of business relationships, and the avoidance of what is regarded by some as the uncertain, imperfect and prejudiced Court system in China.

Negotiation is the form of dispute resolution that is most attuned to Chinese culture and attitudes because: (a) that culture favours harmony and good relationships between people, and (b) most Chinese people would prefer a compromise that represents control and involvement of the parties. Chinese people, when handling commercial and civil disputes have generally had this attitude. Although negotiation has been mentioned in a number of PRC Laws concerning foreign investment in China, there is no formal requirement for negotiation. For example, Article 14 of the Equity Joint Venture Law 1979 provides that if a dispute cannot be resolved through consultation, it should then be conciliated or arbitrated. The language of the above-mentioned provision was intended to encourage parties to resolve their dispute through a less formal and less costly process than litigation. Parties to a process of negotiation, conciliation or arbitration have more autonomy to make a rational choices (or compromises) than they do within the process of litigation. This may explain why negotiation, conciliation and arbitration are encouraged.

in Chinese law. Most Chinese would prefer not to take an action in the People’s Court. Only in the last 20 years, after the introduction of various economic reforms, has litigation of commercial disputes become more familiar to the Chinese people. However, with civil disputes, people may still prefer to settle them by the other means. As Brahm and Li asserted, ‘Chinese culture places a premium on harmony; open conflict is something to be avoided.’

4.5 Centralised Political Power

Although China is a vast country with an immense population, a long history and a splendid historical heritage, her economic, political and cultural development was sluggish for a long time after the transition from slavery to feudal society. This feudal society, began with the Dynasties of Zhou (1122 BC to 256 BC) and continued to the Qin dynasty (221 BC to 207 BC), lasting for over 800 years. The feudal landlord state was the organ of power protecting this system of feudal exploitation. While the feudal state was torn apart into rival principalities in the period before the Qin Dynasty, it became autocratic and centralised after the first Chin emperor unified China, though some feudal separatism remained. The emperor reigned supreme in the feudal state, appointing officials in charge of the armed forces, the law courts, the treasury and state granaries in all parts of the country and relying on the landed gentry as the mainstay of the entire system of feudal rule. One of the most

46 Ibid 37.
remarkable features of Chinese history is its great age and continuity, having had over three thousand years of unbroken cultural and political tradition.\textsuperscript{48}

A reason for pursuing a centralised political system was to provide unity to the nation and consolidate the feudal monarch’s power. As Zhou illustrates:

Chinese culture, tradition, custom, and social structure in the first stage had an astonishing and remarkable impact on the whole of Chinese history. The main characteristic of Chinese history in the first stage is the patriarchal system. The patriarchal system is the primitive miniature of Chinese history and the base of its highly centralised political system which lasted more than 2000 thousand years in China.\textsuperscript{49}

China is one of the few countries in the world that is overwhelmingly culturally and ethnically homogenous. The unity of the sovereign State (and central imperial rule) was paramount, and even the slightest challenge to it was to be prevented at all costs. The real administrative and political power resided in the parallel organisational hierarchy. The greatest fear for an emperor had always been the secession of nationality regions and the consequent disintegration of the sovereign State and central rule. The main reasons for the establishment and maintenance of a highly centralised political structure in China were the need for arbitration in internal disputes and the need for national defence against external invasions.\textsuperscript{50} This belief in the unity of China dates back to Imperial times. The Chinese have consistently sought to unify themselves, and from the Sui Dynasty onward enjoyed almost unbroken rule under a single government. To achieve these purposes, the executive

\textsuperscript{48} John E Schrecker, \textit{The Chinese Revolution} above n 9, 3.
enjoyed power to govern every aspect of life such as the political, economic, educational and social life, and each was responsible to the monarch. Law as an instrument of government played the role of strengthening the feudal system. Zhao observed that China’s historical failure to develop the rule of law and, instead, adopting a highly centralised political system, may be attributed to its historical legacy of highly centralised rule and its political-philosophical emphasis on rule by virtues and virtuous men.\textsuperscript{51}

Certainly, both the centralised political system and the force of traditional thought of Confucius were powerful means for a feudal monarchy to rule a vast country. On the one hand, centralisation of political power weakened the effectiveness of laws. As Menski observes:

\begin{quote}
Despite the hierarchical ordering and other formal remnants of legalism in the codes, it is important to be aware that the administration of the entire system was thoroughly infused with Confucian ideology which underpinned the legal administration of imperial China for almost 2000 years down to 1912. It must also be remembered that legal administration was not a separate government activity but an integral part of the administrative machinery.\textsuperscript{52}
\end{quote}

For example, Bodde and Morris pointed out the facts that; the judicial system of imperial China, like the governmental system as a whole, was a centralised monolith with no division of powers; that there was no private legal profession; that at the lowest level of the district or department, where all cases originated, the magistrate rarely possessed any specialised legal training and handled the cases that came before him simply as one of many administrative duties.\textsuperscript{53} On the other hand, the preference for avoidance of conflict has a greater ingrained influence on Chinese people’s behaviour than do legal rules.

\textsuperscript{52} Werner F Menski, Comparative Law above n 5, 485.
\textsuperscript{53} Derk Bodde and Clarence Morris, Law in Imperial above n 26, 113.
Nowadays, even though the feudal system has been replaced, traces of these cultural and social factors still remain in Chinese society and the Chinese people.

Foreign investors in China can expect to experience the shock of these differences to their own cultural and political backgrounds. The experience of Shanghai-Volkswagen Automotive Co Ltd is an example of the effect of the traditional non-litigious negotiating style with Chinese parties in respect of cooperation, relationships and dispute resolution. Additionally, the underlying influences of centralised political power are reflected in the legal requirements for foreign investment proposals.

4.6 Law and the Communist Party in the PRC

It is often suggested that the Chinese traditional philosophies and the westernisation of Chinese law at the end of the Qing period had been replaced or abandoned since the establishment of the PRC in 1949. As Wing-Tsit Chan suggested, ‘Philosophy in Communist China can be summed up in one word, Maoism.’ Indeed, the sources of Mao’s inspiration were Engels, Marx, Lenin, and Stalin and not the Confucianists. However, the origin of the current legal system can be traced back to the period of the Chinese Soviet Republic in the revolutionary period prior to the establishment of the

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54 As a result of the increased contact with the West during the late Qing period China had more trade activities with the west and exposure to western liberal ideas. A strong undercurrent of westernisation and political reform began to grow alongside intellectual attempts to modernise. Events including the Taiping and Boxer Rebellions (1851–1864), the Self-Strengthening Movement of 1860–1894, and the Hundred Days of Reform of 1898 are all testament to the atmosphere of change in China. See Patricia Blazey and Kay-Wah Chan (eds), The Chinese Commercial Legal System (Lawbook, 2008) 45.


56 Wing-Tsit Chan, A Source Book in Chinese above n 1, 773.

57 Ibid.
In 1954, the first *Constitution of the PRC* was promulgated. It is the fundamental law of China and has the highest legal binding power. It states the country’s fundamental system and aspirations.

The socialist elements of the Chinese legal system come primarily from Soviet sources. The ideology or spirit of such laws was obviously influenced by the then Soviet Union. The Soviet Union served as an ideal model for China. In that period, the Chinese government relied not only on the Communist Party and workers and peasants but also on capitalists and intellectuals who agreed with the socialist system. The laws, including the *Constitution*, were quite balanced in reflecting the interests of these sections of the Chinese population.

From 1957 to 1976, with the exception of three to four years in the early 1960s, China was deeply engaged in political movements. Its laws of that period reflected the ‘class struggle’ type of political environment. At the same time, China adopted a highly centralised, planned economic system. Economic plans and administrative orders, instead of law, had binding force on local governments and enterprises of different sectors of the economy such as manufacturing, distribution and service. Laws thus became a tool of...
class struggle. The role of law was reflected in the communist ideology during early period of the founding of the PRC in which law was basically used as a political weapon with the terroristic threat of force. Liu Shaoqi, the president of the PRC in 1956, said in the Eighth National Congress of the CPC in 1956:

During the period of revolutionary war and in the early days after the liberation of the country, in order to weed out the remnants of our enemies, to suppress the resistance of all counter-revolutionaries, to destroy the reactionary order and to establish a revolutionary order, the only expedient thing to do was to draw up some temporary laws in the nature of general principles in accordance with the policy of the Party and the People’s Government.

In fact, in the ten years of the Great Cultural Revolution, laws were not considered to be necessary, let alone important, to society.

4.6.1 The Post-Mao Period

The situation did not change until the leader of Communist Party Mao died in 1976. Pragmatic policies were adopted by the Chinese Government in 1978 when the government announced that the country would, from then on, concentrate its efforts on economic construction. That announcement was not surprising as at that time the Chinese economy was on the verge of bankruptcy. This did not mean, however, that the Chinese government

organisation and ideology, also called ‘Socialist Education’). Then it was interrupted and followed by the so-called ‘Cultural Revolution’ of 1966–1976 during which virtually all laws and the entire legal system were destroyed. Personal pronouncements and party policies replaced law.

70 The Great Cultural Revolution was a violent mass movement that resulted in social, political and economic upheaval in China starting in 1966 and ending officially with the death of Mao in 1976. It resulted in nationwide chaos, economic disarray, and stagnation.
71 Kuihua Wang, *Chinese Commercial Law* above n 42, 12. It took until 1979, when the Chinese Government adopted a policy of opening up to the outside world to welcome foreigners and foreign capital, for the Government focus to return to law-making. Much of this legal reform was primarily aimed at economic reform and, in particular, the encouragement of foreign investment.
had decided to change its political directions or ideology, quite the contrary. The 1982 Constitution stipulated the ‘four cardinal principles’ as guiding principles for the development of the country.

On the economic front, however, the government realised the need to modify its rigid economic system, including central planning and People’s Communes. Economic growth requires capital and advanced technology as well as advanced methods of management. The pragmatic policies therefore directed that those requirements be imported from foreign countries and the neighbouring regions. In 1979, when the Chinese government adopted a policy of opening up to the outside world to welcome foreigners and foreign capital, the government had little choice but to begin making relevant laws.

As far as the Chinese current legal system is concerned, it is natural to pay much attention to its Communist system. However, it should be realised that it too has grown up in the soil of China and inevitably must be affected by the profound and deeply entrenched Chinese culture. Blazey states:

In the world of business, customs and culture play a large part, so much so that the prospective foreign investor cannot expect to meet with any success in China without an understanding of how the Chinese undertake business and how it intermingles with Chinese culture. Chinese culture has evolved as a result of many historical influences such as Confucianism, to create a business environment that operates on developing relationships of trust.

Economic reform has now been taking place for more than 30 years and social conditions have been dramatically changed. There has been debate among those who are

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72 The ‘four cardinal principles’ refer to upholding the pursuit of the socialist road, the proletarian dictatorship, communist party leadership and adherence to Marxist-Leninism-Mao Zedong thought.


74 Patricia Blazey, ‘Culture and Its Relationship to Undertaking Business in China’ in Patricia Blazey and Kay-Wah Chan (eds), The Chinese Commercial Legal System (Lawbook, 2008) 57, 57.
interested in Chinese law about whether a western legal system should be transplanted into China.\textsuperscript{75}

It is clear that a very large proportion of the legal reform that has been undertaken has been driven by the needs of economic development. Much of this legal reform was primarily aimed at the encouragement of foreign investment.\textsuperscript{76} From 1978 to 1989, numerous laws and administrative regulations were adopted to encourage foreign investment and domestic economic reforms. In fact, since the late 1970s, the Chinese Government has implemented hundreds of laws and regulations to govern China’s economic development.\textsuperscript{77} In the period from mid–1997 to mid–1999, the NPC and its Standing Committee alone passed or issued over 327 pieces of legislation and decisions.\textsuperscript{78} Issues in relation to political reforms were raised several times but no major law in this area was adopted in that period. Regarding this, Keith observes that:

The specific connotations of “policy is the soul of law” varied with changes of Party line, but it often related to the Party’s political need for extra-legal flexibility in dealing with class enemies. Party policy was not only a priori to law, but, in the absence of law, policy acquired the role and status of law.\textsuperscript{79}

The situation changed with Deng Xiao Ping’s tour to southern China in 1992 during which Deng worked hard to promote economic reforms and, in particular, the establishment

\textsuperscript{75} Ronald C Keith, ‘Chinese Politics and the New Theory of Rule of Law’ (1991) 125 China Quarterly 109, 118. “In light of widespread western condemnation of the Tiananmen Square event, it may seem somewhat capricious to raise the issue of the “rule of law” as it is understood in China; however, prior to 4 June the Chinese Communist Party sanctioned a provocative theoretical debate which featured the “rule of law” as opposed to the “rule of man.”

\textsuperscript{76} Ibid.

\textsuperscript{77} Ibid.


\textsuperscript{79} Ronald C Keith, ‘Chinese Politics’ above n 75, 110.
of a market economy with socialist characteristics. Since then a number of important laws have been enacted in relation to commercial transactions, administrative litigation, the judiciary system and others. These include: the *Company Law of the PRC 1993*, *National Compensation Law of the PRC 1994*, *Contract Law of the PRC 1999*, *Copyright Law of the PRC 2001 amendment*, *Trademark Law of the PRC 2001 amendment*, and the *Enterprise Bankruptcy Law of the PRC 2006*. Such laws have contributed greatly to establishing the legal order of the domestic market and its relationship with the international market by providing compatible legal prescriptions.

Economic exchanges with foreign countries and regions and China’s own effort to join the WTO have gradually made the Chinese market an integrated part of the world market. China is the largest economic/trading power among developing countries and in 2008 was the seventh largest merchandise exporter in the world. The Chinese economy has become an inseparable part of the global economy. The interdependence between China and the rest of the world makes it impossible for China to resist the cultural, political and

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legal influence of foreign countries on the one hand, and to welcome foreign capital and advanced technology on the other.

Changes in the economic environment have also developed awareness and an understanding of law in society in China. Law was defined as the total sum of the codes of behaviour enacted or approved by the State to be implemented with the guarantee of the State’s power of enforcement in accordance with ‘the interest and will of the ruling class’.\(^{88}\) Whilst making the law, the ruling class must take into account the endurance and strength of the ruled or the non-ruling class. In addition to the restraints of material conditions, law is also subject to politics, morality, culture, history, tradition, science, and technology.\(^{89}\) As Professor Zhou asserts:

Law is the total sum of the social stipulations in the form of the will of the authority. It serves as the basis for the judiciary in handling cases, has the characteristics of universality, explicitness and certainty whose contents mainly stipulates rights and obligations, mainly and primarily reflects the will of the ruling class, and eventually is subject to social and material conditions.\(^{90}\)

Hence, according to these theories, since China is ruled by the people, the will of the ruling class is also the will of the people.\(^{91}\) Even though there has been influence of Marxist theory on the legal system it seems that traditional Confucian thought still impacts on current authorities and is crucial to the direction of the nation. For example, the former President Jiang Zeming (in a speech at the Meeting Celebrating the 80\(^{th}\) Anniversary of the Founding of the Communist Party of China in 2001) said:

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88 Ibid 10.
The fundamental task of developing a socialist culture is to turn people from generation to generation into citizens with lofty ideals, moral integrity, better education and a good sense of discipline. We should persevere in arming the people with scientific theories, guiding them with correct public opinions, shaping their outlook with noble ideas, and inspiring them with good cultural works ... We should combine the rule of law with the rule of virtue in order to lay a lofty ideological and ethical foundation for a good public order and a healthy environment.  

It is not easy to distinguish clearly between the impact of Communism and that of traditional values on contemporary Chinese politics. However, there have been and still are existing party policies that reflect the traditional norms. For example, in the Communist Party of China Sixteenth Central Committee of the sixth Plenary Meeting in 2006, in a comprehensive analysis of the study of building a socialist harmonious society, made the following decision:

Social harmony is the essence of socialism with Chinese characteristics and attributes. It is the country’s prosperity, national rejuvenation and an important guarantee for the well-being of the people. Building a socialist harmonious society, our party looks to Marxism-Leninism, Mao Zedong Thought, Deng Xiaoping Theory as guidance to carry out the scientific concept of development from the socialist cause with Chinese characteristics and the overall layout of a well-off society. The overall situation of our major strategic task reflects the building of a prosperous, democratic, civilised and harmonious modern socialist country with the inherent requirements of the whole party embodying the common aspiration of people of all ethnic groups.

This suggests that there still is, in modern China, a very close nexus between ethical and political theory as it was expressed in Confucianism.

During the past 30 years, in line with decisions to completely reform its economy, China has done much to establish a modern and internationally recognised legal system

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92 江泽民 [Jiang Zeming], ‘江泽民在庆祝建党八十周年大会上的讲话’ [Speech at the Meeting Celebrating the 80th Anniversary of the Founding of the Communist Party of China, Beijing], The People’s Daily, 2 July 2001, 1.
with an emphasis upon rule by law rather than rule by the CPC. In the 1993 Constitution amendment, the concept of a ‘socialist market economy’ was introduced to replace the ‘planned economy’.\(^95\) In the 1999 Constitution Amendment, a provision was added to state that the PRC ‘governs the country according to law and makes it a socialist country under rule of law’.\(^96\)

Party control over the judicial system has weakened. In Jiang’s research on Chinese legal reform, he asserts that even though much of the work to develop laws is ‘on track’, there are still many obstacles to be confronted in the course of legal reform. There is tension between China’s old and new economic structures and between law and politics. In particular there is still a substantial gap to be bridged between the creation of legal norms and the enforcement of such norms.\(^97\) In fact, whilst China has been quietly reforming its legal system for decades, China’s legal system is not as prominent as are those in the west.

The question of whether a westernised legal system is suitable for China may be a central issue in any examination of the current Chinese legal system. As discussed in previous chapters, China has developed its legal tradition for a long period of time and a solid fundamental Confucian culture has influenced not only every aspect of Chinese society and politics but also how the government rules society. Some might argue that the rule of law is the ultimate answer for China.\(^98\) However, it would be too simplistic to

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\(^{96}\) Ibid art 5.


\(^{98}\) There has been some debate about the existence or otherwise of the rule of law in China as part of China’s admission to WTO. China’s commitment to comply with WTO legal requirements is regarded as an opportunity for China to transform into a rule of law country to be consistent with all the other WTO members. See Pat K Chew, ‘The Rule of Law: China’s Scepticism and the Rule of People’ (2005) 20 Ohio
transplant the rule of law into China without consideration of China’s thousands of years of history. Miyazawa agrees that law and culture are inter-related when he suggests that:

All laws are culture-laden, and even ostensibly universal law is actually based on unique and local culture; people evaluate imported laws and indigenous laws on their relative performance in facilitating efficient market transactions, as well as on their relative success in enabling good society, and they rely on their own culture to discern the good from bad; and through a global transmission of ideas and institutional information, a combination of cultural law and universal law will emerge.\textsuperscript{99}

It is therefore not surprising, or controversial, that any study of Chinese law (and in particular its practical manifestations) must take serious account of the cultural and historical underpinnings of such law. To ignore these aspects would be to deny the opportunity to either understand why things are happening in the way that they do and, for business purposes, to possibly invite failure.

4.6.2 The Role of the Communist Party of China in Reality

China’s political system and decision-making processes are often a mystery to western society. The CPC came into the dominant power since 1949 and has continued to rule as a one-party state to the present. The CPC formally established in Shanghai on 23 July 1921 and operated upon the base principle of democratic centralism.\textsuperscript{100} In theory the CPC’s democratic centralism allows for debate and discussion of policy among Party members but requires unquestioning support of policy once decisions are made.\textsuperscript{101}

The party’s most powerful policy and decision making entity is the Politburo and its Standing Committee. The rest of the CPC formal structure consists of layers of local, municipal and provincial party congresses and committees. The contemporary CPC is organised into an expansive, hierarchical network of organisations that reach into many aspects of society. A wide variety of institutions including universities and schools, state-owned enterprises and private corporations frequently have party committees.

The Constitutional basis for the CPC’s leadership has been set down in different (political, social, economic, legal, military, cultural and spiritual) aspects of the state.\(^{102}\) As the Preamble of the Constitution states, ‘under the leadership of the CPC the Chinese people will continue to adhere to the people’s democratic dictatorship and the socialist road’.\(^{103}\) The CPC’s centralised administration reflects the fundamental principals of unification of the nation through strong control by the central government as has often been the case in Chinese dynastic history. Despite China’s vast population and massive geographical area, it has demonstrated efficient management of its very significant economic development over the past few decades. At the same time however, such centralised control of administrative systems has presented difficulties in accommodating the needs of foreign investors. These matters will be explored in more detail in chapter 8.

### 4.7 Conclusions

The social organisation of any highly evolved civilisation is not a mere consequence of natural evolution. Its structure is largely a result of conscious efforts built on the basis of

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philosophies.\textsuperscript{104} China had created her notions of governing state and made success of uniting the whole country over more than a thousand years of civilisation. The mixing of Legalist and Confucian elements is especially evident in the Chinese traditions concerning law and justice.\textsuperscript{105} It would appear that there is a resilient core of Confucianist thinking in the culture of Chinese people that is so strong that it may have become be a serious factor in the way that some laws are made in China and certainly in the effectiveness of some laws in practice. Chinese legal development is in many ways sharply different from that experienced in other civilisations.\textsuperscript{106} As Van der Sprenkel pointed out that there are three unifying and interrelated features:

 Dependence on irrigated agriculture; a centralised, bureaucratic administration and a literary tradition, the most important elements in which were ethical philosophy and history. A centralised hierarchical bureaucracy which identified itself with an ethical and political orthodoxy, was able to impose on the governed a picture of society in which the unity of the whole was exaggerated, its own role was overstressed and the value of Confucian thought was overweighted in relation to that of other schools.\textsuperscript{107}

The reforms that began in the late 1970s and accelerated in the 1990s have proven to be appropriate to the needs and possibilities of Chinese society and led to remarkable success, particularly in economics.\textsuperscript{108} In respect of laws relating to Chinese doing business with foreigners in China, there may be some reluctance by the Chinese people to readily adopt certain parts of a system of rigid laws to govern their behaviour. There may even also be some reluctance by the government, administrative authorities and Courts to enforce such

\textsuperscript{104} Weibin Zhang, \textit{Confucianism and Modernisation: Industrialisation and Democratisation of the Confucian Regions} (Macmillan, 1999) 59.
\textsuperscript{106} Derek Bodde and Clarence Morris, \textit{Law in Imperial} above n 26, 49.
\textsuperscript{108} John E Schrecker, \textit{The Chinese Revolution} above n 9, 231.
parts of laws that conflict with the very nature of the people to which the laws (or parts of laws) apply.

In the west, laws are invariably described as being a barometer of public attitudes, opinions and moral standards. They are changed along with changes of political control of states and with variations in people’s attitudes and standards as assessed from time to time. Regrettably, those ‘assessments’ can often occur by way of superficial, media-led campaigns or political manipulation of people’s fears or ignorance.

For western governments, academics or those engaged in business in the west to suggest that western law-making, in terms of method or content, provides the only acceptable standard of law-making that should be applied in China, or anywhere else in what may be described as the ‘developing world’, is somewhat arrogant but, historically, not unusual. Clearly, there are elements of the culture of China that manifest themselves in different ways of dealing with relationships, including business relationships. Those foreigners wishing to engage in business in China simply need to accept those differences. For China’s government however, expressing those different approaches or attitudes in the form of written laws may be difficult or even impossible.

The question has arisen about whether the centralised power of the CPC, in managing the economy of the PRC and the whole process of foreign investment, is an issue of real concern for foreign investors. As indicated above, the role of the CPC has been placed at the centre of state administration. The leading role of the CPC in the country is also demonstrated by the fact that the CPC leaders also hold the state leadership positions.\footnote{Kay-Wah Chan, ‘The Communist Party’ above n 102, 38.} This centralised decision-making is often, in reality, not quite as dominant as it
might appear by virtue of the making of national laws and regulations and the administrative functions of ministries in Beijing.

The following chapter expands on the development and implementation of laws of China that are directly and indirectly concerned with, or relevant to, foreign direct investors in the PRC.
Chapter 5

Foreign Investment and Development of Foreign Investment Laws in China

5.1 Introduction

China’s absorption of foreign investment is an important component of China’s fundamental principle of opening up to the outside world and a significant practical expression of Deng Xiaoping Theory¹. It is part of the massive task of building up the ‘socialist economy² with Chinese characteristics’.³ According to statistics of foreign investment released from the Ministry of Commerce, the value of approved foreign-invested enterprises in 2010 amounted to USD27.406 billion, up by 16.94 per cent year on year, and the actual use of foreign investment reached USD105.735 billion, up by 17.44 per cent year on year.⁴ Foreign investment has not only contributed to rapid economic growth

¹See Chapter 1 footnote 7.
²<<中共中央关于建立社会主义市场经济体制若干问题的决定>> [Decision Concerning a Number of Issues of Establishment of Socialist Market System] (People’s Republic of China) The Third Full Meeting at the Fourteenth National Congress of Communist Party of China, 14 November 1993, [2]–[4]. The socialist market economy or ‘socialist market economy with Chinese characteristics’ is the official term used to refer to the economic system of China after the reforms of Deng Xiaoping; it is also referred to as ‘socialism with Chinese characteristics’. It consists of a mixture of socialist planning with a market economy. The socialist market economy is a concept first proposed by Deng Xiaoping in order to incorporate the market into the then planned economy of China. Following its implementation, this economic system has supplemented the centrally planned economy in China and the high growth rates in GDP during the past decades have been attributed to it. Within this model, privately owned enterprises are a major component of the economic system.
in China but also facilitated its legal reform since the various economic players’ interests require legal protection. This chapter outlines the development of foreign investment in China since the commencement of economic reforms and introduces the legal framework applicable in the foreign investment sectors. Section 5.2 gives a background to China’s ‘Open Door’ economic policy in 1978 and a broad indication of how foreign investment has grown in the ensuing period. Section 5.3 considers the growth of foreign investment and China’s place in international economic ratings. Section 5.4 chronicles the establishment and development of foreign investment laws and includes details of four distinct stages in the development of those laws. In section 5.5, the legal sources of Chinese foreign investment law are analysed including references to the Constitution of the PRC, specific national FDI laws, national implementation regulations and rules for FDI, local regulations, FDI provisions in other laws and regulations, international treaties and internal regulations. Section 5.6 summarises and concludes the chapter.

5.2 Background of the ‘Open Door’ Policy and Foreign Investment

At the Third Plenary Meeting of the Central Committee of the Eleventh Term of the China Communist Party in December 1978, the ‘Four Modernisations’ (agriculture, industry, defence, and science and technology) were added to the Revised Rules and New Constitution of the Communist Party.\(^5\) To achieve these ‘modernisations’,\(^6\) China engaged in economic reform centred on the introduction of an open market economy. The reform

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covered most areas of the economy, including agriculture, corporate business, pricing structure, financial structure, trade and direct investment, and distribution structure.\(^7\) Since the meeting, China has undertaken the promotion of various economic cooperation programs with western capitalist countries.\(^8\) This policy of reform and openness, which is still in full force, has brought drastic changes to the economy and society of China. Attracting foreign capital and advanced technology was a core component of the ‘Open Door’ policy as part of the aim to achieve economic reform in China. China is now the largest exporter and recipient of FDI among developing countries. It achieved an average annual real growth rate of around 9.5 per cent over the period 1978–2000.\(^9\) According to the findings of Mo:

In 1996, there were about 281,298 foreign invested enterprises operating in China and the total actual investment made there had amounted to about USD1,716.83 billion. Another source reports that as of the end of June 1996, there had been 273,325 foreign-invested projects in China. Of that number, 120,000 had started operations. In 1997, China’s export and import trades amounted to USD325 billion, making it the world’s tenth largest trading nation in terms of annual trading volume. Also in 1997, China actually absorbed about USD45.2 billion in foreign investment, which suggests that there was already a strong trend in the development of foreign investment in China.\(^10\)

In 2007, China ranked as the world’s fourth largest economy, a position it had occupied since 2006, when it overtook the UK to stand behind the USA, Japan and Germany.\(^11\) In February 2011, China moved ahead of Japan to become the world’s second largest economy.

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\(^8\) Gregory C Chow, *China’s Economic Transformation* (Blackwell Publishing, 2\(^{nd}\) edition, 2007) 54. Deng Xiaoping’s Open Door policy encouraged the opening of China to foreign imports and the promotion of exports. Foreign investment, the second component of Open Door policy, was promoted through the opening of different regions of China.


largest economy, behind the USA.\textsuperscript{12} By comparison to other developing countries with fast economic growth such as India, Russia and Brazil, the International Monetary Fund forecast that China would (in 2011) achieve a GDP growth of 9.6 per cent compared to India with 8.2 per cent GDP growth, Russia with 4.8 per cent GDP growth, and Brazil with 4.1 per cent GDP growth.\textsuperscript{13}

5.3 Economic Growth over the Past Thirty Years

While the government of the PRC actively encouraged foreign investment, the continued inflow of foreign money and competition has led some PRC companies and government agencies to debate whether the level of investment is too high.\textsuperscript{14} Nonetheless, FDI has continued to flow strongly into China, not only into traditional manufacturing ventures but increasingly into the equipment manufacturing, electronic machinery, high-level technology, entertainment, retail, and financial service sectors.\textsuperscript{15}

As an example of the rapid growth, the Ministry of Commerce showed on 8 June 2005 that China’s actual FDI in 2005 amounted to USD72.4 billion, up 19.42 per cent over 2004.\textsuperscript{16} That increase revised the January 2005 estimate upward by USD12 billion. The

\textsuperscript{14} Ibid 84.
figures excluded FDI in the sectors of banking, insurance and financial securities. Those FDI figures indicated that the service sector had become a very attractive area for foreign investors.

By comparison, in 2010, the number of newly approved foreign-funded enterprises in China was 27,406, and foreign investment actually utilised reached USD105.735 billion. China’s total import and export trade in 2010 was USD2972.76 billion with a year-on-year growth of 34.7 per cent. Its exports were USD1577.93 billion and its imports were USD1394.83 billion, up by 31.3 per cent and 38.7 per cent respectively.

Chinese investors directly invested in 2,786 overseas enterprises in 122 countries and regions in January-November, 2010. The total Chinese direct investment overseas amounted to USD 47.56 billion. The sources of this investment were, not surprisingly, for the most part concentrated in Asia, with Latin America second and other regions trailing far behind. Hong Kong (where investors from other countries as well as the mainland are also based) held a clear lead, followed by the British Virgin Islands, South Korea, and Japan.

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US investment in China ranked fifth in 2005. After falling sharply in 2003, most likely as a result of caution prompted by the ‘Severe Acute Respiratory Syndrome’ (SARS) outbreak, US investment recovered in 2004 with a 23.1 per cent and 7.2 per cent increase in contracted and utilised investment, respectively. US investment (as a 6 per cent share of the total contracted FDI in China) reached USD17.72 billion from January to December in 2008.

In 2004, FDI ventured northward and inland from traditional investment centres such as the Pearl and Yangzi River deltas and Beijing. From the end of 2006, foreign-invested projects were being set up in the western region of China. According to a report from the Ministry of Commerce, in respect of attracting FDI in the first six months of 2010, China had attracted foreign funds of USD51.43 billion, an increase of 19.6 per cent compared to the same period of 2009. In terms of regional distribution, FDI increased by

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27 Foreign Investment in Central and Western Edge Industry Directory, 23 July 2004. According to the February 2002 release of Provisions on Guiding the Direction of Foreign Investment (State Council Decree No 346) the policy, for the implementation of the national western development strategy in the central and western regions, was to: encourage foreign investment, introduce advanced technology, equipment, development of the central and western areas of comparative advantage industries and technologically advanced enterprises; promote the optimisation and upgrading of industrial structure; and promote the central and western regions to improve the overall quality of the economy, in accordance with the state's industrial policy, announced in June 2000, of foreign investment in central and western parts.
29 Ministry of Commerce of the PRC, ‘2010 年 1–6月全国吸收外商直接投资快讯’ [News of Absorption of Foreign Direct Investment from January to June in 2010] (19 July 2010) 中国投资指南 [Invest in China,
19.1 per cent in the eastern part of China, 11.8 per cent in the central region and 31 per cent in the western part.\(^\text{30}\)

This shift in FDI flows can be attributed to government incentives intended to spur investment in north-eastern and western China; rising land, labour, and living costs in popular coastal investment destinations; and the desire of companies to secure a competitive footing in the domestic consumer market as these areas became more developed and as China opened its retail and distribution sectors.\(^\text{31}\) Automobile maker, Ford Motor Co and foreign automotive parts makers, like Tenneco Automotive Inc and Lear Corp, have set up production facilities in western China.\(^\text{32}\)

FDI in China in the last three decades has been one of the key interfaces of China’s engagement with the outside world. In bare numerical terms, it has been an outstanding success.\(^\text{33}\) The challenge for China over the next five years will be to move to a greater openness while maintaining some of the advantages the existing regime has provided.\(^\text{34}\)


\(^{34}\) Barry Naughton, The Chinese Economy Transitions and Growth (MIT Press, 2007) 422.
5.4 Establishment and Development of Foreign Investment Laws

Since the end of 1978, by adopting the ‘Open Door’ policy China has transformed important aspects of its economic and political structures, promoting international trade and welcoming foreign investment into China. The associated law reform in China was initiated at the Third Plenary Session of the Eleventh Central Committee of the Communist Party of China in late 1978. The Plenum moved not only towards a tentative policy on the need to reform the state-planned economy but also to build a legal system that would support economic growth.

Law schools that had been closed since the late 1950s were reopened, and legal specialists who had been disgraced during the Cultural Revolution were invited to resume their academic and professional activities. One such specialist, Professor Mingxuan Gao of the People’s University Law School, resumed his legal career in 1979 and became actively involved in drafting the first *Criminal Law of the People’s Republic of China 1979*. The establishment and development of a legal system to deal with foreign investment should be considered as one of the most important elements of this reform. The Table 3.1 shows the chronological development of major laws and regulations in relation to FDI.

### Table 5.1: Major Laws and Regulations Related to Foreign Investment Since 1978

<table>
<thead>
<tr>
<th>Year</th>
<th>Regulations Enacted</th>
<th>Plenary Session Events</th>
</tr>
</thead>
<tbody>
<tr>
<td>December 1978</td>
<td></td>
<td>The 3rd full meeting of the Central Committee of the 11th Term of the CCP – Decision was made to concentrate on economic</td>
</tr>
</tbody>
</table>

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35 Professor Mingxuan Gao was born in 1928. He is a PhD supervisor specialising in criminal law. Professor Gao is also the vice-director of the Criminal Research Committee of the Legal Committee of China. He has published more than ninety influential academic texts and 200 articles on Criminal Law, Criminal Legal Theory etc. Gao is an influential academic in contemporary China.
### Ch 5: Foreign Investment and Development of Foreign Investment Laws in China

<table>
<thead>
<tr>
<th>Date</th>
<th>Law Description</th>
<th>Status</th>
</tr>
</thead>
<tbody>
<tr>
<td>July 1979</td>
<td>The Law of the People’s Republic of China on Chinese-Foreign Equity Joint Venture</td>
<td>Amended in October 2001</td>
</tr>
<tr>
<td>July 1979</td>
<td>Provisional Regulations on Foreign Exchange Control of the People’s Republic of China</td>
<td>Amended in October 2008</td>
</tr>
<tr>
<td>1980</td>
<td>Tax Income Law on the Chinese-Foreign Equity Joint Venture of the People’s Republic of China</td>
<td></td>
</tr>
<tr>
<td>August 1982</td>
<td>The Trademark Law of the People’s Republic of China</td>
<td>Amended in October 2001</td>
</tr>
<tr>
<td>December 1982</td>
<td>The Constitution of the People’s Republic of China</td>
<td>Article 18: foreign enterprises, other organisations and individuals are permitted to invest in China according to provisions of China’s law and have various co-operations with Chinese enterprises and other organisations.</td>
</tr>
<tr>
<td>April 1986</td>
<td>The General Principles of Civil Law of the People’s Republic of China</td>
<td></td>
</tr>
<tr>
<td>April 1986</td>
<td>The Law of the People’s Republic of China on Wholly Foreign Owned Enterprise</td>
<td>Amended in October 2000</td>
</tr>
<tr>
<td>October 1986</td>
<td>Provisions of the State Council for Encouragement of Foreign Investment</td>
<td></td>
</tr>
<tr>
<td>December 1987</td>
<td>Technology Contract Law of the People’s Republic of China</td>
<td>Repealed in 1999</td>
</tr>
<tr>
<td>April 1989</td>
<td>Administrative Procedure Law of the People’s Republic of China</td>
<td></td>
</tr>
<tr>
<td>July 1991</td>
<td>Foreign Investment Enterprise and Foreign Enterprise Income Tax Law</td>
<td></td>
</tr>
<tr>
<td>July 1994</td>
<td>Law on Administration of the Urban Real Estate of the People’s Republic of China</td>
<td></td>
</tr>
<tr>
<td>June 1995</td>
<td>Interim Provisions on Guiding Foreign Direct Investment</td>
<td>Regularly updated, the latest update in October 2007</td>
</tr>
<tr>
<td>June 1995</td>
<td>Guideline Catalogue of Foreign Investment Industries</td>
<td>Regularly updated, the latest update in October 2007</td>
</tr>
<tr>
<td>September 1995</td>
<td>The Arbitration Law of the People’s Republic of China</td>
<td></td>
</tr>
</tbody>
</table>

Established Special Economic Zones in Shenzhen, Zhuhai, Shantou and Xiamen.

Development in order to achieve China’s modernisation.
October 1999 | The Contract Law of the People’s Republic of China
---|---
March 2000 | Legislation Law of the People’s Republic of China
October 2001 | The Copyright Law of the People’s Republic of China
January 2002 | Computer Software Protection Regulations
January 2006 | The Company Law of the People’s Republic of China
August 2006 | The Enterprise Bankruptcy Law of the People’s Republic of China
January 2008 | The Labour Law of the People’s Republic of China
April 2008 | The Civil Procedure Law of the People’s Republic of China

For all laws, there have been more than 200 pieces of legislation enacted at the national level alone since 1979, not to mention administrative regulations and provincial and municipal enactments. Judicial caseloads are averaging nearly 5 million per year nationwide and according to the Supreme Court Annual Report 2010 there were 144 million cases filed in China. The number of additional disputes resolved through mediation and arbitration is burgeoning. In 2010 there were 3,593 million first instance case withdrawn as a result of mediation before the courts. The number of law firms has multiplied with more than 5000 having been established since 1990, bringing the total to more than 9000.

National laws and regulations along with local regulations combine to provide a relatively comprehensive Chinese FDI legal system. In China, foreign investment has not

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38 Ibid section 3.
39 Ibid 1226.
always proceeded smoothly and there have been upward and downward trends. These trends can be divided into four stages.

5.4.1 Introducing the ‘Open Door’ Policy – the Initial Experimentation Period

During the first four-year experimental period, the Chinese government adopted cautious and conservative attitudes toward foreign investment. It seemed that both foreign investors and the Chinese government were more interested in experience rather than substantial output. In an interview recorded by Central China Television in 2002, Guangsheng Shi, the Minister of Foreign Trade and Economic Cooperation, revealed the extent of foreign investment in China and indicated that between 1979 and 1982, the amount of FDI into China was quite limited.\(^40\) It amounted to 930 projects with FDI approval resulting in an actual investment of USD1.769 billion.\(^41\)

In 1979, China adopted its first ever foreign investment law, the *Law of the People’s Republic of China on Equity Joint Ventures*\(^42\) (EJV Law). Although the EJV Law is not a complex piece of legislation, its long-term impact should not be underestimated. It was the first time that the Chinese government had adopted a legislative approach to the regulation of foreign investment instead of applying the traditional Communist Party’s policies or governmental unpublished internal directives. Also, the EJV Law embodied basic principles for the Chinese FDI legal system, which has greatly influenced the development

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\(^{41}\) Ibid.

of the legislation.\textsuperscript{43} The EJV law established, for the first time, investment arrangements by shares between foreign parties and Chinese parties. Subsequently the \textit{Law of the People’s Republic of China on Cooperative Joint Ventures} was enacted in 1988 and the \textit{Law of the People’s Republic of China on Wholly Foreign Owned Enterprises} passed in 2000.

Another noteworthy decision made by the Chinese government in the early 1980s was the establishment of the Special Economic Zone (SEZ) system. In 1980, the Chinese government announced the establishment of SEZs along the south-coast, Shenzhen, Zhuhai and Shantou in Guangdong Province, and Xiamen in Fujian Province.\textsuperscript{44} The SEZs served as windows of opportunity for both China and foreign investors and enjoyed special taxation and other preferences. Various experimental practices, such as a low tax incentive policy to attract foreign investment, were first introduced in SEZs were later adopted nationwide by the Central government in its strengthening of the economic model for the rest of China.\textsuperscript{45}

Before 1978 China was economically isolated from the rest of the world. China was basically a socialist state conducting a planned economy.\textsuperscript{46}

In an economy that for decades had been dominated by state central plans, foreign investment has had a positive impact on the Chinese economy. The benefits of FDI were recognised by the highest legal authority in the \textit{1982 Constitution} of China. For the first time ever the Constitution allowed foreign investors ‘to invest in China and to enter into

\textsuperscript{44} Jung-Dong Park, \textit{The Special Economic Zones} above n 7, 3.
\textsuperscript{46} Jung-Dong Park, \textit{The Special Economic Zones} above n 7, 32.
various forms of economic co-operation with Chinese enterprises and other economic organisations’ in accordance with the laws of China.\textsuperscript{47} It also ensured that foreign investors’ ‘lawful rights and interests are protected’.\textsuperscript{48} China had, by its constitutional and legislative changes, made significant and effective changes to its laws to increase, regulate and improve foreign investment within its borders and enhancing its international economic reputation.

5.4.2 A Boom Economy – a Period of Fast Growth

With the recovery and development of the domestic economy, Chinese domestic interest groups demanded further reforms and greater opportunities to access foreign resources. Deng Xiaoping’s call for accelerated reform and development defined the major thrust of subsequent economic policy.\textsuperscript{49} The creation of ‘socialist market economic system’ was written into the Communist Party official policy documents.\textsuperscript{50} The Chinese government further committed China to the expansion of economic and technological exchanges and co-operation with foreign countries. Naughton, in an analysis of the transitions and growth of the Chinese economy, states:

At the beginning of the 1990s a third wave of opening of the Chinese economy was announced by … the creation of another SEZ (Special Economic Zone). The Pudong (east Shanghai) special zone served as an advertisement, as well as a commitment device, by creating an SEZ in the heart of China’s most developed region for the first time.\textsuperscript{51}

\textsuperscript{48} Ibid.
\textsuperscript{50} [Decision Concerning a Number of Issues of Establishment of Socialist Market System] (People’s Republic of China) The Third Full Meeting at the Fourteenth National Congress of Communist Party of China, 14 November 1993.
\textsuperscript{51} Barry Naughton, The Chinese Economic above n 34, 409.
The CPC openly proclaimed that foreign funded enterprises were a necessary element for the development of China’s Economy. In 1983, Hainan Island was declared open to foreign investors with a special incentive policy that was more generous than the policies of the SEZs. The Hainan Island Administrative Region enjoys the most preferential treatment and allows foreign investors to invest in a broad scope of industries. In mid-1984 the Chinese government opened 14 coastal cities and ports to foreign investors. These cities and ports ranged from Dalian in the North to the port of Beihai in the South. Economic and technological development zones were accordingly established in most of these 14 open cities and ports. The opening up of the coastal cities was effective in attracting extensive foreign investment in a short period with the number of FDI projects in those areas equalling the total investment of previous years in the whole country. According to the Ministry of Commerce, the actual utilisation of FDI between 1979 to 1990 was USD20.692 billion, and the total utilisation of FDI in 1993 alone had reached USD27.515 billion, well in excess of the 1980s period.

In 1985, the government decided to open up the country’s three most fertile river delta areas, namely, the Yangtse River Delta in Shanghai (including Hangzhou and Nanjing); the Zhujiang (Pearl) River Delta centered at Guangzhou; and the Xiamen, Zhangzhou, Quanzhou Delta in the southern province of Fujian. In fact, foreign investors have explored markets beyond SEZs or special areas to the inland provinces. As foreign investment has increased, local governments have acquired more and more authority to examine and approve proposed foreign investment projects. The central government in Beijing decentralised approval power—with some limits—to local governments. For example, State Council had given authority to provincial level governments and respective industrial departments to approve foreign investment projects. As a result, investment projects of less than USD30 million (which make up the majority of FDI projects) could apply for, and gain approval, at the provincial level.

The framework of the Chinese FDI legal system was developed during this period. Following a few years of experimental practice, the promulgation of the Regulations for the Implementation of the Law of the People’s Republic of China on Chinese-Foreign Equity Joint Ventures 2001 (EJV Implementation) provided detailed and practical rules for

58 ‘A Notification Concerning A Memorandum of Openness of the Yangtse River Delta, Pearl River Delta and the Xiamen, Zhangzhou, Quanzhou Delta from State Council’ (China Communist Party, 1985).
EJVs.\textsuperscript{62} The EJV Implementation enumerates the market access categories for joint ventures, lays out application procedures and approval agencies,\textsuperscript{63} lists mandatory contents of joint venture agreements,\textsuperscript{64} and regulates management,\textsuperscript{65} labour,\textsuperscript{66} JVC dissolution and liquidation,\textsuperscript{67} land use,\textsuperscript{68} transfer of technology,\textsuperscript{69} taxation\textsuperscript{70} and foreign exchange,\textsuperscript{71} and dispute resolution procedures.\textsuperscript{72}

In 1986 and 1988 respectively, China enacted the \textit{Law of the People’s Republic of China on Wholly Foreign Owned Enterprise 1986} (WFOE Law)\textsuperscript{73} and the \textit{Law of the People’s Republic of China on Chinese-Foreign Cooperative Joint Ventures 1988} (CJV Law).\textsuperscript{74} The enactment of CJV Law and WFOE Law, together with the EJV Law, completed the basic legislation for the three main forms of access for FDI in China: equity joint ventures (EJVs), cooperative joint ventures (CJVs) and wholly foreign owned enterprises (WFOEs). Accompanying the major framework legislation, numerous

\textsuperscript{62} The EJV Regulations were promulgated by the State Council on 20 September 1983, and amended on 15 January 1986, 21 December 1987 and 22 July 2001.
\textsuperscript{64} Ibid, art 11.
\textsuperscript{65} Ibid, art 10.
\textsuperscript{66} Ibid, arts 11[9], 80, 81, 82, 83.
\textsuperscript{67} Ibid, arts 11[10], 89, 90, 91, 92, 93, 94, 95, 96.
\textsuperscript{68} Ibid, art 22, 44, 45, 46.
\textsuperscript{69} Ibid, arts 11[6], 26, 27, 40, 41, 42, 43.
\textsuperscript{70} Ibid, arts 59, 60, 61, 62.
\textsuperscript{71} Ibid, art 23.
\textsuperscript{72} Ibid arts 11[12], 97, 98, 99, 100.
\textsuperscript{73} <<中华人民共和国外资企业法>> [Law of the People’s Republic of China on Wholly Foreign Owned Enterprise] (People’s Republic of China) National People’s Congress Standing Committee, Order No 41, 31 October 2000. The WFOE Law was adopted at the Fourth Session of the Sixth National People’s Congress on 12 April 1986. It was amended on 31 October 2000.
\textsuperscript{74} The CJV Law was adopted on 13 April 1988 by the First Session of the Standing Committee of the Seventh National People’s Congress. The Implementation of the Law of the People’s Republic of China on Chinese-foreign Cooperative Joint Ventures (CJV Implementation Rules) was promulgated on 4 September 1995. An Interpretation on Implementing Certain Articles of the Rules for the implementation of the Law of the People’s Republic of China on Chinese-Foreign Cooperative Joint Ventures (CJV Interpretation) was issued in 1996. The CJV Law was amended on 31 October 2000.
regulations and rules, supplemented with notices from authorised agencies, provided practical guidance for FDIs.

The Chinese government adopted policy-oriented provisions that declared general incentive policies in attracting foreign investment. In 1986, the State Council promulgated the *Provisions Concerning Encouragement for Foreign Investment 1986*, which reiterated the government’s attitude toward FDI and gave greater preferential treatment to foreign investment.

5.4.3 A Cooling Off Period–from Controlling to Regulating

Despite the Tiananmen Square incident in 1989, FDI in China continued to grow. After more than two decades of practice, the Chinese government had gained extensive experience and knowledge in regulating FDI. In 2001, the National People’s Congress amended the EJV Law. In 1991, the *Foreign Investment Enterprise and Foreign Enterprise Income Tax Law 1991* was adopted. Under sustained pressure from the international community, China also began to construct a legal system to regulate intellectual property rights and obligations. The *Copyright Law of the People’s Republic of China 1990* was amended in 2001, which was followed by amendments to the *Computer Software*...
Protection Regulations 1991\textsuperscript{79} in 2002. The Patent Law of the People’s Republic of China 1992\textsuperscript{80} and the Trademark Law of the People’s Republic of China 1993\textsuperscript{81} were amended by the NPC to more closely reflect international standards. More significantly, the Company Law of the People’s Republic of China 1993\textsuperscript{82} (Company Law 1993) was amended in 2006, providing a legal framework for Chinese business organisations. According to the Company Law 1993, limited liability companies with FDI are subject to the provisions of the new law, except where specific foreign investment statutes provide otherwise.\textsuperscript{83} FDI enterprises, to some extent, began to be treated in the same manner as domestic business.

Since the late 1970s, arbitration has been the most popular form for dispute resolution in joint venture agreements. According to Statistics from the China International Economic and Trade Arbitration Commission (CIETAC), there were 16,593 cases filed from 1990 to 2010, of these cases 49 per cent was foreign related dispute.\textsuperscript{84} As China is a society with a non-litigious culture\textsuperscript{85} and an unpredictable judicial system, resolving disputes using an arbitration tribunal is an acceptable alternative to both foreign investors and local partners. In order to provide greater accountability and legal certainty for

\textsuperscript{79} <<计算机软件保护条例>> [Computer Software Protection Regulations] (People’s Republic of China) State Council, 1 January 2002.
\textsuperscript{82} <<中华人民共和国公司法>> [Company Law of the People’s Republic of China] (People’s Republic of China) National People’s Congress, Order No 42, 1 January 2006.
\textsuperscript{83} Ibid art 18.
\textsuperscript{85} This was discussed in Chapter 4.
Foreign Investment and Development of Foreign Investment Laws in China


The economic boom demonstrated the benefits of the ‘Open Door’ policy for China’s development. To push the economic reform forward, China amended its Constitution in 1993, declaring a ‘socialist market economy’.\(^{87}\) The Chinese government indicated its future plans for FDI would include managing foreign investment through rational economic regulations rather than through politically implicated controls. This is evident from the fact that China promoted the establishment of a socialist market economic system and emphasised that the functions of government are regulating and administrating the market through laws and management systems rather than direct interference.\(^{88}\) Through this approach, China aimed to reduce the perception of unreasonable government interference and provide greater certainty for foreign investors. The improvement of the legal environment and more open policies had the effect of promoting foreign investment inflow during the 1990s. The amount of approved foreign investment fund into China in 1992 was greater than the amount of the approved foreign investment fund in the previous

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thirteen years.\textsuperscript{89} Since 1993, China has been the second largest FDI recipient in the world. By the end of 1996, China was utilising around USD40 billion a year.\textsuperscript{90}

\subsection*{5.4.4 Rationalised Economic Development–after the Asian Financial Crisis}

There is no doubt that the Asian financial crisis\textsuperscript{91} had an impact upon China’s economy since south-east Asia is China’s main source of FDI and largest export market. As Naughton’s research revealed, FDI to China falls into four large and quite stable source groups.\textsuperscript{92} By far the largest is the group including Hong Kong, Taiwan and Macau free ports or tax havens.\textsuperscript{93} The Asian financial crisis provided a warning to the Chinese government that it was time to reform China’s financial system, state-owned enterprises and governmental institutions to avoid a similar crisis in China. For example, from the mid-1990s, Chinese authorities began to cut the formerly close ties that bound government and state-owned enterprises.\textsuperscript{94} Even as the rate of FDI into China reduced, China has continued to place greater emphasis on ensuring that the new foreign investments are consistent with

\begin{itemize}
  \item \textsuperscript{89} Ministry of Commerce of the PRC, ‘第一次居发展中国家吸收外资的首位’ [Absorption of Foreign Investment Ranked Number One Within Developing Countries the First Time] in 中国外商投资三十年特别专题 [Thirty Years Special Edition: on Foreign Investment in China] (27 November 2008)  中国投资指南 [Invest in China, Ministry of Commerce of the PRC]  \url{http://www.fdi.gov.cn/pub/FDI/tzdt/zt/ztmc/wzzgx/ssnds/hg/t20081127_99681.html}
  \item \textsuperscript{90} Friedrich Wu et al, ‘Foreign Direct Investments to China and Southeast Asia: Has ASEAN Been Losing Out?’ (3rd Quarter 2002)  \textit{Economic Survey of Singapore} 1, 2.
  \item \textsuperscript{91} The Asian financial crisis erupted in Thailand. Starting in 1996, a confluence of domestic and external shocks revealed weaknesses in the Thai economy that until then had been masked by the rapid pace of economic growth and the weakness of the U.S. dollar to which the Thai currency, the baht, was pegged. In many respects, Thailand, Indonesia and Korea faced similar problems. They all have suffered a loss of confidence, and their currencies are deeply depreciated. Moreover, in each country, weak financial systems, excessive unhedged foreign borrowing by the domestic private sector, and a lack of transparency about the ties between government, business, and banks have both contributed to the crisis and complicated efforts to defuse it.  For details, see Stanley Fischer, ‘The Asian Crisis: A View from the IMF’ (Speech delivered at the Midwinter Conference of the Bankers’ Association for Foreign Trade, Washington, International Monetary Fund, 22 January 1998)  \url{http://www.imf.org/external/np/speeches/1998/012298.htm}.
  \item \textsuperscript{92} Barry Naughton, \textit{The Chinese Economic} above  n 34, 412.
  \item \textsuperscript{93} Ibid, 413.
  \item \textsuperscript{94} Ibid 105.
\end{itemize}
its industrial development goals. Consequently, China has implemented new policies that introduce further incentives for investments in high-tech industries and inland areas. In 2007, that China published a revised list in the *Guideline Catalogue of Foreign Investment Industries 2007*.96

The 2007 Guideline Catalogue restated that foreign investment in basic infrastructure and high-technology industries would be particularly encouraged, while investment in domestic trade and service sectors would be restricted or prohibited.97 At the same time, China eased some restrictions on the operation of FDI, such as allowing conversion of foreign exchange under the current account.98 The *Guideline Catalogue* has been updated by the government on several occasions.99 In response to the increasing size and complexity of FDI in China, legislation governing foreign investment has also significantly expanded. By the 1990s, with economy having ‘grown out of the plan’, the most important tasks were to improve the legal and regulatory environment, create a ‘level playing field’, and reduce some of the most obvious distortions in the economy.100 China today claims relatively comprehensive statutes and regulations for FDI. According to Naughton:

100 Barry Naughton, *The Chinese Economic* above n 34, 103.
China has a generally favourable regime for foreign investors today. Taxes are moderate; investment protection agreements are in place with most countries, an apparatus for arbitration is available; and most legal provisions are adequate in principle.101

Due to the poor legislative coordination between the Central government (State Council) and local government and between different governmental agencies, the increase in legislation has inevitably resulted in confusion and inconsistency in the Chinese FDI legal system. Foreign investors are often confused by the overlapping or conflicting rules.102 It is therefore necessary for investors to understand the FDI legal sources and their hierarchical structures.

China’s National Development and Reform Commission announced the issuing of a new and substantially revised edition of the Guideline Catalogue of Foreign Investment Industries 2004 on 31 October 2007 and it came to effect on 1 December 2007.103 As a guide for examination and approval of FDI projects, the Chinese government divides foreign investment projects (including EJVs, CJVs and WFOEs) into four categories (‘encouraged’, ‘permitted’, ‘restricted’, and ‘prohibited’) under the Provisions on Guiding Direction of Foreign Investment 2002.104 The Guideline Catalogue provides basic guidance for foreign investment in China. According to Nicolas’s study:

Recent policy moves can be perceived as the next logical step with more emphasis placed on domestic development. This is in line with the directions indicated in the 11th Five Year

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101 Ibid 410.
Plan issued in 2006. In accordance with the country’s development needs and WTO commitments. The latest amendment is perfectly in line with China’s overall development strategy, the objective of which is to promote quality of investment rather than sheer quantity. As a result, technological development is now prioritised together with environment friendly activities, while export-oriented foreign investments are, if not discouraged, not as actively encouraged as was the case in the past. In early November 2007, China’s NDRC and the MOFCOM jointly released a substantially revised Catalogue for the Guidance of FIEs. The revised catalogue, which was approved by the State Council and took effect on December 1, 2007, reflects a major shift in China’s FDI policy away from outright encouragement to more selectivity.

The 2007 Catalogue can only be understood in light of the policy it implements. It embodies the decision at the highest levels of the PRC to make substantial changes in China’s approach towards foreign investment. This approach was stated in detail by the Recommendation of National Economic and Social Development of the 11th Five Year Plan of the People’s Republic of China issued in 2006. As Nicholas recognized, that Plan states that China will move from emphasising the quantity of FDI to emphasising the quality of that investment.

The 2007 Guideline Catalogue is another step in Beijing’s plan to reform the FDI environment in China. It is consistent with other measures which eliminated the tax break for foreign invested enterprises, limited foreign merger and acquisition (M&A) activity, and eliminated many supports for export oriented enterprises. It appears that

107 Fran oise Nicolas, ‘China and Foreign Investors’ above n 105.
China is serious about making this change and foreign investors need to become familiar with this new system. Foreign investors should understand that the system is undergoing a dramatic change.

5.5 Legal Sources of Chinese Foreign Investment Law

The *Provisions on Guiding Direction of Foreign Investment 2002* were promulgated by the State Council. The regulations provide guidelines for the direction of foreign investment, enabling foreign investment to conform to the planning of Chinese national economic and social development and for enhancing the protection of the legal rights and interests of investors. For example, the State Council passed the *Provisions Concerning Encouragement of Foreign Investment* in 1986. The purpose of the regulations was to improve the investment environment, absorb foreign investment, import advanced technology, improve the quality of manufactured goods, expand exports to earn foreign exchange and develop the national economy.

Perhaps most significantly, the principal governmental organisations are responsible for administering China’s foreign investment laws. The State Planning Commission, the Ministry of Foreign Trade and Economic Cooperation and the State Economic and Trade

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114 Ibid art 1.
Commission promulgated the *Interim Provisions on Guiding Foreign Direct Investment*.\(^\text{116}\) The *Investment Guidelines* apply to all forms of foreign investment in China and, in a detailed catalogue, enumerate those sectors of foreign investment which are encouraged, permitted, restricted and prohibited. The significance of this is dramatic given the *Investment Guidelines*’ comprehensive sweep and the insight that they provide into the administrative process in China.

EJVs, CJVs and WFOEs have been commonly used by foreign investors in China.\(^\text{117}\) The EJV Law, the CJV Law and the WFOE Law are the major laws to regulate these activities. These three laws have been progressively reviewed and updated. For instance, the EJV Law was adopted on 1 July 1979 at the 2\(^{\text{nd}}\) Session of the 5\(^{\text{th}}\) National People’s Congress. It was then amended twice, in April 1990 and March 2001. The implementation of the EJV Law was promulgated on 20 September 1983 and then amended on 15 January 1986, 21 December 1987 and 22 July 2001.\(^\text{118}\)

The laws regarding foreign investment in China establish a multi-stage approval process for foreign investment projects. For example, in creating a foreign invested enterprise with a Chinese partner, the first step is to enter into a letter of intent outlining the joint venture, in order to establish the basis for the review and approval process.\(^\text{119}\) The Chinese party will then be responsible for obtaining approval for the business from the


\(^{117}\) Ibid 90.


industry bureau, which supervises the specific industry in which the project is involved.\(^{120}\)

The industry bureau may then consult with the State Planning Commission, particularly for larger projects, to insure conformity with the appropriate annual and five-year plans. The Chinese and foreign parties will then prepare a joint feasibility study, which is reviewed by the Industry Bureau and, for larger projects or those involving certain equipment, the State Planning Commission.\(^{121}\) The parties then enter into a joint venture contract or form a foreign invested enterprise, pursuant to documents approved by the Ministry of Foreign Trade and Economic Cooperation. Foreign exchange arrangements, as deemed necessary, must be made with the appropriate branch of the State Administration for Exchange Control.

Thus, a foreign-invested project receives certification of approval only if the proper examination (assessment) and approval authority has reviewed and approved a formal application, feasibility study and organisational documents. Although the Ministry of Foreign Trade and Economic Cooperation and the State Planning Commission are permitted to delegate their examination and approval authority to relevant provincial and municipal counterparts, the delegation must not violate thresholds for specific provinces.


municipalities and regions promulgated by the State Council in Beijing. In general, foreign-invested enterprises with total investment in excess of USD30 million must be approved at the central government (State Council) level.

Where specific aspects of a business transaction are addressed, China’s legal structure seeks to require foreign parties to agree to contractual provisions that are clearly favourable to the Chinese side. For example, the regulations promulgated by the State Council in 2002 to govern technology transfers, the *Ordinance of the People’s Republic of China on Technology Import and Export*, applies. This law requires that a licensor of technology warrants that the licensed intellectual property is suitable for the objective of the project and requires the licensor to be responsible for all infringement costs. Among other things, restrictions on the licensee’s power to develop and improve the technology, on the licensee’s ability to acquire similar technology from other sources and the continued use of the technology after the contract’s expiration, all require special approval. Furthermore, the time limit for the general maintenance of confidentiality may not exceed the duration of the contract unless the examining and approving authorities specifically

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123 The State Administration for Industry and Commerce has promulgated regulations to set the minimum amount of registered capital in relation to the extent of the total investment for EJV.


125 Ibid art 24.

permit otherwise. Such terms set out in the Technology Transfer Law could effectively turn a licensing arrangement into a sale of technology.

There are several characteristics which are quite clear from the record of law creation and the pattern of administration of China’s laws on foreign investment. First, there is a definite policy in China that foreign investment should be strictly on Beijing’s terms.127 Duffy’s research shows that:

... certain industries, such as broadcasting, telecommunications and entertainment are essentially closed to foreign ownership or control. Initially, there was a strong emphasis at the national level on technology transfer and the development of export-oriented industries, which could generate hard currency. There was and still is significant concern that state assets should not pass into foreign hands at inadequate valuations. A strong bias continues towards central government control, reflected in the relatively low threshold for central government approval. The concern is to protect domestic business operations from foreign competition in sectors where the need for foreign technology was not perceived by central planners.128

The central legislative mechanism has operated to enact relatively schematic laws and regulations that direct the parties to the rigorous administrative review process. Where specific matters of significant international business negotiations have been addressed, a rather one-sided approach has often been taken. For example, Japan Suzuki Motor Corporation took advantage of the opportunity presented by lack of regulation on foreign enterprise mergers and acquisitions in China and acquired a 20 per cent share of a listed state-owned enterprise, Northern Tour Motor Company, and successfully operated within the Chinese company. This transaction involved legal issues related to state-owned enterprise operation and information disclosure. In order to prevent this kind of merger and acquisition, the State Council and State Security Supervision Commission issued the

127 Edmund C Duffy, Business Law in China above n 115, 557.
The general thrust of the legislation was not permissive, and one could not conclude that what was not prohibited was therefore permitted. Rather, the administrative process was put in place to allow China to gain experience in managing foreign investment. Since the early 1990s, China has progressed extensively in legislating the foundational rules for its reformed economy. Although there was consensus that experimentation with market-driven techniques was worthwhile, the extent of permitted movement toward market socialism was by no means clear. In fact, the experience under China’s investment laws has been more successful than many would have expected. In large measure, this can be said to have resulted from administrators of the laws at the State Planning Commission and the Ministry of Foreign Trade and Economic Cooperation approaching their task in a remarkably pragmatic manner.

For instance, Chinese law generally does not permit the importation and sale of a product which is the intended output of a new joint Sino-foreign investment project. Yet, pre-production sales are often critical for adjusting the intended product to local requirements or preferences. After considerable internal debate, pre-production sale of

129 Notification Concerning Suspension of Transferring State-Owned Share and Legal Person Share to Foreign Enterprise in 1995.

imported products has been permitted up to 30 per cent of planned output, decided on an ad hoc basis after considerable negotiation and debate.\textsuperscript{131}

New questions concerning the legal environment have arisen which can have profound macro-economic and political implications. Business structures and financing techniques can be proffered by the overseas party about which the administrators have little or no experience. Effectively, the administration of China’s laws on foreign investment is an ongoing dialogue between China and the outside world that is designed to allow foreign investment to flow into China, while the national debate over how best to use and regulate this foreign investment continues. Much of China’s work in the establishment of laws and legal institutions related to the economy has doubtless been intended to promote economic growth.\textsuperscript{132}

Investment laws are developing in the context of the debate as to the pace of economic reform and the role foreign investment will play. To protect state enterprises inexperience in dealing with foreigners, the law initially focused on tilting the playing field against the foreigners by requiring that certain key contracts contain provisions (which in other countries are often the subject of intense negotiation) more favourable to the Chinese party. At the same time, the political climate in China was such that foreign investment was only officially welcome if it brought significant advantages to China, such as advanced technology or export earnings. But the reality of transactions was often very different from the political ideal. Internal directives allow the regulators to strike a negotiated balance between the political objectives and the practical realities. A practical problem for legal

\textsuperscript{131} Edmund C Duffy, ‘Business Law in China’ above n 115, 557.
\textsuperscript{132} Donald C Clarke (ed), China’s Legal System above n 130, 23.
system reformers is that while it is plausible that legal institutions matter, it is not clear what their exact form should be.\textsuperscript{133}

Many governmental directives are permissive, allowing regulators to approve provisions in legal documentation which are otherwise proscribed. By making the directives internal, at least three objectives are achieved. Duffy states:

First, there is a kind of plausible denial should other parties seek similar relief, since the basis for the exception in a given situation can often be distinguished from the case in hand. Second, the lack of publicity has the effect of avoiding a more generalised knowledge of the flexibility in the system, since once a relaxation of standards is published, it becomes the new paradigm. Third, internal directives can avoid some of the political ramifications of taking a pro-investment stand, which has not yet achieved broad political consensus.\textsuperscript{134}

On the other side of the coin, these internal directives can provide a quick means of disseminating an anti-investment stand without facing external pressure from trade negotiators for foreign governments seeking to promote open access to the Chinese economy. Clarke asserts:

Thus, while we can of course assess China’s current economic legislation and institutions-building in terms of their current regulatory content, we should also contemplate whether China is creating an environment that will allow new institutions to arise and existing institutions to adapt or disappear.\textsuperscript{135}

The important point to recognise is that these internal directives are not a sign of an absence of law, but an important artifice permitting the regulatory process to remain flexible and pragmatic in a rapidly evolving and highly political environment. They are also not an excuse for graft and corruption, since they have objective meaning and can be readily and intelligently discussed with regulators. Lubman suggested:

\textsuperscript{133} Ibid 24.
\textsuperscript{134} Edmund C Duffy, \textit{Business Law in China} above n 115, 557.
\textsuperscript{135} Ibid 24.
At the time FDI first appeared on the legislative landscape, policy toward law was just beginning to emerge from its Maoist coma. The National People’s Congress had barely begun to meet regularly again, law was no more than a post hoc expression of policies, and its implementation was just as flexible. A standard feature of Chinese governance has long been the use of secret directives or regulations, addressed principally to officials charged with implementation.\footnote{Stanley B Lubman, \textit{Bird in A Cage: Legal Reform in China After Mao} (Stanford University Press, 2002) 197.}

Finally, over time, when the principles involved have been validated by experience and achieve political consensus, they could be promulgated in public form. Indeed, many of the recently published \textit{Investment Guidelines} make manifest a number of permissions and restrictions which had previously only existed as internal instruments or directives.

Prior to the publication of the \textit{Investment Guidelines}, these positions were not well understood and were the subject of internal directives. However, an idea that the administrative process has become completely transparent is somewhat optimistic. As Brooks and Hill suggest:

\begin{quote}
When foreign investors face regulatory obstacles, they may be able to resolve their problems by complaining directly to the county head or mayor. Domestic investors, especially small private ones, are generally not so fortunate. Not only are there preferential policies for FDI, but policy transparency and simplified administrative procedures are not equally available to domestic investors.\footnote{Douglas H Brooks and Hal Hill, \textit{Managing FDI in a Globalizing Economy. Asian Experiences} (Palgrave Macmillan, 2004) 111.}
\end{quote}

It can be expected that there will be considerable negotiation and administrative interpretation that may give rise to internal directives that, in turn, may reach a sufficiently broad consensus to be officially promulgated. Policy transparency problems are of concern not only to foreign investors but perhaps more so to domestic entities.

Another major contributor to the notion that China does not have meaningful laws regarding foreign investment arises from the country’s regionalism. Fast-developing coastal
and other prosperous areas have sought ways to move their local economies forward despite the central government’s wishes to control inflation and spread development to other poorer regions. This provides clear evidence that the uneven allocation of FDI is a result of not only regional preferential policies, but of the business environment, including infrastructure, supply of public utilities, geographic location and, possibly more importantly, the institutional climate.\textsuperscript{138} Many problems China faces today are associated with entrenched localism.\textsuperscript{139} Qin points out:

Local governments have been given power to adopt measures necessary to boost local GDP growth and are allowed to benefit directly from such growth. As a result, they have been heavily involved in the investment in and operations of local enterprises. To promote their economic interests, local governments often provide subsidies to local firms or otherwise protect them against outside competition.\textsuperscript{140}

The extent to which these regional tensions colour the foreign investor’s views of Chinese law cannot be underestimated. As we have seen, Chinese law sets limits on the size of projects that can be approved at the municipal or provincial level. In most cases, the upper limit for provincial approval has been a total investment of USD30 million.\textsuperscript{141} Prior to 1992, the vast majority of foreign invested projects in China did not exceed this threshold.

\textsuperscript{138} Ibid 110.
\textsuperscript{140} Ibid 183.
\textsuperscript{141} The total investment amount is the determining factor for deciding which government agency has the authority to grant FIE approval. For setting up a foreign-invested manufacturing enterprise in which total investment is more than USD30 million, the applicant must obtain approval from Ministry of Foreign Trade and Economic Cooperation (Ministry of Foreign Trade and Economic Cooperation (MOFTEC) was merged with the State Economic and Trade Commission (SETC) and the sections of the State Development Planning Commission (SDPC) to form the Ministry of Commerce (MOFCOM) in March 2003), while those with total investment less than this amount can be approved by the government authority at the provincial level.
China’s latest \textit{Company Law} has removed requirements on minimum registered capital for a range of company types and allows companies to pay up their capital in two years in accordance with regulations.\footnote{\textit{中华人民共和国公司法} [Company Law of the People’s Republic of China] (People’s Republic of China) National People’s Congress, Order No 42, 1 January 2006, art 26} Investment companies can pay their capital requirement over five years.\footnote{Ibid, art 26.} Under the \textit{Company Law}, companies are mainly incorporated in the form of limited liability companies or joint-stock limited companies. For limited liability companies, the minimum registered capital was lowered to USD5000.\footnote{Ibid, art 26.} For joint-stock limited companies, the minimum registered capital requirement is USD800,000.\footnote{Ibid, art 81.} In addition, the \textit{State Administration for Industry and Commerce} (SAIC)\footnote{\textit{国家工商行政管理局关于中外合资经营企业注册资本与投资总额比例的暂行规定} [Interim Provisions of the State Administration for Industry and Commerce Concerning the Proportion of Registered Capital and Total Amount of Investment of Chinese-foreign Equity Joint Ventures] (People’s Republic of China) State Administration for Industry and Commerce, Order No 38, 17 February 1987.} set the minimum amount of registered capital in relation to the extent of the total investment for EJVs.\footnote{The Provisions also apply to Chinese-foreign CJVs and WFOEs.}

When the underlying economic transaction presents significant political and economic concerns, the Chinese government and particularly those ministries which administer foreign investment, such as the Ministry of Foreign Trade and Economic Cooperation, are aware of the problems and deal honestly and patiently with them.\footnote{\textit{关于深化金融改革，整顿金融秩序，防范金融风险的通知} [Notification Concerning Deepening Financial Reform, Rectifying Financial Order, Preventing Financial Risks] (People’s Republic of China) State Council and Central Committee of Communist Party of China, Order No 19, 6 December 1997.} Where greater transparency is possible, they are willing to provide it.\footnote{\textit{中华人民共和国政府信息公开条例} [Regulations of the People’s Republic of China on Public Government Information] (People’s Republic of China) State Council, Order No 492, 17 January 2007, art 1.} China has taken concrete steps to implement its transparency commitments. These include efforts to open up the rule-making process to more public participation and to standardise the procedures
for granting administrative permissions. But the complexity of both the task at hand and the political environment in which the regulators work cannot be underestimated. The best course for an investor is to fully engage in the process, press every case to the fullest and make maximum use of its business experience and management skills. The outcome will benefit both overseas investors and the Chinese economy.

Sources of Chinese foreign investment law are complex. There is no uniform foreign investment law that governs all types of foreign direct investment. On the contrary, each form of FDI (EJV, CJV and FWOE) is regulated by a specific series of laws and regulations. Similar to many areas of law in China, while there are laws, regulations and rules at the national level in relation to foreign investments, there also are local regulations and rules. Furthermore, in the general Chinese legal system, FDI is subject to a different legal approach to that which governs domestic business. The main sources of Chinese foreign investment laws are categorised below.

### 5.5.1 Constitution

The most important legal document in the People’s Republic of China is the *Constitution*. It has the highest level of binding legal power that is, binding upon everyone conducting any activity in China. The country’s legal and political system and tasks are outlined in the *Constitution*. No laws, administrative regulations or local decrees may contravene the

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150 Julia Ya Qin, ‘Trade, Investment’ above n 139, 181.
151 Ibid 209.
The Constitution 1982 has been amended three times by the National People’s Congress of China (NPC) in 1988, 1993, 1999 and 2004.

Foreign investment first found its constitutional recognition and protection in 1982 when the NPC adopted the new Constitution. The Constitution 1982 includes:

The People’s Republic of China permits foreign enterprises, other foreign economic organisations and individual foreigners to invest in China and to enter into various forms of economic cooperation with Chinese enterprises and other economic organisations in accordance with the law of the People’s Republic of China.

All foreign enterprises and other foreign economic organisations in China, as well as joint ventures with Chinese and foreign investment located in China, shall abide by the law of the People’s Republic of China. Their lawful rights and interests are protected by the law of the People’s Republic of China.

This was the first time that Communist China’s Constitution allowed foreign investment and provided the legal basis for foreign investment protection. Ironically, China had adopted several foreign investment legislative documents before the enactment of the Constitution 1982. However, in a country lacking a tradition of rule of law, no one challenged the constitutionality of the unauthorised legislation on foreign investment before the ratification of the new constitutional provision. In 1993, the NPC amended Article 15 of the Constitution 1982, thereby abandoning a planned-economy and adopting a “socialist

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153 Ibid art 5.
156 A number of legal documents were issued in relation to regulating foreign investment in China before the Constitution 1982 such as <<中华人民共和国中外合资经营管理企业法>> [Law of the People’s Republic of China on Chinese-Foreign Equity Joint Ventures] (People’s Republic of China) National People’s Congress, 1 July 1979; <<中华人民共和国中外合资经营企业所得税法实施细法>> [Detailed Rules for the Implementation of Income Tax Law of the People’s Republic of China on Chinese-Foreign Equity Joint Ventures] (People’s Republic of China) State Council, 10 December 1980; see Table 3.1 for more information.
market economy”\(^{157}\) as the fundamental economic system for China. The constitutional amendment provided a more favourable legal and economic environment for FDI indicating China’s movement toward a market economy. A provision was added to state that the PRC “governs the country according to law and makes it a socialist country under rule of law”.\(^{158}\)

### 5.5.2 Specific National FDI Laws

Under the Constitution, the NPC of China and its Standing Committee are eligible to enact national laws regarding FDI. The EJV, CJV and WFOE pieces of legislation constitute the general legal framework for FDI in China and provide for three main modes of FDI in China. They have been commonly used by foreign investors in China.\(^{159}\) Other forms include foreign investment share enterprise and co-operative development.\(^{160}\)

### 5.5.3 Implementation Regulations and Rules for FDI

The three primary FDI laws only provide general structures for the modes of FDI. According to the *Constitution 1982*, the State Council and its ministries have used their

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157 In 1993, amendments were adopted at the First Session of the Eighth NPC and promulgated on 29 March. The concept of social market economy was introduced to replace planned economy. In 1999, the term social market economy was also added to the Preamble of the Constitution.
160 Kay-Wah Chan, ‘Foreign Investment Law in China’ in Patricia Blazey and Kay-Wah Chan (eds), *The Chinese Commercial Legal System* (Lawbook, 2008) 207, 209. A foreign investment share enterprise is required to hold more than 25 per cent of shares in a Chinese stock company. Co-operative development involves foreign company or companies co-operating with Chinese enterprises or economic organisations in projects on exploring and producing natural resources.
delegated legislative power to adopt numerous rules to implement laws and make regulations.\textsuperscript{161}

The EJV Law and its regulations, the \textit{Regulations for the Implementation of the Law of the People’s Republic of China on Chinese-Foreign Equity Joint Ventures 2001} (EJV Regulations) were adopted by the State Council.\textsuperscript{162} Compared with the 15 articles of the EJV Law, the 118 articles of the EJV Regulation Implementation represent a comprehensive guide for establishing, operating and terminating an EJV in China.\textsuperscript{163} The \textit{Detailed Rules for the Implementation of the Law of the People’s Republic of China on Chinese-Foreign Cooperative Joint Ventures 1995} (CJV Implementation) were promulgated in 1995 to implement the CJV Law (CJV Implementation Rules).\textsuperscript{164} To supplement the CJV Implementation Rules, the MOFTEC issued an \textit{Interpretation on Implementing Certain Articles of the Rules for the Implementation of the Law of the People’s Republic of China on Chinese-Foreign Contractual Joint Ventures 1996} (CJV Interpretation) on 22 October 1996.\textsuperscript{165} Also, like the EJV Law and the CJV Law, there is a set of implementation regulations/rules for the WFOE Law. The \textit{Detailed Rules for the Implementation of the Law of the People’s Republic of China on the Wholly Foreign

\textsuperscript{161} [Constitution of the People’s Republic of China] (People’s Republic of China) National People’s Congress, 4 December 1982, art 89.
\textsuperscript{163} Ibid art 118.
\textsuperscript{165} Kay-Wah Chan, ‘Foreign Investment Law’ above n 160, 215.
Owned Enterprise 1990 (WFOE Implementation) was promulgated by MOFTEC on 12 December 1990 and amended on 12 April 2001.\footnote{Ibid 221.}

Other national implementation rules and regulations for FDI have occasionally been adopted by the ministries of the State Council in accordance with the development of new situations.\footnote{The functions and powers of the State Council are stated in Article 89 of the Constitution of the PRC.} The rules and regulations at the State Council level (including ministries and departments of the State Council) are numerous and very important in regulating the management of FDI. According to the Constitution 1982, the State Council and its ministries are authorised to issue regulations that are applicable nationwide. For example, the Provisional Regulations Governing the Establishment of Investment-type Companies by Foreign Investors 1995 was promulgated on 4 April 1995 by the ministry of Foreign Trade and Economic Cooperation.\footnote{Kuihua Wang, Chinese Commercial Law above n 112, 91.} In 1990, the ministry of Foreign Economic Relation and Trade Promulgated the Contract Management Regulations for Sino-Foreign Equity Joint Ventures 1990, which provides requirements and approval procedures for the management of a joint venture other than that provided in the EJV Law or its implementation regulations.

The establishment of an EJV, CJV or WFOE is subject to examination and approval by the relevant governmental authority or authorities.\footnote{Kay-Wah Chan, ‘Foreign Investment Law’ above n 160, 229.} The Provisions on Guiding Direction of Foreign Investment 2002 was promulgated in 2002.\footnote{ outras [Provisions on Guiding Direction of Foreign Investment] (People’s Republic of China) State Council, Order No 346, 1 April 2002. The State Council published a new set of foreign investment guidelines to replace the provisional guidelines promulgated in 1995. The new guidelines took effect on 1 April 2002.} The guidelines provide the direction of foreign investment and enable foreign investment to conform to the

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planning of Chinese national economic and social development and enhance the protection of legal rights and interests of investors. A *Guideline Catalogue of Foreign Investment Industries 2007* was approved and updated by the Government to be used as the basis for the examination and approval of foreign investment projects in China. The *Guideline Catalogue of Foreign Investment Industries 2007* requires that foreign investment projects must either be ‘joint ventures’ or have a ‘Chinese controlling shareholding’ or ‘Chinese majority shareholding’. Joint-venture projects mean that they must be Sino-foreign equity or contractual joint ventures. Projects with Chinese controlling shareholding are those where the Chinese parties have a stake of over 51%, while projects with Chinese majority shareholding are those where the Chinese parties have a larger stake than any foreign partners.

### 5.5.4 Local Regulations

According to the *Constitution 1982*, the People’s Congress of provinces, autonomous regions and municipalities may adopt local regulations pertaining to FDI that do not contravene the *Constitution 1982*, statutes, administrative rules and regulations. Some municipal governments may, with authorisation from the Standing Committee of the NPC, promulgate local regulations and rules regarding FDI, subject to approval from the standing committees of provinces and municipalities directly under the Central Government, and their standing committees have power to adopt local regulations which do not contravene the Constitution and other laws and administrative regulations: *Constitution of the People’s Republic of China* (People’s Republic of China) National People’s Congress, 4 December 1982, art 100.

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171 Ibid.
173 Ibid.
175 People’s Congresses of provinces and municipalities directly under the Central Government, and their standing committees have power to adopt local regulations which do not contravene the Constitution and other laws and administrative regulations: <<中华人民共和国宪法>> [Constitution of the People’s Republic of China] (People’s Republic of China) National People’s Congress, 4 December 1982, art 100.
committees of People’s Congress at the provincial level. For example, for the provinces and cities having SEZs, their People’s Congresses and the standing committees thereof are able to, in accordance with an empowering decision of the NPC, enact regulations to be implemented inside the SEZs. Furthermore, the provincial level People’s Congresses and their standing committees in the SEZs are authorised to promulgate regulations for the SEZs and ETDZs. Accordingly, Shanghai, Guangdong, Fujian, Zhejiang and other provincial level congresses have adopted regulations for the SEZs and ETDZs located in their provinces. Apart from local regulations there are also local rules. Local rules are enacted by the people’s governments of the provinces, autonomous regions and municipalities directly under the Central Government and the large cities in accordance with their own laws, administrative regulations and local regulations.

5.5.5 FDI Provisions in other Laws and Regulations

FDI enterprises are treated as special legal entities in the Chinese legal system. As a result, Chinese laws and regulations have special provisions governing FDI enterprises in order to distinguish them from domestic enterprises. For example, there are special provisions for foreign investment enterprises in the Regulations of Foreign Exchange Control of the People’s Republic of China, which provides that FDI enterprises should handle their foreign exchange through special channels and procedures. The dual legal system, although not necessarily unfavourable to foreign investors, causes non-national treatment of FDI enterprises.

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177 Ibid art 73.
178 见《中华人民共和国外汇管理条例》[Regulations of Foreign Exchange Control of the People’s Republic of China] (People’s Republic of China) State Council, Order No 532, 1 August 2008.
5.5.6 International Treaties

China has entered into various bilateral treaties with other countries, including bilateral agreements concerning the mutual promotion and protection of investment and bilateral agreements on investment insurance. China has signed bilateral agreements on investment insurance with the United States, which allow US investors to obtain insurance against political risks in China from the Overseas Private Investment Corporation.

In addition, China is currently a signatory to several multinational FDI-related treaties. In 1998, China joined the Multi-lateral Investment Guarantee Agency under the International Bank for Reconstruction and Development, which provides insurance to investors from member countries against political risks to foreign investors in China. In 1990, China signed the Convention on the Settlement of Investment Disputes between States and Nationals of Other States, which established the International Centre for Settlement of Investment Disputes (ICSID). ICSID provides facilities for conciliation and arbitration of investment disputes between contracting States and nationals of other contracting States.

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According to Chinese law, treaties that China has entered into or has ratified automatically become effective in the domestic legal system and are implemented as national laws.\(^\text{182}\)

### 5.5.7 Internal Regulations

In China, administrative branches at all levels have adopted numerous internal regulations to implement the laws and regulations.\(^\text{183}\) Article 89 (1) of the Constitution 1982 and article 56 of the Legislation Law have given legislative power to the State Council. According to Chen, the State Council is, de facto, the most powerful law-making institution in China.\(^\text{184}\) The Council’s deliberations are widely used as guidance for the administration of foreign investment, especially in approval procedures. For example, the *Provisional Measures on the Trial Establishment of Sino-Foreign Joint Venture Foreign Trade Companies* were promulgated by the MOFTEC on 30 September 1996.\(^\text{185}\) These measures were designed to further open up China to the outside world and to promote the development of China’s foreign trade.\(^\text{186}\) Tightened restrictions have been imposed on both Chinese and foreign parties applying for establishment of foreign trade joint ventures.\(^\text{187}\) Most of these regulations are not published and some are even confidential documents that are only available to government agencies. The practice has a long history in communist China.


\(^{183}\) Details on its legislative power and the legislative procedure are set out in chapter 3 of the Legislation Law and the Regulations on the Procedures for the Formulation of Administrative Regulations that was promulgated by the State Council on 16 November 2001.


\(^{186}\) Ibid art 1.

During the thirty-years of a planned economy, the government, dominated by the Communist party, carried out economic plans mostly by internal regulations. Since the state controlled and managed all enterprises, production and supply, it was not necessary to publish these internal regulations. There are now new regulations on the formation of administrative regulations that require that they be published for public comment at least 30 days before their promulgation and permit those drafting such procedures to seek public comment whenever they feel it to be appropriate.\textsuperscript{188}

In order to make progress with its foreign investment program and to avoid waiting upon the slow process of drafting a complete legislative framework, the Chinese authorities adopted three strategies: (1) adopting new laws and regulations in a piece-meal fashion, correcting prior mistakes as they became evident; (2) trying out new proposed laws and regulations through internal guidelines that were made available to Chinese officials responsible for conducting foreign investment negotiations or on occasion adopting such new laws only in SEZs as an experiment; and (3) adopting model forms or precedents of foreign investment contracts that can be used with minor variations for many different investments. Although only the published laws and regulations are legally binding, the bureaucratic structure of the Chinese government and the foreign investment approval processes are such that the unpublished guidelines and model forms are treated by Chinese negotiators with much the same respect as laws.

Thus, the practical framework for the regulation of foreign investment in China is much more than just China’s published laws and regulations. It also includes future laws

\textsuperscript{188} <<行政法规制定程序条例>> [Precedural Ordinance Concerning the Making of Administrative Regulations] (People’s Republic of China) State Council, Order No 321, 16 November 2001, arts 12, 16.
that are expected to be published (but appear only as ‘internal’ guidelines available to Chinese negotiators); it includes legislation from the SEZs, which is applied by ‘analogy’; and it includes model contract forms that have been drafted or approved in prior transactions by the controlling ministry or government agency. 189 For example, the administration of Beijing Economic-Technological Development Area publishes its investment guideline regarding any application for foreign investment project under USD100 million. According to this guideline, the format and content of the agreement of the parties and constitution of the proposed joint venture, are expected to use the model sample. 190 A textual analysis limited to only China’s published laws and regulations therefore would lead one to believe that there is both more uncertainty and greater flexibility within the system than in fact exists once one reaches the negotiating table. 191

However, the development of Chinese economic law encounters several problems. The main problems are the creation of a legal duality, the harmonisation of economic laws and legal definitions. 192

After adopting a market-oriented economic system, China has made great efforts to reduce the use of confidential internal documents and to replace them with published regulations. However, the whole system has for a long period been influenced by the

192 Ibid 288.
ideology of the planned economic system along with many unpublished internal regulations. This has attracted criticism from other countries. This transparency issue occupied a prominent position in China’s WTO accession negotiations. For foreign investors, the existence and use of unpublished internal regulations may add additional, considerable risk to their investment.

5.6 Advantages and Disadvantages of Major Types of Foreign Direct Investment

EJVs, CJVs and WFOEs have been the most commonly chosen forms of foreign direct investment in the early years of the economic reform period in the PRC. Since the late 1980s, equity joint ventures and wholly foreign owned enterprises became predominant and recent years have seen a proliferation of wholly foreign owned enterprises. The rise in popularity of wholly foreign owned enterprises is largely due to relaxed foreign investment restrictions after China’s accession to the World Trade Organisation in 2001 which dismantled some barriers to foreign investment in the retail, trading, wholesale and other sectors.

The WFOE structure gives the foreign investors full business control and profit rights. One of the main attractions of this investment structure is that it takes less time to establish than a joint venture because the foreign company does not need to select a suitable
local partner or negotiate joint venture contract arrangements. In addition, the WFOE structure gives foreign companies greater control over their operations as no local partner is involved in management and human resources decisions. However, not all sectors are open to WFOEs. Foreign investors in industries subject to foreign investment constraints such as telecom and publishing may consider investing through WFOEs established as consulting companies. These types of companies contractually control most business aspects of the licensed business which is formally owned by Chinese investors or, where allowed, a joint venture.

EJVs or CJVs remain as the preferred investment structures for many companies. Joint ventures are preferred when investors want to enter industries in which the Chinese government restricts foreign investment. Both forms of joint venture engage both local and foreign investors and both parties share any risks and losses of the venture projects. A CJV is more flexible than an EJV as parties have more freedom when negotiating terms for the former than the latter. A joint venture may also be preferred when the foreign company needs a partner to share the capital investment burden as well as possessing familiarity with Chinese local conditions and culture. Although many joint ventures have proved to be effective vehicles for entering China, the structure has certain statutory features that diminish its attractiveness to foreign investors. A joint venture requires unanimous approval from its board of directors on major decisions including capital changes, mergers and demergers, amendments to the articles of association as well as other matters contractually agreed by the partners.

198 Ibid.
199 Kuihua Wang, Chinese Commercial Law above n 112, 127.
5.7 Alternative Vehicles for Foreign Direct Investment in China

Alternative investment options include a foreign invested company limited by shares and a joint stock company,\(^\text{200}\) with its capital divided into shares of equal value, and voting rights. The creation of this kind of company is by promotion and free share float. When established by share float, the promoters must subscribe to at least 35 per cent of the shares\(^\text{201}\) and at least one of the promoters must have been profitable in the three years prior to the float.\(^\text{202}\) This structure has the advantage of allowing Chinese partners to invest through companies or as individuals. This structure also facilitates capital formation by allowing the issuing of additional shares to existing or new shareholders.

The foreign invested partnership is a new vehicle that was established pursuant to the *Partnership Enterprise Law of the Peoples Republic of China* \(^\text{203}\). This structure is particularly attractive to the private equity and venture capital industries for establishing renminbi funds.

Foreign investors with multiple projects and large capital investment needs should also consider establishing a foreign invested holding company.\(^\text{204}\) While a holding company may be registered as either WFOE or JV, there are special requirements in terms of capital


\(^{202}\) Ibid, art 6.


contribution. A holding company’s foreign shareholder must either have a total capitalisation of at least USD 400 million worldwide and have contributed at least USD 10 million in its PRC invested enterprises or must have invested a minimum USD 30 million in China. This structure can also raise the investor’s profile because it allows the words “holding company” and “China” to be included in the company’s name.

5.8 Conclusions

China’s ‘Open Door’ economic policy, commenced in 1978, has led to a phenomenal growth in foreign investment in the ensuing period. That growth has been matched by enormous growth in all other terms of trade. The statistical information provided in this chapter demonstrates the very substantial achievement of China over the past thirty years in its place in the world’s economic structure. It is rapidly moving toward the role of the world’s largest economy and for this reason has acquired global responsibilities that were probably unforeseen thirty years ago. One significant part of those responsibilities is the ways in which China deals with FDI within its own borders and the way it has developed and upgraded its legal regime to deal with such investment may be a useful indicator of the way it will cope with its leading role in the global economy.

The radical policy changes that commenced in 1978-79 were accompanied by a very significant modernisation of the laws of China including the establishment and development of a range of foreign investment laws. These laws have been continually reviewed and upgraded over time and there were some identifiable and distinct developmental stages that have been discussed in this chapter. An initial experimental

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Ibid.
period included legislation specific to joint business ventures between foreigners and Chinese partners as well as the creation of special economic regions and government incentives. These economic zones were very widely expanded in the mid 1980s. In the late 1980s and early 1990s the PRC had become very experienced in dealing with foreign investment and had reached the point of creating laws to address concerns of international partners in such areas as intellectual property protection and foreign investor income taxation.

A large and growing body of laws, regulations and policies related to foreign investment has been discussed in this chapter with very detailed information related to the sources of such laws. It is useful to note the differences in law-making processes between China and western ‘democracies’. In general terms it can reasonably be said that China’s law-making processes retain a significant degree of flexibility and adaptability to changing circumstances.

The huge growth in foreign investment in China over a relatively short period has required a rapid growth in the development and implementation of a series of applicable laws. The purpose of these laws has been to create the capacity to deal with all of the financial and other ramifications of a very substantial growth in the types of operations and the very large monetary amounts involved. The control of the activities of foreign investors by way of appropriate taxation regimes and procedural requirements has simply been a part of the process.

As a result of the nature of the political structure in China, the pre-existing methods of ‘management’ of the economy by government have, on the one hand, presented
challenges in designing sets of laws with sufficient levels of transparency and certainty with which ‘western’ investors could feel comfortable and on the other, were laws that the Chinese – with their traditional ways of doing business - were able to accommodate.

More substantive practical aspects for foreign investors concerning the implementation of law and its administration are discussed in the following chapter.
Chapter 6

Practical Legal Factors in the Administration of FDI Law

6.1 Introduction

Since China began economic reform in the late 1970s, FDI has played a significant role in China’s economic development and initiated other aspects of development, including further development of the legal system. In order to comply with the requirements of the World Trade Organisation (WTO) (of which China became a member in 2001), the Chinese government has made very significant efforts to adjust its legal system to accord with western standards. In attempting to satisfy the perceived requirements of both common law and civil law countries, it has radically changed its previously piecemeal and inconsistent economic laws.1

Apart from problems arising in the course of this dramatic economic transition (such as market size, labour costs, quality of infrastructure and government policies),2 one important aspect that has been of concern to foreign investors is whether their rights are legally protected.3 The reality is that whilst China has made rapid progress towards

3 China Briefing, ‘US China Business Council Survey Reveals Top Ten Concerns for Foreign Investment into China’ (19 November 2010) China Briefing <http://www.china-briefing.com/news/2010/11/19/uscbc-survey-reveals-top-10-concerns-for-foreign-investment-into-china.html>. The US China Business Council released its ‘2010 Member Priorities Survey Results for US investors’ on 17 November 2010 after interviewing a cross section of leading American companies. The survey listed the top 10 investor concerns surrounding the Chinese market. Human resource issues, licensing and business approval, as well as competition with state-owned enterprises (SOEs) are considered the top three issues that hinder American investment in China from further growth. Other concerns that are ranked from fourth to
developing a more open and transparent legal system, in many sectors the regulatory framework has failed to keep pace with the transition from a command system towards a situation more akin to a free market economy. Some of the major difficulties in this regard are problems arising from: conflicting national law and local regulations, the manner of exercise of administrative discretionary power, and the government’s desire to encourage foreign investment whilst maintaining a significant level of control over the changing economic environment. In this analysis of practical factors for foreign investors in China, section 6.2 provides an outline of the commercial law regime in China, including the extent of the influence of communist jurisprudence and legal protection for foreign investors. Section 6.3 examines some practical legal concerns for foreign investors, including the existence of conflict between national laws and local regulations. In section 6.4 the seemingly ever-present and often difficult problem of discretionary power in administration of laws is discussed with particular reference to the commercial law regime, ambiguity in the drafting of laws, the issue of apparent lack of transparency in decision-making and the confusion that follows when more than one regulator is involved in making decisions in respect of a foreign investment project or proposal. Section 6.5 concludes this chapter.

6.2 The Chinese Commercial Law Regime

Commercial law in a developing country such as China operates very differently to its counterparts in developed countries. The law and the legal system will be under-developed
and the legal system itself may be based on civil law rather than common law (as is the case in China).\(^6\) In December 1978, the Communist Party of China (CPC) announced\(^7\) a shift of the CPC’s focus from political movement, as witnessed in the Cultural Revolution, to economic development. To fulfil the goal of ‘Four Modernisations’, the CPC adopted the ‘Open Door’ policy, to attract foreign investment, so as to gain the capital, skills, knowledge and technology necessary for economic development (as referred to in Chapter 5).

To push for economic development and attract foreign investment, the Chinese government needed to transform its economy from a state planned economy to a socialist market economy. Within such a socialist market economy, private individuals (including foreign investors) are encouraged to be involved in the national economy, while under the general guidance and control of the central government. To facilitate the development of a market economy, there must be a legal system that both protects the interests of economic participants and facilitates economic activities. A formal and rationalised legal system would make many aspects of economic activities more predictable, and hence encourage entrepreneurship and wealth creation.

China has achieved impressive progress over the past 30 years in building up a legal framework for foreigners to conduct business in China and the quantity of legislation and regulation is increasing. A full array of laws and regulations, related to foreign investment

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is now in place. While there are no exact statistics on the amount of legislation that has been passed by the central and regional governments in relation to foreign investment, there now appear to be several thousand legislative and regulatory instruments on foreign related trade and investment in China.\textsuperscript{8} China has accomplished far more by way of rule-making than it has by way of institution-building.\textsuperscript{9} The commercial regulatory reform in China has been accompanied by distinctive features of the Chinese regulatory state in both its origin and actual functioning.\textsuperscript{10}

With such a detailed body of law, how is it that foreign investors or their lawyers become confused about the Chinese legal system? To accommodate the development of the socialist market economy in a relatively short period, the legal system had to be quickly established. Many problems in China’s institutional environment related to commercial law and foreign firms are rooted in deficiencies in China’s legal and enforcement regime in a number of areas.\textsuperscript{11} Often, rules have been implemented with little assessment of their suitability and effectiveness. This has caused the commercial law regime to be continuously revised. For example, although China has made every effort to attract foreign investment, foreign related business is subject to a strict multilevel and multi-dimensional examination and approval system. This system not only controls business establishment, but also the offering of investment incentives.\textsuperscript{12} As a result, the commercial law regime is still in a state

of flux and has been found to be confusing to foreigners. This will be explored in detail in Chapter 8.

6.2.1 Influence of Communist Jurisprudence

On the surface, the commercial law regime of the PRC — like its counterparts in the Western world — provides rules that govern and regulate economic relations. However, it must be remembered that the Chinese commercial law regime, or Chinese law in general, had its origin in the traditional communist theory of law. Jurisprudence in socialist countries seems to have a common view with regard to law. The law is said to be part of the superstructure of the society and nothing more than an instrument of the ruling class.\(^\text{13}\) So the rule of law — where law acts as a restraint on state power — cannot exist under a communist legal system. The notion of the rule of law, as understood by westerners, is regarded by the Chinese Communist regime\(^\text{14}\) as merely a tool of the bourgeoisie.

Laws and regulations within communist jurisprudence, therefore, are intended to be instruments of policy enforcement.\(^\text{15}\) There is an alleged tendency among senior CPC officials to look at law merely as a pragmatic means of achieving certain goals such as implementing Party policy or instigating economic reform rather than looking at the very

\(^{13}\) Patricia Blazey, ‘Overview of China’s Economic’ above n 6, 48. The law, in Mao’s Eyes, did not resemble anything akin to the Western conception of the rule of law. Mao adopted the Marxist approach to law as a tool to remould society, to suppress class enemies and enforce party policy rather than to protect individual rights.


\(^{15}\) Jianfu Chen, *Chinese Law* above n 12, 35. ‘Instruction of the Central Committee of the CPC to Abolish the Kuomintang Six Codes and Define the Judicial Principles for the Liberated Areas’ February 1949, ‘Law is the will of the state compulsorily and openly enforced through military forces by the ruling class. Law, like the state, is a tool for protection of the interests of certain ruling classes’.
nature or quality of law itself. If that is the case, then laws and regulations are not intended as expressions of immutable general norms that apply consistently across all forms of economic activities, but as tools to achieve immediate policy objectives of the Party. In other words, laws are not a restraint on state power but an instrument of it. As a consequence, the development of the legal system is not a desirable end in itself. Rather it is a means to develop the socialist market economy, to promote prosperity and ultimately to support the socialist system.

### 6.2.2 Protection for Foreign Investors under Chinese Law

In the past 30 years, China has made substantial progress in economic development, particularly in the foreign investment environment. China is known as one of the best places for foreign investment in the world. At the beginning of China’s reform and its opening up to international investment, government policies provided a good environment for the foreign investment companies, such as preferential policies in enterprise income taxes. With the ongoing development of the economy the Chinese government paid

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18 <<中华人民共和国外商投资企业和外国企业所得税法>> [Foreign Investment Enterprise and Foreign Enterprise Income Tax Law] (People’s Republic of China) National People’s Congress, Order No 45, 1 July 1991, art 7. This legislation provided income tax incentives for foreign investment enterprises. For foreign investment enterprises located in special economic zones the income tax rate was 15 per cent of the company profit being half of the normal income tax rate in other non-special economic zones areas.
increasingly more attention to the construction of the system of laws, including the foreign investment laws that are part of that system. Foreign business persons in the PRC, like prudent investors anywhere, would naturally be concerned to know about the operation of the Chinese commercial law regime and how it is applied in practice. A well-developed legal system creates an environment of certainty, where commercial interests of foreign investors should be well protected.

An examination of the commercial law regime of the PRC and local practice by the regulators would have the capacity to confuse foreigners. However, it would be inaccurate to conclude that the Chinese commercial law regime is incapable of offering protection to the commercial interests of foreign investors. It must be understood that the Chinese legal system has developed under a unique historical and jurisprudential background, and is in an early stage of development. The protection offered by the current regime, whilst not yet perfected, has come a long way from the situation that existed 20 to 25 years ago. The lawful rights and interests of foreign investors are protected by the Constitution and laws of the PRC. However, because of the speed of development, some aspects of law making may be still less than satisfactory. The effect of communist jurisprudence on the Chinese legal system should also be emphasised. To traditional Chinese communists, law held no special sanctity and was often just a mere tool of party policy and propaganda.\footnote{Kuihua Wang, \textit{Chinese Commercial Law} above n 8, 37.}

From the time when the CPC announced policies of economic reform and ‘Open Door’, law has been seen as an instrument to regulate the socialist market economy. Although China is, to an extent, trying to distance itself from that view, the shadow of
Marxist-Leninist jurisprudence is still exerting a significant degree of influence. Bearing in mind China’s unique historical and jurisprudential background, it is therefore possible to rationalise and justify some aspects of the Chinese commercial law system and commercial practice that may seem to be confusing at first sight.

As the Chinese commercial law regime is still in its developmental stages, and laws are often used as instruments for implementing economic policies, regulatory efforts are often piecemeal. This leaves the legacy of a plethora of legislation and regulations at central and local government levels, fragmented amongst various functional departments, making it difficult for foreign investors to comprehend the state of the law.

Another aspect of the Chinese commercial law regime is that it gives regulators wide discretion in the exercise of their powers. Chinese legislation and regulations are often drafted in a general form, leaving concrete details to discretionary interpretation by the administrative organs. For instance, the State Administration for Industry and Commerce and its provincial and municipal level bureau have the power to exercise administration on registration of commercial licences, trade marks and anti-monopoly operation activities. The Municipal level of the Administration Bureau for Industry and Commerce has discretionary power to settle cases that attract administrative penalty fines between

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20 <<中华人民共和国宪法>> [Constitution of the People’s Republic of China] (People’s Republic of China) National People’s Congress, 4 December 1982, Preamble. The Constitution Preamble asserts that the basic task of the nation in the years to come was to concentrate its effort on socialist modernisation. Under the leadership of the Communist Party of China and the guidance of Marxism-Leninism and Mao Zedong Thought, the Chinese people of all nationalities would continue to adhere to the people’s democratic dictatorship and follow the socialist road.

21 Kuihua Wang, Chinese Commercial Law above n 8, 11. The new judicial system of the PRC was influenced by Soviet law, Marxist ideology and the Chinese Communist Party’s interpretations of law and justice.

22 Ibid 45.

RMB100,000 (approximately USD15,000) and RMB1 million (approximately USD150,000). In order to prevent abuse of such administrative power, the State Administration for Industry and Commerce in Beijing passed a Guideline to restrain and supervise the exercise of such power. However, such lack of details in the legal regime creates uncertainty in the implementation of law, a situation that a foreign investor may find confusing and disturbing. Furthermore, there is also a lack of transparency in the application of law. When regulators are exercising discretion, they often follow important guidelines which are often unpublished and kept away from outsiders (those outside the regulating entity) further introducing uncertainty to the investment climate. Uncertainties in the legal regime have allowed the law to be used, not to encourage foreign investment as it originally intended, but for ulterior purposes. Hence, there is significant incongruence between the overall legal regime and its interest and actual local practice, as evidenced by such local practices as preferential treatment, corruption, and jurisdictional greed.

Recent developments go some way toward easing foreign investors’ concerns about the apparent contradictions between the Chinese commercial law regime and local practice. The introduction of the Administrative Litigation Law 1989 provides evidence that the

\[\text{Recent developments go some way toward easing foreign investors’ concerns about the apparent contradictions between the Chinese commercial law regime and local practice. The introduction of the Administrative Litigation Law 1989 provides evidence that the}\]

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24 Ibid art 71.
26 According to article 14 of the Regulations of the People’s Republic of China on Public Government Information 2007, there is information that is not permitted to be published based on the State Secrecy Law of the People’s Republic of China. Article 9 stipulates that following the interests of national security and related matters, the leak could harm national political, economic, defence, foreign affairs and other areas of security and interests, and should be identified as a national secret.
Chinese government is committed to further reform of the legal system so it can better provide the protection demanded by foreign investors.

6.3 Practical Legal Factors Concerning Foreign Direct Investment

6.3.1 The Dilemma of National Laws and Local Regulations

Three decades of rapid economic growth has fuelled China’s transition from a centrally planned economy to a market oriented economy, necessitating the development of a legal system capable of fostering and protecting economic development. Before 1978 in China, the economic institutions for agriculture and industry operated essentially under a centrally planned system.

In order to implement the Communist Party of China’s Fourteenth National Congress task of economic reform and to accelerate the reform pace of opening up and socialist modernisation, the Third Plenary Session of the Central Committee discussed the establishment of a socialist market economic system.28

Now, after 30 years of reform, China’s economic system has changed dramatically. Public ownership, as the mainstay of a variety of economic sectors, shapes the pattern of development and has deepened rural economic reform. Since China’s reform commenced in 1978, its legal system has undergone an unprecedented expansion with the promulgation of a myriad of commercial and civil laws at national and local levels.29 While the emphasis on lawmaking contributed to the growing authority and capacity of the National People’s

Congress (NPC) during this period, numerous contradictions, tensions and ambiguities materialised within the law-making system as a whole. Largely as a result of a shifting distribution of authority among the NPC, the State Council and sub-national (primarily provincial) People’s Congresses, the legislative arena is populated by self-interested participants with uneasy power relationships who engage in institutional turf wars at virtually every stage of the lawmaking process.\(^{30}\)

Faced with the possibility of legislative disorder derailing modernisation, China’s leadership in the early 1990s began to consider a ‘law on law-making’ to set out a clearly defined uniform legal hierarchy.

The *Legislation Law 2000*\(^{31}\) represents a significant attempt to produce a more orderly and open legislative system in China. Virtually unique in the world as a law on law-making, it deals with matters of a constitutional nature. Moreover, it represents an attempt by the NPC to solidify its position in relation to other lawmaking and regulatory institutions, namely the State Council and provincial governments.\(^{32}\) China is a unified multi-ethnic country with a unitary political system.\(^{33}\) To ensure that the legal system remains unified, yet at the same time adapts to uneven economic, political and cultural development or different locations, China practices a unified, multi-level legislative system. For instance, the NPC and its Standing Committee exercise the state’s power to make


\(^{32}\) Ibid arts 56, 63.

laws. The NPC enacts and amends basic laws pertaining to criminal offences, civil affairs, state organs and other matters. The Standing Committee enacts and amends all laws except for basic laws that should be enacted by the NPC. When the NPC is not in session, its Standing Committee may partially supplement and revise laws enacted by the NPC, provided that the changes do not contravene the basic principles of law. The State Council formulates administrative regulations in accordance with the Constitution and other laws and records these regulations with the NPC. In line with the specific conditions and actual needs of administrative regions — and on condition that they do not violate the Constitution or other state laws and administrative regulation — the People’s Congresses of provinces, autonomous regions and municipalities directly under the Central government, as well as their standing committees, may enact local statutes and record them with the NPC Standing Committee and the State Council.

In light of their specific conditions and actual needs, and on condition that they do not conflict with the Constitution, other laws and administrative regulations or local statutes passed by their provinces or autonomous regions, the People’s Congresses and their standing committees of large cities may enact local statutes. These are then submitted to the standing committees of the People’s Congresses of their provinces or autonomous

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34 Ibid arts 58, 62, 67.
36 Ibid art 62[3].
37 Ibid art 67[2].
38 Ibid art 89[2], 90.
40 Ibid arts 63–67.
regions for approval before they take effect. In addition, these standing committees must record the local statutes with the NPC Standing Committee and the State Council.\textsuperscript{41}

The \textit{Legislation Law 2000} addresses substantive and procedural aspects of the legislative process and its content is designed to affect the quality of law making in China in the future. Overall, the \textit{Legislation Law 2000} endorses a more open and consultative legislative process. Importantly, it sanctions — though does not require — the use of public legislative hearings as a new mechanism for incorporating greater citizen participation in the legislative process.\textsuperscript{42} The emergence and spread of public legislative hearings in China represents a ground-breaking governance reform, primarily taking root in urban areas at the local level.

While the Law does not yet mandate their use, local People’s Congresses and administrative bodies have started experimenting with hearings, signalling the potential development of a new governance norm in which public participation plays a more valued and institutionalised role in the legislative process.\textsuperscript{43}

Laws and regulations governing foreign investment were passed and amended in the course of China’s economic transition in order to meet the needs of the legal system, to protect the interests of participants, and to facilitate economic development in practice. Accordingly, a legal framework regulating foreign investment has gradually been established. Local regulations and rules, largely concerning investment incentives and preferential economic treatment, were enacted in addition to national laws and national

\textsuperscript{41} \textit{中华人民共和国宪法} [Constitution of the People’s Republic of China] (People’s Republic of China) National People’s Congress, 4 December 1982, arts 63–64.

\textsuperscript{42} Ibid art 34.

\textsuperscript{43} Laura Paler, ‘China’s Legislation Law and the Making of a More Orderly and Representative Legislative System’ (2005) \textit{China Quarterly} 301, 302.
administrative regulations on various aspects of foreign investment. However, as a result of many of the laws and regulations having been amended or further supplemented by other regulations at national or local level without a view to an overall simultaneous harmonisation being achieved, foreign investors have been confused by inconsistencies between regulations at national and local levels. For example, the national level and local level’s protection of famous trademarks and well known brands can be confusing for foreign investors. The Trademark Law 2001 specifies that a famous trademark is protected and no registration of any similar trademark applied to any product will be approved as it would result in public confusion. The main aim of this provision is to protect the famous trademark in all different geographical areas and includes different products and different industries. However, Jiangsu Province passed an administrative regulation to protect a famous trademark with conditions that targeted a similar trademark being used in a business name and product packaging. This regulation was used to protect Jiangsu province’s industries but was not consistent with the provisions of the Trademark Law 2001.


For reasons stated above, laws and regulations in China were made using a ‘scatter approach’, with rules being implemented with little foresight as to their effectiveness. Many of these new laws dealt with the implementation of a market economy.\textsuperscript{48} There are hundreds of laws and regulations related to foreign investment that have been issued at the national level, and many hundreds of rules and regulations issued at the local level.\textsuperscript{49} With such a disparate group of laws, it was no surprise that foreign investors did not have a complete picture of how the rules were to be enforced. A simple description of the written law alone is not enough to understand why local entities behave as they do. It is important to realise that in all international dealings with China that the Chinese have their own history and culture and use legal concepts and institutions in ways that are different from those of the west.\textsuperscript{50} It is essential that foreign investors understand how the legal system operates and how laws are applied in practice.

Additionally, although market reforms have opened the way for private business in China, the Chinese government and bureaucracies still play key roles in most business activities, beyond areas (such as tax collection) that are common functions of all governments. Foreign and domestic companies in China have long complained of the interference of government in business activities.\textsuperscript{51}

Also, as the foreign investment law regime is still evolving, the central government may wish to test the effects of a law or regulation in one area before the rule is introduced.

\textsuperscript{48} Kuihua Wang, \textit{Chinese Commercial Law} above n 8, 43.
\textsuperscript{49} Ibid. The NPC and its Standing Committee made 239 statues and resolutions and the local People’s Congresses issued 4271 administrative rules.
nationally. Model areas are selected and special rules are implemented within those areas. Therefore, the central government may delegate some authority to local officials so that they can exercise the authority in accordance with local circumstances. However, in allowing local authorities the flexibility to adapt laws and regulations to local circumstances or be used as a model for national law, those laws become uncertain and foreign investors can often be confused or even feel that they are disadvantaged.

The *Equity Joint Venture Law 2001* (EJVL 2001) specifies that an Equity Joint Venture (EJV) must be approved by the State department in charge of foreign economics and trade. Article 8 of the EJVL 2001 regulations authorises provincial level government, or an administrative body created by the State Council to be entrusted with the authority to approve EJVs. During the early stages of China’s economic reform, when China was trying to attract capital mainly from Hong Kong and Taiwan, authority to approve EJVs was subsequently granted to the neighbouring Special Economic Zones (SEZs): Shenzhen, Zhuhai, Shantou, Xiamen and Hainan. The central government was setting up a model for laws in preparation for national adoption.

As the economic reform continued, the need to test laws and regulations increased. Subsequently the State Council gave the authority to approve EJVs to 14 coastal port cities,

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52 The National People’s Congress granted Shenzhen Municipal People’s Congress and its Standing Committee legislative power on 1 July 1992. It was a landmark for Shenzhen. In 15 years Shenzhen developed its own rules and regulations (totaling 296) to build the framework document. Strong laws and regulations not only promoted the development of the city, but also provided a reference for national and local legislation.

53 In 1980, the Fifth National People’s Congress approved Shenzhen, Zhuhai, Shantou and Xiamen Special Economic Zones. In October 1980, the State Council approved 2.5 square kilometres in the lake within the Xiamen Special Economic Zone. The lake became the birthplace of the Xiamen Special Economic Zone. On 15 October 1981, construction began on the Xiamen Special Economic Zone. In 1985, the State Council approved the Yangtze River Delta, Pearl River Delta and Fujian Delta as coastal open economic zones. In 1988, Hainan province was approved as a special economic zone.
five Coastal Open Economic Zones, the Pudong New Area, Shanghai, and five inland cities along the Yangtze River.\textsuperscript{54}

Problems were created when local authorities started to compete for jurisdiction over foreign investors and to attempt to further their own interests by the introduction of local laws and regulations. Conflict of laws between central and local levels results at least in part from the central government assigning its rights to both levels. The other reason is the lack of legislation concerning the maintenance of consistency of implementation of law where the local authority is permitted to make local regulations relating to centrally made laws. The central-local relationship in legislation shifts with the development of the market economy. The more power central government releases, the more discretionary power local governments enjoy in all aspects of governance, and the exercise of such discretion is inevitably strongly swayed towards perceived local interests.

\section*{6.4 Discretionary Power of the Administration}

The existence of discretionary power allowing the administrative organs to apply laws is also confusing to foreign investors. Even though in western countries connections may be relevant in business, bureaucrats are expected to be impartial in making administrative decisions. This is largely achieved by means of well established administrative procedures and regulations (including the ways that such regulations should be interpreted) and the

\textsuperscript{54} In 1990, the Central government (State Council) decided to open the central development of Pudong. In 1992, it was further extended to the five cities along the Yangtze River in Yueyang, Shanghai, Tianjin, Beihai, Zhanjiang, Guangzhou, Fuzhou, Ningbo, Nantong, Lianyungang, Qingdao, Weihai, Yantai, Dalian, Qinhuangdao and another 14 coastal cities were include to open up the Yangtze River Delta, Pearl River Delta, South Fujian Triangle, Liaodong Peninsula, Shandong Peninsula, the Bohai Rim region and other coastal open economic zones. Special economic zones, coastal open cities and coastal open economic zones utilise special preferential policies, attract foreign investment, and develop an export-oriented economy and promoting China's development of coastal and inland areas.
means to challenge administrative decision-making by various processes.\textsuperscript{55} These processes usually include internal review systems in the first instance that allow the person challenging a decision to have the process re-examined (often by a more senior officer than the one making the challenged decision) to discover whether there was any error in the decision-making process. Even if the reviewer confirms the original decision, the aggrieved person may have the right to apply to have the decision tested by an external administrative appeals process through a tribunal or court. Freedom of information legislation\textsuperscript{56} may often allow a person wishing to challenge a decision to acquire more information related to the decision-making that may assist in mounting a successful challenge. In the case of challenges to other government or government agency decisions an ombudsman system\textsuperscript{57} allows decisions to be reviewed by an independent ombudsman who may, by criticising certain decisions, bring pressure to bear upon the government department or private corporation to vary its decision. Additionally, there exists the right to challenge the interpretation of a law or regulation through the court process.

In China, the art of using connections (Guanxi) as detours around the formal system exists everywhere in Chinese administration. Bjorkman and Kock discussed the role played by social relationships when penetrating a foreign business network. They suggested that, in particular, the Chinese and the experienced non-Chinese respondents stressed the importance of personal relationships, which were seen as a pre-requisite for most information and business exchanges.\textsuperscript{58} This is a direct result of the broad discretion given to

\textsuperscript{55} Administrative Decisions Tribunal Act 1997 (NSW); Administrative Decisions Tribunal Regulation 2009 (NSW); Administrative Decisions Tribunal Rules 1998 (NSW).

\textsuperscript{56} Freedom of Information Act 1989 (NSW); The Government Information (Public Access) Act 2009 (NSW).

\textsuperscript{57} Ombudsman Act 1974 (NSW).

bureaucrats under the Chinese commercial law regime. Good contacts with local officials can often be a central element in the success of foreign ventures.

After an EJV has been registered, it may be eligible for certain incentives if it can be categorised with a specific status. For example, under the Provisions Concerning Encouragement for Foreign Investment 1986, a joint venture may be granted ‘technologically advanced enterprise’ status. The stated criteria for granting ‘technologically advanced enterprise’ status include the use of advanced and efficient equipment and technology and the production of a newly developed or advanced product, technology transfer or licence agreement. The benefit of obtaining this status includes lower income tax, a limit on land fees, and priority in provisions of infrastructure and short term loans. However, as the authority has wide discretion in granting ‘technologically advanced enterprise’ status, in reality such status is not made with reference to any set criteria but by the EJV’s connections (Guanxi) with local officials. Because the law grants bureaucrats unfettered discretion in granting such status, administrators are open to exercise this discretion in a partial way. For example, according to the Shanghai High Technology Enterprise Identification Measures, the power to decide and identify whether an enterprise meets the criteria of a ‘high technology enterprise’ is held by the Office of Shanghai High Technology Enterprise Identification. This office decides whether the eligible enterprise should undergo further inspection based on the documents they provided.

60 Ibid art 18.
61 Ibid arts 5–9.
62 Ibid art 18.
Decisions related to identification will be made on the basis of the second stage inspection and examination by the same office.\textsuperscript{64} This establishes the practice of seeking preferential treatment through connections, and evolves to become institutionalised corruption.

Although official Chinese policy welcomes foreign investment as critical to the country’s economic development plans, the Chinese government continues to maintain barriers and controls on foreign investment, channelling it toward areas that support the government’s development policies. China encourages foreign investment in priority infrastructure sectors, such as energy production, communications, and transportation, and restricts or prohibits it in sectors where China’s planners have determined that China does not have a specific need or where China wants to protect the local industry.\textsuperscript{65}

The \textit{Interim Provisions on Guiding Foreign Direct Investment 1995}\textsuperscript{66} were released to the public on 20 June 1995 and the \textit{Guideline Catalogue of Foreign Investment Industries 2007}\textsuperscript{67} was issued on 1 December 2007. China has issued updated foreign investment guidelines and provided a revised \textit{Guideline Catalogue of Foreign Investment Industries} for sectors in which foreign investment is encouraged, restricted, or prohibited.\textsuperscript{68} The latter essentially categorises EJVs into industries where foreign investment is ‘encouraged’, ‘permitted’, ‘discouraged’, or ‘prohibited’. For EJVs within the ‘encouraged’ class, the second stage inspection and examination by the same office takes place.

\begin{footnotesize}
64 Ibid arts 9, 15.
\end{footnotesize}
industries, approval by the relevant authority would be easier than EJVs within the ‘permitted’ or ‘discouraged’ industries. If such a guideline were to remain as an internal document, a foreign investor would be unable to assess the proposed EJV’s probability of approval. Such uncertainty surrounding approval would certainly have the effect of discouraging foreign investment. According to the 2007 investment guidelines, the Chinese government still prohibits foreign investment for projects with objectives not in line with national economic development under the state plan. Compared with its predecessor, the updated *Guideline Catalogue* makes amendments on five facts as stated below.

Firstly, the updated catalogue promotes the policy of reform, and was created to fulfil other undertakings made by China to the WTO. Additional service sectors, including logistics and outsourcing, are added to widen the scope of foreign investment. There are also references to the reduction of limitation provisions in foreign investment regulations. Secondly, the Chinese government encourages foreign investors in the ‘clean’ industries. It advocates support for foreign investors committed to protecting the environment and using regenerative energy. The catalogue is added to encourage investors to save resources and enhance the environment.

Thirdly, the Chinese government adjusted the export policy. In view of China’s growing trade surplus and rapid expansion of reserves of foreign currency, and in order to balance imports and exports, and particularly to promote the importation of high

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69 National Development and Reform Commission issued the 11th Five Year Plan on Foreign Capital Utilisation in November of 2006, which stated that China will change foreign investment emphasis from quantity to quality.

technologies and high-tech equipments, a general provision that foreign investment devoted to exporting 100 per cent of its products be an ‘encouraged category’ was removed in the New Catalogue. 71 Fourthly, the earlier catalogue’s references to focusing on China’s western regions were abandoned. In the updated catalogue, different regions in the China now have the same footing in respect of encouraged investment in line with the policy of further utilising foreign investment. 72 Lastly, Chinese authorities do not readily permit the entry of foreign investment into the area of national security and other sensitive areas of the economy. 73

The updated catalogue reflects the attitude and policies of the Chinese government towards foreign investment. Under the 2007 catalogue foreign investment in traditional manufacturing sectors and export oriented projects will no longer be encouraged. 74 The reason for this change is to improve the quality of utilisation of foreign investment. Instead, foreign investment in high technology, new materials production, high-tech equipment, modern agriculture and high-end services (such as modern logistics) is encouraged. 75 The revision of the catalogue demonstrates that China seriously aims to upgrade and optimise its industrial structure in and aims to use foreign capital to achieve a sound and healthy

74 周英峰, 王优玲 [Zhou Yingfeng and Wang Youling] above n 69.
economic development rather than allowing China to be simply used by foreign investors. China has shown, therefore, that it is committed to making changes in its approach towards to foreign investment and the 2007 catalogue is one of the steps already undertaken.

6.4.1 Discretionary Power in the Chinese Commercial Law Regime

There is an understandable tension between traditional communist jurisprudence, where law is seen as an instrument to implement policy, and the need for an objective set of rules to develop a market economy.

In this regard, the Chinese government is faced with a dilemma. A concrete, objective set of laws and regulations would assist China with long term economic development by increasing certainty, and greater certainty in law would ultimately attract more foreign investment and economic progress. However, detailed rules would — in the short term — limit the flexibility of the government and the CPC to implement changes to policy to adapt to the economy. Against this backdrop, the Chinese government decided to favour short-term flexibility over long-term benefits. The law must be flexible enough to deal with different situations and the varieties of human behaviour. In other words, regulators must be given enough discretionary power to adapt rules and regulations to local circumstances. For instance, provincial governments in practice have often further delegated their approval powers to lower level authorities to allow them to deal with matters in accordance with their own local needs.\(^76\)

As part of the evolution of the Chinese commercial law regime, special economic zones or areas serve the purpose of trying out, within some confined areas, the experiences

\(^76\) Jianfu Chen, *Chinese Law* above n 12, 351.
of Taiwan and other Asian countries in the operation of Export Processing Zones with a view to subsequently applying the successful experience to the whole nation.\footnote{Jinyan Li, \textit{Taxation of Foreign Investment in the People’s Republic of China} (Kluwer Law International, 1989) 2–5.} Up to 1992, approximately thirty special zones or model areas had been established. The central government often picked model areas, and special rules were implemented within those areas. For practical purposes, these areas may be seen as places where foreign investors may enjoy various preferential economic treatments and non-financial concessions relating to economic freedom, including reduced income tax rates, special concessions for import and export duties, flexible labour management, special fees for land use, better access to domestic markets as well as simplified administrative processes regarding the examination and approval of foreign investment projects.\footnote{Qun Li, ‘Tax Incentive Policies for Foreign—Invested Enterprises in China and Their Influence on Foreign Investment’ (2008) 18 \textit{Revenue Law Journal} 1, 1.}

In addition, as the Central Government has delegated some authority to local officials so that they are able to exercise authority in accordance with local circumstances and as a result of competition to attract foreign investment, local authorities have offered preferential treatment and concessions and established all kinds of open areas not properly authorised by the Central Government. For example, the Ministry of Land and Resources, the National Development and Reform Commission and the Ministry of Supervision jointly carried out an inspection of abuse of national land resources by the establishment of high technology development areas in China in 2003.\footnote{魏雅华 [Wei Yahua] ‘高新技术开发区：掠土之灾’ [High Technology Development Zones: Disaster of Plunder of Land] (2003) 19 人民网 [The People Online] <http://www.people.com.cn/GB/paper81/10625/966246.html>.} The purpose of this inspection was to prevent local government from over-developing economic areas and causing agricultural land to be commercialised. According to statistics, there were 3837 economic development
zones nationwide, only 232 of which had been approved by State Council and 1019 had been approved by provincial level governments. The remaining 2586 economic development zones had been approved by local governments. As a result, the devolvement of the permission to local authorities — with flexibility to adapt laws and regulations to local circumstances — and the overall use of the exercise as a model for a future national law has led to a substantial increase in uncertainty and confusion for foreign investors.

An investor may have operations within the jurisdiction of two or more competent authorities. The problem is amplified when local authorities start to compete for jurisdiction over foreign investors. For example, it has been reported that the Chinese government has recently closed down about 1200 unauthorised development zones, where local authorities start to regulate foreign investments without authorisation from the central government. The ambiguity of the laws and regulations continues to give bureaucrats broad discretionary power in approving foreign investment project.

### 6.4.2 Ambiguity in Legal Drafting

A common feature of the Chinese commercial legal system is that rules are drafted in an ambiguous fashion. The PRC’s economic statutes often paint a broad picture, leaving many matters unclear. This could be rationalised in two ways. Because of the rapid pace of legal and economic development, the Chinese authorities may genuinely not have time to consider every facet of the legislation, while there may be a pressing need for some regulation in the market economy. However, such approach is fraught with danger. The

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80 Ibid.
81 Jinyan Li, Taxation of Foreign Investment above n 77, 31.
passage of the General Principle of Civil Law 1986\(^{82}\) (GPCL) is one major example in this area. From the beginning of the introduction of the economic reform policy, China was working on a comprehensive civil code. However, that proved to be very time consuming and there was considerable pressure to promulgate a civil code to institutionalise economic relations, particularly from Japanese investors, who were reluctant to invest in China until a civil code was in place. For instance, a study in 2005 revealed that one of the earliest Japanese investments was established by Yamaha Motor in 1980 but it was dissolved in 1984.\(^{83}\) The same study of Japan’s investment in China suggested that slow expansion into the China market was more beneficial for investment because the China market was immature in terms of economic development and the legal environment.\(^{84}\) In 1986 China promulgated the GPCL which was not a comprehensive civil code, but a statement of foundational legal concepts and principles. It lacked the detailed provisions of a typical civil code.

Two of the major reasons for the uncertain nature of the regulatory framework are inappropriate drafting and excessive discretion given to regulators. Does this mean that Chinese law is incapable of protecting the interests of foreign investors? There are sufficient reasons to believe that the PRC is serious in addressing these problems within the Chinese legal system. The Administrative Procedure Law of the PRC 1989 (APL 1989)\(^{85}\)


\(^{84}\) Ibid 4.

and the *Regulation on Administrative Reconsideration 2007* (RAR 2007)\(^{86}\) (promulgated in 2007) address the problem of managing the excessive discretion given to regulatory bodies.\(^ {87}\) This Regulation can be equated to the *Administrative Decisions (Judicial Review) Act* in Australia.\(^ {88}\)

Under the APL 1989, foreign investors may judicially challenge the legality of decisions made by administrative organs. Such decisions may include the imposition of fines, infringement of property rights, and denial of licences. However, the APL review does not extend to the lawfulness of the underlying regulations upon which administrative decisions are based. RAR 2007 facilitates challenges to the legality or merits of decisions. Challenges are heard within the administration but are independently scrutinised. As is the case with APL 1989, the legality of the underlying statute cannot be challenged. It is hoped that the administrative law regime can place effective limits on the power of the regulators to ensure an effective market economy. From the perspective of a foreign investor, limits on the arbitrary exercise of discretionary power would allow more certainty in investment decisions, certainty that would be beneficial to China and foreign investors alike in the long term.

The *Legislation Law 2000*\(^ {89}\) aimed to provide a uniform standard of drafting across government in all levels. It requires laws and regulations to pass through a standard procedure,\(^ {90}\) so they can be reviewed and amended before being promulgated. Hence, there

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\(^{87}\) Ibid art 40.  
\(^{90}\) Ibid arts 12–23.
is less need for redrafting laws and regulations. This results in some diminution of confusion about Chinese commercial laws for foreign investors due to inadequate legislative drafting. Conflicts between national laws and local regulations occur as a result of many administrative bodies exercising legislative power under the *Legislation Law* 2000. In order to prevent such legislative confusion the State Council passed the *Regulation Concerning Procedure of Making Administrative Provision* in 2001.

When foreign investors and lawyers examine the Chinese commercial legal regime, they may be confused by the ambiguous rules, broadly defined discretion, lack of transparency and excessive fragmentation of authorities that exist in the Chinese context. China’s accession to the World Trade Organisation in 2001 raised expectations from foreign countries as to China’s transparency in terms of its legal and administrative systems. They may be even more confused as to why foreign investors have to, for example, find the right connections with officials, or submit two smaller proposals for investment rather than one. In the ten years since China joined the WTO, there have been steps taken by the Chinese government to fulfil the commitment of transparency in the legal system and the administrative system.

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91 Ibid arts 89, 90.
94 There have been numerous legislative steps to improve transparency in the Chinese administrative system such as <<行政法规制定程序条例>> [Regulation Concerning Procedure of Making Administrative Provision] (People’s Republic of China) State Council, Order No 321, 16 November 2001; <<行政法规制定程序条例>> [Administrative Regulations Formulation Regulations] (People’s Republic of China) State Council, Order No 321, 1 January 2002; <<中华人民共和国行政复议法实施条例>> [Regulations on
Compared to the situation 30 years ago, China has made significant progress in relation to the development of commercial law. The first group of foreign investors had to contend with ad hoc policies that were often adopted prior to legislative guidance being issued. Even when the EJV Law was promulgated in 1979, implementing regulations were not enacted until 2001. By comparison, the current Chinese commercial law regime provides much more certainty than was the situation at the beginning of the economic reform program. More importantly, it seems that China is serious about improving its commercial law regime. Improvements to the legal system — such as the APL 1989, the RAR 2007 and the Legislation Law — are directed to address the shortcomings of the Chinese commercial law regime and the legal system in general. As Vice President Xi Jinping said in his speech on the second World Investment Forum of the United Nations,

> China will continue to work to create an open and transparent legal environment. China’s socialist market economy is the rule of law and economy. China’s investment environment is open and transparent legal protection.\(^{95}\)

Even on a theoretical level, the definition of commercial law as a set of objective regulations represents a major departure from the traditional communist theory of the law. So even though the current Chinese commercial law regime may not be able to offer complete protection for the commercial interests of foreign investors, if the current pace of reform is continued, the enthusiasm about investing in China can hopefully be even more justified in the long term.

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Additionally, other laws and regulations in China are often drafted in such a way as to allow policy makers and implementing officials to interpret and implement them in a way that serves their purposes in regulating the economy. As a result of the use of such vague and ambiguous wording in laws or regulations, the administrative authority can interpret, and re-interpret, their meaning, either in official documents or on an ad hoc basis.\textsuperscript{96} This gives the regulators wide discretion to interpret the meaning of the terms to suit current policies. The ongoing uncertainty surrounding such ad hoc interpretation usually ensures that in practice the law is very confusing resulting in uncertainty for foreign investors.

The law related to EJV provides a good example of this. The administration of the \textit{Law on Chinese-foreign Equity Joint Ventures 2001} (EJV Law),\textsuperscript{97} promulgated by the NPC, illustrates how confusion and uncertainty for foreign investors can result. The EJV had been the most popular form of investment for foreign investors between 1987 and 2000.\textsuperscript{98} The EJV Law specifies that an EJV must be approved by ‘the State department in charge of foreign economics and trade’.\textsuperscript{99} Article 8 of the EJV Regulations\textsuperscript{100} enables

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  \item \textsuperscript{96} Xianming Xu, \textit{A Textbook on Jurisprudence} (China University of Political Science and Law Press, 1994) 241–3. Chinese jurisprudence commonly divides authoritative interpretation into three categories: legislative, administrative, and judicial. Generally speaking, `legislative interpretation’ means interpretation given by legislative authorities on laws and rules issued by them; `administrative interpretation’ refers to interpretations of these rules and regulations issued by administrative authorities; and `judicial interpretations’ are those issued by the Supreme People’s Court and Supreme People’s Procuratorate in their judicial and procuratorial work.
  \item \textsuperscript{98} Pan Zhen and Lu Minghong, ‘在华外商直接投资进入模式的选择：文化的解释 一项对3452家外资企业的实证研究’ [Foreign Direct Investment in China Entry Form Selection: Cultural Explanation A Practical Research of 3452 Foreign Invested Enterprises] (10 May 2009) Nanjing Education University School of Commerce <http://sxy.njnu.edu.cn/?uid-1158-action-viewspace-itemid-96>.
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province-level government, or an administrative body created by the State Council to be entrusted with the authority to approve EJVs.

The EJV Law specifies that any proposed EJVs must be sent to an authorised agency for examination and approval. The EJV Law, however, contains nothing about the criteria for approval of an EJV, apart from Article 1 which provides that the establishment of EJVs must be in accordance with principles of equality and mutual benefit and subject to approval from the Chinese government; but what the words ‘principles of equality and mutual benefit’ mean is unspecified. This leads to the examination and approval authority having very wide discretion to approve or reject the formation of an EJV.

Subordinate regulations do not seem to confine discretion for the authority either. The *Regulations for the Implementation of the Law of the People’s Republic of China on Sino-foreign Joint Equity Enterprises 1983* (EJV Regulations), promulgated by the State Council, provide some guidelines as to the type of investment permitted in EJVs.

The EJV Regulations provide that EJVs should: have advanced technical equipment and scientific management; provide benefits in terms of technical innovation; increase

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income in foreign currency; and enable training of technical and managerial personnel.\textsuperscript{103} They also provide that an EJV: cannot be in detriment to China’s sovereignty, violate Chinese law, be in conflict with the requirements of the development of China’s national economy, contribute to environmental pollution; or impair the rights and interests of one party through unequal agreements.\textsuperscript{104}

Whilst the EJV Regulations represent an improvement over the EJV Law, they still contain too many vague and ambiguous terms that give the approval authority broad discretion in approving EJVs. For example, there is no definition as to what constitutes ‘advanced technical equipment’,\textsuperscript{105} or what kind of EJV would not be conforming to the requirement of development of China’s national economy. In reality, the main criteria for the relevant authority to approve an EJV is drawn from priorities expressed in the current state plan, as declared by the CPC, and internal foreign investment guidelines that are not publicly issued. This lack of transparency causes and exacerbates problems in the fair administration of the law, and lowers the level of confidence of those who are subjected to what may appear to them to be preferential or discriminatory treatment by regulators.

\section*{6.4.3 Perceived Lack of Transparency}

In order for the central government to communicate prevailing policy and to ensure the bureaucrats adhere to these policies, internal documents may be issued. These documents usually provide technical details necessary for the concrete application of the primary law.
and employ material missing from the legislation and regulations. They are of particular importance to foreign investors as they show how the primary law is to be applied.

However, whilst they could reasonably be expected to be used as guidance for the interpretation of statutes along with published legislation regarding implementation, in some instances they have been issued to redefine or even contradict the primary statutes to suit changes in the economic climate. For example, the *Economic Contract Law 1981* specified invalidity of some contracts including a contract not complying with the relevant legislation, regulations and administrative rules and national policies.\(^{106}\) Contracts are declared to be invalid as a result of breach of administrative rules.\(^{107}\) Provincial municipal level governments make administrative rules according to local economic policies. Following the introduction of the law, 10 to 15 per cent of contracts were invalidated.\(^{108}\)

These internal documents were often revealed to only a very limited segment of the Chinese bureaucracy, and explorations during this research indicate that such documents are not generally available to the public. They do come to light on occasions when they are applied in matters before the court and in this way can become available to the public. Cases that are complicated or with new factual elements are recommended and collected by the provincial Higher People’s Court and notified to the Supreme People’s Court as special cases that have interpreted laws or new factual circumstances. The Supreme People’s Court publishes a judicial bulletin or gazette to reflect such interpretations. The *Provision*


\(^{107}\) Ibid art 4.

Concerning Work of Judicial Interpretation of the Supreme People’s Court provided that judicial Interpretations shall be published in the Supreme Court bulletin or gazette or the Court Daily.\(^{109}\) It is only in recent years that these interpretations of cases have been published through four publications including the People’s Daily, the People’s Court Daily, the Legal Daily and the Court Gazette.\(^{110}\)

For foreign investors, attempting to find out the content of these rules may require many visits to a relevant agency and even then may often not result in disclosure. Therefore, as foreign business persons face barriers in gaining access to the internal documents, they may be confused as to the state of the applicable law, and what actions they can or cannot take. In addition, as the information contained in these internal documents is so valuable, it has the potential of permitting bureaucrats to give preferential treatment, and so has a very real capacity to lead to corruption.\(^{111}\)

Because the Chinese government recognises law as an instrument to pursue policies, the existence of discretion, as illustrated previously, allows administrative organs to apply laws in a way that is consistent with the spirit of the rules. This manner of implementation is completely different from what Westerners would expect from the ostensibly familiar principles that are embodied in the law. Hence, in the eyes of a foreign investor, there is a

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\(^{109}\) <<最高人民法院关于司法解释工作的规定>> [Provision Concerning Work of Judicial Interpretation of the Supreme People’s Court vol 3] (People’s Republic of China) Supreme People’s Court, Order No 12, 23 March 2007, art 25.


serious incongruence between what is perceived to be the law and what the regulators do in practice.

### 6.4.4 Jurisdictional Greed

Jurisdictional greed refers to the phenomenon where regulators desire to exercise regulatory powers over subjects where that was not what was originally intended when the power was conferred. As discussed above, in some cases there may be more than one competent authority exercising a power (often wide and discretionary) that may apply in a given situation or matter. Therefore there is a potential for a number of regulators to compete to regulate an entity such as an EJV. In reality, given the well entrenched practice of seeking preferential treatment through the use of Guanxi, it would be to a bureaucrat’s advantage to exercise his or her regulatory power as widely as possible, because the wider his or her jurisdiction, the more likely that he or she would receive favours from people who wish to establish Guanxi. The creative interpretation of the discretionary power is one of a number of ways in which a regulator may seek to expand its jurisdiction and for key individuals to reap whatever rewards may flow from that expansion.

The authority for approval of EJVs at different levels of government is limited. Internal documents from the State Council have specified threshold levels for local authorities. Below these levels, the local entrusted office can approve the EJV, with only an obligation to lodge a notice to MOFCOM for the record. Provincial level governments and administrative bodies are allowed to approve EJVs with total investment not exceeding

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USD30 million,\textsuperscript{113} whilst governments below the provincial level can approve EJVs with total investment not exceeding USD10 million.\textsuperscript{114} For investments between USD30 and 100 million, the EJV can only be approved by MOFCOM. Investment exceeding USD100 million would have to be approved by the State Council.\textsuperscript{115}

However, some local authorities accept application for EJVs exceeding that level by creatively applying the criteria in the internal guidelines. For example, if a foreign investor intends to invest USD50 million into an EJV, then on the surface, the EJV would need to be approved by MOFTEC at the central level. However, if the foreign investor proceeds with two similar, but separate EJVs, each with total investment of USD25 million, then the local authority would be able to accept applications for the EJVs. This splitting of EJVs is a common practice. The foreign investor or their Chinese partner may want the EJV to be approved by the local, rather than central, authority. It could be due to better Guanxi between the investor and the local regulator. However, a decision to split an EJV proposal to bypass the central authority may have adverse consequences.

Although MOFTEC is not policing such a situation, if it ever became necessary for the foreign investor to resort to the help of the central authority it could not expect much help as it had already contrived to avoid its original jurisdiction. For example, if a dispute arises between the foreign and Chinese partner and MOFTEC is asked if the joint venture agreement is legally valid and binding, it may respond that it is not. Alternatively, the foreign investor may face future obstacles if the joint venture is to expand beyond the local

\textsuperscript{113} "商务部关于下放外商投资审批权限有关问题的通知" [Notification Concerning Issues of Authorising Power to Approve Foreign Investment] (People’s Republic of China) Ministry of Commerce, Order No 209, 10 June 2010, art 1.
\textsuperscript{114} Ibid arts 1, 4.
\textsuperscript{115} Ibid.
area. For example, the foreign investor may not be treated favourably by MOFTEC if the foreign investor decides to form a foreign investment holding company within China, or if the EJV is to be listed on the stock exchange.

These adverse consequences may, therefore, encourage foreign investors to think twice before attempting to bypass the central ministry’s authority. This is an illustration of how local and central authorities’ competition for jurisdiction over the approval of EJVs can present serious problems for investors and, of course, potentially huge losses.

6.5 Conclusions

The discussion in this chapter has shown that whilst the commercial law regime in China has been undergoing continual reform, there remain serious matters that may affect foreign investor confidence. Aside from any business relationship problems that may arise, the laws and regulations that impact upon foreign investors may begin to have their effects from an early stage in a project. A foreign investor, having decided upon a particular business activity and having created a working relationship with a Chinese partner, may find during the registration and approval process that even the setting of the locality of the investment activity or business can create problems. An issue may arise as to the extent to which a local regulatory authority is authorised to give approval to the project, and whether such approval is lawful by reference to national laws and government policies. The ambiguity or lack of certainty of national laws and regulations and the potential conflict of local regulations, with national laws are an often present danger, particularly when a dispute occurs within the partnership.
The existence of discretionary decision-making power at any stage in a project, from registration and approval through to operational aspects, can expose the business partners to, at the very least, project threatening delays and, in the worst case, to corruption by official decision-makers. The commonly occurring situation where multiple approvals are required from different regulators simply exacerbate or multiply these risks. Additionally, the balancing by government of the need to attract foreign investment as against its desire to maintain tight control creates a situation where changes in interpretation of laws can occur at any time. Foreign investors would be well-advised to take into account of all these potential pitfalls as part of their risk assessment strategies when contemplating projects in China.

At the heart of all trading and business activities is, in the western view, the contract between the parties involved. The enforceability of a contract and general certainty as to outcome as well as the procedures in respect of any disputes are, for the most part, core components in the conduct of business in the view of most western business operators.

Difficulties arose when contract laws, that were developed to cope with the influx of foreign capital, conflicted with the traditional Chinese methods of conducting business. The contract often meant different things to a western investor and its Chinese business partner or operative. Further difficulties arose as between the foreign investor and the Chinese business partner at different geographical locations and in respect of the level of government or administration concerned.

The following chapter contains an analysis of the development of contract law in China during the past thirty years and some concerns that have arisen for foreign investors.
Chapter 7

Development of Contract Law in China

7.1 Introduction

The legal framework regulating foreign investment has been gradually developed in the past three decades. As a result, law relating to the market economy has become a major component of the Chinese legal system. In 1999 the Contract Law of the People’s Republic of China 1999 (Contract Law 1999) was passed by the National People’s Congress. This law not only unified and expanded the previous major legislation related to the contractual system, but also embraced certain underlying principles, including freedom of contract and good faith that were not manifested in preceding contract statutes. This chapter aims to scrutinise the development of contract law and provide some insights into its administration from the perspective of foreign investors. It examines the premise that the role of this law is to serve the needs of economic development. The analysis is divided into a number of sections following this introduction. Section 7.2 examines the evolution of new contract law in China. Section 7.3 deals with difficulties in the administration of the new contract laws with specific attention to foreign investment contracts, government contracts, the interpretation of contracts and inconsistencies between laws. Section 7.4 explores the processes for the approval and registration of contracts including approval requirements generally and for foreign investment contracts, and the registration procedures. Section 7.5

1 <<中华人民共和国合同法>>&gt; [Contract Law of the People’s Republic of China] (People’s Republic of China) National People’s Congress, Order No 15, 1 October 1999. It was passed on 15 March at the 2nd Session of the 9th National People’s Congress and was effective from 1 October 1999.
discusses the enforcement of contracts, and section 7.6 summarises the analysis with observations and conclusions.

7.2 The Evolution of the New Contract Law 1999

The foreign investment law regime has played a significant part in the course of legal reform in China. It is not only an initial motivation for the economic development but also an experimental trial for legal transition. As Chen asserts:

As foreign investment proliferated in China, so did the volume of Chinese laws and regulations both at the central and local levels. These laws and regulations have in fact established a special legal regime for foreign investment enterprises. A unique feature of these laws and regulations is that they deal with specific types and specific aspects of foreign investment; there is no unified code for foreign investment.\(^2\)

The development of contract law in China is an example of how China’s legal reform evolved in the changing economic situation. Contract law has been developed since the late 1970s as a result of the commencement of the ‘Open Door’ policy, and accompanied the consequent growth of the economy.\(^3\)

Contract law in China began its life in the early 1950s but has only seen real and substantial development since the 1980s. After the founding of the PRC, the concept of an economic contract was introduced into China from the former Soviet Union. As a product of a planned economy, an economic contract required that only non-natural legal persons or units\(^4\) could become parties to a contract. It was used in contrast to a civil contract, to

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\(^4\) Jianfu Chen, *Chinese Law* above n 2, 278. Before the late 1970s the major functions of contract were to carry out national planned economic tasks through state owned enterprises. Individual citizens could not be parties to such a contract. Individual economic activities were normally in very small scale. They were settled immediately or conducted by relying upon trust between the participants.
which individuals could become parties. The purpose of a contract at that time was only to indicate the quota of national economic tasks assigned to the particular State Owned Enterprise (SOE) in question.\(^5\)

Despite the government’s endeavours to develop Chinese contract law in the 1950s and early 1960s, a contract was primarily regarded as an administrative and allocative mechanism controlling economic transactions between production units in order to carry out State economic plans.\(^6\) Table 4.1 below shows the chronological developments in contract law. The basic purpose of a contract was to implement the quotas and allocations of goods and services fixed by the State. The understanding of a contract and its legal functions during that period was extremely limited and rudimentary.

After the economic disasters following the Cultural Revolution and as the new market-oriented economic policy began to take shape, the role of contract law was, once again, emphasised. In 1978 and 1979, various government agencies promulgated several interim rules and regulations to fill the vacuum in contract law. Such development reached its height in 1981 with the promulgation of the *Economic Contract Law 1981* (ECL 1981), followed by the *Foreign Economic Contract Law 1985* (FECL 1985)\(^8\) and the Technology

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\(^6\) The prevailing politico-economic system determines the usefulness of contracts. With this conception of contract law, the first set of regulations on contracts in the PRC — ‘The Provisional Measures concerning the Making of Contracts among Governmental Institutions, State-owned Enterprises and Cooperatives’ — were issued in September 1950.

\(^7\) The first major contract law in post-Mao China was the Economic Contract Law: <<中华人民共和国经济合同法>> [Economic Contract Law of the People’s Republic of China] (People’s Republic of China) National People’s Congress, 1 July 1982. Initially it was issued by the 4th Plenary Session of the 5th NPC on 13 December 1981 and effective on 1 July 1982. It was repealed by the Standing Committee of the 8th NPC on 1 October 1999.

\(^8\) <<中华人民共和国涉外经济合同法>> [Foreign Economic Contract Law of the People’s Republic of China] (People’s Republic of China) National People’s Congress, 1 July 1985. It was the second set of
Table 7.1: Development of Contract Law Since 1949

<table>
<thead>
<tr>
<th>Year of Event</th>
<th>Events Related to Contract Law</th>
</tr>
</thead>
<tbody>
<tr>
<td>1949</td>
<td>The People’s Republic of China was established under a Communist government.</td>
</tr>
<tr>
<td>1956</td>
<td>The draft civil code was completed, but it was not enacted due to anti-rightist movements and the Cultural Revolution. The political unrest lasted until 1978.</td>
</tr>
<tr>
<td>1981</td>
<td>China started again to overhaul the civil code. It enacted the Economic Contract Law (ECL 1981), which was the first of three new pieces of legislation on contract law.</td>
</tr>
<tr>
<td>1985</td>
<td>China enacted the second new piece of legislation: the Foreign Economic Contract Law (FECL 1985). In addition, the General Principles of Civil Law was enacted.</td>
</tr>
<tr>
<td>1987</td>
<td>The Technology Contract Law 1987 (TCL 1987) was enacted. This and the two other new contract laws (the ECL 1981 and the FECL 1985) were not intended to be a comprehensive set. They were enacted piecemeal to solve the immediate needs of the economic reform that began in 1979.</td>
</tr>
<tr>
<td>1993</td>
<td>The Economic Contract Law was amended. Also, the drafting process of a new Contract Law started, which was intended to replace the three pieces of legislation of the 1980s.</td>
</tr>
<tr>
<td>1999</td>
<td>The unified Contract Law was passed on 15 March 1999, and became effective on 1 October of the same year. It was supplemented by the Interpretation on Several Issues Regarding the Application of the Contract Law (1) in December 1999 and the Interpretation on Several Issues Regarding the Application of the Contract Law (2) in 2009 and which was issued by the Supreme People’s Court. The Economic Contract Law 1981, Foreign Economic Contract Law 1985 and Technology Contract Law 1987 were repealed.</td>
</tr>
</tbody>
</table>

Contract law is an essential part of every commercial law system. This became particularly vital in China as the planned economy was transformed into a market oriented economy. Laws regulating the sale of goods, business organisations, banking and property contain the contract regulations. It was issued by the Standing Committee of the 6th NPC on 21 March 1985 and effective on 1 July 1985. It was repealed by the Standing Committee of the 8th NPC on 1 October 1999.

9 <<最高人民法院关于适用《中华人民共和国合同法》若干问题的解释(一)>> [Interpretation of the Supreme People’s Court on Several Issues Regarding the Application of the Contract Law (1)] (People’s Republic of China) Supreme People’s Court, Order No 19, 19 December 1999.

10 <<最高人民法院关于适用《中华人民共和国合同法》若干问题的解释(二)>> [Interpretation of the Supreme People’s Court on Several Issues Regarding the Application of the Contract Law (2)] (People’s Republic of China) Supreme People’s Court, Order No 5, 9 February 2009.
general principles of contract. Contract law has an important impact on Chinese economic reform. It has been used not only as a tool to implement Chinese economic plans and policies effectively but also to attract foreign capital. The Chinese government understood that it needed to provide legal security for foreign investors in order to enforce any commercial promises. Therefore contract law has played and will continue to play a significant role in the Chinese economic and legal system.

The regime of contract law in China started to take shape in the early 1980s after China had been through the political turmoil of the Cultural Revolution. The contract rules and regulations prior to 1980 were predominantly used for carrying out governmental economic plans and not for their legal functions. The initial Chinese contract law framework included four key pieces of legislation: the ECL 1981, the FECL 1985, the GPCL 1986\(^{11}\) and the TCL 1987. These laws and their associated regulations and a number of other statutes were formulated during the early stages of Chinese economic reform. The primary role of the legislation\(^{12}\) was to promote state economic policies with the nature of planned allocation of resources. Also, the legislation divided contracts into two categories, that is, economic contract and civil contract. The ECL 1981, FECL 1985 and TCL 1987 regulate economic contracts while the GOCL 1986 governs civil contracts. For example, in accordance with the ECL 1981, economic contracts refer to transactions between artificial

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legal persons only and do not include contracts between natural persons.\(^\text{13}\) Thus these early contract statutes did not govern a broad sector of contractual relationships.\(^\text{14}\)

Since the late 1980s there has been an enormous increase in Sino-foreign business relations with a high degree of business transaction complexity. The result was that these four contract laws had become incompatible with the prevailing economic reality. As an example, a foreign technology contract was outside the ambit of both the TCL 1987 and the FECL 1985. The former only covered technology contracts formed between Chinese domestic parties, while the latter did not govern the category of technology contracts.\(^\text{15}\)

Moreover, inconsistency between the various contract statutes made their application even harder. As an illustration, the FECL 1985 had the underlying principle of ‘equality, mutual benefit, consultation, and agreement,’\(^\text{16}\) whereas the GPCL 1986 was based on the notion of ‘voluntariness, fairness, equal compensation, and good faith.’\(^\text{17}\) Although the ECL 1981 was revised in 1993, the revision was far from satisfactory. The ECL 1993 failed to eliminate the discrepancies that had existed between the preceding contract laws. For instance, the ECL 1993 abolished from its predecessor a certain mode of terminating a contract, but the other contract statutes retained such a method of contract discharge.


\(^{14}\) \text{王家福} [Wang Jiafu], \text{合同法} [Contract Law] (中国社会科学出版社 [Chinese Social Science Press], 1986) 141.


\(^{16}\) \text{Ibid} art 3.

\(^{17}\) \text{中华人民共和国民法通则} [The General Principles of Civil Law of the People’s Republic of China] (People’s Republic of China) National People’s Congress, 1 January 1987. It was adopted by the 4\textsuperscript{th} Session of the 6\textsuperscript{th} National People’s Congress on 12 April 1986 and came into force on 1 January 1987, art 4.
The Chinese government realised that an incoherent and obsolete system of contract law would impede its on-going economic reform and that the restructuring of the contract law system was necessary.  

On 15 March 1999, the *Contract Law 1999* was adopted by the Second Session of the Ninth National People’s Congress (NPC) and scheduled to take effect on 1 October 1999. The promulgation of *Contract Law 1999* constituted not only a major development of China’s contract legislation, but was also an important step in China’s enactment of its much-anticipated *Civil Code*. The *Contract Law 1999* provides general provisions in its Chapters 1–8 for governing all types of contractual relationships, as well as particular provisions in Chapters 9–23 for further regulation of particular categories of contracts. As the statute that deals specifically with contracts, the *Contract Law 1999* was expected to play a crucial role in regulating China’s burgeoning market economy and contribute to China’s further legal development. Wang sums up the effects of the new *Contract Law 1999*:

> Three of the main pieces of PRC legislation on contract that operated prior to 1 October 1999 will no longer exist on and after that date because they are repealed by the Contract Law. These three pieces of legislation are the Economic Contract Law of the PRC, the Foreign Economic Contract Law of the PRC and the Law of the PRC on Technology Contracts. The Contract Law will be the major law on contract on and after that day, but because two other Contract Laws that existed prior to 1 October 1999 will not repealed by the Contract Law, these two laws will continue to operate before, on and after that date. These two laws are the General Principles of Civil Law which came into force in 1987, and

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19 <<中华人民共和国民典(草案)>> [Civil Code of the People’s Republic of China (draft)] (People’s Republic of China) National People’s Congress Standing Committee Legislative Affairs Commission, 6 March 2006.

The previous contract law structure of the 1980s, having three separate contract statutes, reflected China’s gradual progress in understanding and regulating commercial activities. In the early 1980s, owing to the restrictions of the planned economy, inadequate research on contract law and immature legislative skills, it was practically impossible to produce modern comprehensive contract legislation. As a result, the ECL 1981 was enacted to accommodate society’s need for regulation of the vast amount of domestic economic contracts during that period. Later on the FECL 1985 and the TCL 1987 were passed to deal with aspects of contract problems which were not dealt with by the ECL 1981.

After more than 10 years since the enactment and implementation of the ECL 1981, the FECL 1985 and the TCL 1987, serious problems of structure and substance were found in the system. The numbers of contracts formed and contractual disputes were enormous. More than four billion new contracts had been registered with the State Administration of Industry and Commerce and its local bureaux every year nationwide, and the People’s Courts in China were handling about three million contractual disputes annually.21

Firstly, there was serious doubt about the appropriateness of the categorisation of contracts into domestic economic, foreign economic and technology contracts, each of which are dealt with separately by three different laws. As China developed its market economy and as the market became sophisticated, the differential treatment between domestic and foreign economic contracts also became a cause for concern.

Secondly, the application of contract law depends on two factors: whether there is foreign participation, and the subject matter of the contract.\(^{22}\) While the ECL 1981 and the FECL 1985 regulated different contracts according to the parties’ nationalities, the TCL 1987 was distinguished from the other two pieces of contract legislation by regulating contracts on the basis of their various types of subject matter. However, the TCL 1987 did not regulate all contractual relationships relating to technology. Where one party to a contract was a foreign party, the TCL 1987 did not apply and the FECL 1985 became the relevant law. In civil contracts where one or both parties were individuals, such contracts were left out of the then prevailing contract legislation.

Thirdly, many important fundamental contract doctrines were absent from this contract law legislation. For example, offer and acceptance rules, which are important for the determination of the formation and existence of a contract, were not written into any contract legislation.

Fourthly, many doctrines were created and adopted in response to the old planned economy. Such doctrines could no longer function well and serve the needs of the market economy in China then or into the future. For example, the fact that the laws provided for too many circumstances where a contract was void had hindered the smooth operation of commercial transactions, a hindrance that was seen to be detrimental to the development of a market economy.\(^{23}\)

\(^{22}\) Jianfu Chen, *Chinese Law* above n 2, 279.
The new *Contract Law 1999* is a massive document, comprising 23 Chapters, 428 Articles and some 40,000 words (compared with a total of 155 Articles in the 3 existing contract laws). The ECL 1981, the FECL 1985 and the TCL 1987 (with the problems described above) were repealed on 1 October 1999 when the new law came into effect.

### 7.3 The Dilemmas of Administration of Contract Law

Fundamental property rights in China are weak and sporadically enforced. Under China’s *Constitution*, land, factories, natural resources, and other physical assets belong to the state. However, economic transformation in China has created different types of economic entities such as Chinese-foreign joint ventures, wholly foreign owned enterprises and privately owned enterprises. The Chinese government accordingly amended the Constitution in 2004 and stated that China has a state-owned economic system co-existing with multiple types of ownership including private ownership.\(^\text{24}\) Private ownership created under the law is protected as an important part of the national economic system.\(^\text{25}\) Even though state-owned enterprises occupy the major part of the national economy, the private sector has increased its importance in the country. State-owned enterprises are facing unprecedented challenges.\(^\text{26}\) The decentralisation of government in recent years raises doubts as to whether ultimate ownership of individual assets rests with the central government or with increasingly powerful regional units. This state of affairs has led to frequent battles among government agencies over which one has the right to enter into a


particular joint venture with a foreign company. The *Law on Chinese-Foreign Equity Joint Ventures 1979* did not specify which type of Chinese parties were allowed to enter into a joint venture with a foreign party.²⁷ The *Foreign Economic Contract Law 1985* stated that Chinese enterprises or other organisations could enter into contract with foreign parties but this did not include private individuals.²⁸ Later, the uniform *Contract Law 1999* resolved these issues and stated that parties to a contract may include natural persons, corporations and other organisations.²⁹

Differences in the administration of contract law vividly illustrate the difficulties westerners confront when making business deals in China. In most western countries a signed contract is generally legally binding. In China, most major contracts must be approved by the government. For example, the Association of Light Industries approves contracts signed in the leather, furniture, and clothing industries.³⁰ Failure to obtain this approval renders a signed contract null and void. Because of these uncertainties, negotiating with potential joint venture partners can be extraordinarily difficult. Foreigners are never certain that a contract provision once agreed upon will not be amended unilaterally by the Chinese partner.

This situation arises largely because of fundamentally different attitudes toward a business contract. The westerner views it as a future commitment.\(^{31}\) The Chinese counterpart sees it as a description of the current situation and merely a plan for the future.\(^{32}\) According to the latter, the contract needs to be updated and modified as the situation changes. The problems arising from this basic difference in perception are compounded by the fact that, in practical terms, foreigners have little effective recourse to Chinese courts in disputes over such matters sometimes due to the unavailability of updated policies or language obstacles.\(^{33}\) All these factors contribute to the dilemma facing even the largest, most important investors in China: how to develop a long-term corporate strategy in a business climate where contracts can be overturned at the whim of the central authorities or, in some cases by the Chinese partner, and where overtly preferential treatment is given to investors with the best ‘Guanxi’.\(^{34}\)

Efforts by the Chinese government to tighten up the rules that govern business transactions are often precise on paper but vague in implementation. In 1994, China’s first Company Law 1993 took effect.\(^{35}\) This law established regulation of securities, accounting rules, and enforcement of judicial decisions. It also provides for limited liability. This would surely appear to be a step in the right direction, but the absence of a body of case law

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\(^{34}\) (关系) [Guanxi] literally means ‘relationships’ and stands for any type of relationship. In the Chinese business world, however, it is also understood to mean the network of relationships among various parties that cooperate and support one another.

makes it only a modest start. In order to resolve some difficulties arising in the course of implementation, the People’s Supreme Court published an interpretation of matters related to the application of the *Company Law 1993*.  

Such uncertainty in the business climate is especially treacherous for foreigners who lack the language and cultural skills necessary to negotiate creatively with their Chinese partners. Contracts between foreigners and mainland Chinese investors do not possess the implicit guarantees of performance contained in those signed by members of the ‘bamboo network,’ wherein repeated interaction facilitates trust. Because of this, western firms are strongly inclined to invest in short-term, low-risk projects, a fact that creates a further advantage for overseas Chinese entrepreneurs.

### 7.3.1 Foreign Investment Related Contracts

One of the purposes of the new unified *Contract Law 1999* was to accord the same treatment to domestic and foreign contracts. However, parties to a foreign investment contract remain free to choose foreign law to determine contractual disputes, unless any law requires otherwise.
The *General Principles of Civil Law of the PRC 1986* utilises two concepts: foreign civil relationship\(^{40}\) and foreign contract.\(^{41}\) Foreign civil relationships, according to an *Opinion of the Supreme People’s Court (for Trial Implementation) on the PRC General Principles of Civil Law*,\(^{42}\) are those where one or both of the parties are non-Chinese entities, where the subject matter is located overseas, or where the facts — whereby the relationship is created, altered or terminated — take place overseas.

The concept of a foreign economic contract under the existing law is a narrower one, consisting of only those contracts made between a PRC and a non-PRC entity.\(^{43}\) It appears that, until further detailed rules have been made to provide otherwise, the narrower concept remains applicable to foreign contracts under the new law.

Joint venture companies and wholly foreign-owned enterprises established in China are not foreign entities,\(^{44}\) and their contracts with another Chinese entity must be governed by Chinese laws.

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\(^{41}\) Ibid art 145.

\(^{42}\) *最高人民法院关于贯彻执行＜中华人民共和国民法通则＞若干问题的意见（试行）* [An Opinion of the Supreme People’s Court (Trial Implementation) on General Principles of Civil Law of the People’s Republic of China] (People’s Republic of China) Supreme People’s Court, 26 January 1988, [178].

\(^{43}\) *最高人民法院关于适用＜中华人民共和国涉外经济合同法＞若干问题的解答* [Explanation of the Supreme People’s Court on Certain Questions Relating to the Application of the Foreign Economic Contract Law] (People’s Republic of China) Supreme People’s Court, Order No 27, 19 October 1987.

The categorisation of contractual disputes in which a foreign law may be chosen to apply was given a generous meaning in the above explanation by the Supreme People’s Court and includes disputes as to the making, interpretation of the contents, performance, liability for breach, alteration, transfer, suspension, discharge or termination of a contract. But parties cannot ignore the new law when the contract has provided for a foreign governing law as some of the provisions of the new law will still apply. Sino-foreign equity and co-operative joint venture contracts, and Sino-foreign co-operative contracts for the prospecting and exploitation of natural resources, to be performed in China, are governed by PRC laws. Questions as to the ownership, transfer, leasing, mortgage and use of immovable properties are governed by the law of the country where the property is located. The Supreme People’s Court issued the Provisions Concerning Application of Laws for Several Issues in the Trial of Cases of Foreign related Civil or Commercial Contractual Disputes 2007 and specified that in matters related to immovable properties, the principle of closest connection applies which means that laws related to the location of the properties shall apply.

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45 <<最高人民法院关于审理涉外民事或商事合同纠纷案件法律适用若干问题的规定>> [Provisions Concerning Application of Laws for Several Issues in the Trial of Cases of Foreign Related Civil or Commercial Contractual Disputes] (People’s Republic of China) Supreme People’s Court, Order No 14, 11 June 2007, art 2. This provision deals with foreign related civil or commercial contractual dispute matters and which substantial laws should apply. Article 2 of this provision specifies that contract disputes include those related to formation of contract, validity of contract, performance of contract, alteration of contract, transfer of contract, termination of contract, and breach of contract.


7.3.2 Government Contracts

A basic question raised by representatives at the National People’s Congress was whether the new law applied to a contract between the government and a company or individual. One view was that the new law should apply if the contract was made in the course of the government’s economic activities. Article 2 of the new *Contract Law 1999* simply defines a contract as one made between natural persons, legal persons and other organisations if the two parties are of equal status or standing. In the instances where the government is entering a contract this means that the government does not exercise its sovereignty as a state, but rather as an entity in the private law regime. In this case the new *Contract Law 1999* applies. If it is an administrative act of the government then it is not governed by the *Contract Law 1999*. Parties that contract with the government will now have to try to cover this point in their agreement.

There is a broad range of administrative contracts in China. For example, contracts in respect of state-owned land-use utilise ‘rights transfer contracts’, contracts for public works utilise ‘executive employment contracts’. The state-owned land-use rights transfer contracts are granted in order to comply with the national land policy and the performance of such contracts is subject to the command and supervision of the land administrative

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authorities with respect to the land use and duration of the grant. Any breach of these contracts would be susceptible to penalties imposed by the authorities.50

In these types of administrative contracts, where there is a specific law or regulation, the specific law prevails. But in the absence of any specific law or regulation governing such contracts, the Contract Law 1999 applies. The specific laws and administrative regulations referred to include but are not limited to the Law on Administration of the Urban Real Estate 1994, Interim Regulations Concerning the Assignment and Transfer of the Rights to Use of the State-Owned Construction Land Use Right through Bid Invitation, Auction and Quotation 2007.51

7.3.3 Interpretation of Contracts

For a long time in Chinese legal history, the rules on contract interpretation had been inadequate. In ancient China, the ‘Yamen’52 combined both the administrative and judicial power and there was no single judicial unit.53 The judge, who was the head of ‘Yamen’ was also the Governor and did not, in ancient China’s history, need specific contract interpretation rules.54

Even in the contract laws in 1980s, the doctrine of contract interpretation had not

52 ‘Yamen’ in Chinese pinyin is any local office and residence of a bureaucrat of the Chinese Empire. The term has been widely used in China for centuries. Within the ‘Yamen’, the bureaucrat administered the government business of the town or region. Typical responsibilities of the bureaucrat included local finance, capital works, judging of civil and criminal cases, and issuing decrees and policies.
been adopted. The *Contract Law 1999* was the first time that interpretation rules were written into Chinese law. The two primary functions of the interpretation rules are to determine ambiguities in the contract and to supplement the contract in respect of any omissions. In the *Contract Law 1999*, there are three provisions to serve these two functions. Article 125 is a specific rule to deal with the ambiguities, Article 41 sets down the rule of *contra proferentem* and Article 62 appeared to attempt to serve both functions.

As has been widely accepted in China, the contractual obligations arise primarily from the agreement of the parties. Interpretation is thus the means of defining the scope of contractual obligations under the principle of party autonomy.\(^{55}\) The function and role of the judges, during this process, is to seek the true meaning which the contractual parties had agreed.\(^{56}\) Article 125 thus acknowledges that an interpretation is to determine the ‘true meaning’ and the ‘true meaning’ should be sought by reference to the relevant provisions of contract, their purpose, transaction usage and the principle of good faith.

However, this provision is too vague to be implemented by the judges in practice. The case of *Shenzhen Bai Industrial Corporation Limited v Zhongjian Construction Pty Limited Shenzhen Branch Company and Zhongjian Corporation Pty Limited Contract Dispute*\(^{57}\) is an example of defining party’s obligation under the principal of party autonomy. Shenzhen Bai Industrial Corporation Limited (Plaintiff) took legal action against Zhongjian Construction Pty Limited Shenzhen Branch Company and Zhongjian


Corporation Pty Limited (Defendants) to Shenzhen Luohu District People’s Court on the ground of a claim for payment of RMB337,658 (USD52,000) and contractual fine RMB75,635.39 (USD11,600) based on their goods supply contract in January 2008. The Luohu District Court found the fact that the plaintiff and defendant had signed a contract through which the plaintiff supplied concrete to the defendant in January 2008 and that both parties agreed upon price, quantity and payment arrangements in the contract. The plaintiff performed the contract accordingly and the defendant received the supplied concrete. However, a dispute occurred when both parties conducted account settlement. As a result the defendant refused to pay the claimed amount arguing that there was fault in the quality of the concrete supplied by the plaintiff causing construction problems. The plaintiff provided evidence to the court including a contract signed by both parties, quantity receipts and an account settlement sheet signed by the defendant’s managerial staff Mr Guan. The defendant argued that the quality of the concrete was not good as cracks appeared in the construction and denied Mr Guan’s signature represented the company. However, the defendant failed to provide evidence to the court within the required period. The Luohu District Court’s judgment held that the contract between the parties was genuine and represented their free will and that it was a valid contract that was binding upon the parties. The defendant argued that the supplied concrete was faulty but failed to provide evidence in support of that claim. The Court held that Mr Guan was the responsible staff member for all construction material in the company and that a third party had a reasonable expectation of him acting on behalf of the company. As a result, the plaintiff’s claim was

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58 Ibid para 1.
59 Ibid para 2.
60 Ibid.
61 Ibid para 3.
62 Ibid.
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upheld and the defendant was ordered to pay the claimed amount to the plaintiff within ten days.\(^{63}\)

The defendant appealed the Luohu District People’s Court decision to the Shenzhen Intermediate People’s Court in 2009.\(^{64}\) On appeal, the appellant claimed that the final accounts of both parties had not yet been settled. The appellant claimed that the respondent did not supply the concrete on time and had already breached the contract.\(^{65}\) Additionally, the appellant claimed that the plaintiff had supplied faulty concrete that caused construction problems and provided evidence to the appeal court that included expert inspection and analysis reports on the quality and strength of the concrete. The appellant argued that Mr Guan’s signature on the settlement sheet did not represent the appellant and that the decision of Luohu District Court should be dismissed.\(^{66}\)

The Shenzhen Intermediate People’s Court found that the decision by the first instance court was correct and confirmed that decision.\(^{67}\) The Court found that, according to the arrangement in the contract, both parties agreed that the procedure of accepting the concrete was to be conducted by Mr He. However, Mr Guan was the chief responsible person in the company and that his signature on the settlement sheet should be regarded as an authority from the appellant.\(^{68}\) The Court found that appellant’s provision of evidence of expert reports to the appeal court was not new evidence and the appellant had failed to

\(^{63}\) Ibid 4.
\(^{65}\) Ibid para 3.
\(^{66}\) Ibid para 4.
\(^{67}\) Ibid para 6.
\(^{68}\) Ibid.
satisfy its burden of proof in the first instance so the appeal was not upheld.\textsuperscript{69} The Shenzhen Intermediate People’s Court dismissed the appeal and upheld the decision of the Luohu District People’s Court.\textsuperscript{70}

The main features in this case involve a number of questions, including validity of the contract, performance of the contract and breach of the contract. According to Articles 107 and 130 of the \textit{Contract Law 1999}, where one of the parties of the contract did not perform the contract or performed the contract contrary to the arrangement, it is deemed to be breach of the contract.\textsuperscript{71} In this case, the contract between the parties was genuine and signed in good faith. Both courts confirmed the validity of the contract.\textsuperscript{72} The defendant’s failure to pay the plaintiff constituted breach of contract.\textsuperscript{73} According to the \textit{Company Law 2006}, Zhongjian Construction Pty Limited Shenzhen Branch was not a legal person therefore its parent company, Zhongjian Construction Pty Limited was jointly liable to pay the claimed amount to the plaintiff.\textsuperscript{74}

The \textit{Contract Law 1999} has an interesting provision on the resolution of inconsistencies between two language versions of a contract. If the two versions are agreed to have equal validity, the words used in the two versions are to be regarded as having the

\begin{footnotes}
\footnote{\textsuperscript{69} Ibid.}
\footnote{\textsuperscript{70} Ibid para 7.}
\footnote{\textsuperscript{71} [Contract Law of the People’s Republic of China] (People’s Republic of China) National People’s Congress, Order No 15, 1 October 1999, arts 107, 130.}
\footnote{\textsuperscript{73} [Contract Law of the People’s Republic of China] (People’s Republic of China) National People’s Congress, Order No 15, 1 October 1999, art 130.}
\footnote{\textsuperscript{74} [Company Law of the People’s Republic of China] (People’s Republic of China) National People’s Congress, Order No 42, 1 January 2006, art 14.}
\end{footnotes}
same meaning. If the words used are nevertheless inconsistent, they will be interpreted according to the purpose of the contract.\textsuperscript{75} The People’s Supreme Court exercises its power to interpret the meaning of particular provisions in the event that a contractual dispute could not be concluded. For example, if the parties have not committed a contract to writing or orally but from the performance of their actions it is possible to infer that they had the intention to conclude a contract then the People’s Court may hold that a contract was concluded ‘in another form’ as specified in the first paragraph of Article 10 of the \textit{Contract Law 1999}, unless otherwise provided in law.\textsuperscript{76}

\subsection*{7.3.4 Problems addressed by the New \textit{Contract Law 1999}}

‘Triangular debts’ are often problematic and Article 73 of the \textit{Contract Law 1999} was said to facilitate dispute resolution in such matters.\textsuperscript{77} The Article provides that a creditor may apply to the court to collect a debt due to the debtor from a third party, if the debtor delays in collecting an amount due from the third party. This might suggest that the third party will be required to pay the creditor directly. But the position is not entirely clear.

The legislation does not contain an express requirement to firstly obtain a judgment against the debtor but presumably the creditor needs to prove its debt if it is to succeed.\textsuperscript{78} However, in the process of execution of a judgment, if the debtor has delayed collecting amounts due from third parties, the enforcement division of the court can exercise its power

\textsuperscript{75} \textit{Contract Law of the People’s Republic of China} (People’s Republic of China) National People’s Congress, Order No 15, 1 October 1999, art 125.

\textsuperscript{76} \textit{Interpretation on Several Issues Concerning the Application of Contract Law of the People’s Republic of China} (People’s Republic of China) Supreme People’s Court, Order No 5, 9 February 2009, art 2.

\textsuperscript{77} Ibid art 73.

\textsuperscript{78} \textit{General Principles of Civil Law of the People’s Republic of China} (People’s Republic of China) National People’s Congress, 1 January 1987 (adopted by the 4\textsuperscript{th} Session of the 6\textsuperscript{th} National People’s Congress on 12 April 1986 and came into force on 1 January 1987), art 84.
to freeze the debtor’s accounts until the debtor pays the debt.\textsuperscript{79} Article 223 of the \textit{PRC Civil Procedure Law 2008} already empowers the court to seize a judgment debtor’s assets, including income, to satisfy a judgment.\textsuperscript{80}

By way of exception, Article 73 of the \textit{Contract Law 1999} introduces the concept of a debt that belongs to the debtor personally.\textsuperscript{81} For example, A is a debtor of creditor B. A is also a creditor of another personal debtor C which is due. If the debtor A fails to claim this obligatory right in order to fulfill the debt owed to B, the contract law gives the right to B to exercise A’s right to claim the debt from C. There is no explanation of which kinds of debt fit this category. This concept would be novel to lawyers trained in common law which does not generally regard a debt as creating a personal right or obligation incapable of transfer or attachment, as it generally does not matter to whom money is paid.

Another concern was that there have been several serious incidents involving poorly constructed contracts. Additionally, the question of prohibitions upon sub-contracting needed to be addressed by the \textit{Contract Law 1999}. Inconsistencies among the existing laws were a concern which a unified law could address. Some of these inconsistencies related to the differences between the ECL 1981 and the FECL 1985. The \textit{Contract Law 1999} was intended to result in domestic and foreign contracts being accorded the same treatment.\textsuperscript{82} In the last twenty years China has developed its policies in respect of equal treatment to

\textsuperscript{79} \textit{中华人民共和国民事诉讼法} [Civil Procedure Law of the People’s Republic of China] (People’s Republic of China) National People’s Congress Standing Committee, Order No 75, 1 April 2008, art 220.

\textsuperscript{80} Ibid art 223.

\textsuperscript{81} \textit{中华人民共和国合同法} [Contract Law of the People’s Republic of China] (People’s Republic of China) National People’s Congress, Order No 15, 1 October 1999, art 73; \textit{最高人民法院关于适用<中华人民共和国合同法>若干问题的解释(一)> [Interpretation Concerning Several Issues of Application of Contract Law of the People’s Republic of China (1)] (People’s Republic of China) Supreme People’s Court, Order No 19, 19 December 1999, art 11.

\textsuperscript{82} Ibid art 2.
foreign investors. Substantial laws and procedural laws have been passed to eliminate the gap between Chinese enterprises and foreign investors. These laws state that foreign investors’ interests are regarded as equal to Chinese enterprises and natural persons. For example, the Chinese-Foreign Equity Joint Venture is a legal person and has the same rights as a Chinese enterprise.

Another welcome development was the acceptance by the NPC that an updating of the existing laws was necessary to accommodate developments in China’s market economy, as the existing laws, particularly the ECL 1981, were very much influenced by concepts relevant to a planned economy.

But though it was strongly advocated by some, the principle of freedom of contract has not been incorporated into the Contract Law 1999. The Commission on Legislative Affairs was of the opinion that it was inappropriate to simply state the principle.

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84 <<中华人民共和国合同法>> [Contract Law of the People’s Republic of China] (People’s Republic of China) National People’s Congress, Order No 15, 1 October 1999 (passed on 15 March at the 2nd Session of the 9th National People’s Congress and effective from 1 October 1999), art 13.

in the law.\textsuperscript{86} The new law states instead that parties have a right, of their own free will and free from interference by any unit or person, to enter into contracts according to law.\textsuperscript{87} This is not the same as providing for the binding effect of the contents of a contract. The new law also has a provision empowering the State Administration of Industry and Commerce and other relevant government departments to supervise contracts, within the scope of the department’s jurisdiction, in order to deal with illegal activities that injure the national or social interests.\textsuperscript{88} The intention was to prevent the loss of state-owned assets, and to reduce and prevent fraud.\textsuperscript{89}

An interesting example of realism was the resolution of the issue of whether oral contracts should be given legal force. The proposition was that such oral contracts were hard to prove and so the law should require contracts to be made only in writing, in order to avoid dispute. However, to refuse legal recognition of orally made contracts did not help in the solution of ensuing problems.

\textbf{7.4 Approval and Registration of Contracts}

If approval or registration is required by a law or administrative regulation in relation to the effectiveness, transfer or termination of a contract, that requirement must be complied

\textsuperscript{86} <<关于修改经济合同法的决定>> [Decision Concerning Amendment of Economic Contract Law] (People’s Republic of China) National People’s Congress Standing Committee, 2 September 1993.

\textsuperscript{87} Ibid art 4.

\textsuperscript{88} Ibid art 127.

However, to deprive a contract of effect, a law or administrative regulation may need to state the requirement specifically. A mere requirement of approval or registration may not have such an effect. On 13 May 2009, the Supreme People’s Court (SPC) issued an *Interpretation on Several Issues Concerning the Application of the Contract Law (2)* (Interpretation)\(^91\) that aimed to clarify some of the vague and controversial provisions in the existing *Contract Law 1999*. The Interpretation covers aspects of the formation, validity, performance, termination of a contract and liabilities for breach of contract. Article 8 of the Interpretation provides that if a contract requires approval or registration under any law or administrative provisions before it becomes effective and, if the responsible party fails to apply for such approval or registration, such failure shall be deemed to be ‘actions which violate the principals of honesty and creditworthiness’ under Article 42(3) of the *Contract Law 1999*. The Court can then order the other innocent party to apply for registration or approval on its own and the responsible party shall be liable for losses and expenses as a result of its failure.

This provision is important as many agreements in China are required to be registered with or to gain approval from the relevant authorities in order to take effect. These include joint venture contracts, loan agreements with foreign banks or mortgages involving foreign source funds. This provision will provide wider protection to foreign parties who will now be able to complete the registration or approval process on their own.

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\(^90\) [Contract Law of the People’s Republic of China] (People’s Republic of China) National People’s Congress, Order No 15, 1 October 1999. It was passed on 15 March at the 2\(^{nd}\) Session of the 9\(^{th}\) National People’s Congress and was effective from 1 October 1999, arts 44, 87, 96.

\(^91\) [Interpretation of the Supreme People’s Court on Several Issues Regarding the Application of the Contract Law (2)] (People’s Republic of China) Supreme People’s Court, Order No 5, 9 February 2009.
However, it is unclear whether the relevant authorities will entertain such unilateral submission by one party to the agreement.\(^92\)

### 7.4.1 Approval Requirements for Foreign Investment

The Ministry of Commerce of People’s Republic of China (MOC),\(^93\) which is empowered by the State Council, exercises a power to approve a project involving foreign investment in China. The State Council is the organisation with the greatest administrative power and is a powerful part of the Central Government in China. According to the *Constitution of the PRC*, the functions and powers of the State Council allow it to perform the following legislative activities:

i) To adopt administrative measures, enact administrative rules and regulations and make decisions and orders in accordance with the *Constitution* and the law;

ii) To submit proposals to the NPC or its Standing Committee;

iii) To issue rules governing administrative affairs in respect of national economic and social development, the state budget, urban and rural development, education, science, culture, public health, sports, population control, internal affairs, public security, judicial administration and national defence;

iv) To alter or annul inappropriate orders, directives and regulations issued by the Ministries or Commissions.\(^94\)

This exercise of the executive power is the most significant power in relation to administrative and legislative functions with respect to foreign investment. The procedural requirements related to approval, registration, and form selection are some of the effects of this executive power. As Mo states:

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\(^92\) Ibid.


An inseparable part of the legal framework for foreign investment is the power to approve foreign investment proposals. In China, this power is exercised by relevant government departments.\textsuperscript{95}

It is a measure of the importance to the PRC of every aspect of foreign investment, including its monitoring and future directions, that the government at the highest levels retains such overview and control.

The regulations for the \textit{Regulations for the Implementation of the Law of the PRC on Chinese-Foreign Equity Joint Ventures 1995} \textsuperscript{96} stipulate that the establishment of a joint venture in China is subject to examination and approval by the MOC. The source of the foreign investments is examined as a practical general standard. If the investment comes from outside the territory of China, it is usually characterised as a foreign investment even if it originates from Chinese nationals or companies. A corporation is created or registered through the State Administration for Industry and Commerce by obtaining initial approval from the Ministry of Commerce.\textsuperscript{97}

The MOC, which is in charge of examining and approving a proposed foreign investment project and registrations of companies and business organisations, will examine the substantive validity of all the application documents and the incorporation documentation.\textsuperscript{98} The State Administration of Industry and Commerce (SAIC) will not approve the application unless it is satisfied with the procedural and substantive validity of the information in the document, including but not limited to, the company name, the business purpose, the qualification of the legal representative, the qualifications of directors

\textsuperscript{95} John S. Mo, \textit{International Commercial Law} (Butterworths, 1997) 453.
\textsuperscript{97} Ibid art 9.
\textsuperscript{98} Ibid arts 7–9.
and the supervisors.\textsuperscript{99} Furthermore, any later changes to the registered information are only effective upon the approval of the relevant registration authorities.\textsuperscript{100}

Upon approval of a joint venture, MOC issues an Approval Certificate.\textsuperscript{101} Alternatively, the people’s governments at the provincial and local levels and including provinces, autonomous regions and municipalities directly under the Central Government, or relevant ministries or bureaux under the State Council, (referred to as ‘the entrusted office’) may be entrusted with the power to examine and approve the establishment of joint ventures that comply with the undermentioned conditions.\textsuperscript{102} The establishment of foreign investment is subject to certain procedural requirements. For example, the parties need preliminary approval from the relevant government authority or local government before formally applying for approval.\textsuperscript{103} For example, a foreign investment proposal involving real estate development requires the approval of a transfer of the land-use right contract from the Administrative Bureau of Land of the municipal level government before the project application for approval certificate from the Ministry of Commerce and its authorised departments can be granted. The parties are also required to submit a feasibility study on the proposed project for the purpose of demonstrating its benefits to the Chinese

\begin{footnotesize}
\begin{enumerate}
\item[99] Ibid art 7.
\item[102] Ibid art 6.
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economy and providing evidence of their ability to carry out the project.\textsuperscript{104} If a project is deemed to be strategically important to the Chinese, the government is likely to delay approval of the project until some form of Chinese control is secured in the project.\textsuperscript{105} On the other hand, the government may choose to seek substantial benefits promised by a joint venture at the expense of losing control of the venture to foreign interests. For example, when a Chinese party with 51 per cent share in a Chinese-Foreign Equity Joint Venture is planning to sell all its shares to the foreign investor, such transfer of shares will change the Chinese-Foreign Equity Joint Venture to a Foreign Wholly Owned Enterprise. According to the \textit{Guideline Catalogue of Foreign Investment Industries} 2007, some industries are prohibited from participation in a Wholly Foreign Owned Enterprise.\textsuperscript{106} Therefore, such a


\textsuperscript{106} <<外商投资产业指导目录>> [Guideline Catalogue of Foreign Investment Industries] (People’s Republic of China) Ministry of Commerce National Development and Reform Commission, Order No 57, 1 December 2007, art 5. The catalogue of prohibited foreign investment industries includes farming, manufacturing and mining, including, for example: breeding of China’s rare precious breeds; exploring and mining of tungsten, molybdenum, tin, antimony and fluorite; processing of traditional Chinese medicines that have been listed in the Regulations on Conservation and Management of Wild Chinese Medicinal Material Resources and Rare and Endangered Plants in China; air traffic control operations; development and application of human stem cells and gene diagnosis therapy technology; and news agencies.

transfer can be successful only if approval is granted by the Ministry of Foreign Economic and Trade Cooperation.  

From these approval procedural requirements, the power is exercised by relevant government departments. The common feature of the review authorities is that the power so exercised is part of the executive power and is confined to the power of the relevant local government in the Chinese political hierarchy. It is an inseparable part of the legal framework for foreign investment.

7.4.2 The Registration Procedure

The Joint Venture Law 1995 states that the registering body for joint ventures is the SAIC or any of its local and regional bureaux. Joint Ventures must register within 30 days of receiving the approval certificate. This is in accordance with the provisions of the Measures of the People’s Republic of China for the Administration of the Registration of Chinese-Foreign Equity Joint Ventures.  

The SAIC approves or rejects the registration within one month of receipt of the application documents. When approved, a business licence is issued and joint venture operations can commence on the same day.

If a joint venture desires vary its operation in such ways as: moving to a new geographic site; varying or transferring its registered capital; or extending the contract period, it must, along with the requisite approval documents, register the changes with the


109 Ibid art 2.

SAIC where the joint venture is located.\(^{111}\) In instances where the chairman of the board of directors or the general manager is changed, the joint venture must immediately register the change and ensure that the business licence is amended.\(^{112}\) These procedural administrative steps require attention and time from the managing personnel and constitute a cost to the joint venture.

### 7.5 The Enforcement of Contracts

Since the promulgation of the *Contract Law 1999*, the issue of contractual enforcement has been a central focus along with other issues.\(^{113}\) Dispute resolution mechanisms are often utilised as contractual enforcement either to compel performance in the face of actual or threatened non-performance or to address damages or other remedies for failed performance. Traditional methods of dispute resolution include mediation, arbitration, litigation and injunctive relief and compliance with awards and judgments. The *Contract Law 1999* promulgates a range of detailed provisions to ensure contractual enforcement.

For instance, Article 12 provides standard forms of contract to ensure that contractual parties cover every detail of the business arrangement from the formation of the contract, performance of contract, termination, remedies for breach of contract and so on.

The Chinese view of contract formation is quite inconsistent with the western conception of a finalised contract. Foreign investors often find it difficult to enforce even

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\(^{112}\) Ibid arts 4, 8.

\(^{113}\) Mo Zhang, *Chinese Contract Law: Theory and Practice* (Brill Academic Publishers, 2006) 1. Issues that must be dealt with for foreign partners doing business in China include, among others, whether China has a sound legal system, whether private interests will be protected effectively under the socialist system of China and whether a contract will be honoured and enforced in China.
Ch 7: Development of Contract Law in China

simple, implicit contracts. Most firms entering China are not accustomed to doing business without clear contracts. Pattison and Herron point out:

Westerners view contract formation as the culmination of a negotiating process and period. The contract is the ‘end result’. From the Chinese perspective, the ‘final’ contract signifies that a relationship exists and terms-negotiations may now continue. The ‘final’ contract signals the beginning for real contract negotiations.114

Ahlstrom, Young, Law and Law give some historical explanation of this contradictory conception referring to the infancy of Chinese contract law when compared to the long established contract law tradition in the West suggesting:

China launched its Economic Reform and Open Door Policy in the late 1970s, drawing many foreign firms to its shores. However, most firms knew little about doing business in China and less about the way in which it’s institutional and legal structure could affect a firm’s success. Many were surprised by the lack of legal infrastructure and commercial tradition to guide business transactions. The institutional environment, including property rights, contract law, company law and arbitration and numerous commercial customs differ considerably from that of the West, and this has a number of implications for firms and investors as they move into China.115

Jenner adds further historical context to the emergence of modern contract law in China:

Traditionally, it is expected that the guilds, clan organisations, and other non-governmental groups resolve contract disputes and decide when the end of an agreement will be supported or maintained. The courts would get involved only as a last resort, usually in response to the seizure of property or disorderly behaviour.116

After economic reforms began in the late 1970s, contract enforcement once again became an important issue as commercial activity started to expand outside the state-owned sector. Traditionally, guild and clan associations play an important role for the enforcement of contracts.117 As a result, contracts were not well codified, and people in China

traditionally accept this degree of ambiguity. The uniform Contract Law was enacted in 1999 in order to bring Chinese business practice into some kind of conformity and consistency. Failure to fulfil contractual obligations is still a common contract dispute. It is said that in China signing a contract signifies the beginning of negotiations. How contracts are dealt with and treated in the general business culture will be another matter. For example, foreign investors contracting a business with Chinese partners, would have a different attitude towards performance of contract.Foreigners may expect every step in the contract to be followed to the letter while the Chinese parties would possibly view the contractual arrangement with more flexibility because the Chinese see a contract as an intention of doing business together rather than detailed requirements of the business activities. From this point of view, enforcement of contract might involve more than just the dispute resolution system itself.

Even though the availability and effectiveness of such dispute resolution forms a critical component of contract enforcement, effective contract enforcement should be considered on a broader systematic basis. It should include not only the overall contractual arrangement and its context but also the existence of a traditional contractual legal environment including the broader relationship between the parties and attitudes towards contractual relationships. China is seeking to create a business-friendly environment

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<http://works.bepress.com/cgi/viewcontent.cgi?article=1000&context=chunlin_leonhard&sei-redir=1>.
characterised by predictable legal enforcement of contract rights. Significant efforts have been made to develop a national business atmosphere in which contract enforcement is reliable and consistent with international commercial standards and practice.\(^{121}\)

Nevertheless, prospective foreign investors should be aware that from a cultural perspective, informal dispute resolution tends to be more consistent with important elements of Chinese culture and tradition including Confucian ethics and the characteristic desire for harmony. The Chinese view of dispute resolution is grounded in Confucian ethics.\(^{122}\) The underlying principle of Chinese cosmology is harmony with nature and among persons.\(^{123}\) Confucian ethics promotes several cardinal relationships — between father and son, ruler and subject, husband and wife, elder and younger brother, and friends — in order to achieve stable social order. The Chinese characteristic of non-litigiousness will be discussed in more detail in Chapter 8. There is a marked preference to resolve disputes through alternative dispute resolution methods rather than through litigation.\(^{124}\) In fact, most business contracts in China include a clause stipulating that negotiation should be employed before other dispute settlement mechanisms are pursued.\(^{125}\) Cultural realities and other considerations explain why informal dispute procedures are included in a well

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\(^{122}\) The Confucian theory of ethics as exemplified in *Li* is based on three important conceptual aspects of life: ceremonies associated with sacrifice to ancestors and deities of various types, social and political institutions, and the etiquette of daily behaviour. His discussions of *Li* seem to redefine the term to refer to all actions committed by a person to build the ideal society, rather than those simply conforming to canonical standards of ceremony. In the early Confucian tradition *Li*, still linked to traditional forms of action, came to point towards the balance between maintaining these norms so as to perpetuate an ethical social fabric.


structured contract. For example, parties may be contractually obligated to address and escalate matters within their respective management groups — in order to avoid or resolve disputes without litigation — using other more formal mediation arrangements that are legally justifiable whilst still maintaining sensitivity to Chinese cultural and social norms. This is related to a traditional non-litigious culture for resolving commercial disputes apart from such factors as inefficiency, cost and time.

There is often significant concern from foreign investors about whether there is adequate legal protection for their business operation and about potential major difficulties in the development of their business. Having studied Chinese Uniform Contract Law (UCL) [Contract Law 1999], Gillies and Kapterian observe that:

While there are still gaps in the UCL and its application in the courts is still very new, the enactment of a general contracts code in China is an important step in modernising China’s contract law and commercial relationships. The general obligations which will be grounded by the requirements of fairness and good faith will provide a basis for the development of a contract law suitable for China’s ongoing engagement with the global economy and its entry into the WTO. On the negative side, it may be argued that the UCL has not gone far enough to protect the integrity of everyday commercial transactions. Provisions still allow the government to supervise and approve contracts, and in so doing, to interfere with their formation and transaction. The principle of freedom of contract is accordingly attenuated.126

The extent to which people and organisations are allowed to have very broad freedom of contract is one that can throw up its own set of problems leading to the dilemma in societies where the law has been deformed in practice. Perhaps the underlying reasons

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for such deformation, as demonstrated in the case of the United States of America in recent years,\textsuperscript{127} are substantial justification for China exercising caution.

Unfettered freedom of contract can allow excesses and contractual arrangements that have the potential to harm others, including other organisations and even governments. It can be argued that a government, acting responsibly, should properly exercise a measure of control over such potential excess. Given the potentially devastating consequences of unfettered freedom it might be suggested that the Chinese government is taking a more responsible approach than some western law-makers. The dangers for individuals, corporations and even governments has been demonstrated by the recent world international economic crisis that grew out of the excesses of US financiers with apparently little or no governmental control over their activities.

7.6 Conclusions

In light of the western view of the centrality of the contract to all types of business ventures, this chapter has discussed in great detail the development of contract law in China over the period of economic expansion and growth of foreign investment in the PRC.

Foreign investor involvement in the course of economic development in China has no doubt been a significant accelerative factor for legal reform. In developing legal reform, China has wanted to demonstrate stable economic development upon the world’s

\textsuperscript{127}Peter Schiff, ‘There is No Pain-Free Cure for Recession’ \textit{Wall Street Journal}, 27 December 2008, A11 <http://online.wsj.com/article/SB123033898448336541.html>. Recession fears caused America to embrace greater state control of the economy and to administer unimaginable federal deficits from 2008. With faith in the free markets taking a back seat to fear and expediency, almost the entire political spectrum agreed at the time that the federal government must spend whatever amount is necessary to stabilise the housing market, bail out financial firms, restore liquidity to the credit markets, create jobs and make the recession as shallow and brief as possible.
competitive economic stage. Nevertheless, in the environment of very impressive annual growth rates and enormous volumes of trade, the fact that economic transition is still under way may easily be forgotten. Business in China can still be a risky venture for foreign investors, especially for small and medium-scale investors with no significant political support. Foreign investors frequently complain that contract law in China seems to be intangible as far as its enforcement and administration are concerned. In contract disputes, litigants raised concerns about difficulties in enforcing judicial judgments and also about their observations that, when it is necessary for courts to adjudicate the substantive contractual rights and obligations, it is not uncommon for Chinese courts to invalidate private contracts, sometimes on formal grounds, thus frustrating the expectations of the parties. 128

There is no simple answer as to why existing legal mechanisms so often seem less than satisfactory when it comes to undertaking business activity, particularly in the case of foreign investment in China. However, the importance of the underlying political, moral and social environments has often been neglected, even though their influence in the course of social transformation and evolution are profound. In China, a deepening legal reform had been promoted and undertaken since economic transformation commenced, and the development of Contract Law has played a significant role in respect of the legal reform process. The Chinese court system has developed to a point where it is possible to resolve most practical contractual disputes. However, as contract laws were evolving in the 1980s, in particular those related to foreign investment, it became obvious that there was a lack of consistency within and between them as they applied to different fields of activity of

foreign investment. Difficulties in the administration of the new laws were also being experienced in contracts with government and the interpretation of contracts generally.

It was not surprising that the PRC government was struggling in its efforts to set in place a system of laws that would work effectively to satisfy the needs of investors who were familiar with western legal regimes that had been tried and tested over a great many years. Additionally these new laws in China were to operate in a completely different political and social environment to those operating in most western legal systems at the time.

This study has shown that the ways that Chinese business operators conduct their business activities is a major difficulty for the introduction of a consistent and predictable regime of western style business laws, and there seems little doubt that this factor prevails. The task of reversing those traditional habits has proven to be difficult to achieve; until it is achieved, foreign investors ignore it at the risk of frustration and possible failure. The question that arises is whether it will ever be fully achieved. It could be said that there are features about the traditional ways that do not need to succumb to the letter of the law. If this is to be an ongoing state of affairs, then what is required is adjustment by those foreign investors seeking to do business with Chinese counterparts.

Registration of contracts and approval requirements have been areas where foreign investors have been vulnerable in the past. The pre-existing reliance upon the Chinese party to correctly complete such registrations has proved costly on occasions where proper approval had not been granted before the business commenced. For example, J P Morgan approached Liaoning Securities Co. Ltd, a company that was close to financial bankruptcy

\footnote{Ibid [6].}}

Provisions of the Contract Law 1999 give nominal protection to foreign partners by allowing them to perform the registration or approval process. However, the registration processes are still cumbersome and subject to long delays — something that the prudent investor needs to factor in to the overall process.

Enforcement of contracts continues to be a vexed issue in Chinese business with foreign investors. In an attempt to address the issue the government introduced standard forms of contract in relevant laws that encouraged the parties to address as many different aspects of the business relationship as possible including dispute resolution processes. However, these have had limited success. The very deeply entrenched Chinese view of the meaning of a contract — as a starting point for a business relationship rather than the iron-clad set of rules to which each party is bound — is so long established that it is not to be easily swept aside, no matter what the written law states.

By its law reform activities China has shown that it recognises that disputes involving foreign parties needed to be properly dealt with. In the period January to April 2010, Australian direct investment in China had reached USD644 million and China’s total direct investment in Australia nearly USD60 billion.\footnote{Ibid [6].} Whilst this demonstrates that
Australian economic investment in China has been continuing to grow since the *Trade and Economic Framework* between Australia and the People’s Republic of China signed in Canberra on 24 October 2003,\(^{131}\) it would also seem to indicate that Chinese investors do not appear to experience serious impediments when investing in Australia. This may well be the result of there being far more predictable legal and business environments in Australia as compared to those in China. For this reason, the challenges that Australian investors are likely to face in China, in particular as they enter new industrial sectors and regions, need to be closely examined and understood. One clear example of such challenges is the perception that firms often must engage in transactions where personal connections appear to be of greater importance than their Chinese partner’s operational capabilities.\(^{132}\)

Active economic and investment activities by Australian investors and those from other countries in China have required legal protection for Chinese participants and for foreign investors alike. *Contract Law 1999* has provided such protection to an extent. However, difficulties in terms of implementation and enforcement of the *Contract Law 1999* remain as areas of concern for foreign investors.

Some of the practical effects of the above-mentioned factors upon western business operators (particularly Australian business-people) in China have been assessed by direct surveys of, and discussions with, such investors. In the following chapter, this research encompasses the outcome of such enquiries that shows the relevance of these aspects for foreign investors and the need for awareness of them. Whilst knowledge of the practical

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\(^{131}\) Department of Foreign Affairs and Trade, *Australia-China Free Trade Agreement: Joint Feasibility Study* (This study prepared by the Department of Foreign Affairs and Trade, Australia and Ministry of Commerce, China, March 2005) 5.

\(^{132}\) David Ahlstorm et al, ‘Managing the Institutional Environment: Challenges’ above n 116, 42.
circumstances referred to in this chapter may not, of itself, provide a solution, such
knowledge can, it is suggested here, be of importance to the foreign investor in managing
its strategies in dealing with the legislative and administrative systems of the PRC.
Chapter 8

A Research Survey of Australian Enterprises Operating in China

8.1 Introduction

For the purpose of acquiring knowledge as to the ways in which the legal environment in China practically affects those who have chosen to engage in business activities in that country, this research included enquiries with a group of Australian enterprises that were operating in China at the time of the survey.

A secondary purpose of the survey and interviews was to ascertain whether the responses contributed answers to two of the central questions of this study, those being (i) whether or not social and cultural factors and differences between western business operators and their Chinese business partners played a significant role in how Chinese laws manifested in practical terms, and (ii) how such laws were perceived by both western and Chinese partners.

A survey questionnaire was conducted and interviews were undertaken with the group members. The survey sought to identify some practical, surface issues about the foreign investment environment in China concerning aspects of the legal environment and the administrative system. The primary research methodology involved anonymous
questionnaires followed by interviews with senior personnel of a sample of seven companies that were operating their businesses in China. Questionnaire participants initially responded to 35 questions in the questionnaire relating to concerns about the legal and administrative environment in China and matters related to cross-cultural management.

Section 8.1 introduces the nature of, and reasons for, the research questionnaire and interviews. Section 8.2 discusses the background of the economic relationship between Australia and China, and thus the environment in which Australians enter into business relationships with Chinese partners. Section 8.3 gives an outline of the nature of the research survey. Section 8.4 begins to reveal how the survey responses need to be read in light of the attitudes of Chinese partners and the cultural environment in which the business relationship exists. In section 8.5, some major factors affecting foreign investors are explored including the role of the Chinese bureaucracy, the value of interpersonal connections, the issue of corruption and the interaction between formal and informal law. Section 8.6 discusses the impact of China’s admission to the World Trade Organisation upon foreign investors and Chinese policies. Section 8.7 summarises and concludes the chapter.

8.2 Background of Growing Economic Interests between China and Australia

The broad picture of the development of economic activities between China and Australia in recent decades is the backdrop against which those Australian or Australia based business operators have been steadily increasing since China commenced rapid economic growth as a result of economic reform commenced in the late 1970s. Australian Bureau of
Statistics figures for 2009 regarding Australian merchandise trade\(^1\) with China shows that exports to China were valued at AUD42.353 billion (USD38.128 billion), representing growth of 31 per cent over the previous 12 months; while imports from China were AUD35.782 billion (USD32.204 billion), representing growth of only 1.5 per cent.\(^2\) In merchandise trade between China and Australia in 2010, exports to China reached AUD58.340 billion (USD52.506 billion) (a year on year growth of 37.2 per cent), and imports from China were AUD39.249 billion (USD35.324 billion) (a year on year growth of 9.7 per cent).\(^3\) It is evident that the trade and investment relationship between Australia and China has developed substantially. China’s transformation has offered opportunities for Australia. According to Australian statistics, in the 12 months to June 2009, the total value of merchandise traded between Australia and China (imports and exports together) was AUD76 billion. This level has grown by an average of 22% per year in the ten years to 2009, making China Australia’s largest trading partner (ahead of Japan and the United States).\(^4\)

Although Australian investment is not as competitively substantial as those from the United State of America, Japan or the European Union countries, Australian investment in

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China has been rising since the 1980s.\(^5\) For example, Australian mining giants such as BHP Billiton and Rio Tinto have a strong presence in China.\(^6\) They include Australia’s advanced sectors for trade and investment including mining, construction, transportation, banking, insurance, accounting and legal services.

Also, in August 2002, the Australian Liquefied Natural Gas Corporation (ALNG) was chosen as the resource supplier for the Guangdong LNG project for China.\(^7\) Contracted Australian investment in China has expanded steadily in recent years. China and Australia released a joint statement during the official visit by China’s Vice Premier Li Keqiang to Australia (29 October 2009 to 1 November 2009). It recognised that:

The combined GDP of our two economies is greater than USD5 trillion, the two sides agreed that China and Australia enjoy strong economic complementarity, and it serves the common interests of both sides to advance economic, trade and investment cooperation on the basis of reciprocity and mutual benefit. Australia is a long-term stable supplier of mineral and energy resources to China. China is a competitive supplier of goods to Australia.\(^8\)

Additionally, the launch of bilateral free trade agreement (FTA) negotiations in Beijing in April 2005 marked a significant milestone in the economic relationship.\(^9\) However, Australian investment in China has remained fairly modest relative to overall growth in bilateral trade between the two countries. For example, by the end of 2005 China was Australia’s 20\(^{th}\) largest investment destination (AUD2.043 billion) with the focus of

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that investment on manufacturing, mineral exploration, legal, banking and education services, whereas China was the 18th largest investor in Australia (AUD2.275 billion).10

The relationship between Australia and China has been more active and substantial in respect of export and import activities and investment involvement. China is Australia’s largest trading partner, with total trade (goods and services) in 2009 valued at AUD$85.1 billion, an increase of 15.1 per cent over the previous year. At the end of 2008, total Australian investment in China had been AUD6.9 billion, making China our 14th largest investment destination.11

The Australian resources sector is the largest and most high-profile investment category in China.12 The potential for greater investment growth is strong. For China, Australia offers strong economic credentials backed by a highly skilled and multilingual workforce, a dynamic services sector, sophisticated telecommunications and IT systems and an open regulatory environment.13

For Australia, China offers a large market and a fast growing economy and continues to improve its overall investment climate through regulatory, legal, financial, and taxation reform.14 According to the Australian Bureau of Statistics:

In 2006, China cemented its place as Australia’s second largest trading partner and one of its fastest growing export markets - bilateral trade in goods and services reached a record

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12 Foreign Affairs, Defence and Trade References Committee, Opportunities and Challenges: Australia’s Relationship with China (Commonwealth of Australia, 2005) 194.
14 Foreign Affairs, Defence and Trade References Committee, Opportunities above n 12.
$50b. Australia exported goods and services worth $24b to China. Major Australian merchandise exports to China included iron ore, alumina, wool and copper ore.\textsuperscript{15}

The Trade and investment relationship between Australia and China is substantial and has developed well since the 1970s when both countries established their diplomatic relations.\textsuperscript{16} Two-way merchandise trade has grown from AUD113 million (USD96.05 million) in 1973 to AUD78.2 billion (USD70.38 billion) in 2009. China is Australia’s largest trading partner, with total trade (goods and services) in 2009 valued at AUD85.1 billion (USD76.6 billion), an increase of 15.1 per cent over the previous year.\textsuperscript{17}

China has become increasingly more important for Australia as a result of its increasing economic, political and strategic weight in the Asia-Pacific region and in the global economy. It is reported that China is one of the countries that retained their positions as the largest recipients of Foreign Direct Investment (FDI) in the South, East, South-East Asia and Oceania region.\textsuperscript{18}

China has been highly successful in attracting and absorbing extensive FDI as a result of policies developed over the past quarter of a century. There is no doubt that FDI


\textsuperscript{16} National Archives of Australia, ‘Fact Sheet 247 – Australia’s Diplomatic Relations with China’ National Archives of Australia <http://www.naa.gov.au/about-us/publications/fact-sheets/fs247.aspx>. Australia’s first diplomatic mission in China opened in 1941 and closed after the Communist victory over the Nationalist Kuomintang and the subsequent establishment of the People’s Republic of China (PRC) in 1949. Cold War fears of Communism characterised Australia’s relations with China over the next two decades, with Australia refusing to recognise either the Communist government of the PRC in Peking (Beijing) or the Nationalists in the Republic of China (Taiwan). In 1966, under Prime Minister Harold Holt, a diplomatic mission was established in Taipei. In 1973 the Whitlam government established diplomatic relations with the PRC. The Taipei embassy closed and an embassy was opened in Peking.


has brought benefits to China. Although Australia is not one of the largest investors in China, Australian investment in China is significant and growing.

The *China Daily* newspaper reported that the Ministry of Commerce of the PRC stated, according to the United Nations Conference on Trade and Development (UNCTAD) 2004 annual report on investment flows:

Within the region, there was considerable unevenness of FDI flows to different sub-regions and countries, as well as industries. Overall, inflows were concentrated in North-East Asia ($72 billion in 2003) and in services. Setting aside the special case of Luxembourg (owing to trans-shipping), China became the world’s largest FDI recipient in 2003, overtaking the United States, traditionally the largest recipient … China overtook the United States as a top global destination for foreign direct investment (FDI) in 2003 while the Asia-Pacific region attracted more investment than any other developing region.\(^{19}\)

China’s continuous economic growth provides massive opportunities globally to business participants. Meanwhile, the legal and business environments in China have attracted the close attention of those enterprises that have already been operating in China as well as that of potential foreign investors. It is no surprise that Australian enterprises are seeking to join this enormous economic market. On 24 October 2003 Australia and China signed the Australia-China Trade and Economic Framework. According to the Department of Foreign Affairs and Trade of Australia:

The Trade and Economic Framework set the direction for the future development of the strong and rapidly expanding trade and economic relationship between Australia and China. The practical measures and co-operative activities contained in this Framework will make it easier to do business with China and provides for closer government, business-business and people-people linkage.\(^{20}\)

In June 2010, the former Australian Honourable Minister for Trade Simon Crean said:

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The speed with which the Australia-China economic relationship has progressed is astonishing. China is our largest two-way trading partner, and last year became our largest export partner. Two-way trade is now valued at AUD85 billion, or nearly 17 per cent of Australia’s total trade. The upwards trajectory shows no sign of slowing and this year, two-way trade may well exceed AUD100 billion. Australian investment in China also continues on an upward trajectory, with about AUD7 billion in Australian investments in China in 2008, up from just AUD1.35 billion in 2003. 

The continued growth in trade between Australia and China has led to a consequent increase in the number of Australian enterprises participating in, and investing in, China. The experiences of some of those investors have been the focus of a survey and follow-up interviews conducted as part of this thesis.

### 8.3 A Research Survey in Australia

In an attempt to gain a better understanding of the challenges arising from China’s institutional environment, interviews were conducted with seven individuals closely involved with foreign firms operating businesses in China. The interviews ranged from 30 minutes to an hour discussion based upon a set of ten questions. Detailed notes of the interviews were taken and a complete report of each interview was dictated. Interviews were generally based on an earlier questionnaire completed by 132 participants and focused on some particular aspects of the legal environment for a foreign investor conducting business in China. As the handling of legal matters and related disagreements in China can be sensitive, interviews were conducted face to face on condition of anonymity. The interviews were all conducted at the interviewees’ offices in Sydney, Australia. One of the interviewees was the founder of a China-based legal consulting firm that also deals

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regularly with legal problems of foreign firms in China. The other six interviewees were senior managers of large foreign enterprises with extensive operations in China.

The interviews elicited useful information and led to substantive observations that provided some insight into aspects of foreign investment in a rapidly changing China. It would be an over-simplification to suggest that the survey and interview procedure would enable a grasp of all problems that foreign investors are facing in their operations in China. However, it can safely be regarded as a window upon the reality of foreign investment and some of the special aspects of current legal practice in China today with regard to foreign investment. The survey was confined to a small sample of business operators thus the value of its findings will be somewhat limited.

The responses to the questionnaire indicated a number of common experiences of Australian foreign investors regarding the Chinese legal environment and administrative system. Ninety-four per cent of participants were doing business in or with China between 1983 and 2004 in the wholesale, manufacturing, IT or financial or legal services, or education and health services sectors. Among them, 55 per cent considered partner selection as a priority strategy to enter China’s market. During the beginning of the economic reform period in 1990s, the Chinese-Foreign Equity Joint Venture format was chosen by the majority of foreign investors. According to statistics from the Ministry of Commerce of the People’s Republic of China (PRC) in 2002, equity joint ventures accounted for 42.91 per cent in cumulative FDI.\(^22\) One of the reasons that partner selection for foreign investment seemed so popular was that a Chinese partner with good connections


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with the host government was perceived to be very helpful and important for the western party to have successful business in China. Hal Sirkin the Senior Vice President of the Boston Consulting Group Chicago office and head of the firm’s global operations practice, suggested, ‘One of the major problems is to just knowing whom to partner with in China.’

Luo Yadong’s study also revealed that timing of investment, industry and local partner selection are critical to the overall performance of a venture. Local partner selection is one of the strategies essential to a joint venture’s efficiency and risk reduction. A survey into UK-Chinese joint ventures reported that while choice of Chinese partners appears to be highly constrained, on the whole UK parent companies analysed the joint venture decision thoroughly and generally concluded that they had joined forces with the right partner. When selecting a Chinese partner the most important characteristic is seen as the partner’s ability to negotiate with the host government.

With respect to the legal environment in China, more than 72 per cent of respondents to the survey questionnaire rated ‘negotiation’ as the most efficient dispute resolution method and 94 per cent agreed that to avoid disputes rather than taking legal action is a Chinese problem-solving approach. Also, 94 per cent agreed that the Chinese prefer to suppress or settle matters in private through negotiation and compromise rather than to engage in litigation with the relevant government authority. It is traditional in China

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26 Ibid.
to reach agreement and resolve disputes through a process of friendly consultation. The 1985 *Foreign Economic Contract Law*’s chapter on dispute resolution begins with a statement to the effect that when contractual disputes arise, the parties should do everything possible to resolve them through consultation or third party mediation. Perhaps surprisingly, in the past, parties would have often preferred to abandon their rights rather than go to court.

Additionally, regarding the administrative system in China, more than 69 per cent of those surveyed with the questionnaire considered good communication with the Chinese government important or very important for their business operation. More than 91 per cent believed that utilising Chinese partners or networks was the most efficient way to deal with administrative matters in China and 94 per cent believed tolerance and compromise are necessary to deal with Chinese officials. More than 55 per cent had informal relationships with administrative institutions. All respondents agreed that the development of networks is a necessary requirement for doing business in China. The Chinese culture is distinguishable from western culture in many ways and this includes the ways that business is conducted. For example, the Chinese prefer to deal with people they know and trust. On the surface this does not seem to be much different from doing business in the western world but, in reality, the heavy reliance on relationship means that western companies have to make themselves known to the Chinese before any business can take place. Furthermore, this relationship is not simply between companies but also between individuals at a personal level.

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level. The relationship is not simply a precursor to, for example, sales being finalised, but is an ongoing process. The company has to maintain the relationship if it wants to do more business with the Chinese.

The survey questionnaire responses gave a glimpse of the nature of problems in the foreign investment environment in China. Respondents noted that, in the quarter of a century since the commencement of the ‘Open Door Policy’ in 1979, the Chinese government has made great efforts to reduce barriers to foreign investment and to improve the investment environment through legal reform and reintroduction of a series of preferential policies.  

Hundreds of new laws and regulations governing foreign investment have been passed and been given effect in order to improve the foreign investment environment. Chinese legislative and administrative bodies have shown remarkable diligence and energy in formulating and adopting rules on a wide variety of subjects, many being technically complex. As well, China’s accession to the WTO in 2001 promised further foreign investment liberalisation. General commitments made by China have included non-discriminatory treatment of foreign and domestic enterprises, adherence to WTO rules on intellectual property rights, and elimination of various requirements on foreign investment. However, the written laws do not appear to be functioning in ways...
that could have been reasonably anticipated. Some socio/legal phenomena, such as the administrative discretionary power and networks, have resulted in the formal laws being ignored or manipulated. In response to the interview question ‘What are the major difficulties for a successful business in terms of cultural factors?’ an interviewee, who was conducting a cooperative business with an influential Chinese state owned enterprise, said:

One of the big difficulties is finding the right person, the right decision-maker with the right amount of power who can implement things so you can do business. There is no doubt that relationship is very important depending on what type of business you’re dealing with. The business I deal with is a state owned enterprise, so obviously business, and government connections, and relationship and friendships come with that.

This observation is in line with the views expressed by the other interviewees, reinforcing the idea that connections with people who have power may be crucial for business operations and that awareness of this aspect is important for foreign investors. The role of the government or the state owned enterprises associated with governmental power in the economy was always protected, and important economic decision-makers at all levels — from the members of the State Council down to the managers of factories — comprised a powerful supplementary network for transmitting and implementing the economic goals and policies of the government.

Connections can be valuable in any country, but in most western countries the primary focus of a business is its product or service because buyers and sellers deal at arm’s length. In China, the quality of the product is important, but Guanxi is even more

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35 Interview with Interviewee ‘13’ (Sydney, 15 December 2004).
It can take a long time to develop Guanxi independently, but it can be accomplished vicariously. The most effective vehicle is the joint venture with a local participant that has Guanxi at levels appropriate to the transaction.

Experiences of institutional interference also appear unavoidable for foreign investors. One of the interviewees, relating his business experience in China said;

We did experience a lot of interference from Customs. We were importing goods into China and there was constant interference from Customs. Mostly it was in relation to the non-giving of ‘kick-backs’. Whether you are importing or exporting products you do have to have some relationship with Customs. I feel that Customs officials still have a lot of local, domestic authority and power in terms of clearing your goods quickly and agreeing on the value of the cleared goods, calculation of VAT – those types of issues.  

Whilst facing a dramatic economic transition, the Chinese government is confronting a dilemma. The need to enact a set of concrete, objective laws and regulations that would assist long term economic development by increasing certainty conflicts with the reality that such rules, in the short term, would limit the flexibility of the government to implement changes to policy to adapt to the economy. The government has clearly decided to retain flexibility in the administration of law to deal with different situations and varieties of human behaviour so regulators continue to be given enough discretionary power to adapt rules and regulations to local circumstances. For example, the ZunYi Municipal Government promulgated a local administrative decision regarding enhancing credit grants for small business for promotion of local economic development. It is clear that a local government is entitled to enact local administrative rules in order to promote

38 Interview with Interviewee ‘13’ (Sydney, 15 December 2004).
39 Kui Hua Wang, Chinese Commercial above n 29, 43.
local economic interests. That discretionary power, and more particularly its use, misuse or abuse, is one of the matters at the heart of many of the difficulties reported by respondents. Whilst the interviews, and to some extent the questionnaire responses, can be regarded as anecdotal to some extent, they do serve as pointers to some of the essential features of the social, cultural and legal aspects that are pertinent to the central questions of this research.

8.4 Relating the Survey Responses to Local Chinese Conditions

This study demonstrates how law is affected by, and in turn affects, social relationships in China. Because of the Chinese emphasis on relationships, trust is regarded as more important than any written document supposedly evidencing commercial arrangements. For example, if the Chinese party and foreign/western party have agreed on a new joint venture, the Chinese party will want the terms to be as broadly framed as possible but the foreign party wants to be specific about all details. This situation is very common during a negotiation between Chinese and westerners. Successful business dealings with the Chinese require more than competent negotiating skills. An understanding of the essential aspects of Chinese culture is vital.41

There are long-established customs and practices that are most closely associated with, but not limited to, cultural elements in a society. These include informal constraints embodied in traditions, accepted conventions, and subconsciously accepted rules and customs.42 Such institutions develop over time through social interactions, reflecting

41 Bee Chen Goh, ‘Trade and Investment Negotiation’ above n 37, 34.
actions that are appropriate and conceivable.\(^\text{43}\) In a commercial context in China, such rules exercise their influence quietly upon maintaining relationships and mutual obligations in Chinese society.

Such rules are well-established, and can be traced to China’s long history and rich culture, but formal laws and case precedents were not part of the institutional structure for social governance.\(^\text{44}\) In addition, certain normative and cultural elements and conventions manifest themselves in the way of doing business in China, as evidenced by the heavy reliance on relationships rather than the formal rule of law.\(^\text{45}\)

### 8.5 Central Issues Affecting Foreign Investment Operation

One of the aims of this research survey was to analyse business conditions in China concerning social and legal aspects from foreign investors’ business experience. It may not reflect the entire picture of the business environment; however it can provide an opportunity to gain some valuable insight. As the Australian Foreign Affairs, Defence and Trade Reference Committee suggested:

> Clearly, Australian companies need to be able to read accurately the messages and signals being conveyed to them in their dealings with Chinese businesses. They also need to know how to respond appropriately and to their advantage.\(^\text{46}\)

Openness to foreign investment is an important, but not sufficient, condition for sustained GDP growth for China. It is important that good macro-economic policies are

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\(^{45}\) Ibid 44.

\(^{46}\) Foreign Affairs, Defence and Trade Reference Committee, *Opportunities and Challenges* above n 5, 232.
complemented with a host of other institutional policies that together comprise the total investment climate. China’s solid macro-economic performance over the past decade is unquestionably sound. China has gradually improved its investment environment over the last three decades.\textsuperscript{47} However, some continuing impediments in the investment climate in China have been identified by western countries that have various levels of economic engagement with China. In this respect, the Australian Foreign Affairs, Defence and Trade References Committee observed:

> In 2005 … in some cases there were grounds for Australian businesses to consider China a ‘risky place to do business’. Evidence pointed to a legal and regulatory environment that is complex, time-consuming, expensive, uncertain and at times discriminatory. China is a country that, despite reform, still has inadequate legal protections, poor corporate governance, intellectual property rights violations, government interference—particularly at the local level—and corruption.\textsuperscript{48}

> Two analysts of the International Monetary Fund (IMF) pointed to explicit restrictions written into laws and regulations as well as other restrictions that are an important part of the overall investment climate in the minds of investors.\textsuperscript{49} Corruption and bureaucratic red tape which raise business costs are part of some implicit disincentives for investment in China.\textsuperscript{50}


\textsuperscript{48} Ibid.


8.5.1 Bureaucracy

Chinese officials and scholars have debated the merits of tight control over China’s economic, social and political stability against the advantages of free markets. The phrase *Yi kai jiu luan, yi zhua jiu jin* (‘as soon as you open it up, you get chaos, but if you grasp it tightly, it dies’) expresses this balancing act in vivid terms, and it suggests that government — not the markets or the individual — is the most powerful force in the Chinese economy. Every firm in China, whether foreign or domestic, public or private, must manage its relationship with government as carefully as it would a relationship with a key investor or customer.

The architecture of Chinese government is like a matrix, with geography on one dimension and the functional areas of government on the other. On the geographic axis, there is the central government in Beijing, which controls the next level, which consists of the provinces and China’s four largest cities. Below the provinces are cities and counties, with townships and villages at the fourth and lowest level. On the other axis, powerful government ministries control key sectors of the economy and locate offices at each of the geographic levels. At each node in the matrix, there is tension between geographic and functional interests, which can dramatically slow the decision-making process.

Foreigners often believe that China’s government is monolithic, with consistent policies and practices across all bureaucratic levels and geographic areas and that the Communist Party is the organised expression of the will of society.\(^5\) This perception largely springs from the fact that the central government generally does do a good job of speaking with one voice on key policy matters. For example, the Central Committee of the

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Communist Party is served by a Secretariat and other departments. At provincial, municipal, and county levels there are similar leadership bodies (CCP committees) and staff offices. Every agency of the national, provincial, and county governments has within it a Party committee. Policy matters emanate from the central government and accordingly will be passed on to provincial, municipal and county level governments as guidelines for implementation.\(^{52}\) Bureaucratic debates over policy are usually concealed from the public.\(^ {53}\)

There is a tremendous variance in how the goals and policies of the centre are interpreted and implemented at the other levels of government. One important reason is simply the size of the country, where single provinces have populations that exceed those of some of the largest countries of Europe. For example, according to a report from National Statistics of China in 2011, the population of Guangdong Province in November 2010 was 104,303,132 ranking the highest provincial population in China.\(^ {54}\) Germany’s population in 2011 is 82,302,000.\(^ {55}\) Regional diversity in China has increased over the past decades of economic reform, particularly with regard to personal incomes. According to statistics from the United Nations, China’s per-capita GDP in 2009 was USD3769.\(^ {56}\)

\(^{52}\) <<关于进一步贯彻落实中央落实政策小组扩大会议纪要的补充意见>> [Supplementary Opinions Concerning Enlarged Meeting Memorandum of Further Implementing Policies from Central Committee] (People’s Republic of China) General Office of Central Committee and State Council, 22 February 1986.


compared to USD277 in 1979.\textsuperscript{57} Policies from the central government are often seen to be vague and open to interpretation. This would imply that central policy-makers want local leaders to be able to adapt them to local conditions.

Local autonomy in China can often result in increased negotiating power for foreign firms. When local governments have the discretion to award financial incentives to foreign investors, these investors can negotiate simultaneously with multiple local governments, bargaining with each to achieve the most satisfactory outcome. Similarly, when a foreign company is established in multiple jurisdictions, the potential of downsizing or the promise of expansion can provide the foreign investor with negotiating power over local governments. The effect may be further magnified when a number of foreign companies co-locate in the same jurisdiction and coordinate their pressure on local government. A research study, conducted by Zhejiang University School of Economic and Development and Reform Committee of Zhejiang Province, indicated that the competition to attract foreign investment projects between local governments in the Yangzi Delta region has damaged national interests.\textsuperscript{58} For example, the Kunshang Technology Economic Zone provided incentives to export-orientated foreign investment with a 10 per cent income tax rate\textsuperscript{59} which is lower than the national income tax rate of 15 per cent for foreign investment according to the \textit{Foreign Investment Enterprise and Foreign Enterprise Income Tax Law 1991}. 


\textsuperscript{58} 谢晓波, 黄炯 [Xie Xiaobo and Huang Jiong], ‘长三角地方政府招商引资过渡竞争行为研究’ [Study of Over Competition to Attract Foreign Investment between Local Governments in the Yangzi River Delta] (2005) 8 技术经济 [Technical Economy] 70.

\textsuperscript{59} Ibid.
However, when local concessions to foreign firms extend beyond guidelines set by higher levels of government, foreign investment firms may lose their power to appeal when disputes and/or clear malfeasance occurs. Similarly, when foreign firms start their negotiations at the central level, as is often the case with large projects, it is in their interest to locate operations in areas with close relations with the central government. When, as an example, Motorola negotiated its landmark deal to open a major manufacturing centre in China, it traded on the unprecedented size of its capital commitment to gain complete ownership control of its operations, a concession that could only be approved by the central government.\(^60\) When the production facility was located in the northern industrial city of Tianjin, it meant that the project would be geographically close to Beijing, and that its daily interactions would be with the administration of the Tianjin Municipality, which reported directly to the central government.\(^61\)

The often fluid relations between central and local governments are only one reason why Chinese bureaucracy is much less monolithic than it seems. Although the central ministries in Beijing seem to have clearly defined boundaries of authority, these are the result of years of aggressive negotiation and in-fighting among ministries.\(^62\) When there is a new and volatile development in Chinese society, such as the rapid rise of the internet, rival ministries will compete intensely for the right to monitor, regulate, and tax the new

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\(^61\) Ibid.

activity. New regulations and policies are often vague and poorly defined because they are the outcome of a compromise between rival bureaucratic factions. These rivalries can continue for years, and often the intervention of one of China’s top leaders is required to settle disputed matters. In fact, at all levels of government, decisions that may seem routine are often pushed up through the bureaucracy until they reach an appropriate senior official. For example, the central government issues guidelines to regulate how local governments should exercise administrative power in order to prevent these organisations from abusing such powers.

Every few years, debates about political reform have been published that include the suggestion that China is on the verge of political disintegration into a feudal collection of municipalities, provinces, and geographic regions. There are certainly powerful separatist forces at work in China, largely attributable to China’s vast size and population, geographical barriers to communication and transportation, linguistic and cultural differences, growing income inequality, local protectionism, and vastly different attitudes toward the outside world. These forces are concrete and easily understood by foreigners, while the forces that maintain China as a single political entity are not as obvious. These include the increased economic interdependence among China’s regions, including rapidly

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63 迟福林 [Chi Fulin], ‘行政体制改革与政府转型’ [Administrative System Reform and Governmental Transform] (24 January 2011) 瞭望新闻周刊 [Liaowang News Weekly]


increasing exchanges of capital and labour, legal changes that have increased the centre’s share of tax revenues, and a personnel system that rotates the top political appointments in local governments. These forces, however difficult for the outsider to appreciate, are at least equal in power to the forces that threaten to pull China apart. China has been aware that social conflict arising from uneven economic development between and within regions has threatened the stability of society. Discussions and studies on these matters in government departments and academic institutions have been active and open. The central government can still apply overwhelming pressure on specific locations for specific purposes for a limited time, although it often does have to select its battles carefully.

Responses to the survey for this research indicate that for most foreigners operating businesses in China, bureaucracy comes in the form of daily interactions with the many local agencies that control, regulate, tax, inspect and monitor the foreign enterprise. Interviews with the survey participants suggested that good connections with local government can play an important role in relation to successful business operation in China.

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From a survey of executives of electronics enterprises in Hong Kong with business operation in the Pearl River Delta China, the results confirmed the importance of personal relationships for doing business in the Pearl River Delta and suggest that companies rely on personal relationships for business not only for cultural reasons but also to cope with deficient legal and political institutions. While it is possible to have smooth cooperation with local government, particularly if the foreign enterprise has the support of local leaders, it is common for senior managers in both foreign and domestic firms to spend a great deal of time sorting out problems with the Chinese bureaucracy.

Sudden changes in the regulatory environment are not random events, and the complaint that the Chinese bureaucracy behaves irrationally is not only inaccurate but also unhelpful regarding a possible resolution of the problem. A new, unannounced tax on a foreign enterprise, for example, can be the result of many factors. The local tax agency may be experiencing a decline in tax revenue from other sources, possibly because the local economy is heavily dependent on loss making, state owned enterprises. There may be a renewed sense that foreign firms are already privileged through a variety of laws and regulations that give them various financial incentives to invest in China, and that a new tax will ‘level the playing field’ with domestic firms. Regrettably, the new tax may also be an attempt on the part of a local official to extract a bribe from the foreign firm. According to Jia, Yan and Yan:

Research on foreign headquartered companies investing in the Suzhou Economic Zone, Jiangsu province was an example. Suzhou Economic Zone has lost its financial revenue from annual growth rate of 68 per cent (1994 – 2004) to 24 per cent in 2005. The reason for

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this decline was that major companies such as Nokia, Nike and Adidas moved out to the Beijing and Shanghai areas as these areas had better taxation regimes than other regions.\footnote{贾康，阎坤，鄢晓发 [Jia Kang, Yan Kun and Yan Xiaofa], ‘总部经济地区间税收竞争与税收转移’ [Headquarter-Based Economy, Regional Tax Competition and Revenue Transfer] (2007) 2 税务研究 [Tax Affair Research] 12–7.}

In the interview section of the survey for this research, in response to the question — ‘Has your business in China experienced institutional interference, for example in the form of the exercise of discretion by an authority?’ — one of the interviewees related their business experience in China in the following manner, admitting that there were still problems in this area:

We’ve had problems where various levels of government have interfered. We’ve won projects then they’ve tried to overturn them at a high level of government – effectively it was corruption. They had their favourite entities that they wanted to put in there for whatever reason. We’ve challenged that on a couple of occasions – sometimes we win, sometimes we lose – but that’s part of the learning process. They’ve caught on that they still need to think those things through sometimes.

This respondent expressed a number of concerns regarding their company’s experience in China. The questions of return on investment, lack of legal sophistication, and lack of foreign investor control were indicated:

In our business there is a desire by Chinese firms to tap into the experience of foreign firms and that’s good and there is also a strong desire by foreign firms to be strongly involved in Chinese projects. What is concerning and what has happened to us is that we have put a lot of intellectual property and effort into moving a project forward with very little return including where we’ve given ideas and we’ve trained people and have introduced them to projects here in Australia and the like. All of this in the early parts of a project — only to find in the later parts of the project we are, sort of ‘pushed out’. That’s a risk management procedure so you need to watch how much you give for what you get back – so you need to be aware of that issue.\footnote{Interview with Interviewee ‘7’ (Sydney, 2 December 2004).}

While responding to a question related to ‘institutional interference’ this interviewee had, perhaps unwittingly, made reference to an issue (possibly specific to his own industry) arising from a cultural difference as they perceived it, stating:
There is still a cultural thing in China where I think, even in the major cities and even in sophisticated companies that they don’t quite grasp the value of expertise and the value of ideas et cetera, they think that the value of that is so little compared to the value of say a building or a structure. They tend to minimise the value of expertise. In my area of business, the Chinese are second to none in the world. They are very, very experienced and very good at dealing with detail and implementation but not very good at ideas – particularly at bringing in new technology and the expertise that may be on similar projects overseas – which are very valuable to China but they tend to under-value that and therefore, from a business perspective we need to be very careful about how much we give for how much we get back. So that’s a major cultural issue I think.74

Another interviewee investor expressed their experience somewhat differently by reference to the difficulties and delays in the examination and approval process, observing:

Well, it’s taken 5 years to get approval, to get a licence to practise in Shanghai. I don’t think the reason is interference. I think that when we applied, the legal processes in China were not yet … were still in the embryonic stage. Now you can not expect the government to suddenly become mature and to change a system that has been in practise for … so therefore, I wouldn’t call it interference but they need a long time to grasp the western system.75

Evaluating the capabilities of a Chinese firm involves much more than simply assigning it an ownership category. Some state-owned firms are very profit driven, and collectives can have many of the shortcomings of state-owned enterprises. Privatised firms vary dramatically in their performance and profitability. According to Chow and Yau’s research, foreigners tend to identify most strongly with market-oriented firms, since they can readily understand the sources of their success.76 The local firm’s knowledge of the culture and the market and sharing of financial risks are also reasons why joint ventures are set up.77

In many industries, a profit-oriented approach is not enough. Good connections with government may be essential in order to secure bank loans, favourable interpretations of

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74 Interview with Interviewee ‘7’ (Sydney, 2 December 2004).
75 Interview with Interviewee ‘4’ (Sydney, 20 December 2004).
77 Ibid.
regulations, access to supplies and materials, and other benefits. State-owned enterprises by
their nature are hard-wired into the Chinese bureaucracy, but other types of firms must use
their Guanxi, or informal connections, to have any influence.78

8.5.2 A System of Interpersonal Connections

Guanxi, literally meaning ‘relationships’, stands for any type of relationship. In the Chinese
business world, however, it is also understood as the network of relationships among
various parties that cooperate with and support each other.79 This essentially implies a
mentality amongst business persons of exchanging favours, which are expected to be
reciprocated regularly and voluntarily. The Chinese, like business people elsewhere, have
their unique way of conducting business.80 Many China experts refer to a business culture
in China that is based on strong family networks or cultural ties secured in Guanxi
(interpersonal) connections that are underpinned by strong Confucian ethics.81 Therefore, it
is an important concept to understand if one is to function effectively in Chinese society.

Regardless of business experiences in one’s home country, in China it is Guanxi
that makes all the difference in ensuring that business will be successful. By the use of
Guanxi, the organisation minimises the risks, frustrations, and disappointments when doing
business in China. Often it is acquiring Guanxi with the relevant authorities that will
determine the competitive standing of an organisation in the long run in China. Moreover,

79 Lisa A Keister, ‘Guanxi in Business Groups: Social Ties and the Formation of Economic Relations’ in
Thomas Gold and Doug Guthrie (eds), Social Connections in China: Institution, Culture, and the Changing
81 Senate Foreign Affairs, Defence and Trade Committee, ‘Building a Better Trading Relationship and
the inevitable risks and barriers a foreign business will encounter in China will be
minimised when it has a Guanxi network working for it. That is why the correct Guanxi is
so vital to any successful business strategy in China.

Survey interview respondents suggested that although developing and nurturing
Guanxi in China is very demanding in terms of time and resources, the time and money
necessary to establish a strong network was well worth the investment. It is normal practice
for domestic businesses in China to establish wide networks with their suppliers, retailers,
banks, and local government officials.

In response to the question in the interview survey — ‘Establishing networks is
considered a very important aspect of doing business in China. Can you give examples of
networks you have developed and why they are important? How does this compare with
doing business in other western countries?’ — one interviewee said:

Networking has become the buzz-word if you have business in China because everybody
will talk about networks. But networks are ... starting social contacts is what networks are
all about because the Chinese way of doing business is establishing social contact, by
establishing a network. In the west a network doesn’t seem to be so important. The Chinese
culture is to get to know the person before doing something. In the west it’s not so much to
get to know the person but the firm is known or the firm is an associate member or the firm
is referred to. It will depend on your reputation, your referral, whereas in China and other
Asian countries they would like to put a face to a name.\textsuperscript{82}

Chinese culture can be distinguished from Western culture in many ways, including
how business is conducted. Evidence has shown that the foreign company needs to fully
maintain the relationship if it wants to do more business with the Chinese.\textsuperscript{83}

\textsuperscript{82} Interview with Interviewee ‘1’ (Sydney, 23 November 2004).
\textsuperscript{83} Scott Wilson, ‘Law Guanxi: MNCs, State Actors, and Legal Reform in China’ (2008) 17 \textit{Journal of
Contemporary China} 48, 48.
Since Guanxi also functions as an information exchange network, companies with wide Guanxi or relationship networks often have much higher performance than companies with little or no relationship with Chinese colleagues. According to a new survey of more than 4,000 entrepreneurs, business managers and aspiring entrepreneurs in China, 93 per cent of business owners say Guanxi, the networks and relationships (primarily with the state) are important to their own business success.\(^8^4\)

As a result, in practice, commercial activities have heavily relied upon social networking. Difficulties inevitably occur for business people or organisations without Guanxi. According to Pitta’s investigation, in 1993 AST sold 140,000 machines in China (31 per cent of the personal computers purchased in the country). China’s entire personal computer market last year came to USD638 million, less than half the USD1.4 billion in revenue that AST alone reported in the 1993 fiscal year. The success of AST personal computer sales in China occurred because AST was in a good position to set up business in Hong Kong, where AST co-founders Albert Wong and Thomas Yuen had knowledge of the importance of personal relations in making these sales.\(^8^5\) Attention to the development of social networks may require very significant input of time and resources for business operators. For a western business organisation this is often a completely new and challenging process because it somehow moves the business centre of concentration upon marketing of products towards paying more attention to apparent socialising as the core of developing Guanxi.\(^8^6\) According to Yang’s analysis, in China, Guanxi can assist transnational companies not only to obtain sources of information and resources, including


business opportunities, government policies, scarce necessities and availability of professionals, but also be of great value to them in terms of building up corporate reputation, enlarging market share and even motivating employees.87

In relation to a common problem experienced by new foreign investors in China, that of identifying then communicating with, the appropriate local contacts, one of the survey interviewees explained:

My experience is that many foreigners have gone to China and stayed in the wrong hotels, bought food for the wrong people and had many meetings with the wrong people. They have gone over very unsure of what’s going on. I think a very key thing is to find the right people to deal with who will make decisions quickly and to also find the person who has the power to make those decisions rather than wasting time with too many other people who have promises of connections when in fact it’s not the case. One of the big difficulties is finding the right person, the right decision-maker with the right amount of power who can implement things so you can do business. There is no doubt that relationships are very important depending on what type of business you’re dealing with.88

This interviewee also raised an important underlying difference in respect of ‘ease of operation’ for the foreign investor when dealing with a State owned enterprise as compared to operating in the private sector, saying:

The business I deal with is a state owned enterprise, so obviously business, government connections and relationships and friendships come with that you know. If you were dealing with the private sector – yes, things can happen much more quickly because you don’t have the bureaucracy attached as with government business but the risk is quite higher. There are a lot of entrepreneurs now in the private sector who can make promises to do things very quickly but the risks are significantly higher too. So I guess you’ve got to identify your key sector – whether you’re going to deal with state-owned or government business or you’re going to deal with the private sector.89

In a business context, Guanxi can take place between a firm manager and a government official whose decisions can have an impact on the firm. Business associates may also rely on Guanxi, using their personal relationships to ensure that mutual

88 Interview with Interviewee ‘13’ (Sydney, 15 December 2004).
89 Ibid.
obligations are met. The strongest forms of *Guanxi* develop between classmates, blood relations, and people from the same city or province when they are living in other parts of China. Foreigners can and do resort to gifts and other favours to create a sense of obligation on the part of the receiving party, but even under the best of circumstances they can never compete with these stronger forms of *Guanxi*.

However, one of the biggest mistakes that foreigners can make in China is to assume that the cultivation of *Guanxi* alone will lead to success. Personal relationships in business matter everywhere but no one suggests that they can entirely replace good business sense.

The Chinese can be very critical of someone who is seen to use *Guanxi* extensively for personal gain. According to Fan’s study, *Guanxi* may bring benefits to individuals as well as the organisations they represent but these benefits are obtained at the expenses of other individuals or firms and thus detrimental to the society.\(^90\) The Chinese can also have mixed feelings toward the simple, ingenuous person at the other end of the spectrum who has no *Guanxi* skills at all. To westerners, relationships help the individual however, to the Chinese, they also define the individual. In China, if you are related to a senior official you will be treated with more respect.\(^91\) While admiring the pureness of their morals, they will also lament their inability to get anything done in the real world. The vast majority of Chinese fall between these extremes. They may possess competent *Guanxi* skills but will use them selectively and only when official procedures have failed. At the same time, they

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may have a circle of friends within which favours are done out of genuine affection and where any expectation of reciprocity or material gain would be considered to be rude.\textsuperscript{92}

Several factors suggest reasons for the enduring importance of \textit{Guanxi} in China.\textsuperscript{93} One is the continuity of Chinese tradition, including heavy government intervention in the economy, a powerful bureaucracy and the freedom of local officials to interpret policies and regulations emanating from the central government.\textsuperscript{94} Also, there is a sense that the complexity and speed of economic transition have outpaced the ability of written rules and official institutions to support it.\textsuperscript{95} The seeming persistence of \textit{Guanxi} in Chinese society, in spite of conscious and conscientious efforts to eradicate it by Communists and capitalists alike, offers interesting insights into the complex interactions of culture, institutions and social practice in a modern society.\textsuperscript{96}

As China has become wealthier and more urbanised, the concept of \textit{Guanxi} is increasingly seen as a vestige of traditional society and of the worst aspects of socialism. Critics see it as fuelling the country’s rampant corruption, and as an obstacle to China becoming a modern society based on the rule of law.\textsuperscript{97} To suggest that \textit{Guanxi} is still important can even be insulting to some managers and officials in China’s largest cities. \textit{Guanxi} is a laborious, time-consuming activity, and its practice contradicts the fast-paced, cosmopolitan image cultivated by China’s coastal cities. Moreover, many educated Chinese

\begin{itemize}
  \item \textsuperscript{93} Irene Y M Leung and Rosalie L Tung, ‘Achieving Business Success in Confucian Societies: The Importance of \textit{Guanxi} (Connections)’ (1996) 25 \textit{Organisational Dynamics} 54, 65.
  \item \textsuperscript{94} Xinxiang Chen, ‘State Intervention and Business Group Performance in China’s Transition Economy’ (PhD Dissertation submitted to University of Minnesota, April 2009) 80.
  \item \textsuperscript{96} Thomas Gold et al,‘An Introduction to the Study of \textit{Guanxi}’ in Thomas Gold, Doug Guthrie and David Wank (eds), \textit{Social Connections in China: Institutions, Culture and the Changing Nature of Guanxi} (Cambridge University Press, 2002) 1, 4.
  \item \textsuperscript{97} Ibid 3.
\end{itemize}
feel that a stronger, rule-based legal system — which would take away the freedom of officials to interpret regulations in ways that can benefit them personally — as essential for China’s continued development.98

8.5.3 Claimed Corruption of Government Officers/Employees

Many foreigners assume that the tradition of Guanxi in China goes a long way toward explaining China’s serious problem with corruption.99 It is certainly true that the Guanxi-related exchange of gifts and favors100 would be considered bribery in most countries (and increasingly in many parts of China)101, but China’s corruption problem is mainly the result of weak law enforcement, vague regulations that allow government officials to interpret them on a case by case basis, and its very prevalence, which gives bribe-takers a sense of safety in numbers. Dai suggested that for complete success in eradicating corruption, China would have to adopt the democratic model of checks and balances.102

The conventional definition of corruption is the use of an official office for private gains, a definition that does not include private sector crimes such as embezzlement and fraud.103 The Criminal Law Amendment 2011 specifies that any public servant who takes advantage of their position to encroach, steal, swindle or use other illegal means to take

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98 Yadong Luo, Guanxi above n 80, 174.
100 Ying Fan, ‘Guanxi’s Consequences above n 90, 371.
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possession of public property shall be guilty of the crime of embezzlement. Any person, who is appointed or authorised by state organs, state-owned companies, enterprises, institutions and other organisations to manage and administer state property, who commits any of the above acts shall be guilty of a crime of embezzlement. The Chinese context is much more complicated because managers in state-owned enterprises, who report to government ministries rather than private investors, have opportunities for embezzling state funds that are not available to their counterparts in more market-oriented firms.

Unlike the members of many authoritarian governments, China’s leaders openly acknowledge that it is one of China’s most significant economic and political problems. This attitude is in response to polls and surveys indicating that corruption is the source of tremendous resentment toward the Communist Party of China. This is because, as China is a one-party state, much of the corrupt activity in China is undertaken by Party officials, which means that attempts to battle corruption require the Party to police itself, an inherently difficult task anywhere. Corruption has worsened since the economic reforms began in the late 1970s. During the Tiananmen student protests of 1989, corruption was one

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105 Ibid.
107 <<中共中央国务院关于反腐败斗争近期抓好几项工作的决定>> [Decision Concerning Carrying Out a Number of Works of Anti-Corruption] (People’s Republic of China) Central Committee and State Council, 5 October 1993.
108 Ibid art 3.
of the major complaints of the protesters.\textsuperscript{110} Pre-reform corruption did exist, but because China was poorer and much more tightly controlled, bribes came in non-monetary forms, such as better housing and permission to travel abroad.\textsuperscript{111} The corruption problem is now so severe that it has led some to argue that the only solution is political reform leading to a democracy and that this should be the direction of future anti-corruption efforts.\textsuperscript{112}

Corruption is difficult to measure directly. Those who pay and those who receive bribes are both committing illegal acts. It is axiomatic that secrecy is part of the arrangement and that most of the time both sides are satisfied with the transaction. Surveys on corruption\textsuperscript{113} have measured perceptions among diplomats, academics and executives but the results from such surveys can be misleading. Increased arrests and convictions,\textsuperscript{114} for example, can mean an increased commitment to fighting corruption, but it can also create the perception that the problem is getting worse. In any event, the Chinese widely believe that arrests for corruption are politically motivated and often interpret a major arrest

\begin{footnotesize}
\begin{enumerate}
\item Zengke He, ‘Corruption and Anti-corruption in Reform China’ (2000) 33 Communist and Post-Communist Studies 243, 243.
\item ‘Corruption and Anti-Corruption’ (1999) 1 Inside China Mainland 1, 1. According to recent revelations by the Supreme People’s Procuratorate Procurator, General Han Shubin, 1,820 cadres at the county/section level and above were implicated in cases of alleged crimes handled by procuratorial agencies in China in 1998, including former deputy governor of Hubei Meng Qingping and two other province/ministry level officials.
\item 曹建明 [Cao Jianming], <<最高人民检察院工作报告 2009>> [The Supreme People’s Procuratorate Annual Report 2009] (10 March 2009) The Central People’s Government of the People’s Republic of China <http://www.gov.cn/test/2009-03/17/content_1261384.htm> . The report indicated that there were 33,546 corruption related cases in 2008 and 41,179 people were prosecuted. There was a one per cent increase compared to 2007.
\end{enumerate}
\end{footnotesize}
as a sign that the target of the investigation, while certainly guilty of corruption, has possibly lost out to other more powerful political enemies.\textsuperscript{115} 

Research has indicated that China’s corruption epidemic partially results from the transitional nature of China’s economy.\textsuperscript{116} Pockets of very extensive entrepreneurial vitality exist in an overall environment that is still subject to heavy government control, creating perfect conditions for corrupt activity. A manager in a private firm, for example, is faced with a long list of regulations, taxes, licensing fees and fines, sometimes reaching the point where financial obligations to the state exceed the firm’s total revenues. A close relationship with a local government official may be an obvious solution. The forms of corruption can be as simple as a one-time bribe payment or as complex as a partnership in the business. While these arrangements are illegal, it is often argued that they are necessary in order to develop the private sector.\textsuperscript{117} Moreover, as long as the official’s gains are modest, the chances of detection and punishment are often minimal. This is because, according to the \textit{Criminal Law Amendment 2011} and the \textit{People’s Procuratorate Provisions Concerning Filing Standard of Cases Accepted for Investigation}, a public servant’s acceptance of a monetary amount of RMB5,000 or more shall be regarded as constituting the crime of bribery.\textsuperscript{118}

\textsuperscript{117} Ibid 16. 
American foreign investors are subject to the terms of the *Foreign Corrupt Practices Act 1977* (USA) (FCPA) (substantially revised in 1988),\(^{119}\) which effectively criminalises the paying and taking of bribes by Americans and US firms. According to Campos, since the FCPA punishes American investors when they or their partners in the joint ventures bribe local officials, some American investors in China may prefer wholly foreign-owned enterprises over joint ventures because of the FCPA.\(^{120}\)

Australia signed the *United Nations Convention against Corruption 2003* (UNCAC) on 9 December 2003 then ratified it on 7 December 2005 and has implemented the mandatory requirements and some non-mandatory requirements.\(^{121}\) Westerners accuse Asian firms of paying bribes more readily than other foreigners, but the Asians reply that the Chinese demand bribes from them more often.\(^{122}\)

As corruption has become a more public issue in China, with frequent news reports of major arrests, it has become more subtle and difficult to detect. A direct payment from a foreign firm to a local official in order to avoid a new tax, for example, may attract too much attention. Instead, hiring a retired official from the same tax office, who then serves as a liaison between the two parties in exchange for a ‘consulting fee’, serves the same purpose.

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\(^{119}\) Within the United States federal legislation, a facilitating payment or ‘grease payment’, as defined by the *Foreign Corrupt Practices Act* (FCPA) of 1977 and clarified in its 1988 amendments, is a payment to a foreign official, political party or party official for ‘routine governmental action’, such as processing papers, issuing permits, and other actions of an official, in order to expedite performance of duties of non-discretionary nature, that is, actions that they are already bound to perform. The payment is not intended to influence the outcome of the official’s action, only its timing.

\(^{120}\) Shuhe Li and Peng Lian, ‘Governance and Investment in China’ in José Edgardo Campos (ed), *Corruption: The Boom and Bust of East Asia* (Ateneo De Manila University Press, 2001) 69, 80.


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purpose, but it is not clear if such an appointment breaches any law. The media often reveals the corrupt activities of officials using their influence for payment of bribes.123

Guanxi can take on many forms. It does not have to be based on money. Trustworthiness of both the company and individual is an important component. Following through on promises is a good indication of this. Frequent contact fosters friendship as well. Chinese feel obliged to do business with their friends first. There are risks with this system as well. When something goes wrong, the relationships are challenged, and friendships can quickly dissolve.

In response to the following questions — ‘If we accept that there are still difficulties of achieving foreign investment success in emerging economies such as in China, what do you consider are the major difficulties for a successful business in terms of cultural factors? What factors other than cultural factors are important in your experience?’ — one interviewee commented specifically on legislative overlap and complexity:

I think there is a lot of concern about in terms of a public (listed) company like ours about risk management and the status of legislation in whatever area of business you are in. In the last five years certainly, the rate of development of legislation by the central government has been very rapid and that’s good. A lot of the legislation is, in my mind, good legislation. It is well-meaning. It is still very complicated because you have that level of legislation and the multiple level of legislation at provincial level and city level as well. What I think is the biggest challenge at the moment is the implementation of that legislation down at the city level, and the cross-over and the duplication that exists in some areas. So from that point of view one needs to be extremely careful when looking at that from a risk management viewpoint. Having said that, again I think that things have changed quite dramatically.124

124 Interview with Interviewee ‘3’ (Sydney, 15 December 2004).
On the issue of official corruption, this interviewee indicated that, while the situation was, in their view, improving, it remains as a serious risk factor for foreign investors:

Ten years ago it was – it was risky. It’s not as risky now but one needs to be extremely careful. So that’s one area, another area I think that causes concern for public companies, particularly Australian companies, American companies and British companies, is corruption. That still exists in my experience of various levels of government. Again, not so much now. I think in the bigger cities things have moved on a bit and things are more sophisticated but down at the grass roots level in the secondary cities and in the rural areas it’s still quite endemic. And that is a major concern from a ‘foreign corrupt practices’ viewpoint if you are an Australian company or an American company. But all that means for a company like ours is that you need to have quite strict risk-management procedures in place.\textsuperscript{125}

This concern was echoed by other interviewees, but for this interviewee a third concern remained:

The third thing is the ability to transfer your profits, to transfer your profits out of the country. Again, that is rapidly changing. Our company has moved from being a branch office to being a WOFE – a wholly owned foreign enterprise for that very reason. Having said that, the processes of doing that are still quite complicated and time consuming. It’s not very efficient but I’m sure it will get more efficient with time and with China’s acceptance into the WTO. It’s all part of the ongoing process of business improvement I guess.\textsuperscript{126}

It is clear from the foregoing that corrupt practices in China remain a matter for concern both for domestic residents and for foreign investors. Of course, such practices are not confined to China. They exist worldwide within western countries that possess the most sophisticated and advanced systems of law, regulation and policing.\textsuperscript{127} In such circumstances there is always a ‘payer’ and a ‘payee’. However, it seems that the existence of other matters that cause concern for foreign investors in China might lead to some undue emphasis on the issue of corrupt officials or regulators.

\textsuperscript{125} Ibid.
\textsuperscript{126} Ibid.
\textsuperscript{127} ‘Global Corruption’ (2003) 13 Business Mexico 50, 50–3; Transparency International, ‘Corruption Perspexction Index 2010’ Transparency International <http://www.transparency.org/policy_research/surveys_indices/cpi/2010/results>. The 2010 corruption perspective index measures the perceived levels of public sector corruption in 178 countries around the world. China was ranked 78\textsuperscript{th} with 3.5 point in 2010.
8.5.4 The Formal Law – Informal Law Dichotomy

It is important to acknowledge that informal law and legal practices can play an equally important role in legal activity as do formal laws. It has been said that in China, the creation of formal law is much easier than its application, since informal legal traditions continue to dominate modern, formal ones. In primitive societies, religion, law, and morals were indistinguishably mixed. The separation of morality and of religion from law belongs very distinctly to the later stages of the process of the development of a rule of law. The western legal tradition is characterised by, among other things, the clear separation of these three ideas. But although religion, law and morals are separated in western law, they are nevertheless still very dependent on each other. Since the 1980s, China has introduced thousands of pieces of legislation to make the business environment for foreign companies more attractive. However, in some instances the practice was inconsistent with the new laws because of the legacy of the old way of doing things in China often prevailing over legislative reform.

In the interviews, among the questions asked was: ‘If we accept that there are still difficulties of achieving foreign investment success in emerging economies such as in China, what do you consider are the major difficulties for a successful business in terms of cultural factors? What factors other than cultural factors are important in your experience?’ One interviewee responded:

The first one, in my experience, is where the Chinese do not place a lot of emphasis on contracts whereas in the west the contract is the most decisive piece of paper. I feel that in China it’s getting better now. A handshake was the closing of a deal whereas in western culture the written form is vital. If this difference is not overcome in the near future it will

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create a lot of difficulties because the handshake, although in Chinese culture is legal, it is inappropriate for western culture as it doesn’t have any basis in law at all. So that is one of the most important barriers that have to be overcome.\(^{130}\)

Other cultural differences (and some of their effects) were obvious to this interviewee:

In the east the ways of negotiating involve banquets and social gatherings whereas in the west you go to your legal firm office, discuss contracts then you sign on the bottom line – that is it. And there is no need to socialise with very expensive eating. But in the east – in China in particular that is the way. Maybe that is another aspect that we should look at. I think in doing business, if you don’t understand cultural matters it is going to be very difficult. I think that with the Chinese, before the contract there are a lot of friendly relations but in the west, before the contract you don’t need to have any relationship. In China there is a lot of nurturing before you come to the point of agreement whereas in the west there doesn’t need to be too much nurturing.\(^{131}\)

These comments reinforce the importance (for foreign investors) of the different status of contracts between a foreign investor and a Chinese business partner as an issue for concern and early preparation. When added to the difficulties that might be experienced by a foreign investor in dealing with a sometimes unpredictable regulatory framework it is not surprising to find confusion and frustration amongst some foreign investors. When asked ‘What regulatory and institutional challenges did you experience in China as a foreign investor? How do they compare to doing business in Australia?’ the same interviewee responded:

Well I think in Australia, when you approach the authority, the authority will consider your application and state it’s response in the reply because in Australia we consider that all authorities are working for us. In China it’s a different story altogether. Although in China it is opening up to the west, the person in authority expects you to submit to that authority – this is still very strong. Therefore it is natural that that predatory and authoritarian styles are being used. Also we can go up and talk to Bob Carr (former Premier of NSW, Australia) – in China you can’t do that. This is an important difference in a democratic country.\(^{132}\)
The matter of dispute resolution in foreign investor operations in China (and the methods available or appropriate) was raised by numerous interviewees. One interviewee, when asked ‘In the questionnaire, you agreed that avoidance of disputes rather than taking legal action is a Chinese problem-solving approach. Can you explain and cite examples in your experience of dealing with conflict with a Chinese partner if any?’ said:

Dispute resolution you are talking about? We’ve always advised our clients that in any circumstances we can resolve disputes much, much better than going to court. We have important clients from the Australian ministry in China who we have advised to use alternative dispute resolution methods rather than going to court and somehow they have accepted our advice and in the end all parties are happy because they chose not to confront the dispute and take it to court. The reason is that in alternative dispute resolution all parties at the end of the day are better off. Number one for lower legal fees, number two, it may be in the future both parties would like to work together again. If a dispute is taken to court – no matter what – one party will be very angry.\textsuperscript{133}

In response to the question ‘What regulatory and institutional challenges did you experience in China as a foreign investor?’ How do they compare to doing business in Australia?’ the same interviewee replied:

You’ve got to be careful of criticising the Chinese system because we have our own system here and we are used to them, but the Chinese ones are different. The biggest issue in our area I think is a regulation framework around our services in the same way as with legal services and the ability of a foreign firm to operate in China. It’s a very similar situation in engineering and environmental services. We can provide advice, as a wholly owned foreign enterprise, to foreign and local firms operating in China from an engineering or environmental viewpoint. We can project manage but we can’t actually submit drawings for approval – for development approval for instance to build a new factory or build a building or whatever. Those processes require a local, Chinese design institute – a registered design institute – to make those submissions and to be able to sign them.\textsuperscript{134}

The lack of freedom to operate in associated aspects of the same industry was clearly a concern for this interviewee but he had identified a strategy to attempt to overcome the problem:

So the answer to that from our point of view is that we would normally work in joint venture with one of those design institutes. That in general terms can be quite successful.

\textsuperscript{133} Ibid.
\textsuperscript{134} Ibid.
and can be difficult at other times. It’s about relationships and the design institute – how sophisticated they have become. 20 years ago it was quite difficult, but now it’s much, much better. But it does create problems for us because we can’t do things in our own right. As a foreign company we have to go through the design institutes so in some ways that’s a restrictive trade practice.

The restrictions and controls upon some of this foreign investor’s business activities in China were clearly a source of irritation but were not serious enough to cause a cessation of operations or, one might assume, the profit of the enterprise. The interviewee continued:

Having said that, the same thing applies in Singapore and the same thing applies in Australia but to a lesser degree. But these are the challenges that you have to face but there has been discussion that some of these requirements will be eased in China as a result of WTO and particularly if the free trade agreement between China and Australia goes ahead. So this is an example of one of the things we face in our particular industry. In many other industries and in business generally, there are similar things and you just need to face them and be aware of them I guess.

This interviewee concluded with some general guidance to those planning to become foreign investors in China:

One of the big problems of a company going into China for the first time is to navigate your way through all of those particular issues and understand them. But you can get good advice on those sorts of things from your legal firm in China. So it’s a matter of asking the right questions and being aware of what you’re getting into and trying to find a way through that. For us there is no point in going in to do things that the locals can do and do cheaply. We need to add value and we can do that in areas such as project management, contract management and dealing with other foreign companies for example.\(^{135}\)

Whilst the agendas of the various players in the foreign investment processes in the PRC have some commonality, there are some clearly competing interests. The desire of the PRC government to protect China from the ‘market’ taking over control (as can be said to have occurred in the west in many instances) is balanced against its desire to maximise foreign investment activity. The government is also aware of the need to avoid domestic

\(^{135}\) Ibid.
criticism of its granting of preferential treatment to foreign investors as against local business operators.\(^{136}\)

### 8.6 China’s Accession to the WTO and its Effects on Substantive Laws and their Administration

China became a member of the WTO on 11 December 2001. As a member, China gave a commitment that it would comply strictly with WTO requirements.\(^{137}\) The commitments China was required to implement are summarised in the Protocol, which represents the terms and conditions of the various bilateral negotiation agreements between China and the WTO members.

The concessions required from China fell into four categories. First was market access to goods and related mainly to the commitment of foreign trade liberalisation and tariff barrier reduction under the General Agreement on Tariffs and Trade (GATT). China agreed to reduce tariffs on industrial goods to an average rate of 8.9% and to sustain this average against future increases. The second related to market access in services and required the lifting of bans on market access as required under GATT. A number of service sectors that were previously closed or severely restricted to foreign investment were required to be liberalised including finance, telecommunications, and insurance. The third related to the Trade Related Aspects of Intellectual Property Rights (TRIPS) Agreement and China’s acceptance of and adherence to internationally accepted norms to protect and enforce the Intellectual Property Rights (IPRs) of foreign companies and individuals in China. The fourth related to China’s transparency-related commitments: China specifically agreed to translate into one of the WTO languages and make publicly available all WTO-related laws, to apply such laws in a uniform and neutral manner, and to allow judicial review of administrative decisions relating to such implementation.\(^{138}\)


\(^{138}\) World Trade Organisation, ‘Accession of the People’s Republic of China’ (Protocols of China’s Accession to WTO, WT/L/432, 23 November 2001) <http://docsonline.wto.org/imrd/gen_searchResult.asp?RN=0&searchtype=browse&q1=%28%28+%40meta%5FSymbol+WT%5FCACC%5FCCHN%5FC49+or+WT%5FCACC%5FCCHN%5FC49%5FC%2A+or+WT%5FCCL%5FC432+or+WT%5FC432%5FC%2A+%29+or+%28+%40meta%5FSymbol+WT%5FCMIN%2A+and+%40meta%5FTitle+%28accession+and+working+and+party+and+china%29+and+%29+%29+&language=1>. 359
These external pressures on China to reform and to implement measures necessary under the WTO commitments have been the catalyst for the creation of a modern legal framework to support its new market-oriented, rule-based trading system. Following its decision to apply for membership to the WTO, China had already commenced the systematic overhaul of its existing laws, administrative regulations, and departmental rules to comply with WTO rules and its WTO accession commitments. From the end of 1999 to end of 2008, the Central Government enacted, adopted, revised, or repealed more than 887 laws, administrative regulations, and department rules covering trade in goods, services and transparency and uniformity in application of trade measures.

China is providing significantly improved market access on a secure basis, including access in the agricultural, industrial and services sectors, with in-built provisions for growth in access. These include remarkable progress for the agricultural sector in improving household food security and reducing the incidence of malnutrition and the fact that foreign investors are now able to own up to 40 per cent of shares in commercial banks in China. Tariffs are bound (that is, guaranteed) in the WTO, non-tariff measures that cannot be justified in the WTO are being progressively eliminated, restrictions on the right of enterprises within China to engage in trade are being phased out, and China’s standards system is being brought more into line with international norms. For instance, one of the first steps taken by the Chinese government after accession to the WTO was the

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140 <<中国的法治建设>>白皮书 [Rule of Law in China] (国务院新闻办公室 [Information Office of the State Council], Beijing [Beijing], February 2008), section 4, para 8.
142 Gregory C Chow, ‘The Impact of Joining WTO on China’s Economic, Legal and Political Institutions’ (Speech delivered at the International Conference on Greater China and the WTO, University of Hong Kong, 22-24 March 2003)
reissue of the *Guideline Catalogue of Foreign Investment Industries 2007* and the related *Provisions on Guiding the Direction of Foreign Investment 2002*. The Catalogue sets out lists of industries in which foreign investment is encouraged, restricted or prohibited. Investment in an industry which is not included in the list is considered to be permitted. The Catalogue was updated in 2007. China is reforming other trade regulations and administrative practices in a way that will support further growth in trade. The *Foreign Trade Law 2004* was originally issued in 1994 and was reissued on 6 April 2004 with significant changes in order to comply with China’s WTO commitments such as adopting the national equality of treatment principle. Also, China agreed to improve the transparency of its licensing system within the administrative system. The *Law of the People’s Republic of China on Administrative Licences 2003* has set out procedures for licensing.

China is in the process of implementing these commitments. Implementation is the subject of a formal annual review process in the WTO in which Australia participates. In addition, the Australian government is monitoring China’s implementation and has been taking up specific issues with the Chinese government. Australia participates actively in

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147 Ibid Ch IV.
joint efforts within the Cairns Group\textsuperscript{149} and with other like-minded WTO members to ensure that new WTO members, including China, will participate meaningfully in the multilateral reform process for trade in agriculture, including giving commitments to limit the subsidisation of the agricultural sector. Accession negotiations are non-reciprocal and offer a unique opportunity for Australia to address existing trading problems, secure new market access, and achieve commitments which provide a substantial degree of transparency and security in future trading conditions. Australia engages actively in accession negotiations to ensure that the commercial interests of Australian businesses are accommodated adequately.\textsuperscript{150}

The potential of the Chinese market has been given a significant boost by membership of the WTO, resulting in even greater trading opportunities for Australia and adding further impetus to already fast-growing bilateral trade. China’s WTO commitments have provided new opportunities in a wide range of sectors including wool, sugar, wheat, barley, meat, seafood, horticulture, dairy, oilseeds, wine, processed food, hides and skins, chemicals, pharmaceuticals, metals, information technology, automotive, telecommunications services, and in the financial and professional services sectors.

WTO membership is also resulting in a more open, secure and predictable business environment in China as China is committed to reduce trade barriers and limit future

\textsuperscript{149} World Trade Organisation, ‘Understanding the WTO: Organisation Membership, Alliances and Bureaucracy’ World Trade Organisation \textltt{<http://www.wto.org/english/thewto_e/whatis_e/tif_e/org3_e.htm#cairns>}. The Cairns Group was set up just before the Uruguay Round began in 1986 to argue for agricultural trade liberalisation. The group became an important third force in the farm talks and remains in operation. Its members are diverse, but share a common objective — that agriculture must be liberalised — and the common view that they lack the resources to compete with larger countries in domestic and export subsidies. Australia is one of the members of Cairns Group.

increases, improve significantly its administration of trade regulations and increase the transparency in the way such measures are applied. Australia has consistently given strong support to China’s membership as an important step in China’s integration with the world and regional trading systems.

The survey, with questionnaires and interviews conducted with a group of Australian business people with operations in China as discussed in this chapter, gave first hand information that provided a better understanding of China’s business and legal environment in the post-WTO accession period. The business experiences in China from the participants have confirmed that China has unresolved issues in relation to its administrative and legal systems that were discussed in Chapter 6.

8.7 Conclusions

This part of the study shows that there has been a very large growth of trade between China and Australia in the past two to three decades. This has corresponded with an increase of the incidence of Australian investors entering into business partnerships in China. A survey of a group of Australian business operators in China was conducted as part of the research. The survey elicited a number of causes of concern for some of the investors involved in the survey including:

i) confusion in respect of the implementation and interpretation of both national laws and local regulations,

ii) difficulties in finding the appropriate decision-maker, and slow decision-making processes,

iii) dealing with government interference and delays,

iv) lack of knowledge of how to deal with the discretionary power of decision-makers, particularly at local levels,
v) knowing how to choose, and choosing, the right local Chinese partner,
vi) methods of building relationships of trust with Chinese partners,
vii) understanding differing perceptions of the meaning of written contracts and operating within the uncertain boundaries arising from such differences,
viii) avoidance of corrupt practices,
ix) dealing with disputes, and
x) appreciating the importance of, and working with, the system of networking or Guanxi in Chinese business activity.

Competing interests in terms of local, provincial and national authorities at the different administrative levels and as between different individual decision-makers, coupled with sometimes conflicting interpretation of laws has been, and continues to be, a frustrating experience for some foreign investors.

Corruption is a very real problem in China and foreign investors are very often exposed to it. The government has acknowledged the magnitude of the issue and appears to be making substantial efforts to address it by way of investigation, punishment and wide exposure as discussed above. China’s law-makers have been under continuing pressure to enhance the foreign investment experience in recognition of the immense value such investment brings to its economy. The resultant changes to policies, laws and regulations are beginning to bring China’s foreign investment legal environment more into line with international expectations. In part, China’s admission to the WTO in 2001 and the extra scrutiny flowing from such membership has assisted that process.

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151 Accession of the People’s Republic of China WT/L/432 (23 November 2001) (Decision of 10 November 2001). Under the chairmanship of Ambassador Pierre-Louis Girard of Switzerland, the Working Party concluded almost 15 years of negotiations with China and agreed to forward some 900 pages of legal text for formal acceptance by the 142 Member Governments of the WTO. As a result of the negotiations, China has agreed to undertake a series of important commitments to open and liberalise its regime in order to better integrate in the world economy and offer a more predictable environment for trade and foreign investment in accordance with WTO rules.
Ch 8: Research Survey

The following chapter continues the examination of some actual experiences of investors in China in the context of both the legal and social environments. Also, by way of contrast with the experience of less substantial investors, it examines the case studies of two large scale western investors and their relationships with government in the PRC.
Chapter 9

Some Insights into Social and Legal Concerns for Foreign Investors

9.1 Introduction

Earlier chapters of this thesis have demonstrated that foreign investors in China have often experienced difficulties in coming to terms with an often unpredictable legal environment and quite unique administrative systems. The nature of human relationships with business partners in China is also an area that may be difficult to understand and predict. The different social, political and economic systems are likely to form part of the explanation for confusion and frustration on the part of some foreign investors along with the fact that China is undergoing dramatic transitions both economically and socially.

It is not surprising for foreign investors to have concerns when attempting to deal with a system that has such a unique history and background. Although some foreign firms have succeeded in China, many have failed and left, having concluded that Deng Xiao Ping’s ‘Open Door’ policy of 1978 was not truly intended to create a free market society, at least in the foreseeable future.¹

However, the relatively sudden openness of the Chinese market may not be the only explanation for some failed foreign investment cases. Expanding upon the earlier

discussion in this thesis, it is considered to be important to further examine Chinese social and legal aspects that, it is suggested here, are embedded in the success or failure of foreign investment proposals.

Section 9.2 expands upon some Chinese social characteristics, including Chinese business culture and ‘Guanxi’ or personal connections. Section 9.3 discusses relationships with Chinese governments. Two specific foreign direct investment (FDI) cases, those of German Volkswagen Group and American Motor Corporation, are examined in some detail in this section in order to provide some insight to the difficulties that foreign investors sometimes encounter. Section 9.4 discusses the underlying characteristics of law in China including its role, some inherent conflicts that exist between the various law-making bodies and the difficulties arising from inconsistencies between the laws made by them. Section 9.5 summarises and concludes the chapter.

9.2 Social Aspects

In this thesis, it has been demonstrated that FDI operations in Chinese society inevitably involve dealing with both business counterparts and governmental officials — often at a number of levels. Relationships and networks are built between and among people. Hence, the effective deployment of human resources is crucial to the success of building such relationships. Chinese business culture and relationships with government are here explored to demonstrate the importance of personal connections for FDI and long-term success in China. An important starting point is an understanding of how Chinese conduct their business operations and how they relate to each other when in business relationships.
9.2.1 Chinese Business Culture

Chinese business practice is vastly different from the more formal and therefore probably more predictable western methods that are often considered to be more professional.\(^2\) It might be argued that nowadays China’s business practice — having been opened up to the international community including China’s joining the WTO — is conducted in a more western style; however, Chinese business culture is still very different as a result of the country’s unique history and background. Throughout history, Chinese business-people from different regions have exhibited distinct characteristics.\(^3\) Business culture in China has become an important factor for foreign investors to be aware of when they are dealing with their Chinese partners or government administrative personnel. It seems a very natural progression that in China a business relationship inevitably becomes a social relationship, with each strengthening the other.

Throughout Southeast Asia, where many markets are underdeveloped and law is often unpredictable, informal networks have become the preferred vehicle for many complex transactions.\(^4\) The financing for a USD100 million property deal can be arranged in a matter of days within the ‘bamboo network’.\(^5\) Under such circumstances, personal trust replaces formal — as well as more expensive and time consuming — ‘due diligence’ processes. As a result, the cost of doing business is lowered substantially. Without these


informal arrangements, many business transactions would be impossible or prohibitively expensive. Seen in this light, the extensive trade among overseas Chinese is a direct response to the high transaction costs inherent in many economies in Southeast Asia such as the Philippines, Indonesia and particularly in China which lacks sophisticated political and economic institutions.\(^6\)

These trans-national trading networks are very much in accord with Chinese tradition.\(^7\) They allow for the flexible and efficient transmission of information, goods, and capital in what are often informal agreements and transactions.\(^8\) Confidence and trust replace contracts as the major guarantees that commitments will be met satisfactorily.\(^9\) In a region where capital markets are rudimentary, financial disclosure is limited, and contract law is weak, interpersonal networks are critical to moving economic resources across political boundaries.\(^10\)

Doing business in a foreign country can be both risky and rewarding. This is particularly the case in China, where everything seems to be on a huge scale, including the challenges and opportunities that face western businesses. The difficulties are numerous, starting with substantial differences in language, customs, and the pace of everyday life. When actually doing business in China, there are several risks foreign business people need to understand. The first is the importance of going in with eyes open. Foreigners simply cannot enter a venture in China with only a cursory understanding of its terms and

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\(^10\) Murray Weidenbaum and Samuel Hughes, *The Bamboo Network* above n 5, 52–53.
conditions. As Edelman and Suchman asserted, awareness of the importance of organisational environments and non-contractual relations in business is essential. There are four other specific risk issues related to China: maintaining local partnerships, the existence of fraud, and corruption; and natural hazards. These obstacles are compounded by sharp divergences from western legal systems, which may often prevent the orderly progress of business contracts and transactions.

In the case of China, informal local variations are often far more serious than formal legal hurdles because they cannot be predicted. The combination of these obstacles creates a barrier to a foreign business that wants to participate in China’s rapidly growing economy. In the world of business, customs and culture play a large part, so much so that the prospective foreign investors cannot expect to meet with any success in China without any understanding of how the Chinese undertake business and how that business intermingles with Chinese culture. Relationships between foreign investors and their Chinese colleagues or partners are crucial for successful outcomes in business ventures in China. For the purposes of this research it is seen as important to explore in some depth the nature of these relationships in business practice in China.

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14 Patricia Blazey, ‘Culture and Its Relationship to Undertaking Business in China’ in Patricia Blazey and Kay-Wah Chan (eds), The Chinese Commercial Legal System (Lawbook, 2008) 57, 57.
9.2.2 ‘Guanxi’ – Relationships

Networking is important for any business in any country. However, it has more important implications in China. ‘Guanxi’ (personal connection) has been identified as a necessary pre-condition to do business successfully in China. In the view of Chen and Chen:

We view Guanxi as an indigenous Chinese construct and define it as an informal, particularistic personal connection between two individuals who are bound by an implicit psychological contract to follow the social norms such as maintaining a long term relationship, mutual commitment, loyalty, and obligation.

‘Guanxi’ can be defined in different ways. Literally it means a special relationship or connection. Since ‘Guanxi’ and relationship could function as an information network, companies with wide ‘Guanxi’ and relationship networks often have much higher levels of performance than companies with little or no relationship with the Chinese. The hypothesis has been tested using data from 102 ventures within China in a study in which the results confirm that the nature of the personal relationships and ‘Guanxi’ have a measurably positive impact on the performance of these ventures.

People in China still prefer to trust or rely upon their personal relationships when they are dealing with business. This indicates a lack of confidence or trust in the legal and regulatory system. However, there is a different attitude in western countries, where people can do business with strangers with some quite high level confidence that the legal system can protect their interests when disputes arise. In the Chinese context it can be suggested that ‘Guanxi’ assumes some of the functions of a legal system, ‘mutual favours’ were not

16 Ibid.
17 Patricia Blazey, ‘Culture and Its Relationship’ above n 14, 58.
traditionally viewed as corruption, and ‘Guanxi’ operating as a code of conduct partially substituting for the rule of law. Chung and Hamilton who explored the nature of Chinese business practices by looking at their social foundations suggest:

> Although relational rules play a role in Chinese economic practices similar to that of a legal framework in western economic practices, the results are quite different. Whereas western legal norms de-personalise market activity, Chinese relational rules personalise transactions, making them part of the interpersonal social matrix of daily life.¹⁹

> ‘Guanxi’ is different from the western concept of networking. It is long-term and concentrated and involves ties of loyalty whereas western networking is more akin to having a wide range of acquaintances. In the west a business relationship has a group implication, whereas in ‘Guanxi’ the ties are always personal. Personal loyalty is more important than loyalty to the organisation. Lin and Ho’s study reveals that national culture and Guanxi have significant impacts on organisational behaviour.²⁰ Confucius was very concerned with relationships and social propriety,²¹ stating that a strict social hierarchical order should apply in order to maintain social harmony.²² The Confucian term ‘li’ actually refers to ritual. Rituals are manifested not only in terms of appropriate behaviour and roles, but also for ceremonies and other social processes.²³ Confucian teaching and its historical importance will be discussed in Chapter 8. To this extent, ‘Guanxi’ has to be regarded as a part of culture that should be taken into account in every aspect of business as it embraces all the roles in Chinese life.

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²² Ibid 80.

9.3 Relationships with Chinese Governments – Two Case Scenarios

The automotive industry is a notable example that has demonstrated the importance of relationships with relevant governments for foreign investors in China. As with economic growth, developing an automotive capacity is clearly significant for China’s aim of having world class technology and quality performance in developing its automotive industry. As a result, China’s central government enacted automotive policy by promoting joint ventures between Chinese and foreign suppliers. It was therefore important that foreign investors’ operations in this sector acquired targeted and sustained policy support from the Chinese government. The Chinese government has maintained tight control over the automotive industry, including joint ventures with foreign companies. According to the Seventh Five-year Plan 1986 China planned to develop automotive parts manufacturing industries in order to eventually have all automotive parts made in China. The Government had announced its intention to promote consolidation of the automotive industry around the Shanghai Automotive Industry Corporation (which is part of a joint venture with General Motors), Dong Feng Motors Corporation (which is part of a joint venture with Citroën), and First Automotive Corporation (which is involved in a joint venture with Volkswagen). In 1995, two companies, Shanghai Volkswagen and Tianjin Auto, accounted for 72 per cent...
of the market for passenger cars in China. In 2003 sales of Volkswagen Group in China reached 700,000 units compared to a figure of less than 100,000 units in 1992. The practice of these joint ventures between Chinese government and foreign investors has demonstrated the significance of a good relationship with government. It also provides insights to some failed Chinese-western cooperation. To an extent, such ventures reflect the reality of the notable influence of the Chinese government on business activities generally.

9.3.1 German Volkswagen Group

In 1994, Volkswagen decided to make an investment of RMB2.3 billion (USD 277.8 million) in China, to have the capacity to manufacture 300,000 cars annually and to be the largest car manufacturer in China. It established two joint venture operations, one with First Auto Works (FAW) (producing the ‘Jetta’ and the previous-generation Audi 100 from kits), and the other with Shanghai Volkswagen (SVW) (producing the 1980s model ‘Santana’). The two plants built 130,000 cars in 1993, accounting for more than 50 per cent of China’s total automobile output. Volkswagen’s involvement in China had begun in 1978 when the Chinese Minister of Machinery and Construction visited Wolfsburg in Germany. The Shanghai Volkswagen contract was signed in 1984 after five years’ negotiation. Dr Posth, chairman of Volkswagen Asia-Pacific, revealed in an interview:

[29]‘Face to Face: with Martin Posth of Volkswagen Asia-Pacific (4th Quarter 1994), International Motor Business 6, 16. Martin Posth was the chairman of Volkswagen Asia-Pacific in 1993.
[30]Ibid.
Several years of discussion and negotiation followed until, by the end of 1981, the Chinese
government and Volkswagen agreed to work together. Contracts were signed in 1984 and
trial assembly operations began shortly after. The first major production plant was opened
in 1991. It takes a long time to set up business in China.\textsuperscript{31}

The new company was capitalised at USD40 million (approximately RMB330
million). Several details of the contract revealed Volkswagen’s careful foresight. Firstly,
the new joint venture was owned 50 per cent by Volkswagen, 25 per cent by Shanghai
Automotive Industrial Corporation (SAIC), 15 per cent by the Bank of China, and 10 per
cent by the China National Automotive Industrial Corporation (CNAIC).\textsuperscript{32} While
Volkswagen was the largest shareholder, the diversity of partners spanned geographic
boundaries for the venture’s operations. The Bank of China could provide or guarantee
necessary loans; SAIC would have an interest in solving local problems; and CNAIC could
be a link to the central planners. Secondly, the contract allowed Volkswagen to convert its
RMB profits for hard currency until 89,000 cars were produced.\textsuperscript{33} Volkswagen thus would
avoid the kind of foreign exchange problems experienced by other foreign investors.
Finally, the contract specified that while Volkswagen would try to increase the local
content, the responsibilities of developing qualified local suppliers rested squarely on the
side of the Chinese.\textsuperscript{34}

Coming under criticism from CNAIC in respect of this ‘local content’ and ‘local
suppliers’ issue, Volkswagen’s precise contract provided some respite for the Germans, as

\textsuperscript{31} Ibid.
\textsuperscript{32} René Haak, ‘Market and Technology Leadership in the Chinese Car Industry – Japanese and German
Strategies in a Dynamic Environment’ in René Haak and Dennis S Tachiki (eds), \textit{Regional Strategies in a
Global Economy: Multinational Corporations in East Asia} (Monographien Aus Dem Dentshen Institut Für
Japanstudien, 2004) 183, 196; Mike W Peng, ‘Controlling the Foreign Agent: How Governments Deal With
\textsuperscript{34} Ibid; Shanghai Volkswagen, <<上海大众概况>> [Shanghai Volkswagen Profile] Shanghai Volkswagen
it indicated that the Chinese were responsible for developing local suppliers that would meet Volkswagen’s standards. However, the Germans neither complained to the press, nor sought to directly confront the central government. Instead, they chose quiet persuasion and reasoned arguments, and allowed the Chinese to find a solution to the problem. In the end, the criticism from CNAIC abated because of Volkswagen’s efforts and also because of the Shanghai local government’s — and particularly the mayor’s — lobbying. Volkswagen was fortunate that, with a sympathetic mayor, the Shanghai local government often sided with its position. The reason that the local government in Shanghai showed a strong interest in the joint venture was the enterprise’s growing economic importance. Its production crossed the 100,000 unit mark by 1993. In the mid-1990s, Shanghai Volkswagen was the largest Chinese-foreign joint venture in China and was listed as a ‘pillar firm’ in Shanghai’s development plan. At the venture’s full capacity of 300,000 vehicles in 1997, it contributed up to 17 per cent of municipal output, and had captured 52 per cent of the automotive sedan market in China.

Peng’s study compared joint ventures in Beijing to those away from central government. On the Volkswagen approach Peng suggests:

As a result, a basic level of trust had been established before the venture was formed. Later on, in the drive toward higher localisation levels, again the Germans refrained from finger-pointing when facing criticism from the central government. Instead, they quietly worked

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39 Mike W Peng, ‘Controlling the Foreign Agent’ above n 36, 165.
with the local government, thus reaching the mutually shared goals of increasing local content.\footnote{Mike W Peng, ‘Controlling the Foreign Agent’ above n 36, 148.}

Volkswagen’s approach towards the Chinese government when they were dealing with the operational problems was moderate and practical. It chose to take advantage of its relationship with government rather than creating direct conflict. Volkswagen might have chosen to exercise its majority control right in the joint venture and force its decision on to the operation; however, such an approach may not be an efficient way to deal with any disagreement between Chinese and German parties in such a situation. Volkswagen has a very well developed understanding of the importance of its reliance upon the Chinese government for its substantial operation in China. Volkswagen’s managers in China had grasped the concept of the importance of maintaining a good relationship with its Chinese partners and other significant Chinese participants. This understanding has contributed to its success in China.

\subsection{American Motor Corporation (AMC)}

The ‘Beijing Jeep’ was the largest and most visible manufacturing joint venture established by the American Motor Corporation (AMC) and the Chinese in the early 1980s.\footnote{Eric Harwit, \textit{China’s Automobile Industry} (Armonk, 1995) 12.} The negotiations between AMC and CNAIC on behalf of the central authorities took four years from 1979. An agreement was signed in 1983 to establish a joint venture, named the ‘Beijing Jeep Corporation’, by AMC and the Beijing Automobile Works, a state-owned enterprise.\footnote{从\textit{Jeep}到奔驰：解读中国第一家合资车企\text{[From Jeep to Benz: Analysing the First Automotive Joint Venture of China]} (24 March 2011) 新华网 [Xinhua News] \text{<http://news.xinhuanet.com/auto/2011-03/24/c_121225248.htm>}.} Of a total of USD51 million (approximately RMB422 million) initial capital,
AMC held 31 per cent, contributing USD8 million (approximately RMB66 million) in cash and technology judged to be worth another USD8 million.\(^{44}\) The 69 per cent share of the Beijing Automobile Works comprised a contribution which included buildings, equipment, and USD6.6 million (approximately RMB54.6 million).\(^{45}\) Intense differences of objectives between the two sides were clear from the beginning. The Chinese hoped that the Americans would help design a completely new model. A policy to support joint ventures and use these as a means of technology transfer was implemented.\(^{46}\) Moreover, they wanted to export most of the venture’s output.\(^{47}\) The Americans, on the other hand, were primarily interested in selling completely knocked down (CKD) kits of their existing Jeep Cherokee model for local assembly.\(^{48}\) In the end, the Americans signed the joint venture contract pledging to help develop a new model that the Chinese insisted upon, but the contract contained little detail on the timing and financing of the process.\(^{49}\) After the initial period, both sides quickly found that the new vehicle was not easy to design.\(^{50}\) Facing potentially hundreds of millions of dollars in further investment to create a new model, the Americans balked. They insisted that the Chinese import the Jeep Cherokee CKDs for domestic assembly, and that implicitly allowed AMC to make a profit on kit sales.\(^{51}\) The Chinese side reluctantly gave up the plan for the new model, on the condition that kit parts would

\(^{44}\) Mike W Peng, ‘Controlling the Foreign Agent’ above n 36, 150.  
\(^{45}\) Ibid.  
\(^{49}\) Ibid 4.  
\(^{50}\) Jim Mann, Beijing Jeep: The Short, Unhappy Romance of American Business in China (Simon and Schuster, 1989) 130.  
gradually adopt Chinese-manufactured components, a process called ‘localisation’. The Americans objected and notified Chinese bureaucracies at all levels, including, progressively, the Beijing Municipal Government, CNAIC, the State Planning Commission, and eventually the State Council. But no solution was forthcoming. Frustrated, the Americans publicised the crisis by complaining to western media such as the Wall Street Journal and Business Week, which published reports on the crisis in April 1986. They also wrote directly to the Chinese Premier, with a concrete threat of shutting down the joint venture. Only through the intervention from the then Premier, Zhao Ziyang, was the venture saved.

In this case the Americans resorted to highly unconventional tactics (in the Chinese view) in making their case, including publicising the crisis in the media, bringing the matter directly to the higher authorities, and threatening to shut down the joint venture. Facing the crisis, various bureaucracies seemed to break down, unable to reach a solution until the Premier took a ‘top down’ approach to solve it. The role of the local government in Beijing was, at best, ambiguous. Unlike local governments in Shanghai, the local government in Beijing initially seemed to be indifferent to the looming crisis, even when the venture halted production. This situation differed from the Volkswagen case in that two levels of bureaucracy were involved. In Beijing the joint venture was tightly overseen by the central government through CNAIC. In Shanghai, although CNAIC maintained

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56 Jim Mann, *Beijing Jeep* above n 50, 182.
nominal control, it was the local government that was in charge. The Shanghai officials’ strategy of ‘settling for less’ seemed to be more rational, realistic, and flexible than their counterparts’ approach in Beijing.\footnote{The World Fact Book 1997, ‘Country-by-Country’ above n 26.}

Many western investors seeking participation in China’s growth have been disappointed. They have spent a great deal of time and money in the region over a period of years and have little to show for it. However, Volkswagen is a significant exception. This success story is worth noting in view of the many complaints in recent years about the difficulties of operating and managing joint ventures in China. Its success has no doubt relied on significant factors such as its early entry, resourcing, effective marketing, management skills, and commercial strategies. However, the major factor of Volkswagen’s success was its relationship with the Chinese government. Connecting and networking with the Chinese government is still a vital skill to master when considering large scale foreign investment. As Child points out:

\begin{quote}
Early entry and investment in building up a good relationship with local government are significant factors for joint venture success in China. Volkswagen … entered the Chinese market early which enabled them to build up considerable political credibility with the government authorities – an important factor in countries such as China where government still plays a major role.\footnote{John Child, ‘Challenges of Establishing Successful Joint Venture in China’ (3 April 2003) Spotlight on John Child <http://www.fernando.emeraldinsight.com>.
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\end{quote}

The preceding two cases seem to suggest that building coalitions with local government agencies seems to be a good strategy that may pay off in the long run. Although central authorities in China usually have the power to veto investment projects, having a local partner that can clearly gain from a project and is therefore committed to the undertakings, appears to be enormously helpful. Shanghai Volkswagen benefited from such
a close relationship with the local government in the venture’s struggles to get established. In contrast, Beijing Jeep, at least initially, suffered from a lack of local support, and had to resort to highly unconventional and risky tactics, such as publicising the problem to media and threatening the government, to solve its problem.\textsuperscript{59} Stefan Marowski’s review of a volume by Harwit and Sharpe, that contained case studies of four automotive joint ventures in China, notes:

\ldots the four cases (Beijing Jeep, Shanghai Volkswagen, Guangzhou Peugeot and Panda Motor)\textsuperscript{60} studies are preceded by describing the political players and institutions that were most instrumental in shaping the development of car manufacturing facilities in China and in determining the nature and extent of foreign direct investment in this sector.\textsuperscript{61}

Clearly, during the reform era China has been very successful in attracting FDI for its economic development despite a developing legal system. Woo Young Wang revealed in his research that the solution to the puzzle lies in the informal institutions underlying FDI development in China.\textsuperscript{62} He found that networks of personal connections (Guanxi), which are pervasive in Chinese society, have played a major role in facilitating FDI flows to China.\textsuperscript{63} While foreign companies have been able to establish a presence in China, their moderate level of satisfaction with performance of their projects may be attributable to their inability to build very strong and appropriate ‘Guanxi’ with the relevant authorities. The social aspect of interpersonal relationships in China is subtle and deeply entrenched, and on the surface it may not appear to be as important as it is. Some might argue that this kind of personal relationship is very similar with western ‘relationship marketing’ that also

\begin{itemize}
\item \textsuperscript{59} Ibid.
\item \textsuperscript{60} Eric Harwit, \textit{China’s Automobile Industry} (Armonk, 1995) 67–133.
\item \textsuperscript{62} Woo Young Wang, ‘Informal Institutions and Foreign Investment in China’ (2000) 13 \textit{Pacific Review} 525, 556.
\item \textsuperscript{63} Ibid.
\end{itemize}
intends to gain trust in order to promote business. However, the underlying differences are based upon the influence of China’s long history and philosophy including Confucian thought, an aspect that will be discussed in a later chapter. It is reasonable to conclude that a well established awareness of the importance of close relationships is central to the success of the foreign investor in China.

9.4 Underlying Legal Characteristics

China’s economic development has been accompanied by legal and economic reforms of great cultural significance. Foreign investors engaging business activities in China not only need to maintain an ongoing awareness and understanding of its business culture but also of its developing legal system, particularly in regard to the current legal framework within which commerce is conducted. It is important to examine the role of law and conflicts of laws in light of underlying traditional socio-legal relationships in order to acquire a reasoned understanding of the practical implementation of law and its practice.

9.4.1 The Multi-level Nature of Law in China

At the outset, it is important to know the meaning of ‘law’ in China. Generally speaking, the concept of law has been inherited from the former Soviet Union. Wang and Zhang suggest that:

Law is the sum-up of action rules embodying the ruling class’s will and customs and rule of public life confirmed by the state authority and is defined by legislation. From this socialist point of view, the concept of law is focused upon the nature and function of law, that is, law as an instrument of the ruling class. According to almost all the textbooks of jurisprudence in China’s law schools, it is the ruling instrument of the bourgeoisie in a capitalist society and of the working class in a socialist society. The Communist leaders view law primarily as a political instrument of the Party for maintaining the socialist order and one-party rule in China’s politics.

Acknowledging this concept of law, that is law as an instrument of control, will assist non-Chinese to understand the Chinese government’s attitude to law and its application. However, it can be reasonably argued that laws everywhere are all tools or instruments needed for the maintenance of the stability of any country.

In a broad sense, the body of law in China includes laws, regulations, rules, some decisions, and even interpretations by the Supreme Court or the Supreme Procuratorate, which can be divided into several groups according to their jurisdiction and enforcement. On the top of the pyramid that constitutes the legal system is the Constitution, the supreme

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69 In March 1999, the NPC of the PRC adopted and amendment to the Constitution 1982, incorporating in Article 5 yi fa zhi guo (governing the country in accordance with law) and jianshe shehui zhiyuan jishi guojia (building a socialist rule of law state).
law in China. The Constitution now in force was enacted in 1982 after the other 3 preliminary Constitutions, those of 1954, 1975 and 1978. It was amended respectively four times, principally to reflect the policy and economic developments in China.\(^\text{70}\)

The second level of law is the set of ‘basic statutes’ enacted by the National People’s Congress (NPC). This is not the same basic law as in the Basic Law of Hong Kong Special Administrative Region, although the latter was also enacted by the NPC. According to the Constitution 1982, basic laws include the basic statutes concerning criminal offences, civil wrongs, the state organs and other matters.\(^\text{71}\)

The third level is ‘statutes’, which specifically refer to the statutes enacted by the Standing Committee of the NPC. As the NPC has a conference only once a year and members of the NPC are voters from the functional electorates not professional politicians, its standing committee makes most of the statute law. Also, there is no stipulation concerning the separation of legislative power between the NPC and the Standing Committee. Most of the substantive laws have been made by the latter.

But then, there is the most controversial law-making method — administrative legislation. The Constitution 1982 states that the State Council exercises the following functions and powers:

1. to adopt administrative measures, and
2. enact administrative rules, regulations decisions and orders in accordance with the Constitution and the statutes.


State Council makes laws as according to:

i. delegated laws which are granted by the NPC; and
ii. administrative regulations made by the State Council; and
iii. administrative rules made by ministries and commissions of the State Council.\(^{72}\)

Again, because there is no special limit to the power of delegation of the Congress, and because most laws adopted are drafted by branches of the State Council, the administration seems to become the most powerful legislature in China.

The base of the law pyramid is local enactment which includes:

i. local regulations, statutes and the administrative rules and regulations adopted by the people’s congresses of provinces and municipalities directly under the central government, and their committees;\(^{73}\)
ii. autonomous regulations and specific regulations of people’s congresses of national autonomous areas, which include autonomous regions, autonomous prefectures and autonomous counties;\(^{74}\)
iii. special delegation of the NPC to Municipalities of Economic Special Regions, larger cities, counties, and capital cities in provinces, notwithstanding the Basic laws and other enactments in the Special Administrative Regions of Hong Kong and Macao.

Apart from the above-mentioned organs, the Supreme Court and Supreme Prosecutor also have powers to interpret laws in accordance with the *Decision of the NPC’s*

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\(^{72}\) Ibid art 89.
\(^{73}\) Ibid art 100.
\(^{74}\) Ibid art 116.
Standing Committee Concerning Judicial Interpretation 1981. The Administrative Procedure Law of the PRC 1989 stipulates:

In handling administrative cases, the people’s courts shall take the law, administrative rules and regulations and local regulations as the criteria. Local regulations shall be applicable to administrative cases within the corresponding administrative areas. In handling administrative cases of a national autonomous area, the people’s courts shall also take the regulations on autonomy and separate regulations of the national autonomous area as the criteria.

Even though China has this multi-subject law-making system, the Constitution 1982 has no provisions which constrain the different law-making powers. As a result, conflicts of laws occur from time to time among all these law-making bodies.

9.4.2 Various Conflicts of Laws in China

The Constitution 1982 expressly prescribes that: ‘No laws or administrative and local regulations should contravene the Constitution.’ However, different institutions in China have been substantially granted the right to make law, and, as there is no constitutional review, with the ongoing development of the economy, conflicts of law can easily occur. Conflicts of law have raised problems of application and compliance, which in turn influence the decisions of the Courts. A brief examination of the basic types of conflict of law that occur in China follows in an attempt to discover the institutional reasons for such

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75 <<关于加强法律解释工作的决议>> [Decision of the NPC’s Standing Committee Concerning Judicial Interpretation] (People’s Republic of China) National People’s Congress Standing Committee, June 1981, art 2.
77 Ibid art 52.
conflict. Conflicts of law can be divided into three basic types according to the law-making body’s status in the whole law-making system. Each basic type has its own subdivisions.

9.4.2.1 NPC versus NPC Standing Committee

Conflicts of law between the laws of the NPC and those of its Standing Committee derive from two causes. The first is the vague demarcation between the Council and the Standing Committee. The second reason is that the NPC is not a place for professional politicians as it is composed of delegates who are selected from designated functional electoral districts who meet only once a year. As Peerenboom observes:

The law-making and rule-making processes still lack transparency, and opportunities for public participation are limited, notwithstanding some improvements since 1978. The quality of much legislation remains low, in part due to the lack of practical experience and competence of drafters. Laws and regulations are subject to frequent change. Even more worrisome, there is a shockingly high incidence of inconsistency between lower and superior legislation.

Although the NPC is the supreme authority in China, it has no obligation to explain its own enactments; thus there is no legal process to review any conflict that may occur with legislation enacted by its Standing Committee. For example, on the one hand the Constitution 1982 stipulates that the NPC may revise the Constitution, enact and revise

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the Criminal Law, Civil Law, laws of state institutes and other basic laws,\textsuperscript{82} and revise or annul improper decisions made by the Standing Committee.\textsuperscript{83}

On the other hand, Article 67 states that the Standing Committee may:

\begin{enumerate}
\item construct the Constitution;
\item enact and revise laws except what should be enacted by the NPC;
\item during the session of the NPC, supplement and revise laws enacted by the NPC while not contravening the basic principles thereof;
\item construct laws; and
\item annul administrative regulations, decisions and orders made by the State Council which contravene the Constitution and laws. \textsuperscript{84}
\end{enumerate}

As a result, even if the Standing Committee enacts laws within the scope of responsibility contrary to NPC legislation, no institution can correct the error, for it is the Standing Committee which will interpret both the Constitution and the laws. In fact, no law has ever been annulled by the Standing Committee.\textsuperscript{85}

\textbf{9.4.2.2 The Legislature versus the Executive}

The same problem occurs between the legislative authority and the executive organ of the government. Firstly, with the development of modern society, the complexity and technicality of most enactments make it impossible, as elsewhere in the world, for the legislative members to draft law without help from experts from the administration. In 1985, the Third session of the Sixth meeting of the NPC’s Standing Committee passed a

\textsuperscript{82} Ibid s 3.
\textsuperscript{83} Ibid s 11.
\textsuperscript{84} Ibid art 67.
resolution that empowered the State Council to make regulations and acts in respect of the ‘Open Door’ policy and economic reform.\(^\text{86}\) Secondly, no provision in either the Constitution or the Organic Law of the State Council 1982\(^\text{87}\) provides ministries with the power to enact regulations; however, most of the regulations now in force have been enacted by them. Also, there are conflicts between different departments of the State Council. With the expansion of administrative regulation more regulations are made, not by the State Council, but its functional commissions and ministries. These are called sub-regulations. According to a statistic published in 1994, in the period from 1979 to the first half of 1994 the NPC and its Standing Committee adopted 270 laws and decisions, while the State Council enacted about 1500 administrative regulations.\(^\text{88}\) The State Council published the first White Paper on the Rule of Law in China in 2008. Legal reform in China has made impressive progress. There are 229 currently effective laws adopted by the NPC and its standing committee and the State Council enacted 600 currently effective administrative regulations, there are 7000 provisions enacted by various levels of People’s Congress and their standing committees.\(^\text{89}\)

Also, local laws on foreign investment form a significant part of the legal framework for foreign investment in China. Local governments have considerable authority in approving foreign investment proposals and extensive powers in making local laws,

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\(^\text{89}\) <<中国的法治建设>>白皮书 [Rule of Law in China] (国务院新闻办公室 [Information Office of the State Council], 北京 [Beijing], February 2008) para 29.
regulations and policies on foreign investment. Local laws, regulations and policies should not conflict with national laws and regulation. However, when it comes to the interests of a local economy, the situation can be different. Some local policies on attracting foreign investment may not be consistent with the national laws. For example, during the mid 1990s there were some cities in Guangdong province in southern China which were the most rapidly developing areas in China at that time. They had policies of attracting foreign investment by promoting the package sale of village land for foreign-invested manufacturers. The Administration Bureau of National Land intervened and issued a notification concerning abuse of agricultural land in order to exercise control over the illegal transfer of collective land. In fact, these policies were inconsistent with the Land Law which regulates all village land as collective property which, as collective property is not permitted to be transferred into commercial land use. This was a confusing situation for foreign investors many of whom had invested in projects that included the purchase of village land on which they had built factories.

9.4.2.3 The Legislature versus the Judiciary

In the 1981 NPC Standing Committee Decision Concerning Reinforcement of Judicial Interpretation 1981 (adopted at its 19th session, 5th Meeting), the Supreme People’s Court and Supreme Prosecutor were empowered to interpret laws and decrees concerning the application of concrete cases. The meaning of the ‘application of concrete cases’ is not, however made clear in the Decision Concerning Reinforcement of Judicial Interpretation 1981. Judicial interpretation does not resemble its counterparts in the west. The Judiciary does make laws in the name of judicial interpretation. Conflicts of law not only exist between the legislature and the judiciary, but also in the judiciary itself, that is, between the Supreme Court and the Supreme Prosecutor. The Decision Concerning Reinforcement of Judicial Interpretation 1981 made it clear that such conflicts would be resolved by reporting to the NPC Standing Committee.

The problem of central-local conflicts of law is a reflection of the more general central-local relationship in China. Conflicts of law between the two levels results from the State Council’s assignment of its rights to both the administrative authority and to the local
level administrative bodies.\textsuperscript{98} The extensive legislative power granted to the State Council has thus made the Council, de facto, the most powerful law-making institution in China. This would appear to explain the huge number of administrative regulations issued by it.\textsuperscript{99} The problem is exacerbated by the lack of legislation concerning central-local separation and balance.

The central-local relationship in legislation shifts with the development of the market economy. The more power that the central government releases, the more discretionary power local governments enjoy in all aspects of governance. In 1994, separate systems of taxation were being applied despite this being more appropriate for a federation than for a unitary state. Compared to other unitary countries, local levels have more law-making power in China in accordance with the Constitution.\textsuperscript{100} The local levels did not enjoy such law-making powers in the past because the central government controlled and constrained the economic resources.\textsuperscript{101} After the adoption of the ‘Open Door’ policy, the central government gradually surrendered some of its power of decision-making, while local levels of administration took advantage of this to advance their own interests by implementing local laws and regulations.\textsuperscript{102} According to a mid 1990s investigation by the Product Bureau of the State Council Reform Commission, two thirds of the local officials agreed with the assertion that: ‘For the sake of local interests, even if policy constraints

\begin{thebibliography}{99}
\bibitem{98} Jiang Zihao and Ma Beihao, \textit{The Existing Issues, Causes and Resolution of Administrative with the Administrative Legislative System} (2005) 151 Government Legal System Study 1, 2.
\bibitem{100} Constitution of the People’s Republic of China (People’s Republic of China National People’s Congress, 4 December 1982, art 100.
\bibitem{101} Jiang Zihao and Ma Beihao, above n 98, 1.
\bibitem{102} Ibid 4.
\end{thebibliography}
exist, we will make it work for us'. This is a clear indication of the rising eagerness of the local institutions to strive for the interests of their local areas.

It is very natural for different local levels to have conflicts of law as a result of the different arrangements made by the central government for different regions in China. This is exacerbated in the southern provinces which are assigned more discretion in both economic and social terms and have looser ties to the central authority.  

9.4.3 Further Analysis of Inconsistency between Laws

Brief references have been made to the problems arising from the question of inconsistent laws adopted by the different law-making bodies in China. The issue is worthy of more detailed consideration. Every legal system must have rules for reconciling conflict between inconsistent laws. Observers in China have argued about this mixed legislative system since the early 1990s. The solution in the common law system, which is applicable in such states as the UK or New Zealand, is the ‘doctrine of implied repeal’. Where there are two inconsistent (or conflicting) statutes, often the latter can be deemed to have implicitly repealed the earlier to the extent of the inconsistency, although this is not always the case. The doctrine of implied repeal applies in China to resolve conflicts between laws enacted

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105 Ibid 8.
106 David Pollard et al, Constitutional and Administrative Law: Text with Materials (Oxford University Press, 2007) 342. The doctrine of implied repeal states that a provision in an earlier Act of Parliament may be repealed impliedly (as opposed expressly) by the subsequent enactment of a provision in an Act of Parliament which is so inconsistent with the earlier provision that, in effect, it erases the earlier provision.
by the same legislative body, for example, conflicts between two statutes of the NPC or two statutes of a provincial legislature.\footnote{<<中华人民共和国立法法>> [Legislation Law of the PRC] (People’s Republic of China) National People’s Congress, Order No 31, 15 March 2000, arts 83–84.}

The second rule adopted implicitly or expressly is the doctrine of ‘central paramountcy’, which is also very common in federal systems. Where there are inconsistent (or conflicting) central and local laws, it is the central law which prevails. A similar doctrine applies in Australia, in the US and in Canada.\footnote{Peter Hogg, ‘Is the Supreme Court of Canada Biased in Constitutional Cases?’ in Christine Leuprecht and Peter H Russell (eds), \textit{Essential Readings in Canadian Constitutional Politics} (University of Toronto Press, 2011) 276, 286. A wide definition of inconsistency would result in defeat of provincial laws in the same field of federal laws. This happens in United States and Australia. In Canada it requires the direct contradiction between the federal law and provincial law to trigger the paramountcy doctrine.} In China the doctrine of ‘paramountcy’ also applies when it comes to a conflict between the NPC and other above-mentioned law-making bodies. Another variation of this rule is the doctrine of ‘higher level paramountcy’, which applies where conflicting laws are enacted by different levels of the same law-making body; (for example, conflicts of administrative regulation made by the provincial government and a municipality in that province or conflicts of some rules made by a Ministry and a lower level branch).\footnote{<<中国的法治建设>>白皮书 [Rule of Law in China] (国务院新闻办公室 [Information Office of the State Council], 北京 [Beijing], February 2008) para 28.} However, it is notable that no such constraint is set for: (a) a conflict between different departments of the same level (such as those between Judicial Interpretation and Executive Regulation); (b) regulations between different departments of the State Council; or (c) where conflicts of law exist in different, but still local, levels.\footnote{<<中华人民共和国立法法>> [Legislation Law of the PRC] (People’s Republic of China) National People’s Congress, Order No 31, 15 March 2000, art 86.}
There is also another effective resolution method for the conflicts of law, namely negotiation or, more formally, reconciliation. In China, conflict of statutes between different provincial legislatures is unlikely to occur because the legislative authority of each province is confined within its own territory. However, conflict of regulations between different branches of the administration is bound to occur from time to time because such regulations are applicable in the same territory. In these cases, the conflicting regulations will be referred to the State Council for decision and rulings.  

For example, the *Administrative Procedure Law of the PRC 1989* proclaims:

> If a people’s court considers regulations formulated and announced by a local people’s government to be inconsistent with regulations formulated and announced by a ministry or commission under the State Council, or if it considers regulations formulated and announced by ministries or commissions under the State Council to be inconsistent with each other, the Supreme People’s Court shall refer the matter to the State Council for interpretation or ruling.  

This is an apt illustration of the conciliation rule in the ‘living law’ in China. Despite all of these resolution mechanisms, conflicts of law in China are still a major problem that continues to bewilder the Chinese legal community. One reason for this is that conflicts of law continues to be an obstacle for the court when they apply laws in a specific case. The 2003 ‘*Luoyang Seed Case*’ was an example. This was a seed reproduction contract dispute case with the claim of economic loss by the plaintiff on the ground of failure of performance of contract by the defendant. The issue arising out of this case was which law should be applied for the purpose of calculation of the economic loss by the

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111 Ibid arts 86[2], [3].
113 <<河南省汝阳县种子公司与河南省伊川县种子公司玉米种子代繁合同纠纷案>> [Henan Province Ruyang County Seed Company v Henan Province Yichuan County Seed Company — Seed Reproduction Contract Dispute] 洛阳市中级人民法院 [Luoyang Municipal Intermediate People’s Court, People’s Republic of China], 洛民初字第 26 号 [Economic First Instance No 26], 27 May 2003.
plaintiff. The plaintiff claimed its loss based upon the *Seed Law of the People’s Republic of China 2004*\(^{114}\) in which it argued that the economic loss should be estimated on the market price when the decision was made. However, the defendant argued that the *Regulations Concerning Administration of Agricultural Products of Henan Province 1984*\(^{115}\) should apply in which it stated that the price of the seed should follow the government directed price. The difference between the two bases of calculation was RMB680,000 (approximately USD82,000).\(^{116}\) The first instance court — Luoyang Intermediate People’s Court — delivered its judgment that the provision in relation to the seed price in the *Regulation Concerning Administration of Agricultural Seed Products of Henan Province 1984* shall be invalid as a result of it being in contradiction to the national law of *Seed Law of the People’s Republic of China*.\(^{117}\) The second reason was that these principles are neither expressly stipulated in the *Constitution* nor written in other national legislation. Therefore, it will be at the discretion of those in the most powerful position to decide when they should or should not be applied. Finally, there are neither legal proceedings to coordinate such mechanisms nor a statutory process to deal with such matters concerning conflicts of law. Consequently, there is a pressing need to establish some mechanism to address this situation.

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\(^{115}\) *河南省农作物管理条例* [Regulations Concerning Administration of Agricultural Seed Products of Henan Province] (People’s Republic of China) Henan Provincial People’s Congress Standing Committee, 27 April 1984.

\(^{116}\) *河南省汝阳县种子公司与河南省伊川县种子公司玉米种子代繁合同纠纷案* [Henan Province Ruyang County Seed Company v Henan Province Yichuan County Seed Company — Seed Reproduction Contract Dispute] 洛阳市中级人民法院 [Luoyang Municipal Intermediate People’s Court, People’s Republic of China], 洛民初字第 26 号 [Economic First Instance No 26], 27 May 2003.

\(^{117}\) Ibid.
The primary need is to set up an efficient law-making system. Governmental power is vested in one national authority; and local authorities are subordinate to the national authority. The powers of a city, borough or county are granted to it by the national legislature, and may be taken away, altered or controlled at any time by the national legislature.\(^{118}\) No matter what kind of institution it is, there will always be laws to demarcate responsibilities between the two levels.

The Communist Party of China preferred a typical unitary country. However, local levels were vested with powers to make law simply as a result of the practical reality that direct control at the central level brought about too many technical obstacles. As a result, although the state structure in China is characterised as consisting of centralised power, there are indications that it is also characterised by some federal features, such as autonomous regions, special regions and the four municipalities.

What appears to be necessary in China today is more work on confining different legislatures or law-making bodies to their own territories. The Government will be faced with a continuation of problems as more and more discretionary power is demanded by the lower or local levels. So it would be wise to take measures to deal with such serious aspects.

\(^{118}\) [Legislation Law of the PRC] (People’s Republic of China) National People’s Congress, Order No 31, 15 March 2000, art 88. The Supreme People’s Court gave an interpretation that the people’s courts invalidation of a contract shall only be based on laws that are promulgated by the NPC and its Standing Committee and the State Council but not based on local governments regulations. [Interpretation Concerning Several Issues of Application of Contract Law of the People’s Republic of China (1)] (People’s Republic of China) Supreme People’s Court, Order No 19, 19 December 1999, art 4.
China today needs not only constitutional rules to regulate statutes, but due process to carry out these rules. According to Yasuhen and Yaxin, rights and duties stipulated in the substantial law are an illusion of rights and duties unless they are manifested in concrete decisions.\(^\text{119}\)

In the Chinese system, both parties in a conflict of law have the right to take part in an action and to resolve disputes in public. In consideration of the public nature of procedural law, there is no good reason why the *Constitution* should not apply to procedural laws. Given the extreme rapidity of change over the last twenty to thirty years the time is probably right for a constitutional review to ensure the protection of rights, obligations and powers vested by the *Constitution* and to deal with the local/central problems referred to above.

Inter-regional conflicts of law should also be dealt with. This was not a problem in the past because the reach of provincial statues was confined to their own territories and there seemed to be no need to set rules for conflicts. For example, the *Regulations Concerning Land Use Right Transfer of Shenzhen Special Economic Zone 1994*\(^\text{120}\) can only apply within the Shenzhen Special Economic Zone area. It is not applicable nation-wide or to other cities.\(^\text{121}\) But Hong Kong and Macao have since reverted to the PRC and there exists a real dilemma in trying to integrate the legal powers of the competing jurisdictions. The legislative system is a multiple system that has been described by some private

\(^{120}\) <<深圳经济特区土地使用权出让条例>> [Regulations Concerning Land Use Right Transfer of the Shenzhen Special Economic Zone ] (People’s Republic of China) Shenzhen People’s Congress Standing Committee, 18 June 1994.
\(^{121}\) Ibid art 4.
international law scholars in China, as ‘one country, two systems, four legal families’.\textsuperscript{122} Also, considering the surging demand for discretionary power from the local authorities, there is a possibility, based upon the various economic conditions in different regions, that the local levels will be granted law-making powers more or less similar to those of the special administrative regions.\textsuperscript{123}

Over-empowerment and abuse of powers at local levels have been major problems in Chinese history. In the past, conflicts arising from these causes used to be settled by wars, but in contemporary society law is supposed to be able to contemplate and lead to the resolution of such conflicts. If law is not utilised in time, it is conceivable that both economic and political battles will occur in and amongst the newly developing regions of China.

\section*{9.5 Conclusions}

In terms of social factors as discussed here, there is little doubt that the comparison between the ‘depersonalised’ relational rules in western business practice and the quite different ways in which Chinese business relationships maintain and enrich personal relationships supports the validity of the proposition that the western foreign investor in China can benefit by, to some extent, casting aside their normal concepts of how business should be done. The different attitudes of communicating with Chinese authorities as between the German Volkswagen Group and the American Motor Corporation as discussed in this chapter, shows that the importance of good relationships with Chinese parties for foreign

\textsuperscript{122} An often repeated expression of former President Deng Xiao Peng.

\textsuperscript{123} 《中国的法治建设》白皮书 [Rule of Law in China] (国务院新闻办公室 [Information Office of the State Council], 北京 [Beijing], February 2008), para 24.
investors and the complicated administrative influences on the business environment in China. This indicated that the good balance of German Volkswagen Group in the course of handling the business partnership and dealings with the administration has contributed to its success in China’s motor vehicle market. According to Lenganberg:

Relationships with government officials are highly significant for modern day business. This is not surprising considering that China’s unique context of institutional force still contains many elements of state-designed arrangements and functions.\(^{124}\)

The importance of relationships at almost every level of activity in China cannot be overstated. It also extends to the working relationships between individuals, small business operators, corporations and authoritative decision-makers at every level and, it must be said, has appeared to work very effectively, despite the fact that it can also be manifested in ways that border upon being, or actually are, corrupt. The case studies discussed here show that some ‘hard-line’ business practices that may well be acceptable in some western countries have the capacity to invite failure when adopted in China. The conciliatory style of negotiation in dispute situations certainly appears to be a more appropriate and effective approach for foreign investors in the PRC.

The characteristics of the legal structures of China have been examined in some detail here, and it has become clear that the structure invites confusion and conflict on the one hand and opportunities for ‘flexible’ interpretation and possibly manipulation or exploitation on the other. The PRC government can certainly utilise these elements of the law to its advantage in properly attempting to retain some level of control of economic

activity of the country. China is physically vast and the imposition of total central control of all laws over the whole country would seem an impossible feat. It is undoubtedly politically wise to devolve a measure of power to the regional and municipal centres but there may be a cost to such devolution.

The traditional levels of legal semi-autonomy that exist between different regions of the country also contribute to the incidence of inconsistency between laws, conflicts of law and varied interpretations of laws — all of which have the capacity to assist, frustrate or confuse the foreign investor.

Traditionally, those governing China have always had to cope with the difficulties presented by huge distances and diverse groupings within its borders as well as (from time to time) the unpopularity of the idea of imposition of rules from the capital. In modern China it is the case with much foreign investment activity that a great deal of decision-making and regulation occurs at provincial and regional locations as well as within the SEZs.

This aspect has earlier been shown to present opportunities for foreigners in terms of competition between different Chinese localities and authorities for the operation of a business, building infrastructure, employment opportunities, local income tax and so on.125

In general terms it can be fairly said that the continuing existence of certain cultural habits, preferences and attitudes has the capacity to impact adversely upon foreign investors in China. However, if those investors have gained some understanding of those local characteristics and, in addition, make some effort to modify pre-conceived notions about,

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for example, contract formation and dispute handling, then adverse outcomes can very likely be limited.
Chapter 10

Conclusions

10.1 Introduction

As has been discussed in the previous two chapters, Chinese legal tradition developed from both Confucianism and Legalism.¹ The interlacing of the two dominant streams of thought has been shown to pervade not only the legal codes promulgated during imperial times, but to underlay the administration of justice and the legal institutions that have been developed up to the present.²

This chapter concludes the research by suggesting that an understanding of the role of the history of Chinese legal tradition gives an explanation for the coherence (and sometimes a perceived lack of coherence) of the law and government in the current legal system in China. This thesis has explored the relationship between modern foreign investment in China and the laws of that country and, more specifically, the application of Chinese laws to foreign investment. It has shown that an understanding of the nature of, background to, and influences upon Chinese law is knowledge that can be invaluable for the successful exercise of investment in or with China today.

A recurring observation in this research has been the significance of an understanding of Chinese history and its influence on Chinese legal system. The influence

has been so long-standing and all-pervasive in Chinese society that it continues to have profound effects upon Chinese legal practice today, even though China has been through quite radical stages of political change and development. Its implications have been examined in several aspects in relation to foreign investment and the legal framework.

Section 10.1 of this chapter introduces the proposition that within the character of the Chinese people there is an ingrained and pervasive belief system that has resulted from centuries of acceptance of some basic concepts of human behaviour in addition to and complementary to laws from time to time. One aspect of significant importance for foreign investors is that related to the need to establish strong relationships — often at a personal level — with Chinese partners. It is also necessary for the foreign investor to accept the importance of establishing links between significant players in the particular sphere of activity concerned and to understand that the regulatory framework requires patience and an acknowledgement of the need, in many instances, for assistance by the Chinese partner in navigating the local requirements. Section 10.2 summarises the subjects broadly under discussion in each of the preceding 9 chapters of this research and includes some specific conclusions drawn from the study. Section 10.3 presents some more general conclusions from the research

10.2 Summary of Earlier Chapters

The introductory chapter discussed the background of the Chinese economic system at the time when China’s political leaders decided to attempt the transformation of the country’s economy from a ‘command’ economy on the verge of collapse to a market economy on a global scale.
The need for the development of a legal regime to facilitate and support the enormous development of China’s trading relationship with the rest of Asia and the western world was immediately evident and this study documents much of the development of such a legal system over the past three decades.

As part of the general development of its laws, China developed, and continues to develop a specific set of laws to deal with ever-increasing levels of foreign investment in the PRC. During this process the role of law and the relationship between law and government began to be revealed and, as a result, that relationship has continued to be the subject of external scrutiny. The scrutiny, often incorporating some doubts as to the motives of the government of the PRC, centered upon the seemingly contradictory position of a communist government system engaging in a capitalist, market driven economic policy.

China’s rapid economic reform has not only developed the country’s economic system and led to its position as one of the most rapidly growing and strongest economies in the world it has also facilitated and, it is suggested, demanded the development of its legal system to be one more aligned with the legal systems of western market economy states.

This research has mapped the development of Contract law in China and in so doing has provided an example of the nature of the country’s modern legal reform process. It shows that legal reform is based upon, and relies upon, the changes inherent in economic transformation. Specific laws were necessary to service the needs of China’s progress and changes to economic policies.
Also, matters relating specifically to foreign investment operations have been examined. China has been a popular foreign investment destination since the opening of its massive market and its manufacturing skills to the world. Whilst there have been many successful international business operations in China, there have also been some substantial failed enterprises. The lack of a consistent and transparent legal system along with complicated systems of administration have certainly been major contributing factors as, of course, have been the often misplaced expectations of some of those seeking access to the Chinese market or its manufacturing advantages.

The survey that was conducted as part of this research identified some common concerns amongst Australian individuals and enterprises operating their business in or with China. Legal and social aspects regarding China’s business, administrative and legal environment were examined. The survey and interviews indentified a number of existing difficulties in terms of relationships with Chinese government at a various levels, Chinese partners and the Chinese judicial system. The conclusion drawn from these investigations is that whilst actual laws and regulations in China may be difficult to comprehend on occasions and often do not demonstrate a clear direction for the foreign investor, it is often the nature of individual relationships where communication breakdowns occur and this can, and often does, lead to unsatisfactory and possibly costly outcomes.

The outcomes of the survey and interview component of this study confirms the thesis that the success of business relationships between foreign investors and Chinese partners are not simply dependent upon reaching agreement and committing the terms of such agreement to a written contract between the parties.
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Even though initial written contracts nearly always exist between the foreign investor and his or her Chinese partner, they are often regarded by the Chinese participants as general blueprints for the ongoing relationship rather than iron-clad arrangements for all aspects of a business partnership in the way that such contracts would normally be designed in the west.

Additionally, social and legal aspects of the current environment in China have been explored from the perspective of China’s historical and cultural background. In an examination of Chinese legal tradition, the influences of Confucian and Legalist philosophies in Chinese political and legal evolution have been explored. It is concluded here that these philosophical positions have had profound influence on Chinese legal tradition and are still functioning in current society in subtle ways. It is suggested that, in the search to understand the complexities of western business relationships with Chinese partners, an understanding of Chinese history and culture and their influence on the legal system is an important pre-requisite knowledge.

There is little doubt that connections with people who have power may be crucial for business operations and that awareness of this aspect is important for foreign investors. The role of the government or the state owned enterprises associated with governmental power in the economy was always protected. Important economic decision-makers at all levels (from the members of the State Council down to the managers of factories), comprise a powerful supplementary network for transmitting and implementing the economic goals and policies of the government. Connections can be valuable in any country but in most western countries the primary focus of a business is its product or service because buyers and sellers deal at arm’s length. In China, the quality of the product is important, but
Guanxi is even more so. It can take a long time to develop Guanxi independently, but it can be accomplished vicariously. The most effective vehicle is the joint venture with a (local) participant who has Guanxi at levels appropriate to the transaction.

This research has been limited by a number of factors in indicating that some future investigations may be appropriate. Firstly, the survey for this research took place in 2005 and the passage of time, particularly with the pace and dynamics of development in China since then, may have resulted in a range of different experiences for foreign investors in China in the last six years. Secondly, important factual information about immediate past events and decisions in China are often difficult to obtain causing difficulties in maintaining objectivity about current issues. It is often the case that, only after many months or even some years after policy or administrative decisions have been made, does it become possible to rationally analyse their nature and their practical effects. In the intervening period it may be that an observer’s or analyst’s own prejudices and interests are more likely to influence their views or conclusions. Thirdly, the Chinese philosophical and social systems were, and are, very complex and composed of so many interacting strands that are difficult to fully unravel.

10.3 Concluding Comments

Today, law in China serves as a means both to consolidate the achievements of economic reform and to promote further development of economic reform by way of standardising

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3 ‘Guanxi’ in this context essentially means connections or networking.
and institutionalising changes in the economic system.\(^5\) Deng Xiaoping said in the Communique of the Third Plenary Session of the Eleventh Central Committee of the CPC that law must be used to establish stability and order for economic development.\(^6\)

In China, Party policy decides the direction of economic reform and development. China’s prominent scholar Chen suggested, ‘Law is the fixing and codification of policy. It is necessary to stabilise, in legal form, Party policies that in practice have repeatedly proven their effectiveness and whose implementation should be continued.’\(^7\) Therefore, law is a better tool than policy, capable of securing and institutionalising policies in a more universal manner and of providing stability and order (supported by the threat or use of the state’s coercive forces) for economic development and defining rights and duties in relation to the state as represented by various administrative authorities.\(^8\)

To date the ‘stability’ referred to may not have been achieved in practical terms for many foreign investors whilst some very substantial, long term joint venture operations —

notably some major motor vehicle manufacturers — seemed to have achieved such stability. By 1997 they had captured 52 per cent of the sedan market in China.9

The ‘Open Door’ policy recognises that China needs not only foreign technology and foreign capital, but also foreign management expertise, marketing experience and marketing networks. Competition among provincial and local authorities to attract foreign investment by offering preferential treatment and concessions (other than those granted or approved by the central government) has increased the possibility of conflict between central and local authorities but this has probably benefitted foreign investors rather than hurt them. The Chinese Constitution does not expressly give any exclusive powers to the central government. It does allow local government at the provincial level to make local regulations and rules, provided that these regulations and rules do not contravene the Constitution, the law and administrative rules and regulations issued by the central government.10 Therefore, it remains unclear whether locally granted preferential treatments and concessions are legally valid, in particular when central government policies change. This clearly constitutes an important issue in the medium to long term for a potential foreign investor.

As in other areas of economic activities, various forms of foreign investment developed and were often permitted by ad hoc policies ahead of reformulation and enactments of relevant legislation. However, as foreign investment increased in China, so did the volume of Chinese laws and regulations both at the central and local levels. These laws and regulations have resulted in a special legal regime for foreign investment

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enterprises. A unique feature of these laws and regulations is that they deal with specific types and specific aspects of foreign investment, there being no unified code for foreign investment.\textsuperscript{11} The trend appears to be towards uniformity while still allowing certain special concessions for foreign investment that brings foreign technologies and capital.

Some of the vagaries of the day to day dealings in setting up and operating a new business China will continue to cause frustration. Among the vital ingredients for an entry strategy for foreign investment and for sustained operations in China for the foreign investor are patience and a willingness to cope with the Chinese ways of conducting business.

An assumption by a foreign investor that the mere existence of a law guarantees that all parties concerned will comply with such a law, may be risky. Western business operators generally expect the laws to be complied with within the normal range of flexibility that might be available. Laws may often, in practical terms, be seen by Chinese partners and, importantly, by administrators — as general guidelines. Understanding the variable nature of the administration of some laws relating to foreign investors and the building of strong administrative and personal, relationships are valuable strategies and may well result in desirable outcomes.

In the trend to ever increasing economic globalisation, no country will be able to dissociate itself from the world economic system. Economic globalisation has promoted economic growth and increased the output of the world; it has also resulted in increasing interdependence between all countries in terms of economic activity and trade. China

\textsuperscript{11} Jianfu Chen, ‘China: Constitutional Changes’ above n 7, 163–4.
became a member of the WTO on 11 December 2001. As a member, China gave a commitment that it would strictly comply with WTO requirements. As discussed earlier in chapter six, China is providing significantly improved market access on a secure basis, in the agricultural, industrial and services sectors with in-built provision for growth in that access.

The Chinese legal system is a work in progress. China’s legal reform effort also depends to a significant extent on the dynamics of its legal culture. Legal culture may be defined by references to sociology and political science, customs, values, and opinions, and ways of thought and behaviour.¹²

The perspective of this thesis has been to focus on legal culture as a basis for understanding the relationship between imported and local norms. It is suggested here that the analysis of China’s legal culture provides appreciation of the tension between the globalised systems of liberal legal norms — from which many of China’s legal reform efforts are drawn — and of deeply embedded systems of local norms and values.

In China, the effects of globalised regulatory norms are confronted by powerful forces of Chinese local culture. The resilience of local norms, despite new institutional arrangements, is a salient factor of political culture of modernising societies,¹³ and is no less evident in the area of Chinese legal culture. Local norms in China derive from traditional values contextualised by diversity in local socio-economic and political

conditions, which include factors such as status, gender, age, education, and employment.\textsuperscript{14} Although indigenous legal norms may emerge and become stable and influential through a process of formalisation of customary values,\textsuperscript{15} when local traditional norms are ineffective to manage the totality of changing social and economic conditions, new norms may emerge as an alternative.\textsuperscript{16} Acceptance of imported norms may then become possible to the extent that these respond to local conditions more effectively than traditional norms. According to Cotterrell:

\begin{quote}
Culture, therefore, appears fundamental – a kind of lens through which all aspects of law must be perceived, or a gateway of understanding through which every comparatist must pass so as to have any genuine access to the meaning of foreign law.\textsuperscript{17}
\end{quote}

The Chinese economic reform process has created opportunities for increased reliance on law in management of the economy and society. Increased complexity in socio-economic and political relations may require norms of formality and objectivity to replace informal and subjective relational norms associated with tradition.\textsuperscript{18}

The Chinese legal system, particularly as it relates to foreign investment, is still in development but there are aspects of Chinese law that appear to be difficult to reconcile with western laws. The most significant factors appear to be the variable administration of


\textsuperscript{17} See Roger Cotterrell, \textit{Living Law: Studies in Legal and Social Theory} (Aldershot, 2008); R Zimmerman and M Reimann (eds), \textit{The Oxford Handbook of Comparative Law} (Oxford University Press, 2006) 283.

laws across geo-political boundaries and the legal and political difficulties that exist between central government and provincial and local governments and regulators.

Foreign investors in China encounter a somewhat unpredictable investment environment and are witnesses to an unprecedented commitment to the modernisation of laws and the Chinese legal system. As referred to earlier in chapter five, observers have expressed concerns about problems in the investment environment, such as lack of predictability and unclear dispute processing. These are continuing and possibly inevitable hurdles arising from China’s economic evolution.

For foreign investors China’s huge market presents an opportunity for their business to expand enormously. However, China’s legal system is difficult to become accustomed to because it is not only operating within a complicated Communist social system but is also impacted by a long history of traditions.

It is this researcher’s view that a better understanding of China’s current legal reform can be achieved by the analysis of the effects of traditional embedded customs that are still operating within the legal system in subtle but persuasive ways. Careful consideration of the social conditions within which the legal system is operating is, this researcher suggests, worthy of significant attention in order to move towards efficient and successful outcomes in legal reform in China today. It is suggested here that some understanding of such factors is an important prerequisite for foreign investors in equipping them to operate in China.

Foreign direct investment in China, with 32 years history since the promulgation in 1979 of the Joint Venture Law, has had its elements of drama and reports of dissatisfaction.
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The problems of the effects of social and cultural factors on the PRC legal system (described above) have been serious obstacles and, although their severity has been reduced, it remains more difficult for foreign investors to do business in China than in many other locations.\(^\text{19}\) The key to attracting foreign direct investment remains China’s wage costs, but the attractiveness of investing in China has been increased by reducing the drawbacks referred to earlier, in particular removing most of the bureaucratic obstacles which suggested that smaller investments may not be worth the effort involved. However, according to Kirby and Kaiser’s research concerning small and medium sized firms from Germany and the UK:

> Joint ventures, though successful, are not without their problems. Their experiences are similar to those of large multi-national enterprises. As the key to success is often predicated upon the successful selection of the joint venture partner, assistance is required to help SMEs in the process of identification and selection of appropriate partners.\(^\text{20}\)

The most debatable consequences for China are the ‘Open Door’ policy’s links to social and political change. New ideas of how to do business, exposure to images of capitalist societies, being encouraged to think on the job and having material possessions have all contributed to an increased desire for the rule of law and political pluralism. Direct foreign investment in China has been a success, increasing Chinese economic welfare and realising profits for the foreign investors. According to Zhang’s study:

> The role of FDI in the Chinese economy has become increasingly important. In 2004, FDI inflows constituted seven per cent of gross fixed capital formation; 21 per cent of China’s tax revenue came from the foreign-invested enterprises (FIEs); 28 per cent of industrial


output was produced by FIEs; and more than half of China's exports (57 per cent) were created by FIEs.\footnote{Kevin H Zhang, ‘Foreign Direct Investment in China’ (2006) 13\textit{ Canadian Foreign Policy} 35, 35.}

It is important, however, neither to exaggerate nor to belittle this success. Not all FDI succeeds and not all of China is attractive to foreign investors.

Before investing in China, investors are advised to carefully study the program of policies relating to the sector in which they intend to invest. China has developed a very elaborate legal system to provide protection for foreign investment. At the same time, the system is often subject to policy parameters, which are established at the central government level. Therefore, when looking to invest in China, investors are advised to study carefully the policy directions currently in force and to seek the advice and support of government officials and concerned ministries.

Although the need to create an appropriate legal framework for foreign investors is notable, they take time to be absorbed in a centrally governed economy, as officials need to overcome their suspicion of foreign capitalists and to understand foreign business practices.

Additionally, it is important for potential foreign investors to have an understanding of the effect of social and cultural factors on the legal system in China. Understanding the local culture and traditions has been well addressed in the international business literature for international corporations operating their global operations — especially in developing countries. Integrating western and Chinese cultural elements and traditions into a company’s business policies and operational procedures and ensuring those policies and procedures are protected by local legal
systems — has emerged as another key success factor for an international venture in China. As Chen affirms:

There are many issues that are important and relevant in regard to doing business in and with China. Indeed, an understanding of Chinese political and legal systems and sensitivity to Chinese social and cultural issues are indispensable. Although the convergence of the two legal systems, domestic and foreign related, is yet to be achieved and completed, there is no doubt, at least once a foreign business is established, that many aspects of domestic law will be applicable to foreign business.22

The NPC passed the China Enterprise Income Tax Law in 2007 in order to provide a ‘level-playing field’ for both domestic-invested enterprise and foreign-invested enterprises to comply with the WTO’s national treatment rules.23 There are, of course, two sides to the coin, and numerous pitfalls are often experienced on the path to prosperity in China. The sometimes miraculous numbers that appear in any description of the economic progress of China in recent years cannot disguise the problems associated with the country’s developmental transition period.24 China has made very significant progress in a wide range of aspects of its legal reforms since 1995.25 Even though the Chinese legal system is still tightly politically controlled, significant changes in the legal system might prove to be signs of truly significant changes in the political system as well.26 This research has examined how law in China is created in the context of cultural and historical

23 CCH Hong Kong Limited, Tax Compliance in Greater China: China, Hong Kong and Taiwan (CCH Hong Kong Limited, 2008) 70.
25 Donald C Clarke, ‘Introduction The Chinese Legal System since 1995: Steady Development and Striking Continuities’ in Donald C Clarke (ed), China's Legal System: New Developments, New Challenges (Cambridge University Press, 2008) 1. 1. A wide range of subjects in relation to legal development included the legislative process, the implementation of legislation via the interpretive practises of courts and administrative agencies as well as through the enforcement of civil judgments, the personal staffing system in the role of legal advisers, criminal law and human rights, the key area of foreign trade and investment law and China’s place and role in the international legal order.
dimensions. Chinese law was indigenously developed from the secular philosophies of social morality, namely Legalism and Confucianism. The patriarchal relationship and behavioural norms within the extended family or clan were not only reflected in the power structure of officialdom but also formed the basic foundation and standards for social conformity. Foreign investors’ operations in China must meet the challenge of differences of legal culture and tradition because these will continue to provide significant influence in the future shaping of the legal system of the PRC. It is to be hoped this research will provide assistance to academics, international practitioners and people conducting business in, or with, China, in their efforts to understand China’s foreign investment policies and laws and, perhaps more importantly, their attempts to understand the people with whom they are, or will be, working in their China venture.
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