

Rule of Law and Business Conditions in China
Testimony by
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Mr. Chairman and Members of the Commission:

Thank you for the opportunity to testify today before this distinguished body on the rule of law in China. I am here today representing the American Chamber of Commerce in China, an organization in Beijing of over seven hundred fifty companies and approximately 1,500 individuals formed to represent the commercial interests of the American business community in China. There are few subjects of greater interest to our members than the development, current state, and future prospects of the Chinese legal system. My personal interest in China began in 1965 as a teacher at the Chinese University of Hong Kong, continued through a Ph.D. in Chinese history at Princeton, and intensified during a business career beginning in 1980. I lived in Taipei, Taiwan from 1991 to 1996. In 1996 I moved to Beijing, where I am Managing Director for China of APCO Worldwide.

In my testimony today, which focuses on the rule of law as it affects business conditions, I will define rule of law in terms of transparency and consistency. By transparency, I mean the promulgation of laws and regulations that have been developed with the participation by affected parties and which are easily accessible, objective, and clearly understandable. By consistency, I refer to the fair, reliable, and nondiscriminatory application and enforcement of laws, regulations and contracts. China is proof that economic growth and social progress can occur despite a legal system that is manifestly neither transparent nor consistent. But AmCham China has been an outspoken advocate of the proposition that economic growth and social progress can only be sustained and maximized over the medium and long term by establishing and enhancing the rule of law. A transparent, consistent legal system is required to treat participants in the economic system fairly and is one of the foundations of a just society; its absence is a deterrent to investment and encourages socially damaging recourse to non-legal means of redress and protection.

The concept of the rule of law outlined above is relatively narrow. A broader definition might include references to economic systems such as a market economy, to political institutions such as free and fair elections, to the balance between liberty and responsibility within society, and to conceptions of universal human rights. Defined in this fashion, the rule of law takes many forms. Many would agree, for example, that the rule of law exists in Canada, the United Kingdom, Germany, Japan, Taiwan, and Singapore, but it takes quite different institutional and substantive forms in each. The advantages of a narrow definition of the rule of law for my purposes today are: there is broad consensus as to its elements; it is at the core of all legal systems commonly recognized as embodying rule of law in its broader sense; and it provides a framework sufficient to encompass most commercial issues, such as property rights and contractual rights.

In thinking about China, it is always useful to consider trends, as well as conditions at a particular point in time. When China began its reform process in 1979, it did so essentially without a legal system. The legal profession did not exist, there were few published laws, the courts were political instruments intended to administer substantive "justice" defined ideologically and morally rather than legally, and the National People's Congress functioned as a consultative and advisory rubber stamp rather than as a legislature. The only constraint on the power of the government bureaucracy was the overlaid bureaucracy of the Party, and the only restraint on the Party was the PLA. There was also the theoretical possibility of popular revolt, but

that had been exhausted in the excesses of the Cultural Revolution and other mass movements in the thirty years after 1949.

Since 1979, China has made extraordinary progress in drafting laws and administrative regulations, establishing law schools, training lawyers, and improving courts. The basic elements of a comprehensive system of economic and commercial law have now largely been put in place. Moreover, they are fundamentally consistent with international practice, though not always US practice. It is a stated goal of China, enshrined in its constitution, to establish the rule of law, though the government and Party do not necessarily share our conceptions of the rule of law. There is an intense public discussion in the press and on television on this concept and explicating the legal rights of citizens. But the standards of transparency and consistency are much more difficult than simply passing adequate laws and regulations with the expressed intent of establishing rule of law. Just as a financial center is not simply a group of tall buildings labeled "Financial Center", so too the rule of law depends on the professionalism and values of many players, on what might be called "legal system software" throughout the society. In particular, the rule-making process and the enforcement process are both crucial.

An important corollary of establishing a transparent, consistent legal system in China is the acceptance by the government and Party of limits on its authority and a reduction in its administrative discretion. The Party as an institution and senior leaders as individuals have assumed the right to act arbitrarily and to enjoy special privileges in order to achieve goals justified in Marxist terms. In the reform process since 1979, the National People's Congress has typically written broad legislation stating general principles to be later amplified by implementing regulations issued by the relevant Ministry or other agency. The implementing regulations often contained not objective standards, but rather subjective standards that could only be applied to specific facts by recourse to government personnel on a case-by-case basis. To some extent this was necessary given a hectic pace of legislation in areas with few precedents in Chinese practice or law since 1949. It was also deliberately intended to preserve wide latitude for officials to manage many aspects of the economy as they wished. In the shift toward a market economy, it has become widely accepted in China that the Party and government must reduce their roles as owner and investor in the economy, largely withdraw from their roles as manager of the economy, and focus primarily on their functions as a regulator. The rule of law will facilitate this difficult transition. Establishment of the rule of law, even in the narrow sense used here, is therefore not trivial, nor is it irrelevant to broader political and social issues. To the extent it is successful, it will protect companies and individuals from the exercise of arbitrary power.

Moreover, the rule of law is not easily compartmentalized or confined to a single sector, such as commercial transactions of foreign companies. If, for example, the government wished to encourage development of the privately owned residential housing market by allowing foreign banks to issue home mortgages to Chinese individuals, it must also establish the ability of the foreign bank to take a clear lien, and in the event of default, seize the home and sell it on the open market. It will then be obvious that the same rights must be available to local bank competitors. Perhaps not so obviously though, the individual homeowner must have clear title to his property in order to mortgage it. This in turn implies a much greater degree of certainty in owning such property and may lead as well to a degree of protection against the arbitrary exercise of eminent domain or failure to pay legally required compensation by local governments and developers.

To summarize these points, I do not believe that the rule of law will necessarily or inevitably lead to a particular outcome with respect to economic system, political institutions or human rights regime, but I do believe that it will strengthen the accountability of institutions and generally improve the protection of the rights of individuals.

In our 2001 White Paper issued almost eighteen months ago, AmCham China noted past progress in legal reform but expressed the view that it had stalled in recent years. We cited vague, poorly drafted laws and regulations that depend on subjective interpretations from government officials; continued reliance on

internal regulations formally considered state secrets but used to regulate the economy; inconsistent, selective enforcement; lack of independence of the judiciary; and local protectionism.

Local protectionism is not simply a matter of favoritism. It is exacerbated by the fact that most judges are not university graduates, much less lawyers; by the widespread practice of *ex parte* communications; by corruption; and by the willingness of local courts to uphold local regulations inconsistent with higher level government laws. Lack of independence is often cited as the fundamental weakness of the Chinese judiciary, a view that AmCham China shares, but given these other problems, it is not clear that truly independent local courts would immediately improve the legal system. It will be necessary to improve the courts and the legal system generally on many fronts over a long period of time. We have called for independence of the courts from political direction, trials open to the public, improved evidentiary rules and procedures, appointment of judges based on professional merit, and salaries sufficient to discourage corruption.

We were cautiously optimistic in the 2001 White Paper on business conditions in general, but with respect to rule of law suggested that lack of progress was outweighing positive developments.

On December 11, 2001, China became a member of the World Trade Organization. Regarding the rule of law, as in other areas, WTO accession resulted in new energy, greater political will, and a clearer sense of direction. China has committed to:

- Administer in a uniform, impartial and reasonable manner all its laws, regulations and other measures of the central and local governments governing its trade and foreign investment regime;
- To conform central government laws, as well as all administrative and sub-national government regulations, rules, and measures to WTO obligations;
- To establish a mechanism under which both individuals and enterprises can bring to the attention of the national government cases of non-uniform application of the trade and foreign investment regime;
- To enforce only published laws and regulations (thus eliminating the legal force of internal documents) and to make them available before they are implemented or enforced;
- To designate an official journal dedicated to the publication of all laws, regulations and other measures affecting the trade regime, and to establish a single enquiry point where information on all such laws can be obtained;
- To establish impartial and independent tribunals for the prompt review of administrative actions, and to provide contact points with respect to administrative actions. These commitments are extremely important with respect to establishing the rule of law in trade and foreign investment and to encouraging it generally.

Literally thousands of laws, regulations and rules have been reviewed for consistency with WTO rules and China's commitments and the process of revising or abolishing those with inconsistencies is basically complete. It will be some time before the legal and business communities are able to draw conclusions as to how well this task was done, but there is no doubt the effort was massive and in good faith. The promised enquiry points have been established, laws are increasingly being made available prior to their effective date and in some cases in draft form for comment, and a study is underway to establish a publication similar to the Federal Register to bring together information now published in many separate places.

It is to be hoped the central government will also be able to use WTO accession to strengthen its control over the provinces. All provincial governors have been called to Beijing for WTO training seminars and told in blunt terms that lack of compliance at provincial or local level with the WTO framework will be damaging for their careers. Whether such measures will be sufficient to meet the commitment to administer laws and regulations in a uniform, impartial and reasonable manner locally as well as centrally remains to be seen. Two years ago, a Law on Legislation was passed by the National People's Congress attempting to rationalize the legislative process and establish the principle that sub-national jurisdictions may not pass laws and

regulations inconsistent with those of the central government. This has reportedly had little practical effect and the issue will undoubtedly be revisited.

The statement of principle provided by the new WTO commitment is important, but uniformity, impartiality and reasonableness are subjective criteria difficult to evaluate. Moreover, meeting this commitment will require significant changes in behavior that will be perceived as damaging various special or local interests. Our argument, of course, is that the interests of all stakeholders in the society, not simply foreign investors and businessmen, will be served by making this effort.

Reflecting WTO accession, the AmCham China 2002 White Paper released last month emphasized the great, but uncertain opportunity we now face. WTO accession has given the reform process new energy, but we are also aware of the difficulties and constraints. As to the rule of law specifically, we cite a number of areas of modest progress, while reiterating the same basic problems with respect to transparency and consistency (now further distinguished as uniformity and enforcement).

A concrete example of the countervailing pressures at work on the ground is the vexed area of intellectual property rights.

Intellectual property rights were not recognized in Chinese law in 1979, and a pattern of rampant violations of copyrights, trademarks and patents soon became a problem for foreign investors. Pressure from the United States, the European Union and others had some effect in changing Chinese policy statements, but these were somewhat grudging and were not reflected in changes on the ground. In the last three years, however, the policy debate on this question has been won. A study by the Ministry of Information Industry identified copyright violations as the single biggest obstacle to the development of a Chinese software industry. This was followed by State Council regulations in 1999 requiring all government offices to use legal software and again in 2000 requiring all entities, including enterprises, to do the same and demanding enhanced, coordinated enforcement of the law. The Development Research Center, the leading think tank under the State Council, in early 2000 issued a report quantifying the economic losses of counterfeiting to the state in the form of lost revenue, to enterprises in the form of lost sales and damage to their reputation, and to consumers in the form of poor quality, even dangerous goods. Counterfeiting was identified as one of the major targets of the market rectification campaign launched last year, along with smuggling, fraud, and other violations of commercial law. Leaders such as Premier Zhu Rongji and State Councilor Wu Yi provided strong, focused attention to these problems.

Substantial revisions have been made in copyright, trademark and patent laws. While further improvements could be suggested, in general the legal framework is close to international standards and capacity building continues, often with foreign assistance. The European Union, for example, has funded a program to develop IPR laws that trains judges and law professors. Our member companies participate in such seminars to present case studies, and have also assisted with additional funding. Foreign companies also regularly hold training programs for local prosecutors, customs officials and other relevant authorities. The UN Development Program is sponsoring a program to train local economic planning officials in sustainable development that includes a substantial focus on how to transition away from specializing in counterfeiting, as some localities do. Foreign companies have supported the UNDP with funding as well as direct participation.

Our member companies have actively fought to protect their intellectual property. One large consumer products company routinely gathers evidence and presents it to the authorities, which conduct raids observed by company personnel, confiscate counterfeit goods and bring prosecutions. Last year that one company was involved in over three hundred such raids. In one case, a factory that was about to be closed because of dropping sales was rescued by putting counterfeiters out of business. The company invited the police and prosecutors who worked on the case to tour the factory, where the grateful work force greeted them with

applause. In another case, a company making batteries saw its sales increase by 135% in one year by closing down a single counterfeiter. There have been recent court victories in copyright cases as well, such as a case involving an internet domain name squatter where the rights of the foreign company were firmly upheld.

Unfortunately, however, these positive examples do not reflect the general situation. China is not a single economy; it is a group of large, disparate regional economies. Although the central government can be described as authoritarian, its ability to control what happens in local areas is limited. Many factors such as those outlined above weigh against successful litigation for those attempting to protect their rights. Our members continue to report continued, large economic losses due to IPR violations. For those selling brand products in the Chinese market, the general estimate is that 15-20% of revenue is lost due to counterfeiting.

In response, our member companies are shifting their focus from the content of the laws to problems of enforcement. In many cases, the dollar value of confiscated goods is low, so violators are dealt with in administrative procedures and assessed low fines, often never paid. There are also administrative bottlenecks in effectively transferring cases from civil to criminal authorities. Foreign companies are thus emphasizing criminal proceedings with modest success in the last year.

One of the unanticipated consequences of WTO accession is likely to be an increase in the export of counterfeit goods manufactured in China to the rest of the world. China committed in the WTO protocol to give trading rights, presently restricted, to all legal entities in China. This means it will be much easier to import and export goods, and is a major improvement for US exporters and their customers in China. WTO will bring increased trade and the Customs will improve its efficiency in order to move a larger volume of goods across the borders of China in both directions. This is also a good thing, but unfortunately these developments will also make it easier for counterfeiters to export and increased enforcement in China will lead them to do so. If the fakes are sold in Latin America, Eastern Europe or the United States, it is more difficult to gather evidence and prosecute in China.

We thus see a mixed picture: progress with respect to IPR law and policy, but continued failure to make enforcement effective. AmCham China is convinced that this problem will eventually be brought under control, because there are strong local interests in doing so. Chinese companies are damaged more than foreign companies by IPR violations and they know it. The Chinese government finds its economic ambitions hindered by its IPR environment and it is trying to change it. Our members will continue to defend their legal rights and assist further development of the legal system.

The IPR case can stand as representative of the status of commercial aspects of rule of law in China. Given this situation, what approach should we take to encourage further progress toward transparency and consistency in the legal system generally?

First, we should recognize that despite a rapid pace of social change since 1979, likely to be accelerated by WTO accession and a new generation of leaders, capacity building is a long-term enterprise dependent on institutional and cultural change in many sectors. In my opinion, it is a reasonable goal to strive for the rule of law as defined above with respect to property rights and contractual rights during the anticipated ten years in power of the next generation of leaders, that is, roughly 2003-2013. Full establishment of the rule of law will probably take longer.

Second, given the complexity of the process, we should encourage a multiplicity of players to pursue diverse avenues of institutional change, preferably in partnership with Chinese counterparts. The most active and important supporters of development of rule of law have been the European Union through the EU-China Legal and Judicial Cooperative Program, the Ford Foundation, the Canadian International Development Agency, the German government through the German Technical and Cooperation Corporation (GTZ) program to train MOFTEC lawyers.

The Asia Foundation and The US-China Legal Cooperation Fund, a program of the education and research arm of the US-China Business Council also have small, but effective grant programs. The Fund has attracted support from approximately forty corporate donors. To quote the Fund, "Contributors... share the belief that the people and the economies of the United States and China will benefit from further development of strong, transparent, impartial and equitable legal institutions...." Grants are made in such areas as training of judges and lawyers, legal protection of human rights, administrative law, commercial law and arbitration, and legal aid for the poor and special focus is on projects that demonstrate support from both US and Chinese sources. We strongly encourage member companies with sufficient resources to consider support for this Fund as part of their corporate social responsibility programs in China.

Academic cooperation between American universities such as Columbia, Harvard, Stanford, and Yale and various Chinese universities in research and legal education is well established and productive.

The American government, though it takes an active public role of advocating improvements in the rule of law in China, has been conspicuous by its absence. Recently a three million dollar appropriation was made, primarily to support a legal education program of Temple University Law School. Though a welcome beginning, this is a meager record compared with that of the European Union, individual European countries and American private sector donors such as the Ford Foundation. Furthermore, while we welcome the sustained effort of the EU to improve the rule of law in China, I should parenthetically note that the adoption of European legal concepts and practices tends to favor the commercial interests of European companies familiar with them. AmCham member companies would welcome a material effort by the United States to balance this influence.

Another way in which the US government can assist the development of rule in law in China and at the same time assist American economic interests is to support the efforts of US law firms to be permitted to hire PRC qualified lawyers to practice PRC law. If permitted to hire PRC lawyers to practice PRC law, the US firms can have a significant positive impact on the sophistication and professionalism of the PRC lawyers and judges through their internal training programs, the impact of their corporate cultures, and the increased competition they will foster in the legal arena. They will also be able to provide better service to their clients, including many of our members. China made no WTO commitments on this point, highlighting the need for continued bilateral discussion on the economic reform process beyond the WTO framework.

Third, we should not assume that we can know the outcome or that there is only one satisfactory result. Forces such as economic development, modernization, and globalization have not led to convergence among nations in the past, and will probably not do so in the future. The Chinese are a very large nation, with a well-honed sensitivity to foreign pressure. As has been the case with smaller nations, the Chinese legal system will reflect the interplay of its own social, cultural and institutional forces much more than standards suggested from abroad.

We should recognize, but not be discouraged by the fact that our goals for Chinese legal reform are not those of the current leadership. China has stated it is attempting to build a socialist market economy governed by rule of law. Whatever the term "socialist" may mean, it does suggest a greater degree of state ownership of major enterprises than in the United States. Moreover, the Chinese government has articulated a conception of human rights placing more emphasis on responsibility to the community than individual rights, in which the right to subsistence is more important than personal liberty. Finally, the Communist Party intends to continue its rule. But if one reviews the history of such stated goals since 1949, and particularly since 1979, it is apparent that they have changed frequently and dramatically. If the past is any guide, China's stated goals today will not necessarily be her goals in the future.

If a legal system is established that protects property and contractual rights by promulgating accessible, objective and understandable laws with participation by affected parties, and enforcing them in a fair, reliable,

and nondiscriminatory manner, the continued existence of the special, extra-legal privileges of the apparatus of the Party and government and of senior cadres and their families personally will be more and more anomalous. I personally do believe that establishment of the rule of law in the narrow sense defined here will inevitably and positively impact broader social and political trends. It is therefore to be desired that the rule of law be expanded as rapidly as possible.

Considering actions that this Commission might recommend to the Congress and the Executive branch in support of this process, I would like to call to your attention the Commercial Law Development Program (CLDP) of the Office of the General Counsel in the Department of Commerce. CLDP provides training and consultative services seeking help in guiding the evolution of legal systems. It specifically focuses on "international economic agreements, foreign investment laws, project and trade finance, export controls, intellectual property rights, and government ethics". All of these areas are currently under development in China, important to implementation of its WTO accession commitments, and key building blocks of commercial rule of law. CLDP has not been able to work in China, despite our strong national interest in having it do so, because it is partially funded by the Agency for International Development (AID). As you know, the Congress has barred AID from China since 1989 in reaction to the Tiananmen Square incident. In order to bring the CLDP to China, where it is badly needed and could make a contribution in the interest of both countries, AmChina China supports either removing the ban on AID funds in China, or finding another acceptable way to fund the program.

We also encourage the Congress to appropriate a material level of funding for the Department of Labor and the Department of State to develop their own programs to assist development of the rule of law in China.

Thank you very much. I look forward to your questions.