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# China And Laos: Different Roads to the Market

John McDonnell\* and Douglas Clark\*\*

## INTRODUCTION

A potent debate is taking place between scholars who specialize in observing the planned economies of Asia. The debate focuses on the prospects for a "third way" to sustained economic growth and prosperity which consists of neither market capitalism nor fully planned socialism. Put simply, the third way describes an economy where both planned and market economies co-exist.<sup>1</sup>

Although China and Laos possess different physical characteristics and historical backgrounds, similarities exist in their traditional cultures and their paths of modern development. The economy and law in both countries until the nineteenth century can be described as predominantly feudal and based on kinship ties. It was not until the late nineteenth and early twentieth centuries that industrialization and Western-style legal codes came to China and Laos. Even then, Western-style economic development was confined to the larger cities in both

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1. As Nolan puts it:

Instead of the market being viewed as an enemy to be crushed ('Capitalism is like a dog in the water to be beaten'), markets and competition [are] viewed as an essential part of the process of running a successful economy. The model [being] that of the Soviet and Chinese NEP [New Economic Policy] periods, with the intention being to enable the benefits of planning and the 'magic whip of competition' to operate in tandem.

P. Nolan, *China's Experience in Comparative Perspective*, a Paper Prepared for a Conference on the Chinese Economy in the Reform Period, Nov. 1991, Australian National University, at 8. An early development of theory concerning the third way in relation to both capitalist and communist economies in general may be found in OTA SIK, *THE THIRD WAY: MARXIST LENINIST THEORY AND MODERN INDUSTRIAL SOCIETY* (1976).

countries and, in both countries, protracted civil wars leading to the success of communist revolutions destroyed much of the development that had taken place. Further, once in power both the Chinese Communist Party (CCP) and the Laotian People's Democratic Party (LPDP), despite their countries' low level of economic development, attempted a rapid transition to socialism by following the Soviet model of central planning and rapid industrialization.<sup>2</sup> Finally, both countries are now in the process of reforming their economies.

Thus a comparison of Chinese and Lao contemporary economic policies will help in an evaluation of the success and future potential of these policies. A comparison is meaningful because they have adopted very different policy approaches to economic reform, and thereby offer a basis for comparing whether the third way or the "one cut of the knife"<sup>3</sup> adoption of market-oriented measures is more successful. More particularly, they will provide a basis for determining whether a strong legal system is a prerequisite to an open economy.

Supporters of the third way agree with key figures in the Chinese leadership<sup>4</sup> that an indigenous approach to economic reform can result in high growth, despite the continuation of state intervention in the exchange of goods and services and the absence of extensive property rights. They assert that such an approach demands a high degree of political unity and a strong but benevolent ruling body. An honest administrative system run by a political apparatus can fulfill the role of an extensive, impartial legal system. This new style of authoritarian government, at one time called the South Korean Model, provides a vehicle for focused strategic decision making directed at achieving long-term goals. Such a government is immune from "pluralistic" or "democratic" compromises which inhibit growth and

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2. The correctness of this Soviet model has been the subject of much theoretical debate. Marx argued that socialism was only possible once an economy had achieved a high degree of material wealth, this wealth being created during the capitalist stage of development. The Soviet model, on the other hand, suggests that it is possible to bypass the capitalist stage. See C. Linden, *Marxism-Leninism in the Soviet Union and the PRC: Utopia in Crisis*, in CHINA AND THE CRISIS OF MARXISM-LENINISM 12-15 (Franz Michael et al. eds., 1990); S. CHIN, THE THOUGHT OF MAO TSE-TUNG: FORM AND CONTENT 8-10 (1979); Mao Zedong, *The Chinese Revolution and the Communist Party*, in 1 SELECTED WORKS OF MAO TSE-TUNG 311.

3. Nolan, *supra* note 1, at 3.

4. See, e.g., Jiang Zemin, *Building Socialism the Chinese Way*, Speech at a Meeting Marking the 70th Anniversary of the Founding of the Communist Party of China (July 1991), BEIJING REV., July 8-14, 1991, at 20.

the improvement of popular living standards. Some argue that this form of authoritarian regime is essential if the market is to properly perform its role as "the magic whip."<sup>5</sup>

This is a direct challenge to arguments that such a rationalist-positivist approach is impossible because it presumes an unrealistically high degree of knowledge of the workings of society.<sup>6</sup> Friedrich von Hayek adopted the view that sustained growth depends on the development of a "spontaneous order" or "cosmos."<sup>7</sup> Such an environment can be developed only within a relatively open economy where governments enact laws as a means to achieve certain goals, rather than the goals themselves in the form of ideology.<sup>8</sup> Most importantly, it depends on the legal recognition of property rights and the free exchange of goods.<sup>9</sup> Accordingly, this group believes the third way cannot lead to stable economic growth in socialist countries which have imported only limited aspects of market economies. Instead, they argue that such countries will inevitably have to become full-fledged market economies.

The third way cannot be dismissed as ineffectual Marxist economics. It has its origins in a structure which precedes communist revolutions, and even Marx himself. Max Weber notes that in traditional China, economy and law were based on administrative municipalities.<sup>10</sup> A comparison of traditional and

5. Nolan, *supra* note 1, at 10.

6. Friedrich A. von Hayek, 1 LAW, LEGISLATION AND LIBERTY: A NEW STATEMENT OF THE LIBERAL PRINCIPLES OF JUSTICE AND POLITICAL ECONOMY ch. 1-3 (1973) (Volumes 2 and 3 were published in 1976 and 1979, respectively) [hereinafter 1 HAYEK, 2 HAYEK, 3 HAYEK].

7. 1 HAYEK, *supra* note 6, at 35-39; 2 HAYEK, *supra* note 6, at ch. 10, especially 124-25. See also YUN-WING SUNG, THE CHINA-HONG KONG CONNECTION 1 (1991).

8. Such a spontaneous order can only exist where certain legal rights are recognized. 1 HAYEK, *supra* note 6, at 35-39; 2 HAYEK, *supra* note 6, at ch. 10, especially 124-25.

9. MAX WEBER ON LAW AND ECONOMY IN SOCIETY 99 (M. Rheinstein ed., 1954).

10. Weber contrasted Germanic and Roman commercial law with Chinese law in the following manner:

Municipalities were recognized in official law only as organizations for carrying the family liability for taxes and charges. On the basis of kinship group membership, they still exercise the strongest conceivable authority over their members, organize common institutions of all sorts of economic activity, and manifest a degree of cohesion with which the officials of the imperial authority had to reckon as with the strongest local authority. These phenomena which are no more recognized in the legal concepts of official Chinese law than they were anywhere else, have often enough impeded its effectiveness.

*Id.* at 185.

modern legal and economic structures shows a remarkable degree of similarity, despite the tremendous social upheaval which accompanied and followed the civil war (1927-1949) and Japanese invasion of China (1937-1945).<sup>11</sup> Indeed, the most radical change in the Chinese legal and economic structure may be the introduction of the European concept of the market. Deng Xiaoping has described the process of introducing market reforms as "crossing the river by touching stones."<sup>12</sup>

Laos, on the other hand, does not have a strong traditional legal and administrative base. However, the basic bonds of the society were based on patrilineal kinship ties and custom, as in China. Ineffectual regimes ran Laos from the last days of French governance (1893-1949) until the conclusion of hostilities which accompanied the communist victory in 1975. Following the success of the revolution, the LPDP followed a path similar to that of the CCP. The LPDP attempted to rapidly implement a full-scale command economy. In 1979, after this strategy failed to produce positive results, the Lao government gradually introduced a range of market reforms to the state planning system. In contrast to China, this adoption of the third way was soon rejected in favor of a more thoroughgoing adoption of market capitalism.<sup>13</sup> Laos has now completely abandoned state planning and is attempting to quickly move to a full market economy with a strong rule of law. The LPDP, however, retains strong controls over the institutions within Laos and the inevitable confrontation between the interests of the party and a formal economic apparatus has yet to occur.

In summary, while the Chinese have adopted an approach of picking their way towards a market economy without any clear policy or legal framework (an approach which is consistent with the Maoist dictum of two steps forward and one step back), the Lao have decided to move directly towards a market economy and to establish a legal framework appropriate to it. These different approaches have been adopted notwithstanding the fact that both countries remain under the control of communist governments. On the basis of Laos's rejection of the third way in favor of more rigorous market-oriented reform, this Article argues that eventually China will be forced to abandon its pursuit

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11. Jones, *China: A Long-Term Appraisal of Country Risk*, in ROSS GARNAUT, CHINA'S REFORMS AND ECONOMIC GROWTH (forthcoming).

12. Some have added "on one foot" to this phrase to indicate the limits Deng and the rest of the Chinese leadership have put on the scope of reform.

13. This is characterized as the "big bang" or "one cut of the knife" approach to market reform. Nolan, *supra* note 1, at 3.

of the third way in order to reach a suitable level of economic, if not political, reform.

## I. THE ECONOMIC HISTORY OF CHINA

Debate over economic development in China is not limited to the modern period. Many hold that China in the Song dynasty (960-1279 A.D.) produced unparalleled economic growth and technological change and that the Mongol invasion which followed inhibited economic growth and allowed Europe to overtake China.<sup>14</sup> Despite the very advanced technology of the Song Dynasty, later stagnation left China far behind Europe by the advent of the industrial revolution. The CCP leadership supports the view of an economically stagnant traditional China restrained by "feudal" institutions, and reformers ominously hark back to this time when emphasizing market-oriented development strategies.

Recently, this view has been revised.<sup>15</sup> A study of Hankow (now part of Wuhan) demonstrates that China possessed a complex, integrated national market by the mid-eighteenth century, in which institutional changes fostered trade expansion and new forms of contract. If this progress had continued, China would have advanced much closer to an integrated market economy. These institutional advances were set back,<sup>16</sup> however, when the Taiping Rebellion disrupted the Chinese economy.<sup>17</sup>

It is possible that legal reform contributed to economic growth during the Song period and the mid-eighteenth century, but that these reforms and the development of autonomous corporations engaged in widespread trade were relatively easily displaced by the traditions based on kinship and informal relations to which Max Weber refers.<sup>18</sup> Less controversial is Weber's conclusion that the lack of secure commercial laws, particularly

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14. Jones, *supra* note 11, at 2.

15. WILLIAM T. ROWE, *HANKOW: COMMERCE AND SOCIETY IN A CHINESE CITY, 1796-1889* (1984); THOMAS G. RAWSKI, *ECONOMIC GROWTH IN PREWAR CHINA* (1989).

16. This decline of Chinese market-based institutions in the nineteenth century agrees with Max Weber's view that kinship and political patrimonialism obstructed the development of autonomous corporations engaging in widespread trade. Rowe's view differs from Weber's, however; Weber's analysis does not agree with the idea of a flourishing market economy at any time.

17. The Taiping Rebellion (1850-1865) failed in its attempt to overthrow the Qing Dynasty. The rebellion left China chaotic and bankrupt.

18. Jones, *supra* note 11, at 5.

contract law, and the ineffective legal apparatus of the nineteenth century restricted growth.

This follows the jurisprudential principle that the exercise of individual choice will not lead to desirable results, such as economic growth, unless it is ordered (what Hayek describes as "cosmos" or spontaneous order). Jones's view of China's economic history clearly agrees with Hayek's precepts:

For rapid invention, the ordered disorder — the spontaneous, unplanned order — of an open society will ultimately be necessary. For innovation, what is needed are property rights, legal framework, and incentives for investment also characteristic of such societies but a fraction less dependent on full 'openness'.<sup>19</sup>

In the late Qing dynasty (1644-1911) such order had broken down. China lacked formal legal codes to regulate, for example, the banking sector. Individuals were beaten to death for business failure, and if judges were unable to decide between litigants they were often both tortured in open court. Jones concludes that although the Song and the Ming-Qing periods of Chinese history involved an enormous volume of market activity, the failure to create universal institutions stifled growth.<sup>20</sup>

Before its collapse in 1911, the rulers of the Qing dynasty set about reforming the legal system on the basis of European codes, a process later continued by the Nationalist (KMT)<sup>21</sup> government, which was never able to consolidate its power over China. The KMT government enacted a large number of laws and provisional regulations which were eventually drawn together in six codes enacted between 1929 and 1935, including the Civil Code and the Commercial Law. Specific laws dealing with commercial activity such as bankruptcy and insurance were also enacted.<sup>22</sup>

Continuous internal turmoil and ineffective administration within the KMT, however, prevented the effective enforcement

19. Jones, *supra* note 11, at 16.

20. Jones, *supra* note 11, at 6. It is possible that incapacity to develop lasting institutions was due to some inhibitory cultural factor such as the predilection for "magic" or "kinship" regulatory norms. Recent work by Rawski supports this approach. RAWSKI, *supra* note 15. Jones and others have reservations. See, e.g., Ramon H. Myers, *How did the Modern Chinese Economy Develop?* ASIAN J. 150 (1991); PHILIP C. C. HUANG, *THE PEASANT FAMILY AND RURAL DEVELOPMENT IN THE YANGTZE DELTA, 1350-1988* (1990). These authors indicate that where the market has been allowed to flourish, the Chinese historically have responded to it positively. This is important because both the Chinese and Lao legal systems have their origins in notions of kinship.

21. The Nationalist Party is also known as the Kuomintang (KMT).

22. Alice E. Tay, *Law in Communist China — Part 1*, 6 SYDNEY L. REV. 153, 164 (1969).

of these new laws. In rural areas, the KMT government first battled warlords and, later, the Communists. In the cities, the primary base of KMT support, the government faced huge problems implementing the new laws against the entrenched interests of the old ruling elite and corrupt officials.<sup>23</sup> The only places where Western-style economic laws were enforced were those cities under Western or Japanese control, such as Shanghai or Qingdao.<sup>24</sup>

During the course of the revolution (1927-1949), the CCP controlled a number of predominantly rural areas in China. The economy in these areas was primarily agrarian and localized and, therefore, did not demand a large degree of planning. The legal system established by the CCP in these areas was primarily revolutionary in nature and emphasized class struggle over stability.<sup>25</sup> Economic laws were restricted to revolutionary laws aimed at achieving greater "social justice" such as land reform decrees and laws which prohibited leasing land for profit. When the communist takeover of Chinese urban areas was imminent, the CCP moderated its stance by promising protection "to all privately-owned factories, stores, banks, warehouses, vessels, wharves, and the like, except those 'controlled by bureaucratic capital.'"<sup>26</sup> Nevertheless, the CCP abolished all the laws, decrees and judicial organs set up by the KMT and established a common program directed at establishing a socialist planned economy. Under the program, the CCP aimed to transform a semi-feudal, semi-capitalist economy into a socialist, state-run economy. Realizing the practical economic and social dislocation such a conversion would cause, the CCP initially did not directly attack the capitalist economy. Rather, the CCP reduced the role of the capitalist economy by levying surcharges against private transactions, prohibiting money lending, and setting up state-run distribution systems, thereby cutting "the purse strings and not the heads of the capitalist class."<sup>27</sup>

By 1954, the CCP had sufficiently established its rule over the country to enact its first constitution. This constitution accorded priority to the development of the state sector of the

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23. JAMES P. BRADY, *JUSTICE AND POLITICS IN PEOPLE'S CHINA: LEGAL ORDER OR CONTINUING REVOLUTION?* 52 (1982).

24. For a description of the situation in Shanghai, see Hurst Hannum & Richard B. Lillich, *The Concept of Autonomy in International Law*, 74 AM. J. INT'L L. 858, 868, 871-72 (1980).

25. Tay, *supra* note 22, at 166.

26. *Id.* at 171.

27. BRADY, *supra* note 23, at 94-95.



economy, and the Chinese commenced a policy of rapid industrialization. Nevertheless, capitalist ownership was still recognized as one of four basic forms of ownership, which probably reflected internal tensions within the party. Over the following twenty-five years, however, almost all forms of private ownership of the means of production were nationalized. This process did not occur without opposition from within the party, most notably from Liu Shaoqi and Deng Xiaoping, who in 1963 started to introduce limited reforms to revive the private sector. In 1966, however, Mao Zedong reasserted his control within the party by unleashing the Cultural Revolution (1966-69), a mass movement aimed at destroying bureaucratic and capitalistic tendencies. This movement was accompanied by disregard for pre-existing legal institutions, which began to regain their vitality after Mao's death in 1976. Until then, property and all economic activity came under the control of the state.<sup>28</sup>

One legacy of this period of Chinese history is the regulation of society on the basis of central government directives implemented in an irregular fashion by local administrative units. More recently, some Chinese leaders have recognized that the implementation of an impartial legal system is necessary to curb administrative excesses, control corruption and enforce central government policies. In this context, the steps that Laos has taken to implement such a system provide a useful example for further reform.

## II. THE ECONOMIC HISTORY OF LAOS

A multiplicity of ethnic groups separated by geographical and linguistic barriers, a weak communications and transportation infrastructure, and the lack of strong unifying institutions other than Buddhism make an analysis of the economic history of Laos difficult. For centuries the poorest country in Indochina, this conglomeration of tribes or clans has eschewed "nation-building" in favor of safeguarding tribal independence.

Laos has rarely been ruled by a national and central government. Power struggles have engulfed this small, landlocked country for much of the last two centuries. Warring ethnic groups within Laos have been backed by Thailand, Kampuchea, Burma, France, China, the U.S.S.R., the United States and Vietnam. In addition, any attempt to introduce new institutions would have had to contend with the traditional beliefs of the

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28. LINDEN, *supra* note 2, at 15-18.

Lao people. Buddhism and animistic customs served as a further barrier to the development of formal institutions. Whether cultural inhibitions or centuries of subjugation prevented the development of any institutional framework remains unclear.<sup>29</sup>

In 1893, Laos was absorbed into French Indochina. The French soon attempted to introduce their laws. The French, however, did very little to improve the economy of Laos, limiting themselves to the business of extracting coffee, cotton and tin. More extensive development and capital investment was restricted by an agricultural economic base, a perceived lack of export goods, a poor infrastructure and abundant cheap labor. Consequently, the French did little to establish legal or economic structures within Laos. They did not even attempt to establish a system of education, setting up only one school designed to cater to the children of high officials. Rather than undertake institution building, the French allowed the old feudal ruling classes to remain in power as representatives of French interests.<sup>30</sup>

French disinterest limited the development of a monetized economy to Vientiane and a few other urban areas. Even there, the laws were often Eurocentric in substance and in conflict with local customs, such as those regarding land tenure.<sup>31</sup> The French Indochina Labour Code drew largely from the experiences of France and other more developed countries, and was ill-adapted to conditions in Laos.<sup>32</sup>

Laos was granted independence from France in 1949.<sup>33</sup> It was soon the site, however, of a civil war between the French-backed Royal Lao forces and the communist LPDP. For most of the civil war, Laos was effectively divided into two zones: lowland southern areas controlled by Royal Lao forces and mountainous northern provinces controlled by the LPDP. As in

29. One suspects that the reality is close to Ch'i's description of warlordism in China: "[P]olitical disintegration had caused economic disintegration. . . . As time went by, however, economic disintegration in turn retarded political reintegration." HSI-SHENG CH'I, *WARLORD POLITICS IN CHINA* 173 (1976).

30. H. LUTHER, *SOCIALISM IN A SUBSISTENCE ECONOMY: THE LAOTIAN WAY — AN ANALYSIS OF DEVELOPMENT PATTERNS IN LAOS AFTER 1975 6-7* (Chulalongkorn Univ. Soc. Res. Inst., 1983).

31. DONALD P. WHITAKER ET AL., *LAOS: A COUNTRY STUDY* 226 (U.S. Government Printing Office, 1972). Whitaker states that patterns of land tenure in Laos rest more on tradition and local custom than on law. *Id.*

32. *Id.* at 241.

33. The Royal Crown Prince of Laos, at the instigation of the Japanese, declared independence from France in April, 1945. However, this insurrection was quickly put down by French forces following the defeat of Japan.

China, the civil war seriously hampered economic development, a problem further compounded by the spillover from the Vietnam War in the 1960s. Agriculture was the main industry of the country and was performed in the traditional labor-intensive fashion.

Larger cities controlled by forces backed by France and the United States had a limited monetized economy. This economy, however, was heavily reliant on foreign aid, particularly from the United States. In rural areas, whether under Royal Lao government or LPDP control, trade was primarily carried out by barter. During the civil war, the LPDP made little effort to nationalize or collectivize agricultural production. In both zones, there was a limited amount of light manufacturing. In the Royal Lao government zone this was carried out by private enterprise, but as with most other industries, it was heavily dependent on foreign aid. In the LPDP controlled areas, manufacturing appears to have been under state control.<sup>34</sup> As production was limited to a few essential items, however, its economic impact was small, leaving the economy in the countryside in its traditional state. The LPDP found itself in charge of a ruined economy after the fall of the Royal Lao government in 1975. The massive outflow of skilled technicians and managers who fled to nearby Thailand and points beyond, compounded the economic damage suffered from the civil war, the Vietnam War, and the sudden absence of Western aid.<sup>35</sup>

Following the Soviet example, the LPDP established the goal of moving from the traditional economic system directly to socialism, bypassing capitalism. However, as in China, it did not seek immediately to abolish the private sector. Nevertheless, price controls and attempts to discourage profiteering resulted in the closure of a number of private markets. The shortage of trained personnel also led to large decreases in production in both private and nationalized industries. The primary goal was the collectivization of agriculture, and up to 2800 collective farms were established by 1979. Within the first five years of government, the degree of bureaucratic interventionism in Laos exceeded even that of China so that "a peasant needed up to seven signatures to cross a provincial line, three to move his pig to the next village, and one even to kill a chicken."<sup>36</sup>

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34. WHITAKER, *supra* note 31, at 244.

35. MACALISTER BROWN & JOSEPH J. ZASLOFF, APPRENTICE REVOLUTIONARIES: THE COMMUNIST MOVEMENT IN LAOS, 1930-1985, 196-97 (1986).

36. *Id.* at 173. Because of the loss of aid from the United States, Laos was

### III. THE PROCESS OF REFORM IN CHINA AND LAOS

By the mid 1970s China found itself with an extensive planned economy that was beginning to show signs of being unable to meet the needs of the people. At the end of the 1970s, Laos was in much the same position even though it had not developed planning institutions as large and sophisticated as those in China. Laos, however, has since undergone a more radical transformation in the direction of market-oriented reform. Regardless of whether this change was ideological or pragmatic in nature, the contrast illuminates the prospects for China's economic and legal development.

#### A. REFORMS IN CHINA

The death of Mao Zedong in 1976 marked a watershed for China. The "Gang of Four" were removed from power, weakening the internal party position of those who favored a centrally-planned economy with a strong emphasis on heavy industry. By 1978, supporters of a mixed approach to development, led by Deng Xiaoping, were able to introduce wide-ranging economic and political reforms. The primary goal of the economic reform program was the rapid but even development of the economy, with equal emphasis being placed on the development of light and medium, and heavy industry. One of the stated goals of this drive was to quadruple the per capita gross national product (GNP) of the Chinese economy from about \$250 in 1980 to \$1000 by the year 2000.<sup>37</sup> A fundamental element of these reforms has been an attempt to delegate microeconomic decision making to industrial and agricultural enterprises,<sup>38</sup> rather than the central government, while allowing the central government to retain a strong hold on macroeconomic monetary and fiscal controls. Autonomy from state planning is intended "to give [state owned]

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forced to rely on assistance from the Soviet Union. This had some ironic consequences. When the Laotian Vice-Premier Nouhak visited Moscow to secure additional aid, Soviet Premier Alexei Kosygin advised him to stop the drive towards socialism before even more disgruntled Laotians fled to Thailand. Nayan Chanda, *Economic Changes in Laos, 1975-1980*, in CONTEMPORARY LAOS: STUDIES IN THE POLITICS AND SOCIETY OF THE LAO PEOPLE'S DEMOCRATIC REPUBLIC 116, 123 (M. Stuart-Fox ed., 1982).

37. SAMUEL P.S. HO & RALPH W. HEUNEMAN, CHINA'S OPEN DOOR POLICY: THE QUEST FOR FOREIGN TECHNOLOGY AND CAPITAL 8-9 (1984).

38. *Communique of the 3rd Plenum of the 11th Congress of the Chinese Communist Party Central Committee (1978)*, in JIANCHI GAIGE, KAIFANG, GAOHUO (UPHOLDING THE REFORMS, OPENING UP TO THE OUTSIDE AND VITALISING THE ECONOMY) 2 (People's Publishing House, Beijing, 1987).

enterprises greater flexibility . . . and responsibility."<sup>39</sup>

The theoretical underpinnings of the reforms were explained by Chen Yun, one of the senior leaders of the party. He argued that during the socialist stage it is necessary to supplement direct government control through state planning with indirect control through free market reforms. It is necessary, therefore, during the entire socialist period to have two economic sectors:

- (1) The planned economy sector [and]
- (2) The market regulated sector. (That is, where there is no planning and production is only carried out in accordance with market demand. That is, the sector that is regulated by unseen forces.<sup>40</sup> The first sector is basic and important; the second sector is subordinate and of secondary importance, nevertheless, it is indispensable.)<sup>41</sup>

Political reform, though never implemented to the same extent as economic reform, has been recognized as necessary to allow for more rationality in the implementation of economic reforms. It represents an attempt to move away from reliance on the personal power of senior leaders to reliance on the power of institutions, including a state government separate from the CCP. Reform, however, was not designed to do away with the leading role of the CCP, nor was it to meant to abolish socialism.<sup>42</sup>

## 1. Reform of the Legal System

Both economically and politically, the development of the legal system has been a necessary element of the reform program. Economically, a legal system was needed to regulate those parts of the economy no longer directly controlled by state planning,<sup>43</sup> as well as to attract foreign investors to China by showing them that their investment would be protected. As part of the political reform, the legal system was to be the tool used to separate state and party functions. Law, moreover, would provide a more efficient method of controlling those who

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39. HO & HUENEMANN, *supra* note 37, at 11.

40. The original Chinese for "regulated by unseen forces" is *you manmuxing tiaojie*.

41. Chen Yun, *Jihua yu Shichang Wenti (The Planning and Market Problem)*, in JIANCHI GAIGE, KAIFANG, GAOHUO, *supra* note 38, at 17-18.

42. Deng Xiaoping, *Gaige Zhengzhi Tizhi, Zengqian Fazhi Guannian (Reform the Political System, Strengthen Conceptions of the Legal System)*, in JIANCHI GAIGE, KAIFANG, GAOHUO, *supra* note 38, at 379-80.

43. QIYE FALU SHIYONG SHOUCE, (A PRACTICAL GUIDE TO ENTERPRISE LAW) at *Preface* (Shanghai People's Pub. House, 1988).

breached party policy than reliance on internal party and state controls.

A key element of the reforms was the promulgation in 1982 of a new constitution,<sup>44</sup> as well as the enactment of a number of laws to control and regulate economic relations and foreign investment. On its face, the Constitution lays the basis for the effective establishment of the rule of law. Its three main chapters set out general principles and the rights and duties of citizens and the state. It emphasizes the separation of the state and the CCP, and mentions restrictions on the latter. For example, Article 5 states that “[all] state organs and military forces, *every political party*<sup>45</sup> and social group, every enterprise and business organization all must obey the Constitution and law. Every act breaching the Constitution and law must be investigated.” Article 128 further provides that “[t]he People’s Courts have the right to independently hear cases, according to law without interference from administrative organs, social groups or individuals.”

Since 1979, a large number of laws regulating economic relations have been enacted. Their value, however, has been nominal. Although they provide a framework for economic activity, the lack of an independent judiciary and the significant role of informal personal power in China eviscerate their protective power.

The two main laws regulating domestic economic relations are the Economic Contract Law and the General Principles of Civil Law (Civil Law). The former became effective on July 1, 1982<sup>46</sup> and the latter on January 1, 1987.<sup>47</sup> The Economic Contract Law is primarily concerned with the regulation of “economic contract relations between such state entities as enterprises, rural communes and production brigades, state organs, institutions, social organizations and so forth.”<sup>48</sup> It deals with the manner in which contracts are to be made and sets out the basic principles for contract formation, termination, amend-

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44. This replaced the “stopgap” 1978 Constitution which had itself replaced the 1975 Constitution. The new constitution drew heavily on the original 1954 Constitution.

45. Emphasis added.

46. Economic Contract Law, art. 57.

47. General Principles of Civil Law (Civil Law), art. 156.

48. LAW IN THE PEOPLE’S REPUBLIC OF CHINA 552 (Ralph H. Folsom & John H. Minan eds., 1989) [hereinafter LAW IN THE PRC].

ing contracts, and remedies for breach of contract.<sup>49</sup> The Civil Law deals with the economic relations in the non-state sector, such as agreements between private individuals.<sup>50</sup> It covers not only economic contracts but also the regulation of legal guardianship, private household enterprises (*getihu*), partnerships, domestic joint ventures, agency, civil rights and obligations, intellectual property rights, personal rights, civil liability in tort and contract, statutes of limitation, and the application of law to foreign civil relationships.<sup>51</sup> A number of other laws have been enacted to regulate property and inheritance rights, and to implement a taxation system.

These laws have given legal form to the economic reforms in China. They also, however, directly limit the scope of the reform process. Both the Economic Contract Law and the Civil Law declare void any contract which contravenes state planning.<sup>52</sup> Both laws provide that void civil acts have no legal effect from the time the act is commenced. That is, that they are void *ab initio*. The inclusion of non-state controlled enterprises within the confines of the plan and party policy gives legal expression to the concept of the third way — state planning and the free market shall coexist, but conflicts between the two will be resolved in favor of the former. It is not clear if a contract or civil act would become invalid if a change in the state plan or state policy caused a previously valid contract to violate the new plan or policy. The priority given to the plan, however, suggests that such a contract would be void from the time the change in policy occurred.

The Chinese have enacted a number of laws which deal solely with foreign investment and trade to provide greater legal certainty to wary foreign investors and traders. They have also established a number of special economic zones (SEZs), which are designed to attract foreign investment by further limiting the interference of the state.<sup>53</sup>

The three basic laws dealing with foreign investment in China are the Law on Joint Ventures Using Chinese and Foreign Investment (Joint Venture Law), the Law on Wholly-For-

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49. Gao Yongfu, *Economic Contract Laws in China*, in LAW IN THE PRC, *supra* note 48, at 557-65.

50. LAW IN THE PRC, *supra* note 48, at 551.

51. An English text of the Civil Law is reprinted in LAW IN THE PRC, *supra* note 48, at 1053-76.

52. Economic Contract Law, art. 7(1); Civil Law, art. 58(6).

53. Ann Fenwick, *Evaluating China's Special Economic Zones*, 2 INT'L TAX & BUS. LAW 376, reprinted in LAW IN THE PRC, *supra* note 48, at 733, 735.

eign Owned Enterprises (Foreign Enterprise Law), and the Law on Chinese-Foreign Contractual Joint Ventures (New Joint Venture Law).<sup>54</sup> The Joint Venture Law was enacted on July 1, 1979, and came into effect on its date of publication, July 8, 1979.<sup>55</sup> It contained only fifteen articles and was thus supplemented by extensive regulations which came into effect on September 20, 1983.<sup>56</sup> The Foreign Enterprise Law came into effect in April 1986,<sup>57</sup> and the New Joint Venture Law came into effect in 1988.<sup>58</sup> The stated purpose of these three laws is the expansion of international cooperation and technology exchange.<sup>59</sup> They attempt to ensure the security of investments by providing that the government shall protect the "lawful rights and interests" of the parties.<sup>60</sup> The Foreign Enterprise Law goes even further, providing that the "State will not nationalize or expropriate wholly owned enterprises." If special circumstances require nationalization or expropriation, compensation will be paid.<sup>61</sup> More importantly, in the case of wholly foreign-owned enterprises, Article 11 of the Foreign Enterprise Law provides that "[n]o interference shall be allowed in the operation and management activities of a wholly foreign-owned enterprise conducted according to its approved articles of association."

With regard to foreign trade, the Foreign Economic Contract Law came into effect on July 1, 1985.<sup>62</sup> This law applies to economic contracts concluded between foreigners and Chinese enterprises. It sets out the requirements for formation and dissolution of contract, liabilities for breach, and rules for assignment and dispute resolution. The law does not have a direct requirement that contracts accord with the state plan. However, because the domestic Economic Contract Law also applies to these transactions, such contracts found in conflict with the

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54. English texts of these laws and commentary may be found in LAW IN THE PRC, *supra* note 48 at 747-84. See also RICHARD J. GOOSEN, BUSINESS LAW AND PRACTICE IN THE PEOPLE'S REPUBLIC OF CHINA (1987).

55. Joint Venture Law, art. 118.

56. Enforcement Regulations for the Joint Venture Law, art. 118.

57. Foreign Enterprise Law, art. 24.

58. New Joint Venture Law, art. 28.

59. This is stated in Article 1 of the Joint Venture Law, the Foreign Enterprise Law, and the New Joint Venture Law.

60. Joint Venture Law, art. 2; Foreign Enterprise Law, art. 4; New Joint Venture Law, art. 3.

61. Foreign Enterprise Law, art. 4.

62. Article 43, Foreign Economic Contract Law. An English text of this law is reproduced in LAW IN THE PRC, *supra* note 48, at 687.



state plan could be declared void.<sup>63</sup>

SEZs have been created with two purposes in mind: 1) the attraction of foreign technical, financial and intellectual investment, and 2) the limitation of the socially undesirable effects of such investment to areas separated from the rest of the country. The Chinese have enacted many laws and regulations in the SEZs which allow greater freedom of economic activity for both Chinese nationals and foreigners, and have succeeded in soliciting a very wide breadth of foreign investment.<sup>64</sup> Nevertheless, there are still controls on land ownership and an insistence on the protection of the sovereignty of China.<sup>65</sup>

This melange of laws directed at regulating foreign economic relations provides greater security for foreign-owned entities transacting business in China than do the domestic laws regulating transactions between Chinese enterprises. Nevertheless, the laws directed at foreign economic relations still operate in an unstable political and legal environment where political power and personal connections play a greater role than formal laws, and may significantly effect the implementation of state planning and party policies.<sup>66</sup>

Despite attempts at reform, the dual state-party structure, and the highly personal nature of power in China, allows the party or individual party members to influence the way in which laws are implemented. As one Chinese commentator has noted:

In China today not many people say outright that power is bigger than law. But actually nowhere in the country has a mechanism yet been established capable of restricting power abuse in the true sense of the word. There are no hard and fast rules which can subject power-holders to legal restrictions or bring power-abusers to justice. Some power-wielders, who think themselves superior, always take it for granted that laws are something designed for the rank-and-filers, while they themselves stand high above the law, far out of its reach and do not need to be limited by it.<sup>67</sup>

Thus, despite the articles of the constitution noted above, China is far from creating a sufficiently independent legal system to adequately enforce the rights granted by these and other

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63. An Chen, *Why Some Sino-Foreign Economic Contracts Are Void and How to Prevent Voidness*, in *LAW IN THE PRC*, *supra* note 48, at 699, 700.

64. Fenwick, *supra* note 53, at 735.

65. *Id.* at 736.

66. See Goosen, *supra* note 54, at 243-46 for a discussion of the practical problems of contract enforcement.

67. Li Maoguan, *Why "Laws go Unenforced"*, *BEIJING REV.*, Sept. 11, 1989, at 13, 13-14.

laws.<sup>68</sup> Private enterprises acting within the state plan are subject to arbitrary interference from officials. The situation is slightly better for foreign-owned enterprises and joint ventures. Foreign investment, however, cannot be separated from the domestic economy, because foreign investment either relies on the domestic economy for raw materials or labor, or competes with it in the domestic or international market. Thus, problems which affect domestic firms must also cause problems for foreign investors.

## 2. China After Tiananmen

It is argued that since the Tiananmen Square incident China has moved towards an authoritarian regime that is the apotheosis of the third way. Both the existence of state enterprises and market reform have been encouraged. Party Secretary Jiang Zemin set forth two requirements for the success of the third way: 1) using the market to establish sustained non-inflationary growth within a secure legal system without recognizing certain fundamental rights, and 2) requiring state owned enterprises — which operate regardless of market forces — to contribute to the economy.<sup>69</sup>

In relation to state enterprises, the Chinese have developed an intermediate stage for the transition of state enterprises from a command structure to full privatization. Individual state enterprises have been given greater autonomy. They are allowed to retain profits and use them for fixed investment, undertake borrowing from banks, and have acquired greater freedom in the acquisition of resources and disposition of production. Price reforms have allowed some state enterprises to sell goods at a “free price” (meant to approximate the market price) rather than at a fixed price.

Unfortunately, partial reform of state industry has provided a ripe environment for corruption. Parallel markets for many industrial products have provided incentives for shifting output retained for the fixed-price market to the free market. Because this has involved thwarting the directions of party officials, it has also involved considerable corruption. Moreover, despite their huge growth in numbers (from 50,000 in 1981 to 123,000 in 1989) the share of state enterprises in total output fell from sev-

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68. For example, prosecutors of criminal cases may rank higher in the CCP hierarchy than the judges trying the cases, making it unlikely that a judge will find against the prosecution.

69. Jiang Zemin, *supra* note 4.

enty-eight percent in 1981 to fifty-percent in 1988.<sup>70</sup> This was due to the increasing share achieved by a growing and more efficient private sector.

Notwithstanding these problems, some scholars believe that state-owned enterprises can have a positive influence on economic development.<sup>71</sup> These scholars consider state-owned enterprises essential to the third way and adherence to the third way as preferable to the problems that would be associated with a radical move to a full market economy. They overlook one fundamental aspect of the debate, however: whether state-owned enterprises can continue to make a positive contribution to an economy with a growing private sector in the absence of a strong legal framework. This is, of course, a smaller part of the wider debate regarding the role of the legal framework as a *sine qua non* of even a quasi-market-oriented economy. Other economists argue that the strain on the economy produced by state enterprises poses the greatest threat to the economic reforms.<sup>72</sup>

The role of a legal framework in the operation of the state-owned enterprises has been examined by Geng Xiao.<sup>73</sup> Geng gives a useful analysis of the "Contract Responsibility System" which ostensibly governs the operations of such enterprises.

Officially, state enterprises are owned by all Chinese citizens. In practice, however, none of the people have ownership rights. The owners are usually identified as the central government or local governments. The managers and workers in Chinese state-owned enterprises, however, derive substantial entitlements from their control over economic resources in the enterprise and deem themselves to be, in a sense, owners of the enterprise.<sup>74</sup> Moreover, ownership of the assets of the enterprise is not clearly delineated under the law, and the regulations which control their operation go more to the objectives of the

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70. CHINESE ECONOMIC YEARBOOK 35 (1989).

71. Nolan, *supra* note 1 and accompanying text.

72. Ma Guonan, et al., *Economic Growth and Stability in China*. This paper was prepared for a conference at the Australian National University, Canberra, Nov. 11-14, 1991, in preparation of the book, CHINA'S REFORMS AND ECONOMIC GROWTH (forthcoming).

73. Geng Xiao, *Property Rights Arrangements and Industrial Productivity*. This paper was prepared for a conference at Australian National University, Canberra, Nov. 11-14, 1991, in preparation for the book, CHINA'S REFORMS AND ECONOMIC GROWTH (forthcoming). This paper draws from Geng Xiao, *The Impact of Property Rights on Productivity and Equity in Post-Mao Chinese Industrial Enterprises* (1991) (unpublished Ph.D. dissertation, UCLA).

74. These entitlements may include housing, medical care, and superannuation.

enterprise than to the distribution of the returns. Property rights in post-Mao industrial enterprises have appeared in the form of profit sharing arrangements;<sup>75</sup> fringe benefits which are informally controlled and "owned" by managers and workers;<sup>76</sup> administrative regulations which control product price, wages, and productivity; and government influence exerted through loans, subsidies, and appointments.

Under this system, workers lack incentive to increase the profitability of the enterprise because any losses by the enterprise have traditionally been made good by the central government, which has declined to enforce the bankruptcy laws against state enterprises perpetually in the red.<sup>77</sup> Thus, workers strive to maximize the entitlements which must be provided out of the gross returns of the enterprise. As Ma, Garnaut, and Raby have pointed out:

The greatest risk [to the economy] is still that state enterprise deficits, out of control and widening in an inflationary episode through the new feed back mechanisms, will be monetised in the absence of effective enforcement of enterprise responsibility. While the state enterprises' share of total economic activity continues to decline, their effective claim on national financial resources has not declined commensurately. The authorities, in any future period of inflation, will have the power to close out that risk, simply by denying enterprises continued access to unlimited credit. This would seem to be an attractive means of removing what is probably the main risk to continued reform and sustained rapid growth. It will only be used, however, if the authorities are prepared to accept acceleration of the inexorable decline in the role of large state enterprises in the national economy.<sup>78</sup>

The other critical area of the Chinese economy is the domestic private sector. This encompasses investment by both lo-

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75. The profit sharing arrangements, set up between the Government and the enterprises . . . explicitly define the formal and contractual ownership structure of the enterprises. The right to profits is the most important form of property right. . . . The negotiation of profit sharing schemes for each period is usually intensive and changes . . . are difficult to arrange.

Geng Xiao, *supra* note 73, at 4.

76. Unlike fringe benefits in Western countries, which are part of a competitively determined package of employee compensation, fringe benefits in Chinese enterprises are more like welfare benefits. The amount and even the kind of the fringe benefits are unspecified and may vary among enterprises, but cannot be written into a contract nor unbundled and traded for other benefits. *Id.*

77. Recently, however, the government has shown less willingness to support inefficient state-run enterprises. In place of state support, the government has advocated the implementation of the revised Enterprise Law of 1988, which authorizes and regulates the dissolution of inefficient state-run enterprises.

78. Ma et al., *supra* note 72, at 31-32.

cal Chinese and overseas Chinese, primarily from Hong Kong and Taiwan. Many of the investments directed by overseas Chinese operate outside the framework provided for foreign investment referred to above. In the case of foreign investment operating within the foreign legal framework, the impact on contemporary China is at present difficult to determine. This is because the inconsistent application of the taxation and subsidy regimes to individual companies hinders analysis.

Although the Chinese leadership has specifically endorsed the private sector of the economy,<sup>79</sup> the legal position of this sector within Chinese society is even less certain than that of the state-owned enterprises. The private sector is divided into individual businesses (*getihu*) and the larger private enterprises (*siying qiye*). The arrival of private firms was not accompanied by a legal status. Instead, regulation was left to local authorities with wide discretionary administrative powers. This made private entrepreneurs extremely dependent on personal connections and, combined with the market irregularities of a mixed economy, fostered the corruption of the administrative bureaucracy. Even when local authorities chose to promote private business legally, they manipulated it in ways which were not always in accord with government policies.<sup>80</sup>

In the absence of a legal framework, private entrepreneurs were subjected to arbitrary regulation. Unreasonable and arbitrary fees for licenses and laborious planning approval procedures comprised some of the hindrances imposed upon private entrepreneurs. A food stall operator at the Suizhou railway station in Hubei, for example, was charged two separate "road occupation fees" by both the city construction office and the department of public roads. In Chengdu, in 1988, individual businesses could end up paying as many as twenty-nine different levies of this kind on either a regular basis or as a part of government "drives," such as for children's health or city beautification. Since the Tiananmen crackdown, the amount and arbitrariness of these levies seems to have increased.<sup>81</sup> In general, state enterprises have been able to avoid such arbitrary payments with the support of the government.<sup>82</sup>

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79. Jiang Zemin, *supra* note 4.

80. PRIVATE BUSINESS AND THE STATE IN CHINA'S REFORMING ECONOMY 6 (forthcoming).

81. This is based on the authors' discussions with owners of private enterprises.

82. PRIVATE BUSINESS AND THE STATE IN CHINA'S REFORMING ECONOMY, *supra* note 80, at 13.

In order to survive under these conditions, many private enterprises have formed special arrangements with state enterprises. These arrangements (*guahu*), which range from private enterprises which specialize in processing for state and collective enterprises, to those which merely pay a fee for the placement of the stamp of the state enterprise on its registration form, became quite common starting in 1988.<sup>83</sup> The winners in this process have been the middle level bureaucrats whose control over goods, funds, and administrative approvals gave them considerable power over the course of economic development in China.<sup>84</sup> Of course, the interest of these bureaucrats lies not in further reform, but in maintaining the disorderly, experimental transitional stage which gives them the greatest degree of personal discretion. During this stage they are able to use pre-reform, planned-economy powers to manipulate the market economy.<sup>85</sup>

Private investors have also registered as collectives in order to gain greater legal protection and more economic flexibility. This enables them to get the tax benefits of collectives and allows them to exceed the limit on the number of employees who may work for a private enterprise. It has also, however, led to some long legal cases where local governments have found and expropriated "fake collectives."<sup>86</sup>

As part of the reforms, the government set up a bureau to administer the private sector. Some private investors have been able to use this bureau to protect them against the predations of other government organs. The income of the bureaucrats in this bureau comes from levies on the private sector, and thereby provides incentive for its protection. The government has also issued directives on the taxation of private investors which have been largely ignored by local officials where they have conflicted with local needs. Taxation levies are apparently arbitrary and, without proper accounting and bookkeeping on the part of the tax office or the firm, can be altered at will.<sup>87</sup> Especially since 1989, heavy taxes, intended in part to slow growth in the overheated economy, have resulted in the dampening of the private

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83. *Id.* at 17.

84. *Id.* at 19. This is a situation not far removed from that described by Weber above. See *supra* note 10 and accompanying text.

85. PRIVATE BUSINESS AND THE STATE IN CHINA'S REFORMING ECONOMY, *supra* note 80, at 19.

86. *Collective Control of Income Distribution*, in REMAKING PEASANT CHINA (O. Odgaard ed., 1990).

87. PRIVATE ENTERPRISE AND THE STATE IN CHINA'S REFORMING ECONOMY, *supra* note 80, at 26.

sector.<sup>88</sup>

These taxes were also part of a concerted campaign against the private sector by those in the CCP who intend to maintain the state-run sector of the economy. However, many local officials worked to protect the private sector and to consolidate its position.<sup>89</sup> At any rate, by this time the private sector was a vital part of the Chinese economy. This plundering of the private sector ended in 1991 with Deng Xiaoping's renewed promotion of economic reform and economic growth. Recent growth rates of twenty percent per annum in Guangdong (Canton) are almost entirely due to the unfettered growth of the private sector.

While little has yet been done to give the private sector the legal security it requires to operate efficiently, the sector's survival indicates that China may be able to work towards the development of a partial market economy without such legal security. However, a demand for greater security will undoubtedly accompany the growing economic power of the private sector. As of yet, China has not developed a strong legal system to govern either state-owned enterprises or the private sector, and the legal structure which applies to foreign investment within China is limited.

## B. REFORMS IN LAOS

By 1979, the leadership in Laos realized that their country's economic and social circumstances prohibited the complete nationalization of industry. Nationalization of industry and collectivization of agriculture were halted.<sup>90</sup> Government policy shifted to one close to the current Chinese position, namely, a third way.<sup>91</sup> However, this approach gradually weakened until the government commenced a more radical introduction of a free market economy accompanied by a substantive legal structure.

The reforms adopted in 1979 were designed to slow collectivization, ease restraints upon the sale of farm produce in the free market, and introduce incentives for controlled private enterprise in towns.<sup>92</sup> At the urging of experts from the Interna-

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88. L. do Rosario, *To Pay Tax is Glorious: China's Nascent Private Sector Comes under Pressure*, FAR EASTERN ECON. REV., Aug. 24, 1989, at 51.

89. PRIVATE BUSINESS AND THE STATE IN CHINA'S REFORMING ECONOMY, *supra* note 80, at 30.

90. Chanda, *supra* note 36, at 123-24.

91. Luther, *supra* note 30, at 29-30.

92. BROWN & ZASLOFF, *supra* note 35, at 213.

tional Monetary Fund (IMF), a new pricing policy was put into effect in an attempt to coordinate official prices more closely with supply and demand. Subsidies for food and other items were to be limited to within five to fifteen percent of the free market prices. Moreover, restrictions on interprovincial trade were removed and traders were able to import goods more freely. The legal and commercial structure of the Lao economy remained largely unchanged. Hyperinflation followed the implementation of these policies, and significant economic growth did not follow immediately.

The year 1986 marked the end of the first five-year plan. A radical shift away from socialism followed, a shift that was forced on an unpopular government by a disaffected population. Despite the initial reform of 1979, the failure of the economic and political policies of the LPDP during its initial five years squandered much of the goodwill that had greeted the new regime. Remaining collectivization, controls, and taxes caused widespread discontent in the countryside, and inflation and economic deterioration contributed to a deep malaise in the towns. Throughout the country there were negative attitudes toward the severe regulation of travel, monitoring of personal and family behavior, and tedious socialist propaganda. The heavy dependence upon Vietnam, an historic enemy, had further eroded the legitimacy of the regime. These divisions were accentuated by the fact that the Prime Minister and Party Leader Kaysone Phomivane was half Vietnamese and married to a Vietnamese. In fact, it was difficult to discern a base of support in any significant segment of society.<sup>93</sup>

In response to these mounting internal and external imbalances, the government adopted a new system of economic management aimed at making the economy more responsive to market forces. The cornerstone of a new reform plan begun in 1985-1986 was the New Economic Mechanism (NEM). Key measures taken under the NEM included price deregulation and monetization of the economy; devaluation of the Kip and the introduction of a market exchange rate; commercial accountability of state enterprises; restructuring of the banking system; and trade liberalization, tax reforms, and the introduction of a foreign investment code. Public enterprises were given autonomy to determine their own production levels, output mix, investment, employment, and wages. Agricultural procurement prices were freed. Farmers received cash for their produce and the

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93. *Id.* at 216.



state monopoly over the procurement and distribution of rice was ended. The government authorized the private sector to participate in the production and distribution of most goods and services by issuing decrees which established private sector rights, the autonomy of private firms, and the retention of after-tax profits.

Economic growth was still spasmodic through the course of the second five-year plan. It averaged six percent but fell to a low of two percent in 1987 because of a downturn in rice and timber production. Throughout this period inflation averaged fifty percent but decreased near the end of the plan. Laos also had a continuing balance of payments deficit and external debt rose from \$323 million to \$1 billion during this period.<sup>94</sup>

These reforms, however, were instituted in the context of what was still very much a command economy. Although the economy relied heavily on free exchange and the profit motive, the party remained committed to the idea of building a socialist society in Laos, perceiving recent economic advances as laying only the "material and technical" foundation for the transition to socialism.<sup>95</sup> The key feature of the reforms, however, was their movement away from planning as a basis for establishing desirable ends to programs which dealt with the means of reform. From this perspective they had moved from what Hayek describes as "taxis" or directed order to "cosmos" or spontaneous order.<sup>96</sup> To an extent, Laos had already eschewed the third way by 1986 although it still lacked a strong legal system which guaranteed private property rights.

During the second five-year plan Laos made the first moves towards the establishment of a commercial legal structure. In 1987 a decree was passed introducing a new currency reform. Under this decree a single floating exchange rate was established for all transactions. Trading is now controlled by the Ministries of Commerce and Finance but is conducted by approximately two dozen trading companies, including trading companies organized by provincial government authorities. Licensed private sector importers and exporters hold private shares in two of the state trading firms which are known as "partnership companies." The State Bank administers exchange

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94. Australian Int'l Development Assistance Bureau (AIDAB), Laos Country Paper, Canberra, 1990, at 2.

95. ECONOMIST INTELLIGENCE UNIT, LONDON, COUNTRY PROFILE: LAOS, 1990-1991.

96. See *supra* notes 7-8 and accompanying text.

controls. All foreign currency accounts are handled by its subsidiary, the Laotian Foreign Trade Bank. This policy has been so successful in establishing the convertibility of the domestic currency that it can be used interchangeably with Thai Baht and U.S. dollars in Laos. A thirty-two clause law on foreign investment was approved by the Supreme People's Assembly in April 1988. It offered relatively favorable terms to foreign investors as a means of securing capital and technologies which might boost production, especially of export commodities. Potential investors were able to enter into contractual arrangements with local entities and to take equity positions in local private sector companies, joint ventures, and private ventures with up to 100% foreign invested capital. Investors who established wholly owned enterprises were allowed to invest for no more than fifteen years, with the period to be extended at the government's discretion. Substantial tax concessions were available to foreign investors under certain circumstances.

The regime, however, did not offer the security of investment that major Western investors were looking for, nor did it provide a strong legal-commercial framework for doing business. Moreover, this insecurity was exacerbated by the lack of infrastructure and skilled labor. Therefore, although as of early 1990, the government had received 200 proposals for investment and approved eighty-two of them, most of the agreed proposals involved Thai investors who were primarily interested in timber extraction and processing, small scale manufacturing, tourism, and establishing business links with Vietnam.

The most fascinating aspect of the relative failure of the market reforms of the second five-year plan to attract foreign investment is that they did not lead to a return to conservative socialist orthodoxy but rather acted as a spur to the introduction of further market reforms. Tight monetary and credit policies reduced the inflation rate from 75.9% in December 1989 to only 19.6% in December 1990 and to fifteen percent in March 1991.<sup>97</sup> Laos also set about establishing a new framework of commercial laws with the objective of completing the program by July 1992.

The new legal system of Laos consists of a network of legislative acts adopted by the Peoples' Supreme Assembly (PSA), decree laws adopted by the Council of Ministers as well as by individual Ministries, and various other regulations promulgated by Ministries and diverse government offices. Guiding these

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97. LAO MINISTRY OF EXTERNAL ECONOMIC RELATIONS, GUIDE TO FOREIGN INVESTMENT OPPORTUNITIES IN THE LAO PDR 7 (June 1991).

sources of law are the resolutions issued from time to time by the LPDP.

Beginning with the Foreign Investment Law, the PSA began to pass legislation which would provide a framework for all economic activity within Laos. In June 1990 the PSA passed the Contract Law, the Property Law, the Inheritance Law, and the State Banking Law. In its November session in 1990, the PSA passed the Accounting Law, the Insurance Law, the Labor Law, the Code of Civil Procedure, the Family Law, the Tort Law, and the Nationality Law.

The Property Law expressly recognizes private property rights and provides for the protection of such property. Articles sixteen through eighteen of the law extend this protection to private business enterprises which are entitled to be recognized as judicial persons, and sets forth a number of guaranteed rights including the right to sell production and to enter into business associations within the country or abroad. Under the new Contract Law the state now protects freedom of contract formation. This includes the freedom to contract without restraint in relation to joint ventures. There is, for example, no maximum duration for ventures nor any minimum foreign equity participation or foreign capital requirement. Both the Foreign Investment Law and the Contract Law provide for the mediation and arbitration of disputes.

The Labor and Accounting Laws are further examples of Laos' attempts to accommodate the requirements of the market. The Labor Law, while offering a sensible system of worker protection, assures important employer rights such as the right to determine salaries and the right to hire and fire. The new Accounting Law provides a basic framework for assuring that the financial records of all Lao enterprises are easily understood and subject to consistent standards.

The government's future priorities are the adoption of a series of laws dealing with procedures for commercial arbitration, business associations, negotiable instruments, securities and bankruptcy. As stated by the government: "The legal environment in the Lao PDR is rapidly changing from one which relied exclusively on Ministerial decrees that could be modified at will into one that puts strong emphasis on permanent business, commercial and economic laws."<sup>98</sup>

It now appears that Laos has tried and rejected the third

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98. *Id.* at 19.

way. It has implemented a strong legal system which the government states is the framework for a market-oriented economic system. As is evident from the Chinese historical experience, however, adoption of laws does not always mean that these laws prevail over an alternative culture-based system. One test of the movement towards an entrenched market-based system is the persistence of state enterprises. It is these enterprises which represent the residue of privilege endowed by the old planned system. They are the fundamental material of the "iron rice bowl." Under the New Economic Mechanism in Laos, it is intended that the state will disengage from the great majority of these enterprises, and leave the private sector to develop industry, mining, manufacturing, and trade. Although this disengagement has already begun, its completion will take some time. The private sector is still small and the state enterprises will linger since there is no alternative to replace them.

Nevertheless, there is a surprisingly strong commitment on the part of the LPDP to abolish the state enterprises. At the Party Congress held in August 1990, the view was expressed that the recent economic performance of Laos demonstrated that government involvement in production through public enterprises makes control of the money supply extremely difficult in a market-oriented system. When state-owned enterprises were required to compete and charge market prices for the goods and services which they produced, they incurred substantial losses. Financing these losses was a major factor in the increase in the money supply which had led to inflation.

This view was later confirmed by a leading LPDP figure Khamsay Souphanouvong, the Minister for Finance, when he said that with a few exceptions the state enterprises would be privatized. The government aimed to create an environment which would eliminate government intervention in business.<sup>99</sup> This is substantially different to the approach of the Chinese government.

Some problems remain. One significant problem is the liability of state corporations for their debt. Many of them claim immunity from litigation and, therefore, debt repayment obligations. Because many suppliers of state corporations are from the private sector, the impact of this immunity on the economy can be significant. The question of the relationship between the cadres and the technocrats is also an uneasy one. The cadres are reluctant to give up their politically-bequested privilege in ex-

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99. ASIA TODAY, Nov. 1991, at 3.

change for the risk of the market. Nonetheless, seventy-five percent of Laos' gross domestic product is now contributed by the private sector and the third five-year plan aims at a real average annual growth of 6.6%. Foreign investment is now valued at \$300 million and the United States has replaced Thailand as the largest investor in value terms.<sup>100</sup>

#### IV. CONCLUSION

There are two possible conclusions that could be derived from comparing the political economies and legal systems of China and Laos. First, it should be possible to compare the rates of development of a planned economy which has moved to a market economy (Laos) with one which has adopted the third way (China). Unfortunately, statistics from both countries are not sufficiently reliable for such comparisons to be of much value at the present time. On the other hand, the more interesting question is whether Laos represents a precedent for China. This in turn requires a belief in Hayek's analysis that following the third way is impossible and that movement towards a market economy is inevitable.

If traditional economic jurisprudence is accepted as correct, then China's persistence with the third way is doomed. Hayek and Weber reflect this view when they maintain that a market economy cannot exist without a strong legal system which maintains property rights. Hayek goes further in volume three of his seminal work, *Law Liberty and Legislation*, where he maintains that a market economy cannot exist in the absence of democratic government. Observers of China whose views are grounded in traditional Western economic or legal training feel that China's adherence to the third way will lead to an increasingly unstable inflation-prone economy. This, in turn, would cause the leadership to choose between a market economy or central control.

On the other hand, Nolan reflects an economic tradition derived from List, Marx, Engels and, more recently, Deng Xiaoping and Chen Yun. It holds that market economics can be fused with an authoritarian state and the elements of a command economy to produce sustained economic growth without socio-political disruptions such as those currently being experienced in Eastern Europe. The important feature of such a social and economic structure is that, as asserted by its supporters, it can persist without the existence of a strong legal and commercial

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100. *Id.* at 16.

system. Nolan emphasises that China has produced extraordinarily good results despite many serious problems. He points out that in the first decade of reform China outperformed almost all developing countries in terms of output, growth, and export performance, yet remained relatively free of foreign debt and inflation.

It is impossible from the data available to clearly assess which view is correct. One thing on which both groups of observers agree is that the private sector is a vital part of the Chinese economy. This appears to make movement in the direction of more market orientation inevitable. As the dependence of the Chinese economy on the private sector increases so will the private sector's power to demand reform.

From this point of view, what happened in Laos is a microcosm of what could happen in China. In Laos, as the importance of the private sector increased, so did its demands for laws which guaranteed its security.<sup>101</sup> Laos appears to be adopting a legal system which will provide such security; however, its practical effects remain unclear. If these recent changes are implemented successfully, Laos rather than Eastern Europe, may be the benchmark for China's progress.

We conclude that China will eventually have to make the transition to a full market economy if it wishes to enjoy sustained economic growth.<sup>102</sup> In this case, lawmakers will have to eschew notions of traditional law and adopt a commercial legal system which is consistent with the operation of the market. On the other hand, the transitional period of the third way should

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101. [A] legal framework that is impartially enforced is critical to a (market) economy's functioning. The existence of law and order, the enforceability of contracts through the rule of law, bankruptcy laws, a tax system are all important components of such an economy. Moreover such laws have to be transparent and law enforcement has to be equitable.

HELEN HUGHES, CONSTRAINTS ON EXPORT GROWTH IN CHINA 25 (forthcoming).

102. The 14th Party Congress of CCP in October 1992 (held just before the article went to press) has confirmed this trend. Party General Secretary Jiang Zemin in his keynote speech urged that markets be expanded to embrace "bonds, stocks, . . . technology, labour, information, [and] real estate, so as to form an integrated national market system open to all." Shareholding will "help promote the separation of the functions of government from those of enterprises." The Public sector—defined to include the grey area of "collective" enterprises—will remain "predominant," but must compete "in the market on an equal footing." See Lincoln Kaye, *Dengism Enshrined*, FAR E. ECON. REV., Oct. 22, 1992, at 10-11.

not be counted as a loss. It may be that the adoption of this transitional phase in China has enabled it to avoid the upheaval which has occurred in Eastern Europe.