

Law, Chinese Style: Solving the Authoritarian’s Legal Dilemma Through the Private Provision of Law

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“Commerce and manufactures ... can seldom flourish in any state in which there is not a certain degree of confidence in the justice of government.”
(Adam Smith, the *Wealth of Nations* V.iii.7:910).

Abstract

How do authoritarian states build the institutional infrastructure (e.g. secure property rights, contract enforcement, and the rule of law) necessary to support efficient markets? Tremendous political impediments hinder states from developing the rule of law. The path for the West involved parliaments and independent judiciaries that constrained the ruler. China’s path differs considerably; from the beginning, it involved the delegation of authority from the central government sometimes known as “federalism, Chinese style.”

China’s problem with creating the rule of law governing markets is made worse by the “authoritarian’s legal dilemma”; that is, the creation of a strong, non-corrupt judiciary that would *supply and only supply* private law (e.g., secure property rights, contract enforcement). Although China wants to improve its private law, it wants to avoid an independent judiciary that might challenge and constrain the central government.

Using China’s online market as the context, this paper explains how new institutional rules are devised in a weak legal environment, and how Taobao – a Chinese online trading platform – has the means to create law, Chinese style. The Chinese government has effectively off-loaded a substantial part of the development of law to private actors. Taobao – China’s dominant online trading platform with over 440 million active users –

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is not simply an exchange platform, but one in the process of developing a modern legal system that enforces contracts, resolves disputes and prevents fraud. As a private supplier of market infrastructure where formal institutions are lacking, Taobao essentially provides a means for creating law, Chinese style. We argue that law, Chinese style, parallels China's earlier reforms (1980s-early 1990s) which helped create federalism, Chinese style, that provided the political foundations of early market reform. The new form of delegation also involves a combination of authority and policy experimentation. From the standpoint of the central government, one major advantage of this approach to legal development is that it is much less politically constraining on the central government than the Western approach to public legal systems.

1. Introduction

Political-economists widely agree that economic development requires a range of public infrastructure to support efficient markets, including secure property rights, contract enforcement, and the rule of law (Acemoglu and Robinson 2012; North 1981, 1990; Persson and Tabellini 2009; Rodrik, Subramanian, and Trebbi 2004; and Weingast 1995). All of these services are produced by the legal system.

Many authoritarian governments face a dilemma with respect to improving their legal services. To see the dilemma, consider the distinction between private and public law. *Private law* involves the interaction of private individuals (such as property, contracts, and family law), while *public law* involves the interaction of citizens with their government (such as, the legal limits on the central government's powers; the nature of citizen rights, and the rules governing the bureaucracy; in short, the constitution).

The authoritarian's legal dilemma involves the challenge of how to create a strong and independent judiciary that would *supply – and only supply* – private law. The authoritarian government wants to provide private law to improve the economy; but it also wants to avoid the emergence of public law, that is judges willing to constrain the central government. A national

court system, even with a mandate explicitly restricted to private law, might well attempt to constrain the central government, for example when protecting property rights conflicts with the powers of the central government. Courts might seize an opportune moment of strong popular support and attempt to force the government to accept. This dilemma is a commitment problem: a judiciary that is strong and independent in the realm of private law cannot commit to not expanding its jurisdiction to public law and therefore constrain the central government. Absent a solution to the authoritarian's legal dilemma, the central government has avoided creating a legal system capable of providing the rule of law for private law.²

Although the Chinese government has always faced this dilemma, in the past, the undersupply of private law did not become a major hindrance to economic growth. As argued by Clarke, Murrell, and Whiting (2007), the government used various institutional means that substituted for a legal system to enable growth; they mention, for example, the cadre evaluation system and the fiscal contracting system. Clarke, Murrell, and Whiting further note that China's legal developments have, at least thus far, been a consequence of economic growth, not the cause.

Following Clarke, Murrell, and Whiting, we argue that the costs forgone due to the absence of a legal system are rising. Nowadays China's economic growth increasingly relies on small and medium-sized firms that, without a strong enforcement of the private law, are poorly positioned. Yet to preempt the emergence of public law, China has ruled out the Western path: one that established the rule of law for markets through parliaments and independent judiciaries that also constrained the central government. From the start, China's path to reform has differed considerably from the Western one (Oi and Walder 1994; Naughton 1995).

² Notice that this logic is of the form of Acemoglu and Robinson (2006) on why many developing countries maintain "Economic Backwardness."

We argue in this paper that, China has begun to fashion an alternative approach to establishing legal market infrastructure, which we call, “law, Chinese style.” Facing the authoritarian’s legal dilemma that constrains formal legal development, the central government has effectively off-loaded a substantial part of the development and enforcement of commercial law to private actors, namely, various online trading platforms. This approach allows the central government to cabin the domain of the legal system to private law.

To elucidate this private development of law, we focus on Taobao, China’s largest online trading platform, owned by Alibaba.³ We demonstrate that, with over 430 million users and more than 10 million vendors, Taobao is not simply an exchange platform, but a complete market that is in the process of developing a modern legal system. The system includes a very complex reputation mechanism, a credit score, a fraud detection program, and even a jury-like system in which ordinary users can vote to adjudicate cases or to change platform rules. With respect to exchange on the platform, this legal system helps create law, enforce contracts, protect certain property rights, resolve disputes, and prevent fraud. By doing so, Taobao has begun to supply many aspects of market-supporting infrastructure normally associated with the state.

It is crucial to distinguish Taobao from various e-Commerce platforms in the United States and Europe (e.g. eBay and Amazon). Put simply, the absence of publicly provided, rule of law-based legal services in China⁴ leaves many market problems with providing market infrastructure unsolved. These problems have forced e-Commerce platforms to provide their

³ For simplicity purposes, we use “Taobao” to refer to Taobao and its spinoff, Tmall. Alibaba owns both sites, and both have nearly identical institutional arrangements. As the business-to-consumer (B2C) version of Taobao (which is a consumer-to-consumer marketplace), Tmall hosts fewer but larger merchants. In fiscal year 2016, the gross merchandise volume (GMV) of Taobao was 2.202 trillion RMB, and that of Tmall, 1.565 trillion RMB.

⁴ The existing Chinese court system is cumbersome, often corrupt, and more like courts in developing countries than in developed ones. Although China has begun in the last few years to develop commercial codes, it is not clear how these codes will be enforced.

own systems of law in order to retain existing market-participants and to attract new ones. In the United States or Europe, in contrast, a rule of law-legal system makes it far less necessary for platforms to develop their own legal functions. Therefore, while Amazon and eBay also have institutions to curtail market problems, their institutions are less dense and less advanced in legal functions than Taobao's. As a result, we do not observe that U.S. or European platforms make the same contribution to the national legal development as Taobao does to China.

In this paper, we address two related questions about the seemingly implicit delegation to Taobao to design and provide legal and other market infrastructure. Our primary question asks, what is the likely scope of Taobao's legal-creation, and can it provide a systematic basis for a legal system? Secondly, we ask, why would the central government relinquish – or at least implicitly encourage – this authority?

We provide tentative answers to our questions. We argue that the Chinese government has acquiesced in Taobao's efforts; moreover, in subtle ways, it has begun actively collaborating with Taobao. E-Commerce platforms assume from the state the authority to enforce law within their domain; further, they also help the state to create formal law by experimenting with the nature and content of the legal rules appropriate for governing their platforms. In many ways, this development parallels China's earlier reforms (1980s-early 1990s) that created federalism, Chinese style. As with the earlier reform effort, law, Chinese style also involves a combination of authority and policy experimentation (Montinola, Qian and Weingast 1995).

But can we call this private system of rules "law"? To address this question, we draw on the "what-is-law?" framework of Hadfield and Weingast (2013, 2014). They define a system of rules as law when it meets several criteria. We then show that Taobao's system of rules has most of these characteristics and is therefore law.

As to the secondary question, we argue that the government has acquiesced in Taobao's creation of law because it provides a solution to the dilemma raised above, namely, it allows a possible avenue to provisions of private law which is not very likely to assert authority in public law. Additionally, it is not obvious how to design legal market infrastructure, and most attempts in the developing world fail. The implicit delegation of power to platforms allows the central government to stand apart from the experiment so that it may readily be abandoned if the experiment fails without tarnishing the central government.

We further reason that this delegation of authority from the state to the platform is relatively durable – at least as long as the legal rules provide value to platform users. With the number of users approaching half a billion, the central government faces high costs of intervening in Taobao's experiment as long as it remains successful. Moreover, the initial, implicit delegation has recently become more explicit and institutionalized.

This paper proceeds as follows. In the next section, we discuss the importance of legal market infrastructure for the development of markets, and why it is in generally difficult for authoritarian countries to obtain it through formal means. Section 3 and 4 provides the necessary background on Taobao, its operation, its platform, and most importantly, how it creates “law, Chinese style.” The following section evaluates the degree to which its platform can be said to produce law, based on the “what-is-law” framework (Hadfield and Weingast 2012, 2014). Sect 6 discusses why the central government has acquiesced in Taobao's assertion of authority to make law, Chinese style. We then, in section 7, analyze the durability of “law, Chinese style”, and section 8 presents some evidence about state delegation to Taobao on various legal fronts. Our conclusions follow.

2. Legal Market Infrastructure

2.1. Why Authoritarian Governments Commonly Undersupply Legal Market Infrastructure

To work efficiently, markets require various forms of infrastructure, including a legal system. The process of development, therefore, involves building the state capacity to provide law, secure property rights, and protection from predation (Besley and Persson 2009; Acemoglu and Robinson 2012; Weingast 2017). If a strong legal system is vital to development, why doesn't every state have one?

One of the central problems facing any developing country seeking to build a legal system is the problem of government predation – called the exercise of the “arbitrary power” by early modern political theorists, such as Locke, Montesquieu, Adam Smith, and James Madison; and “executive moral hazard” in the modern literature on the political-economics of development (Besley 2005; Besley and Persson 2009; Cox, North, and Weingast 2017). By way of illustration, Montesquieu (1748:157, 162, 164), Adam Smith (1762-63: 325-27), and the American Federalists (1788: F46:307), all argued that executives face incentives to abuse the court system when the latter's ruling conflict with the executive's interest.

Absent strong economic and political institutions to constrain the ruler, authoritarian countries face what we call the “authoritarian's legal dilemma”: a dual problem with respect to creating a judiciary that would *supply – and only supply* – private law. First, how to design the judiciary in a way that it restrains itself to private law, that is, an independent judiciary that will not unilaterally expand its jurisdiction to include public law; and second, how would the central government commit not to intervene in the courts' rulings when the government's interests are at stake? Especially problematic is the inherent tradeoff in this dual problem. The stronger the

institutions committing the government not to intervene to protect its interests, the greater the ability of the judiciary to expand its jurisdiction to include public law and therefore become a major source of restrictions on the central government's powers.

Knowing that an independent judiciary cannot constrain itself to private law ex-post, the ruling elites would not ex ante grant full judicial independence *even in the realm of private law*. We thus raise caution against the optimistic viewpoint indicating that judicial independence can arise in commercial areas but not in full scale (Peerenboom 2008; Wang 2015). It seems difficult, if not entirely impossible, to compartmentalize a national legal development process in that way.

In a nutshell, creating a capable judiciary that is independent and *only* independent in the realm of private law is difficult. This contributes to the common undersupply of legal infrastructure for markets in authoritarian countries.

2.2. China's Pragmatic Approach – And its Limitations

Adam Smith recognized over two centuries ago the nature of the problems to be solved as for fostering markets: “In those unfortunate countries, indeed, where men are continually afraid of the violence of their superiors, they frequently bury and conceal a great part of their stock.” (*Wealth of Nations* II.i.30-31:284-85). Further Dugald Stewart, Smith's first biographer, quotes a famous passage in an unpublished (and now lost) paper dating from 1755: “Little else is requisite to carry a state to the highest degree of opulence from the lowest barbarism, but peace, easy taxes, and a tolerable administration of justice; all the rest being brought about by the natural course of things” (quoted by Dugald Stewart, 1793:322).

In building this state-capacity, China continues to face many of the same problems as the developed West faced in an earlier stage of development. The communist party certainly needs economic growth for legitimacy. Yet the authoritarian's legal dilemma facing China has foreclosed the Western route to legal development through an independent court system and the rule of law. Instead, China appears to have taken Smith's advice exhibited in the second quote in the previous paragraph by adopting a pragmatic approach. It has developed a rule-*by*-law system,⁵ and meanwhile, has generated a variety of non-legal substitutes for the formal legal institutions to undergird the market.

In the post-Mao era, China has established various aspects of a formal legal infrastructure through legal reforms, including promulgating numerous laws, training legal professionals, and expanding the court system (Peerenboom 2002; Stern 2014), which serves the state's goal of enhancing regime legitimacy (Landry 2008; Stockmann and Gallagher 2011; Liebman 2014) and spurring economic growth (Wang 2015). In many accounts, the role of formal legal system in economy is increasing (Clarke et al. 2007), and the state-constructed legal consciousness of ordinary citizens is rising (Gallagher 2006; Whiting Forthcoming).

But the formal legal system remains insufficient to support efficient markets. Many studies have noted problems including the inconsistent signals and laws by local and central governments (Stern 2010; Xu, C. 2011), the decentralized and anomalous interpretations of private law (Chang and Xu 2017), and the weak or selective law enforcement (Peerenboom 2002; Mertha 2005). Fundamentally, as we contend earlier, this undersupply of legal market infrastructure stems from the authoritarian's legal dilemma, which cannot be easily tackled.

⁵ China scholars have used different terms than the rule of law to distinguish China's legal system from the one in the West. See (Landry 2008), (Wang 2015), Whiting (Forthcoming), (Dimitrov 2016), and (Peerenboom 2002).

To still enable market growth, China has used various non-legal substitutes for a formal legal system, including non-law-based administrative measures (Xu, C. 2011), political mechanisms to incentivize officials (Clarke et al. 2007) and personal ties (Xin and Pearce 1996, Wang 2014).

The limitation of China's pragmatic approach – growing under a weak legal system and using non-legal substitutes - is mainly two-fold. First, the absence of the rule of law disproportionately hurts the growth of private businesses (small and medium-sized enterprises in particular). Too often these enterprises lack the resources and political ties to advance their interests in the formal legal system (Ang and Jia 2014). Second, it hinders the rise of a national common market consisting of impersonal exchanges over long distance, especially those among small traders. Without legal support as assurance for trade, people do not trust.

These limitations were less pressing when the Chinese economy was heavily reliant on picking winners or state-led investment. Yet over time, the Chinese economy has become much more integrated with more players; it is increasingly reliant on SMEs and cross-regional trade. All of these trends have raised the value of a national-level legal infrastructure for markets. If China is to continue to grow at high rate, legal market infrastructure will become increasingly important.

3. Taobao and Law, Chinese Style

3.1. Theorizing about Law, Chinese Style

The authoritarian's legal dilemma essentially points to the inherent tensions between two objectives: growth in markets and control over politics. To make the two compatible, an authoritarian state needs a solution to the legal dilemma, and many authoritarian states fail to do

so, choosing instead to compromise their economic growth. As argued earlier, China's long-held pragmatic solution to the dilemma is to use various *non-legal* substitutes, which, increasingly, do not suffice growth demand.

In this paper, we argue that China has devised a novel solution to the authoritarian's legal dilemma; that is, the use of *private legal substitutes* for the formal legal system. We call this alternative route to legal development, "*Law, Chinese Style*." We contend that, in the face of political obstacles to strengthening formal legal system, the central government has in effect allowed specific private actors – the online trading platforms – a substantial role in the development of law.

We further argue that Taobao, as China's dominant online trading platform with over 400 million users, is not simply an exchange platform, but one in the process of becoming a modern market complete with a legal system that enforces contracts, resolves disputes, and prevents fraud. Because China lacks a strong formal legal system, Taobao has come to serve as a private supplier of market infrastructure for its traders that undergirds the competitive, impersonal online market.

For law, Chinese style, to work properly, two conditions need to hold. First, there exists a working private legal system that can, at least partially, substitute for the formal legal system; second, the authoritarian state is willing to delegate or acquiesce to legal functions to - or at least acquiesce in – this private legal system.

We organize the rest of the discussion around these two conditions, showing how and why both are in place. We first show that China's largest e-Commerce platform Taobao is a working private legal system. We elucidate why Taobao provides legal functions (Section 3.2),

how it provides them (Section 4), and whether its platform rules that perform legal functions qualify as law (Section 5).

We then explain why the government has thus far tolerated this private legal creation, and even started to work with it. We trace the political logic of delegation from the perspective of the central government (Section 6), discuss the durability of this state delegation (Section 7), and lastly, present evidence that the delegation truly exists and has been increasingly explicit (Section 8).

3.2. Taobao and Why It Provides Market Legal Infrastructure

Taobao (“Searching for Treasure”) is the world’s most popular online shopping site, and the tenth most visited website around the globe.⁶ Taobao’s business is primarily China-based. It does not sell products but provides a virtual marketplace that enables transactions of goods and services. Launched in 2003, Taobao has grown at a stunning rate. In fiscal year 2016, Taobao (Tmall included) hosted more than 10 million active sellers and 432 million active buyers, amassing an annual gross merchandise volume (GMV) of \$US485 billion.⁷ With respect to user base and GMV, Taobao (including Tmall) currently surpasses Amazon and eBay combined; it also eclipses Walmart Global, the world’s largest brick-and-mortar retailer.⁸ Taobao’s service has been even extended to those without online payment methods or who are not internet savvy.⁹ Up to March 2017, Rural Taobao (Alibaba’s rural expansion initiative) has also opened e-

⁶ The ranking comes from the Alexa list of top 500 sites on June 28, 2017. Retrieved from <http://www.alexa.com/topsites>.

⁷ See two fiscal reports from Alibaba: http://alibabagroup.com/en/news/press_pdf/p170124.pdf, http://www.alibabagroup.com/en/news/press_pdf/p160505.pdf

⁸ Himanshu Goenka (2016, April 6). *Alibaba (BABA) Overtakes Walmart (WMT) As Largest Retailer By Gross Volume*. Retrieved from <http://www.ibtimes.com/alibaba-baba-overtakes-walmart-wmt-largest-retailer-gross-volume-2349025>

⁹ The number of Rural Taobao service points is from http://caijing.chinadaily.com.cn/2017-05/30/content_29547904.htm.

Commerce service points in over 30,000 villages, many of which had no access to commercial parcel delivery service prior to the arrival of Rural Taobao.

Yet in many accounts, one should not expect to see this remarkable market to exist, as China has yet to produce a strong legal system. It is even more counterintuitive given that online transactions are particularly vulnerable to information asymmetries and traders are usually small, anonymous, and from distant localities. How to foster trade when the state-provided legal system is weak or non-existent? The Europeans faced the same problem with the growth of commerce and long-distance trade in the Middle Ages, before the rise of nation states; private institutions such as Maghribi coalition and the private courts then served legal functions (Greif 1989; Milgrom et al. 1990). Here we see a parallel. To create the market, Taobao provides legal market infrastructure out of necessity.

Therefore, Taobao is not simply an exchange platform that matches sellers and buyers. It is fundamentally a market platform that provides legal assurance to trade, without which even if sellers and buyers are matched, they dare not to trade. Taobao has developed the means to create law, Chinese style, as it has become a private supplier of legal infrastructure for the market in the absence of formal, state-run legal institutions.

**Table 1: Platforms vs. Independent Websites:
China vs. the United States (2011)**

| | Online Retailing in 2011 (%) | |
|---------------|------------------------------|----------------------|
| | Platforms | Independent Websites |
| United States | 24 | 76 |
| China | 90 | 10 |

Source: McKinsey Global Institute (2013)

Platforms like Taobao can serve as private substitutes for the lack of strong legal institutions to enforce contract, resolve disputes, and prevent fraud. We argue that this partially explains why platforms dominate e-tailing in China but not in the United States, where the strong legal environment makes the substituting effects of platforms less necessary than they are in China. In 2011, platforms accounted for 90% of the e-tailing market in China; whereas in the United States, platforms accounted for only 24% of e-tailing transactions, as opposed to 76% on independent websites (see table 1). This data is consistent with our argument that Taobao provides more than a platform for exchange, but also of legal serves.

To sum up, the Taobao marketplace is a substitute for a more traditional, government-provided legal system. All else equal, the demand for Taobao's legal and trading services is bigger in China than it would be in a rule of law country.

4. Taobao's Private Legal System

Taobao's private legal system comprises an ecosystem of institutions that address various types of problems associated with market transactions. We call it an ecosystem¹⁰ because Taobao's institutions are intimately connected, mutually supporting, backed by big data and constant evaluation and reevaluation. These characteristics contribute to a self-reinforcing system that improves over time in its capacity to identify and discipline market violations.

Our analysis begins with how Taobao addresses three major problems intrinsic to trade: contract enforcement, fraud prevention, and dispute resolution. We show that Taobao has developed systems that help it identify dishonest traders but also impose various forms of

¹⁰ We use the term "ecosystem" slightly different from the business literature that treats ecosystem as the network of institutions and agents guided by these institutions. We use the term to only refer to the institutions that are interconnected.

punishment. We then discuss several supporting institutions vital to improving the stability, effectiveness, and adaptability of Taobao's legal system.

4.1 Contract Enforcement through Institutionalized Reputation Mechanisms: *The Online Rating System + Escrow Service*

Traders throughout human history face a similar problem regarding contract enforcement known as the assurance problem: when trading parties strike a deal, how do they ensure that each party honors the agreed upon terms? The assurance problem is especially acute in several settings. For example, when an exchange is a two-step process in which one party to the contract performs her obligations first and then awaits the second party to perform his. As another example, a contract may call for one of the parties to make relationship-specific assets that make that party vulnerable to opportunism that potentially allows the other party to extract the value of those assets (Klein, Crawford, and Alchian 1979; Williamson 1985).

The Taobao platform has several mechanisms designed to address these and related problems. First, the online feedback and rating system lies at the center of Taobao's attempt to mitigate this problem. As with other online trading systems, such as eBay, Taobao's rating system creates incentives for all traders to maintain a good reputation by honoring contracts, gathering information, and resolving disputes.¹¹ But Taobao's system goes well beyond those used by eBay and Amazon.

Taobao's rating system consists of two main parts: credit rating and store rating. Both ratings are complex sums of user reviews from each transaction and are displayed publicly on buyers'/sellers' web profile. Credit rating reflects the overall reliability of the seller/buyer over

¹¹ In using a reputation mechanism, Taobao echoes some of the historical institutions in Medieval Europe. For example, the Maghribi traders (Greif 1989) and Milgrom et al. (1990).

the entire history.¹² This rating is cumulative over time and therefore discriminates against new sellers/buyers. To capture the changing dynamics of service quality, Taobao uses another indicator – store rating – to complement credit rating for sellers. Store rating is based on three aspects of the seller over the past six months: the accuracy of product description, customer service, and shipping time.¹³ In addition to the overall reputation of sellers, buyers can also check all past reviews of each product. Customers can rate, write reviews about, and post photos of the product. Taobao can then use text analysis to summarize individual comments, helping users internalize product reviews.¹⁴

Second, Taobao maintains a huge escrow system through Alipay (see details in subsection 5.4). As with Paypal, Alipay is a mechanism that streamlines online payment and reduces the risk of fraud involving cash or credit card transactions. But Alipay is also distinct in providing escrow service for most of the transactions on Taobao. When a buyer initiates a purchase from a seller, she pays her funds into Alipay's escrow account, not to the seller. The money is released to the seller only after all parties to the exchange are satisfied. Failure by one of the parties to follow the rules results in sanctions, such as loss of money in escrow, a change in reputation rating, or being banished from the platform.

4.2. Fraud Prevention through Risk Framework

Big data + Manual Review + State Coercion

¹² For details on the credit rating system, see <https://service.taobao.com/support/seller/knowledge-847753.htm>.

¹³ For each aspect, the seller is evaluated on a 1(very unsatisfied)-to-5(very satisfied) scale. The overall store rating is the average of all evaluations from each transaction happened in the past six months.

¹⁴ Nonetheless, the rating system suffers from multiple limitations: sellers can manipulate reviews by placing fictitious orders to inflate ratings, or they can take fraudulent actions that hurt competitors' reputation; the rating is product/store specific so that it cannot prevent fraud in payment. This is where Taobao's centralized coercive power and big data analysis can aid the rating system, topics we discuss in the next subsection (4.2).

Fraud is a critical issue that must be limited, lest trade stalls. Despite some overlaps, fraud as a concept is distinct from the problem of contract enforcement. Fraud generally involves purposeful deception to pursue unlawful gains, and it is not necessarily related to any specific contracts, as illustrated by identity theft. Fraud types common to online market include online payment frauds, account hacking, attempts to manipulate online reviews, and counterfeit products.

To identify fraud, Taobao utilizes big data analytics, which relies on its trove of user information (e.g. user behavioral data, network data, delivery details) to detect suspicious activities. The big data analytics are assisted by manual review to improve the accuracy of fraud detection (Chen et al. 2015).

Consider online payment fraud. Taobao uses five layers of checks to identify fraud. The first layer – account check – leverages big data analytics to examine account information of both the seller and the buyer, including whether these accounts have exhibited suspicious activities. Obvious fraud cases are immediately sent for auto-decision (i.e. a machine automatically decides on the case). If the case is suspicious but not obvious enough for auto-decision, it will enter the next layer of checks. From layer 1 to layer 4, the fraud risk management system checks different information of the transaction, sending obvious fraud cases to auto-decision and declining highly suspicious transactions. Borderline cases after four layers of checks are sent to the fifth layer, manual review, in which Taobao employees become involved.

To identify counterfeit products fraud, Taobao has devised experiments that crowd-source the review work to a group of experienced Taobao users – the public assessors (discussed in subsection 4.3) – who vote and decide whether a case involves counterfeiting.

After detecting a case of fraud, Taobao can punish fraudulent behavior through both online and offline means. The online means include lowering the user's rating, making the fraudulent store unsearchable for a certain period, or in extreme cases, banning the account. The offline means to punish fraudulent behavior involve the collaboration between Taobao and the state's coercive apparatus. For example, to combat counterfeit products fraud at its source, Taobao shared information with the police and helped them trace suspects who produce and sell counterfeits, leading to the arrest of 400 suspects and the shut-down of 200 brick-and-mortar stores.¹⁵

4.3. Dispute Resolution through Crowd-Sourcing Justice *User Dispute Resolution Center*

Dispute resolution is an indispensable aspect of a workable legal system. Every functioning market needs mechanisms to handle disputes. We consider two: (1) disputes between any pair of market participants; (2) disputes between market participants and market owners/regulators.

When a dispute occurs, the relevant parties can resort to judicial channels provided by Taobao. The party initiating the case may choose from two channels: asking a designated Taobao employee to adjudicate; or using a jury-like panel of public assessors to arbitrate.

Launched in 2012, Taobao's User Dispute Resolution Center (pan.taobao.com) or jury system crowd-sources jury talent to deal with minor, everyday disputes.¹⁶ Most of these disputes

¹⁵ Taobao's massive datasets (e.g. shared phone numbers, chat histories, product return/delivery addresses) helped the state to track the location of offline warehouses and producers involved in counterfeiting, at least for producers that have business connections with online sellers on Taobao.. See Catherine Chu (2014, December 23). *Alibaba Removed 90M Suspicious Listings From Its Sites Before IPO*. Retrieved from <https://techcrunch.com/2014/12/23/alibaba-listings-purge/>

¹⁶ For more details, see <http://www2.alizila.com/how-taobao-crowdsourcing-justice-online-shopping-disputes>.

are of two types: a buyer-seller disputes which often involve contract violations (e.g., complaints about items received that fail to match store descriptions); and platform-seller disputes (e.g., in which a seller believes that Taobao has unfairly penalized it for violating certain rules).

Taobao chooses the jurors – “public assessors” – randomly from a pool of nearly two million. Taobao designates these assessors from experienced users who have volunteered to serve. Qualified candidates must have high reputations. Public assessors are unpaid.¹⁷

For each dispute, the system randomly draws 13 public assessors.¹⁸ Their principal responsibility is to review evidence submitted by disputing parties, and then vote within 48 hours. The public assessors decide which party wins by a simple majority vote. There is no communication between dispute parties and the anonymous assessors or among assessors.

Assessors also provide written comments about this case. If unsatisfied with the jury decision, a disputing party can request Taobao employees reexamine the case.

The beauty of this jury-like system is twofold. Taobao can shift to its users the task of assessment and resolving the disputes, which have been mounting in number as a result of rising trade volumes on the platform. As of February 8, 2017, 1,126,140 “jurors” have resolved 2,295,511 disputes in total.¹⁹ The system also helps Taobao refine its rules. In 2013 alone, feedback from public assessors improved more than 140 Taobao rules governing online stores.²⁰

¹⁷ For these details, see <http://www.iwshang.com/Post/Default/Index/pid/247679.html>. Specifically, pool members need to have a registered account for more than a year; and a sufficiently good “sesame credit rating.” Finally, as to payment: the assessors are motivated by gaining more “experience points” that can translate into different levels and titles, and that can also be donated as real money to charity (source: <http://www.chinaelaw.com/show.php?contentid=20385>).

¹⁸ In 2016, the total number of jurors for a panel was reduced from 31 to 13.

¹⁹ According to the updated statistics on pan.taobao.com.

²⁰ Jim Erickson and Susan Wang (2014, July 18). *How Taobao Is Crowdsourcing Justice in Online Shopping Disputes*. Retrieved from <http://www2.alizila.com/how-taobao-crowdsourcing-justice-online-shopping-disputes>

Importantly, the decisions of Taobao's dispute resolution system are enforceable. Taobao can freeze the payment in dispute, take money from the store deposit (for sellers only), lower the rating of the users involved, or deny the losing party's privileges to use the platform.

4.4. Supporting Institutions:

Payment and Escrow, Credit Scoring, and Voting for Rule-making

Taobao's private legal system also relies on several supporting institutions. Although these institutions do not specifically address any of the major issues in trade (i.e. contract, fraud, and dispute), they ensure that platform rules are interconnected, adaptable, and easier to enforce. We focus on three institutions that contribute to Taobao's legal system, Alipay, Sesame Credit, and the House of Representatives for choosing new Taobao Rules.

As we noted, Alipay, the provider of online payment and escrow services, is the key to law enforcement on the platform. Alipay's escrow service enhances Taobao's enforcement capability in both direct and indirect ways. First, Alipay can directly freeze or deduct from the money that a user has in her account if she violates platform rules. When a dispute over a trade arises, Alipay can freeze the payment in escrow, forcing feuding parties to choose between losing the money or engaging in, and complying with, Taobao's dispute resolution system. Second, Alipay indirectly improves the law enforcement on Taobao by collecting valuable data to identify (potential) rule-violators. The payment data collected from each Alipay transaction provides objective information about Taobao users. Alibaba can then leverage this behavioral analysis to detect fraud (as discussed earlier in fraud risk management) and to evaluate each user's trustworthiness and creditworthiness. Most importantly, knowing that Alipay makes rules/contracts enforceable, in turn, incentivizes users to respect rules/contracts. This produces a positive feedback loop that improves the performance of contracts.

Another important supporting institution is Taobao's Sesame Credit Management. As China's first credit-scoring system, sesame credit uses transaction data from traders and assigns each user or business a credit score ranging from 350 to 950.²¹ The idea parallels a U.S. individual's FICO score determined by his/her eBay rating or Amazon feedback.

Sesame credit assists Taobao's legal system. First, many of the benefits from Taobao require a high sesame score.²² This provides additional and strong incentives for users to maintain a good reputation on Taobao. Sesame credit score provides a simple, comparable measure of a trader's overall trustworthiness and creditworthiness. The ratings help distinguish dishonest traders from others.

Taobao has also begun experimenting with a "House of Representatives" for adopting rules in a manner that gives Taobao users a voice in rule-making, which helps adapt the platform rules to the changing demands of users. When Taobao proposes a rule change or a new rule to the House of Representatives, all buyers and sellers with a decent sesame score can vote on, as well as express their opinions about the rule. Within a certain period after each voting, Taobao makes public the results and adjusts the rule accordingly.²³ From June 2015 to February 2017, the House voted on 42 rules, each of which involved over 10,000 voters.²⁴

²¹ Catherine Shu (2015, January 27). *Data From Alibaba's E-Commerce Sites Is Now Powering A Credit-Scoring Service*. Retrieved from <https://techcrunch.com/2015/01/27/data-from-alibabas-e-commerce-sites-is-now-powering-a-credit-scoring-service/>

²² Benefits include loans to small businesses, a fast track in visa applications and at airports, and even a better reputation on several online dating websites that Taobao partners with.

²³ We observe that this institutional structure has an important historical precedent in the form of a "mixed government" discussed by Aristotle and Polybius, also, in early modern times, Machiavelli, Harrington, and Montesquieu. Mixed government was often thought of as necessary for the long-term stable of republics. This structure is sometimes identified as "the one, the few, and the many"; that is, an executive, such as a king; the nobility (sometimes mixed with ecclesiastic lords), and the commons (for example, the non-nobility with a certain level of wealth). An important aspect of mixed government is that the nobles were often granted the power to make proposals and the commons, the power to accept or reject. In Taobao's case, the first acts as the proposal maker and the jury acts like the commons.

²⁴ See, respectively, <https://rule.taobao.com/rulecycle.htm> and <http://m.v4.cc/News-342575.html>.

5. Evaluating Law, Chinese Style: Are Taobao's Platforms Rules Law?

Not all government-produced rules qualify as law. As a first step to understanding law, Chinese style, we begin with the foundational question: What is law? – and how does it differ from a set of rules created by typical authoritarian governments? To address this question, we draw on the “what-is-law” framework of Hadfield and Weingast (2012, 2014). This approach to law does not presume state enforcement, instead placing law within the broader framework of different types of social order.

The what-is-law framework proposes that, for a set of rules to be considered law, it must have four sets of characteristics.

- First, law is characterized by a set of legal attributes that are frequently identified as marking the existence of law by legal theorists such as Fuller (1964), Raz (1977), and Waldron (2008).²⁵ These attributes include the following: Stability, Generality, Prospectivity, Clarity, Non-contradictory, Consistency, Promulgation, and Feasibility.²⁶
- Second, there exists a common knowledge set of rules – *the common logic* shared by members of the community - that govern the choice of new rules and the adaptation of old ones (Hart 1961).
- Third, law requires a third-party enforcement mechanism, which typically involves a mix of state coercion and decentralized enforcement by citizens and traders.
- A final feature of the what-is-law framework aids coordination of collective punishment, an *authoritative stewardship*. The steward is a unique, institution responsible for resolving ambiguities or uncertainty about the classification reached by the common logic. The steward therefore helps adapt the common logic to changing circumstances.

²⁵ Although these theorists express important differences in their approaches, these details need not concern us here. See Hadfield and Weingast (2012) for more discussion.

²⁶ A brief definition of each legal attribute is given in parentheses. Stability (tomorrow's law will be identical, or nearly so, as today's); Generality (the law applies to large classes of people and singles out no individual); Prospectivity (no retroactive laws); Clarity (the rules delineating rightful and wrongful behavior are clear); Non-contradictory (two different rules cannot require contradictory action); Consistency (between the announced rule and its implementation); Promulgation (the rules can't be secret; i.e., they must be common knowledge); Feasibility (law can't require people to do impossible things).

The what-is-law framework explains how a system of rules qualifies as law, thereby allowing us to judge Taobao's system of rules.

Taobao's legal creation project remains at an early stage. Nonetheless, it has made significant progress on solving the assurance problem for its traders. To this end, Taobao has begun to devise a complex system of institutional components designed to provide many of the services supplied by formal, public legal institutions in the developed countries. We detailed some elements of the new institutions in sections 4.

As we explained the main difference between platforms in developing countries and those in the developed West is that the absence of a functioning, rule of law legal system has forced Chinese trading sites to create law, Chinese style. As we noted, Taobao's reputation mechanism is far more complex than that of its U.S. counterparts; compared with similar services provided by eBay and Amazon, Taobao's dispute resolution system is more developed, takes less time to settle the disputes and has more enforcement capability; additionally, neither eBay nor Amazon provides the escrow service central to Taobao's system.

We briefly assess Taobao's system with respect to these four characteristics of law. Consider the various legal attributes of the first characteristic. In terms of stability, the rules remain in an experimental stage and are evolving. Nonetheless, Taobao has strong incentives to ensure stability of the rules for two reasons, both of which are endorsed by Interview data (Interview SF001): (1) In the past, Taobao endured costly reactions in the past for rule changes that unleashed several large-scale protests; Taobao wishes to avoid this from happening again.²⁷

²⁷ Taobao experienced several protests from vendors. The largest online protests – “Taobao October Rising” (shi yue wei cheng) took place in October 2011 after Taobao announced a new fee schedule. Nearly 50,000 small merchants coordinated and initiated various digital protests. Finally, the government stepped in to mediate; Taobao conceded and offered 1.8 billion RMB to help small business use its platform. Details about the protests can be found in various online sources, such as http://www.chinadaily.com.cn/bizchina/2011-10/13/content_13881570.htm,

(2) Frequent changes in rules created confusion among platform users, making them less likely to follow the rules. The basic approach to fraud appears to be general. As we detailed, Taobao is constantly updating its means of detecting fraud, as in the use of big data and refining algorithms. But the rules about what constitutes fraud seem stable over time, promulgated, known in advance, consistent, and feasible. Because these characteristics are fundamental to any incentive system promoting rightful behavior, Taobao has strong incentives to make sure its rules conform to these attributes.

As to the second characteristic – a set of rules governing how the rules are chosen – Taobao is still experimenting with the institutions for rules. It is not clear whether the employees who judge disputes have begun to assemble a set of rules by which they make decisions. Does Taobao attempt to decide like cases in a like manner? Do these employees share their experiences? Has Taobao begun codifying principles that may have emerged, even if at this point they remain proprietary? Answers to these questions would go a long way toward explaining how far Taobao has come down the path of creating law, Chinese style. The more Taobao's system incorporates these features, the more law-like is the process. Here to, Taobao has strong incentives to address these questions in the affirmative.

The third characteristic, enforcement, is central to Taobao's operation. As noted above (in section 4 and earlier parts of section 5), Taobao has a range of punishments. These actions including adjusting a trader's reputation, assessing fines applied to money held in escrow, banishment from Taobao, and even prosecution using the local, if inefficient, legal system. As emphasized in the what-is-law framework, none of the punishment elements except the last

<http://www.scmp.com/article/987920/online-sellers-stage-charges-protest>, <https://www.techinasia.com/alibaba-tmall-end-digital-protests>.

involve state coercion. They do involve third-party enforcement through Taobao and, hence, indirectly, through the reactions of the community of traders.

Finally, as to the fourth characteristic, the existence of a legal steward, Taobao does have a set of rules and a system for introducing new rules. As noted, it has begun experimenting with the House of Representatives as a means of choosing some new rules.

It seems inevitable that the future of Taobao involves refining the system so that it, to an increasing degree, meets the four sets of characteristics of law. Markets require stable expectations so that traders know what practices are legal and illegal; and, further, they know the consequences of their choices. This seems to require that Taobao move in the direction of establishing the various legal attributes. Further, Taobao is likely to create a system of precedents to ensure widespread promulgation of the rules, that like cases are treated in a like manner, that traders can establish expectations about how they will be treated under the rules, and that a common knowledge system exists for adapting existing rules to changing or novel circumstances. The more certain are users of the rules and their implications, the more easily they can obey the rules. Finally, Taobao will inevitably refine the rules by which the rules are chosen.

6. The Political Logic of Delegation

To work properly as an alternative route to legal development, law, Chinese style, relies not only on the presence of a workable private legal system (discussed in Section 3-5), but also on the willingness of the state to delegate, either implicitly or explicitly. This section discusses the political logic of delegation from the perspective of the central government.

The primary reason for the Chinese government acquiescing in Taobao's assertion of authority to make law, Chinese style, is that this implicit delegation is much less politically constraining than is the direct reforming of the formal legal system. An important feature of the law, Chinese style, is that the reach of this law is limited in scope to traditional areas of private law – especially property and contracting. Put differently, the private provision of private law allows the central government to foster experiments in law as it relates to the economy while lowering the probability that the legal system will challenge the central government in the area of public law.

Secondly, delegating authority to create markets with the rule of law helps conquer the technical complexities in building a workable legal system. The current delegation parallels the delegation of many reforms earlier in the process of marketization, such as allowing Guangdong to reform markets by being “one step ahead” (see Montinola, Qian and Weingast 1995; Shirk 1993). As with the earlier delegation and reform, this approach to create law allows this government to stand above the provision of services, in part to allow multiple experiments and in part so that it is not directly responsible for any failures of the system.²⁸ Delegation allows the central government to distance itself from public dissatisfaction that may arise. If need be, the central government can more easily curtail failing experiments.²⁹ Private actors, therefore, bear the risk of failure and buffer the tensions that could have been directed towards the state; but they also face the prospect of large profits if their experiments succeed.

²⁸ Compared with the previous delegation that typically occurred between the central government and the agents of the state (e.g. the provinces), delegating authority to private actors can distance the entire state from public dissatisfaction and political pressure.

²⁹ For example, in 2010, around 300 sellers initiated a physical protest against Taobao. They gathered in front of Alibaba's headquarter in Hangzhou with banners: “(We) protest against Taobao's ‘July 8th Pseudo Rules’ and Taobao's imperialism, (and we) appeal to the state to improve online shopping regulations.” See details from <http://en.people.cn/90001/90778/90860/7065181.html>

Additional reasons exist as to why the central government delegates institutional functions to *private platforms* rather than to state agents. First, as the platforms control the flow of valuable resources (e.g. information, data and search rank) that affect the economic livelihoods of other market participants, the platforms can serve as *points of control* for the central government.³⁰ In other words, the central government can potentially achieve *indirect yet cost-effective* ruling over the citizenry by simply controlling the platforms that hoard valuable data on individual demographics and behaviors. As a powerful, tool for collecting market information, platforms can reduce and even reverse the center's information disadvantage vis-a-vis local governments. Second, delegating to geographically-transcendent platforms, rather than to sub-national governments, helps the central government recentralize power and to foster a national common market. By breaking down internal trade barriers, platforms furthermore weaken the authority, revenue, and rent-creation by local governments (Liu and Weingast (2017) investigate this topic).

7. Durability of Law, Chinese Style

The durability of Law, Chinese Style, depends on the extent to which a dual commitment problem can be solved.³¹ First, Taobao must commit not to abuse its power, and in particular, not to make confiscatory demands on its users. In the short and medium run, competition with other platforms protects users to an important degree. Otherwise, Taobao risks having its users leave,

³⁰ This echoes Henry Farrell's argument about how some key private actors can serve as "points of control" for the state in international relations (Farrell 2006).

³¹ Consider the fundamental dilemma facing every government in regulating markets (Weingast 1995): a government strong enough to enforce contracts and protect property rights is also strong enough to revoke these rights. Therefore, to assure Taobao to keep investing in its market, the state must – somehow - credibly commit to not confiscate Taobao. Similarly, to assure its traders to make transactions on the platform, Taobao needs to credibly commit to not confiscate the wealth of the traders.

and its market may collapse from within. In the long-term, if economies of scale are present and Taobao becomes a natural monopolist, it may have the ability to extract rents from users.

Second, the Chinese state must commit not to expropriate Taobao or revoke its tolerance with Taobao's private ruling over the online market. Otherwise, Taobao's experiment with providing legal market infrastructure will fail. We argue that there exist some limits on both the state and Taobao that prevent them from acting arbitrarily. These constraints bestow the implicit delegation (from the state to Taobao) with a degree of durability, making reversal costlier, if not entirely impossible.

7.1 Limits on Taobao's Arbitrary Acts

Concerning constraining the arbitrary power of Taobao, one major mechanism is competition. Most traders, especially buyers, use multiple platforms; the low cost of switching platforms means fierce competition between Taobao and other rivalries (e.g. JD and Amazon China). Of course, uncertainty remains about the efficacy of this competition mechanism over time. Due to network effects, platforms may exhibit *increasing* returns to scale,³² making a platform industry often dominated by a handful of giant platforms, or even prevailed by a single one (Eisenmann, Parker and Alstyne 2006). One should not, however, assume that Taobao would reap monopoly profits even if it grows to be a monopoly in e-Commerce. Growing studies suggest that monopoly platforms are distinct from traditional, non-digital monopolies (e.g. Rochet and Tirole 2003; Evans 2003; Moore 2016),³³ and there is an ongoing debate on whether platforms should be subject to antitrust law. It is too early to give a definite answer.

³² This differs from traditional businesses in which an increase in scale after some point often leads to diminishing returns.

³³ Consider two major differences. (1) *Pricing, choice and network effect*: as opposed to traditional monopolies known for charging the customers a higher-than-competitive price, platform monopolies – as they are two-sided or

To summarize this point, Taobao is not yet a monopoly, and platform competition places constraints on it from acting arbitrarily on its users. We cannot, however, be sure of the long-term efficacy of this competition.

7.2 Limits on Government Expropriation

Taobao's power is also checked by the authoritarian government's regulatory power. But how does the authoritarian government commit to not confiscate Taobao and subvert Taobao's private legal system?

Despite the lack of institutionalized limits on the state, which makes Taobao's private ruling still in the shadow of political power, the state would bear various costs were it to confiscate or subvert Taobao. First, working against the threat of expropriation is Taobao's sheer size. Because the number of buyers and sellers is so large – approaching half a billion – the government would pay a high price in curtailing Taobao's business. The platform has a huge support base that could be used to turn on the government were it to attempt to shut down Taobao or to expropriate a major portion of Taobao's value.³⁴ Even if the government might win such a confrontation, it risks tarnishing its reputation in both China and in the international community.

multi-sided markets - usually make their services *free* to the public to incentivize other market-participants (e.g. merchants, advertisers, other service providers) to join as well. Owing to network effects, platforms also appear to offer more (rather than fewer) choices, and better (rather than worse) services to users as the size increases.³³ (2) *Competition among tech monopolies*: As internet platforms are fast evolving, monopoly status is often unstable (Evans 2003), and a platform's competition often arises from companies that offer very different products and services. For example, according to Google's executive chairman Eric Schmidt, Google's biggest competitor in search is Amazon, rather than another search engine.³³ But again, research in this field has just started and the above points are debatable.

³⁴ Recall that the conservatives sought to reverse some of the reforms after Tianamen Square protest in 1989 but were forced to back down by the pro-reform coalition (see Montinola, Qian and Weingast 1995 and Shirk 1993). Political theorists have long-understood that this principle of coordinated resistance is a central mode of policing government transgressions. See Locke, Hume, Montesquieu, Adam Smith, and Madison; and among modern theorists, Fearon (2011) and Weingast (1997).

Second, the recent literature on “regulatory entrepreneurship” suggests that tech companies have inherent advantages (e.g. scalable, highly connected with users) in leveraging popular support against resistant officials or overly protectionist rules (Pollman and Barry 2016).

Third, the interests of the state and Taobao are strongly aligned. Neither Taobao nor the state, at least in the short term, has the incentive to deviate from their collaboration. The authoritarian state has been able to maintain social stability during the recent economic downturn, largely owing to the jobs created by Alibaba. In 2012 year alone, the e-Commerce industry has created more than 2 million jobs directly and 12 million jobs indirectly, which were mainly contributed by Taobao and Tmall.³⁵ Besides job creation, e-Commerce is also critical for China’s transformation from an investment- and export-driven economy to one that increasingly relies on domestic consumption and innovation. In 2015, consumption contributed 66.4 percent to China’s GDP growth.³⁶ And according to BCG, e-Commerce accounted for 30 percent of all growth in Chinese consumption from 2010 to 2015.³⁷

Because the central government’s legitimacy with the people rests in good part on sustained economic growth, expropriation of Taobao would curtail Taobao’s job-creating ability, negatively harm China’s international reputation, and therefore threaten future Chinese economic growth. To the extent that Taobao’s experiment with creating a legal system proves adaptable to other contexts, expropriation would forestall this process as its associated economic gains. Of course, the incentives against expropriation will be stronger to the degree that Taobao’s experimental legal system succeeds.

³⁵ Data is extracted from <https://www.ft.com/content/722e6f0c-bac7-11e2-b289-00144feab7de>

³⁶ Data is extracted from <http://www.reuters.com/article/us-china-economy-gdp-idUSKCN0Y70X9>

³⁷ Data is extracted from Exhibit 3. Retrieved from <https://www.bcgperspectives.com/content/articles/globalization-growth-new-china-playbook-young-affluent-e-savvy-consumers/?chapter=6>

Fourth, the central government faces another cost from expropriation due to do the ownership structure of Alibaba – Taobao’s parent company. First, Alibaba was incorporated in the Cayman Islands, and its two largest shareholders are non-Chinese firms: Softbank and Yahoo. Alibaba is also a listed company on NYSE. Confiscating Taobao would therefore inflict tremendous costs on foreign shareholders and severely damage China’s international reputation. Other Chinese firms would find it harder to raise international capital or become listed on prominent stock exchanges.

Lastly, Taobao’s parent company Alibaba also gained protections through political ties by accepting investments from the funds that are government-backed or run by the scions of the Chinese leaders.³⁸

In short, a wide range of factors imply that the Chinese central government would pay a high price for expropriation of Taobao as long as Taobao succeeds, including threatening its legitimacy. The high costs of either Taobao acting arbitrarily or the government expropriating the company make Taobao’s private legal system relatively durable for now. Nonetheless, this analysis does not imply that Taobao and its users are entirely safe.

8. From Implicit Delegation to Explicit Delegation

To recap, the main argument of this paper is that the Chinese government has delegated a part of the development of law to Taobao. To the extent that credible commitments protect Taobao’s efforts in creating law, Chinese style, it is not crucial whether the delegation is de jure

³⁸ See more details at <https://dealbook.nytimes.com/2014/07/20/alibabas-i-p-o-could-be-a-bonanza-for-the-scions-of-chinese-leaders/>.

or de facto. Nonetheless, in recent years, this delegation seems to become more explicit and institutionalized. We show some direct evidence of delegation here.³⁹

(1) *Official recognition*: The e-Commerce law (draft for comments) released in December 2016 has recognized the role of platforms in regulating the online markets. For instance, the draft law emphasizes the principles of self-management and self-regulation in the e-Commerce industry (Articles 6 and 8). It stipulates that the e-Commerce platforms shall establish a credit rating system, disclose rating rules, share credit scores and penalize users with bad credit records (Article 78). The draft law also encourages the e-Commerce businesses to set up mechanisms to resolve online disputes (Article 64).⁴⁰

(2) *Official delegation of law enforcement authority*: The central government has started to collaborate with private platforms to enforce legal functions that the state apparatus finds difficult to fulfill. Two examples. (a) *Curb commercial bribery*: In May 2017, the Anti-Corruption Bureau of Supreme People's Procuratorate signed memorandum with Alibaba "to create a clean, credible, rule-of-law market environment."⁴¹ It offers Alibaba the access to information about the individuals and businesses having history of commercial bribery, so that Alibaba can legally prosecute these individuals/businesses when they engage in online economic activities. (b) *Enforcing debt payment*: In order to improve the enforcement of court orders, the Supreme People's Court has teamed up with major e-Commerce companies (e.g. Alibaba, JD) since 2015. Platforms punish those who fail to repay debts by lowering their credit ratings, and

³⁹ The material in this section draws on Liu (2017).

⁴⁰ For the full text of the law draft, see http://www.ec.com.cn/article/dszc/dslf/201612/13596_1.html.

⁴¹ For the full text of the memorandum, see http://www.spp.gov.cn/xwfbh/wsfbt/201705/t20170509_190120.shtml.

by restricting them from buying high-priced items online. Up to 2017, Alibaba alone has punished 730 thousand debtors, of whom 50 thousand have repaid debts.⁴²

(3) *Formal institutional development through formalizing platform rules*: The state has incorporated components of platform rules into its own regulations on online trading. A case in point is a return policy stipulating that “consumers shall have the right to return the commodities within seven days of receipt of them without cause.” This policy was first made and enforced by Taobao in 2008 on clothes sold on the platform. In 2014, this regulation was recognized as an industry standard, and was written into the Article 16 of *The Administrative Measures for Online Trading* released by the State Administration for Industry and Commerce.

Additionally, the existing platform rules have strongly influenced the making of E-Commerce Law.⁴³ The China Electronic Commerce Association (CECA) – a business alliance that represents the interests of e-Commerce companies including Alibaba – was authorized by the state to make one of the four draft proposals for the e-Commerce law. The other three drafts were proposed respectively by academics, various ministries of the central government, and the local governments. The final draft is an amalgamated version that synthesizes all four drafts. The practice of having different interest groups, especially the business alliance, to make a draft proposal of a national law is very rare in China.⁴⁴

To sum up, law, Chinese style has become increasingly explicit. Not only do platforms assume from the state the authority to *enforce* legal functions, they also assist the state to *create and reform* formal legal institutions by experimenting with the nature and content of the rules.

⁴² See, respectively, from http://www.sohu.com/a/129962460_115443 and <http://news.163.com/16/0217/07/BG0RBH3R00014Q4P.html>.

⁴³ See, <http://www.isc.org.cn/zxzx/hlwzl/listinfo-32505.html>.

⁴⁴ For details, see <http://www.mofcom.gov.cn/article/shangwubangzhu/201603/20160301274283.shtml>.

9. Conclusions

We ask a series of questions at the outset. In the first, we ask about the authoritarian's legal dilemma, the desire to create private law governing commerce without creating a judicial system capable of challenging the state. We answer this question by explaining that a private system of providing private law has emerged in China with a low risk of challenging or constraining the central government's authority. We call this system, law, Chinese style. Market platforms, such as Taobao, are central to this process.

This thesis leads to two more questions that we address. The primary question asks, what is the scope of Taobao's law-creation? Our secondary question asks, why would the central government delegate this authority – or at least acquiesce in Taobao's assumption of this authority?

In this paper, we developed a framework for addressing each of these questions. Experimentation by online market platforms, such as Taobao, appears to be changing the political, economic, and legal basis of China. As part of law, Chinese style, we argue that Taobao has created far more than an exchange system; it has created a national market platform, including the market infrastructure necessary to sustain markets that the central government has been reluctant to provide.

To determine the extent of Taobao's private lawmaking, we draw on the "what-is-law?" framework of Hadfield and Weingast (2012, 2014). This framework characterizes law by series of criteria: We showed that Taobao's system of rules governing exchange and dispute resolution meet all of these characteristics, at least to a degree. Many of the elements of each of these characteristics are already in place. Resolution by Taobao employees who specialize in adjudicating cases could evolve into a judicial system with Chinese characteristics. Needed is a

mechanism – and a set of incentives – that would ensure these specialists establish and apply rules with the legal attributes. The jury system is another possible source of rules and even case law. Finally, the House of Representatives may well prove the start of a systematic means of adding new rules to cover particularly troublesome circumstances.

This evaluation shows that Taobao has begun experiment with the provision of legal infrastructure, and it has made significant progress on solving the assurance problem for its traders. Yet for Taobao's legal creation to advance, two important questions are concerned: (1) What incentivizes Taobao to keep developing legal infrastructure, rather than exploiting its users with arbitrary acts? (2) How can Taobao's private legal system survive in a politically dangerous environment where government predation and expropriation are real possibilities? These questions essentially constitute a dual commitment problem that we discuss in the paper. We also show that some mechanisms are in place to make durable Taobao's provision of legal infrastructure, at least in the short or medium terms.

Law, Chinese style is not without limitations. The delegation in legal development is still limited in scope (i.e. restricted to certain areas of private law). Taobao's private legal system remains in the shadow of political power, and its existence remains reliant on maintaining a benign relationship with the state, although various costs of intervention can put some constraints on the state's arbitrary acts. Moreover, despite that Taobao's private legal system is largely algorithm-based, there is still room for corruption and nepotism between the users and the platform employees who enforce the institutional rules. Competition among platforms, in theory, can contain this potential abuse of power by business elites; as long as users can vote with their clicks and switch at low cost among platforms, they can prevent the interests of private platforms

from diverging greatly from the general interests of the society. Nonetheless it remains an open question about the long-term efficacy of platform competition.

Well aware of these limitations, we by no means suggest that law, Chinese style is a Pareto-efficient solution to supplying legal market infrastructure. Nor do we contend that government-initiated legal reforms are not necessary for authoritarian countries. Rather, our point is that law, Chinese style presents one of the few options available to authoritarian countries that, as for legal development, strikes a balance between political feasibility and economic efficiency. Essentially, our theory proposes a “second-best institution,” which, according to Rodrik (2008), is more appropriate for the developing world than the alleged “best-practice institutions,” since political barriers cannot be easily tackled in the short term.

Importantly, law, Chinese style, implies a new governance model, which we call, “private governance under state oversight.” That is, in certain governance areas, the state can allow or even encourage multiple key private actors (e.g. online trading platforms) to provide *competing, overlapping systems of private governance*, among which citizens can choose at will; and the state can *formalize* private rules that work the best. But at the same time, the state should avoid one single platform grows to be a state-franchised monopoly, so as to decrease the downside of private governance. Competition among private systems of governance, if possible, is especially valuable for states facing a governance deficit due to the dearth of political competition. After all, most people in China cannot “vote with feet,” yet they can “vote with clicks.” This model draws wisdom from past claims that governance is not necessarily provided by centralized governments (Dixit 2004, 2009), and that competition among private providers of governance facilitates innovation and discovery of new rules (Stringham 2015).

Platforms such as Taobao have another potentially valuable service, namely, that their market designs may well travel to other developing countries. Undoubtedly many of Taobao's rules are uniquely situated for the Chinese culture, political setting and economy. But the structure itself – the platform, the dispute resolution system – is not limited to China. As platforms in other countries imitate Taobao in institutional designs – which has already happened in India, and is likely to take place soon in several countries along the “One Belt One Road”⁴⁵ - we may see more developing states obtain the means to replicate law, Chinese style, and take this alternative route to developing legal market infrastructure. It is too early to tell whether these trends will continue and add up to something important and transforming. But law, Chinese style, holds the potential for such a transformation.

Finally, this paper touches on a number of large issues. In off-loading the building of law, Chinese style, the central government has once again helped develop new approaches to standard problems of development that differ markedly from those in the developed West. In the case of law, Chinese style, the government has opportunistically if subtly embraced the development of law by private actors. Assuming that this experiment succeeds in some form, China will have provided a novel solution to the authoritarian's legal dilemma; namely, the provision of a system of private law with a low probability of the legal system expanding its jurisdiction into public law.

⁴⁵ Alipay funded and offered technological help to Paytm, which has grown to be India's largest mobile payment and commerce platform with 200 million e-wallet users. Alibaba announced that it would partner with local companies in countries along the One Belt One Road (e.g. Thailand, the Philippines), sharing with its partners the technologies in fraud prevention, security risk control and anti-money laundering. This initiative would facilitate the cross-border technology diffusion, and foster the growth of platforms in other developing countries. See the news about Alibaba's technology partnership with Paytm here: http://economictimes.indiatimes.com/articleshow/52563767.cms?utm_source=contentofinterest&utm_medium=text&utm_campaign=cppst; and Paytm's growth here <http://mashable.com/2017/02/27/paytm-200-million-wallet-users/>; and Alibaba's partnership plan in other countries here: <https://www.antfin.com/newsDetail.html?id=590a99df70cfc66a14177b6a>.

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