

# Law, Chinese Style: Solving the Authoritarian's Legal Dilemma through the Private Provision of Law

Lizhi Liu<sup>1</sup> and Barry R. Weingast<sup>2</sup>

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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 legal infrastructure of private law (e.g., property rights, contract enforcement) necessary to support efficient markets? Authoritarians typically undersupply this infrastructure due to an “authoritarian’s legal dilemma”: how to create a judiciary that would *supply and only supply* private law. If a judiciary is sufficiently strong and independent to support private law, it cannot credibly commit not to constrain the autocrat by strengthening public law (e.g., citizen rights, constitution). We argue that China has devised a novel solution to this dilemma: partially outsourcing the provision of private law to key private actors. In China’s 700-million-user e-commerce market, online trading platforms (e.g., Taobao) have privately supplied strong legal infrastructure to enforce contracts, prevent fraud, and settle disputes. Such platforms both enforce and create private law through rule experimentation. This digital route to legal development is politically viable and potentially generalizable to other states.

**Keywords:** Rule of Law; Authoritarianism; China; Politics of Technology; E-Commerce.

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<sup>1</sup> Assistant Professor, McDonough School of Business, Georgetown University, [lizhi.liu@georgetown.edu](mailto:lizhi.liu@georgetown.edu).

<sup>2</sup> Senior Fellow, Hoover Institution, and Ward C. Krebs Family Professor, Department of Political Science, Stanford University, [weingast@stanford.edu](mailto:weingast@stanford.edu).

## 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.<sup>3</sup> A strong legal system produces all of these services.

Many authoritarian governments face a *supply*-side dilemma with respect to improving their legal services. To see the dilemma, consider the long-standing distinction between private and public law. *Private law* involves the interaction of private individuals (e.g., property, contracts, and family law), while *public law* concerns the interaction of citizens with their government (e.g., the legal limits on the central government's powers, the nature of citizens' rights, democratic decision-making, and the rules governing the bureaucracy; in short, the constitution).

The authoritarian's legal dilemma involves the challenge of creating a strong and independent judiciary that would supply – *and only supply* – private law. The authoritarian government benefits from improving private law that facilitates economic growth, but it wants to avoid or delay the emergence of public law, which allows judges to curtail its authority. A national court system, even with a mandate explicitly restricted to private law, might well attempt to constrain the authoritarian government, for example when protecting individual property rights from government expropriation. Courts might seize an opportune moment of strong popular support and force the government to accept court ruling. At the core of the dilemma is a commitment problem: a judiciary that is strong and independent in the realm of private law cannot commit to avoid expanding its jurisdiction to public law, and therefore can

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<sup>3</sup> A large number of scholars have made this claim, including North 1990; Weingast 1995; Rodrik, Subramanian, and Trebbi 2004; and Acemoglu and Robinson 2012.

constrain the government. Absent a solution to the legal dilemma, the authoritarian government has avoided providing fully-fledged private law in its formal legal system.<sup>4</sup>

Although the Chinese government has always faced the dilemma, in the past, the under-provision of private law did not represent a major hindrance to economic growth. Wang has shown that demands of foreign investors helped partially tie the autocrat's hands.<sup>5</sup> Clarke, Murrell, and Whiting have argued that the government used various institutional means to substitute for a strong legal system to stimulate growth, such as the cadre evaluation and fiscal contracting systems.<sup>6</sup>

Yet over time, the economic costs of not having a strong legal system are rising. As the Chinese economy grows larger and more integrated, it is increasingly reliant on small and medium-sized enterprises (SMEs), domestic consumption, and cross-regional trade to drive growth. The rule of law is critical to level the playing field for SMEs, which otherwise are poorly positioned to compete with large or state-owned companies. Moreover, China's ongoing shift in the drivers of growth – from investment/export to consumption/innovation – more than ever requires establishing legal underpinnings to support domestic markets.

Building a legal market infrastructure is increasingly important for China to sustain growth. Yet to contain the development of public law, China has ruled out the Western path. The path for the West involved parliaments and independent judiciaries that constrained the ruler. China's path differs considerably;<sup>7</sup> from the beginning, it involved the delegation of authority from the central to local governments, sometimes known as “federalism, Chinese style.”<sup>8</sup>

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<sup>4</sup> Notice that this logic is of the form of Acemoglu and Robinson 2006 on why many developing countries maintain “economic backwardness.”

<sup>5</sup> Wang 2015.

<sup>6</sup> Clarke, Murrell, and Whiting 2008.

<sup>7</sup> Oi and Walder 1994; Naughton 1995.

<sup>8</sup> Montinola, Qian, and Weingast 1995.

We argue in this paper that, nowadays China has begun to fashion an alternative approach to creating the 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 portion of the development and enforcement of commercial law to private actors, namely various online trading platforms.<sup>9</sup> 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.<sup>10</sup> We demonstrate that Taobao – which has over 700 million users, 10 million vendors, and annual sales comparable to the GDP of the Netherlands – is not simply an exchange platform, but a market in the process of developing a modern legal system. This private legal system helps enforce contracts, protect certain property rights, resolve disputes, and prevent fraud. It 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 change platform rules. Taobao has therefore begun to supply many aspects of market-supporting infrastructure that are normally associated with the state.

Crucially, we distinguish Taobao from various e-commerce platforms in the United States and Europe (e.g., eBay and Amazon). China’s lack of a strong legal system leaves many exchange problems unresolved, such as fraud and counterfeits. Trust remains a pertinent issue that can hinder trade. These problems have forced e-commerce platforms to provide their own systems of law to retain existing market participants and to attract new ones. In the United States

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<sup>9</sup> Our point that large firms take on the role of governments broadly parallels Elizabeth Anderson’s (2019) argument about employee–employer relations in the United States. She argues that large firms play a government-like role, including regulating their employees’ personal lives.

<sup>10</sup> For simplicity, we use “Taobao” to refer to Taobao and its spinoff, Tmall (formerly Taobao Mall). Alibaba owns both sites, which have similar institutional arrangements. As the business-to-consumer version of Taobao (which is a consumer-to-consumer marketplace), Tmall hosts fewer but larger merchants.

and Europe, by contrast, a rule of law-based 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, these institutions are less advanced than Taobao's. Further, Western governments have not used online platforms as a reform tool in the same way the Chinese government has. U.S. and European platforms have not made the same contribution to national legal development as their Chinese counterparts have.

In this paper, we address two related questions about China's outsourcing to platforms to provide a legal market infrastructure. Our primary question is: what is the likely scope of Taobao's legal creation, and can it provide a systematic basis for a legal system? And secondarily, why would the central government relinquish – or at least implicitly encourage the outsourcing of – its own authority?

We provide tentative answers to these questions. We argue that the Chinese government has acquiesced in Taobao's law-making efforts, and in subtle ways has begun actively collaborating with it. E-commerce platforms assume from the state the authority to enforce law within their domain; they also help the state create formal law by experimenting with the nature and content of the legal rules appropriate for governing markets. Many of the platform rules approximate law according to Hadfield and Weingast's "what-is-law?" framework,<sup>11</sup> which employs several criteria to assess the lawfulness of rules. In many ways, this new development parallels China's earlier reforms (from the 1980s to the early 1990s) that created *federalism, Chinese style*. As with the earlier reform effort, *law, Chinese style* also involves delegation of authority and policy experimentation.<sup>12</sup>

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<sup>11</sup> Hadfield and Weingast 2013, 2014.

<sup>12</sup> Montinola, Qian and Weingast 1995.

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 described above: it allows the development of private law provisions that are far less likely to assert authority in public law. Nor is it obvious how to design a legal market infrastructure; most attempts fail in the developing world. The implicit outsourcing of power to platforms gives the central government plausible deniability; if the experiment fails, it can be abandoned without tarnishing the government's reputation. We further reason that this outsourcing of authority to platforms is relatively durable, and that the initially implicit outsourcing has become more explicit and institutionalized.

This paper echoes the burgeoning literature that authoritarian regimes can also achieve a partial form of rule of law or property rights.<sup>13</sup> Similar to Markus,<sup>14</sup> we focus on a firm-level solution to legal development, suggesting that the state is not the sole provider of the rule of law. In contrast to previous studies, we emphasize that non-state actors not only enforce but also actively create rules under the state's acquiescence or explicit delegation.

This paper also enriches our understanding of the political role of the private sector, especially the role of Chinese tech firms that have stirred a great deal of geopolitical controversy. Our paper indicates that the private sector in China has become much more politically relevant than previously identified in the literature.<sup>15</sup> Large private firms, especially tech firms, have become effective arms of the state by carrying out strategic objectives, including market reforms.

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<sup>13</sup> Markus 2012, 2015; Wang 2015; Hou 2019; Cai Murtazashvili, and Murtazashvili 2019; Ding and Javed forthcoming.

<sup>14</sup> Markus 2012, 2015.

<sup>15</sup> Prior research finds that Chinese private businesses do not press for regime change (Pearson 2000; Dickson 2003) or major reforms. Instead, private entrepreneurs often create informal coping strategies to bypass the restrictive formal institutions (Tsai 2006; 2007). Even when holding legislative seats, they pursue mainly business benefits rather than political goals (Truex 2014; Hou 2019).

This points to an important change in Chinese politics: the blurring of boundaries between the state and non-state sectors.<sup>16</sup>

This paper proceeds as follows. In the next section, we discuss the importance of the legal market infrastructure for the development of markets, and introduce the concept of “authoritarian’s legal dilemma.” Sections 3-5 provide background information on Taobao; we further discuss how Taobao creates “law, Chinese style,” and the degree to which Taobao’s platform can be said to produce law. Section 6 discusses why the central government has acquiesced in Taobao’s assertion of the authority to make law, Chinese style. In Section 7, we analyze the durability of “law, Chinese style.” Section 8 presents evidence that the state has outsourced to Taobao on various legal fronts. Section 9 concludes.

## **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.<sup>17</sup> If a strong legal system is vital to development, why doesn’t every state have one?

A central problem facing any developing country seeking to build a legal system is government predation – called the exercise of “arbitrary power” by early modern political theorists such as Locke, Montesquieu, Adam Smith, and James Madison, and “executive moral

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<sup>16</sup> Other recent studies have demonstrated this trend. For example, Ong (2018) shows that local governments subcontract coercive functions to thugs to implement unpopular policies. Chen and Rithmire (2020) find that the state has expanded investments beyond state-owned enterprises.

<sup>17</sup> Besley and Persson 2009; Acemoglu and Robinson 2012.

hazard” in the modern literature on the political economy of development.<sup>18</sup> Montesquieu, Adam Smith, and the American Federalists all argued that executives have incentives to abuse the court system when its rulings conflict with the executive’s interest.<sup>19</sup>

Absent strong economic and political institutions to constrain the ruler, authoritarian countries face what we call the “authoritarian’s legal dilemma”: the dual problem of creating a judiciary to *supply – and only supply* – private law. One aspect of this problem is how to design the judiciary in such a way that it restricts itself to private law – that is, an independent judiciary that will not unilaterally expand its jurisdiction to include public law. The flipside of this problem is how the central government would commit not to intervene in court rulings when its 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 the autocrat’s interests, the greater the judiciary’s ability to expand its jurisdiction to include public law and therefore become a major source of restrictions on the autocrat’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 caution against the optimistic viewpoint that judicial independence can arise in commercial areas but not in political realms.<sup>20</sup> It seems difficult, if not impossible, to compartmentalize a country’s legal development process in that way.

In a nutshell, it is difficult to create a capable judiciary that is independent *only* in the realm of private law. This challenge helps explain why authoritarian countries generally have inadequate legal infrastructures for their markets.

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<sup>18</sup> Besley and Persson 2009; Cox, North, and Weingast 2017.

<sup>19</sup> See Montesquieu 1748, 157, 162, 164, Adam Smith 1762-63, 325-27, and Hamilton, Madison, and Jay 1788, F46:307.

<sup>20</sup> Peerenboom 2008; Wang 2015.

## 2.2. China's Pragmatic Approach – and its Limitations

Over two centuries ago, Adam Smith recognized the nature of the problems to be solved in order to foster 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.”<sup>21</sup>

Dugald Stewart, Smith's first biographer, quoted a famous passage in an unpublished (and now lost) paper 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.”<sup>22</sup>

In building this state capacity, China continues to confront many of the same problems as the developed West faced in an earlier stage of development. The Chinese Communist Party relies heavily on economic growth for legitimacy. Yet the authoritarian's legal dilemma has closed off 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 above by adopting a pragmatic approach.

The first part of the pragmatic approach is to develop a rule-*by*-law system.<sup>23</sup> In the post-Mao era, China has launched legal reforms that establish various aspects of a formal legal infrastructure, including promulgating numerous laws, training legal professionals, and expanding the court system,<sup>24</sup> which serves the state's goals of enhancing regime legitimacy and spurring economic growth.<sup>25</sup> According to many accounts, the role of the formal legal system in

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<sup>21</sup> Adam Smith 1776, II.i.30-31, 284-85.

<sup>22</sup> Adam Smith, quoted by Dugald Stewart 1793, 322.

<sup>23</sup> China scholars have used various terms other than the rule of law to describe China's legal system, for example, rule by law, and partial/limited rule of law. See Landry 2008, Wang 2015, Dimitrov 2016, Whiting 2017.

<sup>24</sup> Peerenboom 2002; Stern 2014.

<sup>25</sup> Landry 2008; Stockmann and Gallagher 2011; Liebman 2014; Wang 2015.

the country's economy is increasing<sup>26</sup> and the state-constructed legal consciousness of ordinary citizens is rising.<sup>27</sup>

But China's formal legal system remains inadequate to support efficient markets. Many studies have noted problems including inconsistent signals and laws advanced by central and local governments,<sup>28</sup> decentralized and anomalous interpretations of private law,<sup>29</sup> and weak or selective law enforcement.<sup>30</sup> As argued above, this undersupply of legal market infrastructure stems from the authoritarian's legal dilemma, which cannot be easily tackled.

To enable market growth, China has also used various *non-legal substitutes* for a formal legal system, which is another part of China's pragmatic approach. These substitutes include non-law-based administrative measures,<sup>31</sup> promotion incentives for government officials,<sup>32</sup> government-business coalitions,<sup>33</sup> informal ties and local civil groups for policy enforcement.<sup>34</sup> There are two main limitations to this pragmatic approach. First, the absence of the rule of law disproportionately hurts the growth of private businesses, particularly SMEs. Too often, these enterprises lack the resources and political ties to advance their interests within the formal legal system.<sup>35</sup> Second, the approach hinders the rise of a national common market consisting of impersonal exchanges over long distances, especially exchanges among small traders. People do not trust such a market without legal support to protect both buyers and sellers.

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<sup>26</sup> Clarke et al. 2008.

<sup>27</sup> Gallagher 2006; Whiting 2017.

<sup>28</sup> Stern 2010; Xu 2011.

<sup>29</sup> Chang and Xu 2017.

<sup>30</sup> Peerenboom 2002; Mertha 2005.

<sup>31</sup> Xu 2011.

<sup>32</sup> Clarke et al. 2008.

<sup>33</sup> Chen 2018.

<sup>34</sup> Mattingly 2019.

<sup>35</sup> Ang and Jia 2014; Xu 2020.

These limitations were less pressing when China's economy relied heavily on large firms, exports, and state-led investments. Yet over time, the Chinese economy is increasingly dependent on the growth of SMEs, cross-regional trade, and domestic consumption to sustain growth. All of these trends have increased the value of a national common market supported by a strong legal infrastructure, one that the authoritarian government finds difficult to provide.

### **3. Taobao and Law, Chinese Style**

#### **3.1. Theorizing about Law, Chinese Style**

We have shown that authoritarian governments often undersupply private law due to the legal dilemma. Many have compromised economic growth as a result. In early stages of marketization, China did not solve the dilemma, either. It still managed to achieve high economic growth because of limited legal reforms and the use of various *non-legal* substitutes for the formal legal system. This pragmatic approach worked effectively in early reforms, but has begun to fall short of sustaining growth.

We argue that, nowadays China has devised a novel solution to the legal dilemma – the use of *private legal substitutes* for the formal legal system. We call this alternative route to legal development “law, Chinese style.” Faced with political obstacles to strengthening the formal legal system, the central government has in effect given specific private actors – online trading platforms – a substantial role in the development of private law.

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

We organize the rest of the discussion around these two conditions, showing 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 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 outsourcing from the perspective of the central government (Section 6), discuss the durability of this state outsourcing (Section 7), and present evidence that outsourcing exists and has been increasingly explicit (Section 8).

### **3.2. Taobao and Why It Provides Legal Market Infrastructure**

Taobao (“Searching for Treasure”) is the most popular online shopping site (and the tenth most visited website) in the world.<sup>36</sup> Its business is primarily based in China. 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 FY 2020, Taobao (Tmall included) hosted more than 10 million active sellers and 726 million active buyers, amassing an annual gross merchandise volume (GMV) of \$US945 billion.<sup>37</sup> Its user base and GMV (including Tmall) currently surpass those of Amazon and eBay combined; it also eclipses Walmart Global, the world's largest brick-and-mortar retailer.<sup>38</sup> Taobao's service has even been extended to those without online payment methods or who are not internet savvy. As of March 2017, Rural Taobao

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<sup>36</sup> This ranking comes from the Alexa list of top 500 sites on June 28, 2017. Retrieved from <http://www.alexa.com/topsites>.

<sup>37</sup> See <https://www.alibabagroup.com/cn/ir/presentations/pre200522.pdf>.

<sup>38</sup> See <http://www.ibtimes.com/alibaba-baba-overtakes-walmart-wmt-largest-retailer-gross-volume-2349025>

(Alibaba's rural expansion initiative) had opened e-commerce service points in over 30,000 villages, many of which previously had no access to commercial parcel delivery services.<sup>39</sup>

Yet in many accounts, one should not expect this remarkable market to exist. China has yet to create strong rule of law to undergird markets. Especially given that online transactions usually involve small and anonymous traders from distant localities, and that the buyers cannot inspect the products before paying, the trust issue should be severe and prevent the online market from flourishing. How can trade be fostered when the state-provided legal system is weak or non-existent? 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 the Maghribi coalition and private courts served legal functions.<sup>40</sup> Likewise, to create a market, Taobao has provided a legal market infrastructure out of necessity.

Therefore, Taobao is not simply an exchange platform that matches sellers and buyers. It has the means to create law, Chinese style. Fundamentally, platforms like Taobao can serve as private substitutes for strong legal institutions to enforce contracts, resolve disputes, and prevent fraud. We argue that this partially explains why such 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. In 2011, online platforms accounted for 90% of the e-tailing market in China, compared to only 24% in the United States (see Table 1). This data is consistent with our argument that Taobao provides more than simply a platform for exchange: it also offers legal services. All else equal, the demand for platforms' legal and trading services is higher in China than it would be in a country governed by the rule of law.

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<sup>39</sup> The number of Rural Taobao service points is from [http://caijing.chinadaily.com.cn/2017-05/30/content\\_29547904.htm](http://caijing.chinadaily.com.cn/2017-05/30/content_29547904.htm). For the welfare impact of rural e-commerce, see Couture, Faber, Gu and Liu forthcoming.

<sup>40</sup> Greif 1989; Milgrom et al. 1990.

**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)

#### 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 ecosystem<sup>41</sup> 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 becomes increasingly able 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 the platform has developed systems that help it identify dishonest traders and impose various forms of punishment. We then discuss several supporting institutions that are vital to improving the stability, effectiveness, and adaptability of Taobao's legal system.

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<sup>41</sup> We use the term “ecosystem” in a slightly different way from the business literature, which defines ecosystem as a network of institutions and the agents governed by these institutions. We use the term to refer only to the interconnected institutions.

#### **4.1 Contract Enforcement through Escrow and Reputation Mechanisms: *Alipay and the Online Rating System***

Traders throughout history have faced 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?

Taobao has created two major institutions to enforce contract.

The first one is Alipay. Alipay is an online payment system similar to PayPal, except that Alipay has incorporated a compulsory *escrow* component into transactions on Taobao. The distinction is that PayPal ensures direct payment between the seller and the buyer. With Alipay, the buyer first 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 either party to follow the rules results in sanctions, such as the loss of money in escrow, a change in reputation rating, or being banned from the platform.

Alipay's escrow service enhances Taobao's enforcement capability both directly and indirectly. First, Alipay can directly freeze or deduct money from a user's account if she violates platform rules. If a trade dispute arises, Alipay can freeze the payment in escrow, forcing feuding parties to use and comply with Taobao's dispute resolution system. Second, Alipay indirectly improves Taobao enforcement capacity by collecting user behavioral data to identify (potential) rule violators and fraud (as discussed in Section 4.2). Most importantly, knowing that Alipay makes rules enforceable in turn incentivizes users to respect the rules and contracts. This produces a positive feedback loop that improves the performance of contracts.

The second institution that strengthens contract enforcement is the online rating and feedback system. As with other platforms, such as eBay, Taobao uses online ratings – the public

reputation of each user – to gather information and incentivize traders to honor contracts.<sup>42</sup> But Taobao's system is far more complicated and developed than those used by eBay and Amazon.

Taobao's rating system consists of user credit rating and store rating. Both ratings are complex sums of user reviews from each transaction and are displayed publicly on buyers'/sellers' web profiles. The user credit rating reflects the overall reliability of the seller/buyer over their entire history.<sup>43</sup> This rating is cumulative over time and therefore discriminates against new sellers/buyers. To capture the changing dynamics of service quality, Taobao uses store ratings to complement the credit rating for sellers. Store ratings are based on three aspects of the seller over the past six months: accuracy of the product description, customer service, and shipping time.<sup>44</sup> In addition to sellers' overall reputation, buyers can also check all past reviews of each product. Customers can rate, write reviews about, and post photos of the products. Taobao can then use text analysis to summarize individual comments, which helps users internalize product reviews.

## **4.2. Fraud Prevention through Risk Framework**

### ***Big data + Manual Review + State Coercion***

Fraud must be limited in order to maintain the flow of trade. Despite some overlaps, fraud is a distinct concept from the problem of contract enforcement. Fraud generally involves the purposeful deception to pursue unlawful gains, and is not necessarily related to a specific contract. Fraud types common to online transactions include online payment fraud, identity theft, online rating manipulation, and counterfeiting.

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<sup>42</sup> By using a reputation mechanism, Taobao echoes some historical institutions in Medieval Europe such as the Maghribi traders (Greif 1989; Milgrom et al. 1990).

<sup>43</sup> For details on the credit rating system, see <https://service.taobao.com/support/seller/knowledge-847753.htm>.

<sup>44</sup> For each aspect, the seller is evaluated on a scale from 1 (very unsatisfied) to 5 (very satisfied). The overall store rating is the average of all evaluations from each transaction over the past six months.

To detect 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. Manual reviews are also used to help improve the accuracy of fraud detection.<sup>45</sup>

For example, Taobao uses a multi-layer risk framework to identify fraud. For example, the first layer – account check – leverages big data analytics to examine whether the accounts in question have exhibited suspicious activities in the past. 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 layers one to four, the fraud risk management system checks different aspects 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. In this process, Taobao has also experimented to crowd-source the review work to a “jury” panel, a group of experienced Taobao users who vote on whether a case involves fraud (discussed in Section 4.3).

After detecting a case of fraud, Taobao can punish fraudulent behavior online, as well as offline in collaboration with the government. 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 methods involve collaboration between Taobao and the state’s coercive apparatus. For example, to combat counterfeit products fraud at their source, Taobao shared information with the police and helped them trace suspects who produce and sell counterfeit products, which led to the arrest of 400 suspects and the shutdown of 200 brick-and-mortar stores in 2014.<sup>46</sup> In this way, Taobao helps strengthen the state’s enforcement power.

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<sup>45</sup> Chen et al. 2015.

<sup>46</sup> See <https://techcrunch.com/2014/12/23/alibaba-listings-purge/>.

### **4.3. Dispute Resolution through Crowd-Sourcing Justice** *An Online Public Jury System*

Dispute resolution is an indispensable aspect of a workable legal system. Every functioning market needs mechanisms to handle disputes. When a dispute occurs, the affected parties can choose between two judicial channels provided by Taobao: asking a designated Taobao employee to adjudicate, or using a jury-like panel of public assessors to arbitrate. The following analysis focuses on the online jury, which constitutes an important institutional innovation.

Taobao's online public jury ([pan.taobao.com](http://pan.taobao.com)) was launched in 2012 to deal with minor, everyday disputes.<sup>47</sup> Most of these disputes are one of two types: (1) buyer–seller disputes that often involve contract violations (e.g., complaints about items received that fail to match store descriptions) or (2) platform–seller disputes (e.g., in which a seller believes that Taobao has unfairly penalized her for violating certain rules).

For each dispute, Taobao randomly chooses 13 jurors (which Taobao calls “public assessors”) from a pool of 4 million experienced users who have high online ratings and have volunteered to serve without pay.<sup>48</sup> The jurors review the evidence submitted by the disputing parties and then vote within 48 hours; one party wins by a simple majority vote. There is no communication between the disputing parties and the anonymous jurors, or among jurors. Jurors also provide written comments on each case. If a disputing party is unsatisfied with the jury's decision, it can request Taobao employees to reexamine the case.

This jury-like system has two main advantages. First, Taobao can shift to its users the task of assessing and resolving the disputes, which have been mounting as a result of rising trade

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<sup>47</sup> For more details, see <http://www2.alizila.com/how-taobao-crowdsourcing-justice-online-shopping-disputes>.

<sup>48</sup> For these details, see <http://www.iwshang.com/Post/Default/Index/pid/247679.html> and <http://www.chinaelaw.com/show.php?contentid=20385>.

volumes on the platform. As of February 24, 2020, 1.72 million jurors had resolved a total of 16 million disputes.<sup>49</sup> Second, the system helps Taobao refine its rules. In 2013 alone, feedback from jurors improved more than 140 Taobao rules governing online stores.<sup>50</sup>

Importantly, the decisions of Taobao’s dispute resolution system are enforceable. As discussed earlier, Alipay enables Taobao to freeze disputed payments and enforce jury decisions.

#### **4.4. Supporting Institutions: *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 easy to enforce. We focus on two institutions that contribute to Taobao’s legal system – Sesame Credit and the “House of Representatives” for changing Taobao rules.

Sesame Credit is China’s first individual credit-scoring system. It uses transaction data from traders and assigns each user or business a credit score ranging from 350 to 950.<sup>51</sup> The idea parallels a U.S. individual’s FICO score determined by her transaction history on eBay. This credit scoring service strengthens Taobao’s private legal system by offering users additional incentives to honor contracts, as many of the benefits from Taobao require a high Sesame score.<sup>52</sup> Sesame Credit also helps identify dishonest traders by providing a simple, comparable measure of a trader’s overall trustworthiness and creditworthiness. Lastly, Sesame Credit protects

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<sup>49</sup> This is according to the updated statistics on pan.taobao.com.

<sup>50</sup> See <http://www2.alizila.com/how-taobao-crowdsourcing-justice-online-shopping-disputes>.

<sup>51</sup> See <https://techcrunch.com/2015/01/27/data-from-alibabas-e-commerce-sites-is-now-powering-a-credit-scoring-service/>. Note that private credit scoring services as Sesame Credit are for commercial use, and – at least for the time being – are not part of the government’s Social Credit Score which serves mainly political ends. See <https://www.wired.co.uk/article/china-social-credit-system-explained>.

<sup>52</sup> Benefits include loans to small businesses, a fast track for visa applications and at airports, and even a better reputation on several online dating websites that Alibaba partners with.

Taobao's voting systems from manipulation and fraud. Only users with a high score can become a juror or a voter at the House of Representatives for changing Taobao rules.

Another supporting institution is the "House of Representatives" for adopting rules, a democratic experiment that gives its users a voice in rule making. The institution opens unessential platform rules to voting, which helps adapt the rules to users' changing demands. When Taobao proposes a new rule or a rule change, all users with a decent Sesame score can vote on, and express their opinions about, the rule. After each vote, Taobao makes the results public and adjusts the rule accordingly. From June 2015 to February 2017, the House voted on 42 rules, each of which involved over 10,000 voters.<sup>53</sup>

It is interesting to draw an institutional parallel between Taobao's House of Representatives and a historical precedent in the form of a "mixed government" discussed by Aristotle and Polybius, and also, in early modern times, by Machiavelli, Harrington, and Montesquieu. Mixed government was often thought of as necessary for the long-term stability of republics. This structure is sometimes identified as "the one, the few, and the many": that is, an executive (e.g., a king); the nobility (sometimes mixed with ecclesiastic lords), and the commons (e.g., 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 platform acts as the proposal maker and the users act like the commons.

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<sup>53</sup> See <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?

Of course, not all rules qualify as law. In this section, we evaluate the degree to which Taobao's platform can be said to produce law. As a first step, we begin with two foundational questions: What is law? How does it differ from a set of rules created by typical authoritarian governments? To address these questions, we draw on the "what-is-law" framework developed by Hadfield and Weingast.<sup>54</sup> This approach to law does not presume state enforcement, as laws existed long before the rise of nation states; the approach instead places law within the broader framework of different types of social order. The framework proposes that in order for a set of rules to be considered law, it must have four sets of characteristics:

- (1) A set of legal attributes that are frequently identified as marking the existence of law by legal theorists such as Fuller, Raz, and Waldron, including stability, generality, prospectivity, clarity, non-contradiction, consistency, promulgation, and feasibility.<sup>55</sup>
- (2) A common knowledge set of rules – *the common logic* shared by members of the community – must govern the choice of new rules and the adaptation of old ones.<sup>56</sup>
- (3) A third-party enforcement mechanism must be functional, which typically involves a mix of state coercion and decentralized enforcement by citizens and traders.
- (4) *Authoritative stewardship* is a unique institution responsible for resolving ambiguities or uncertainties about the classification reached by following the common logic. The steward therefore helps adapt the common logic to changing circumstances.

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

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<sup>54</sup> See Hadfield and Weingast 2012, 2014.

<sup>55</sup> These attributes are briefly defined as follows: Stability (tomorrow's law will be identical, or nearly so, to 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-contradiction (two different rules cannot require contradictory actions); Consistency (between the announced rule and its implementation); Promulgation (the rules must be common knowledge); Feasibility (law cannot require people to do impossible things). See Fuller 1964, Raz 1977, and Waldron 2008).

<sup>56</sup> Hart 1961.

We begin by examining the first characteristics of the framework: whether Taobao's rules have a set of legal attributes. The fact that Taobao's rules have effectively supported a gigantic market (when the formal legal system remains weak) means that Taobao's rules have largely satisfied at least five of the eight legal attributes: Clarity, Consistency, Promulgation, Non-contradiction, and Feasibility. There is no evidence that Taobao's rules have violated Prospectivity. Most of Taobao's rules appear to also have Generality. For example, as mentioned before, Taobao uses a general risk framework to detect various types of fraud and penalize different rule violators. A more debatable attribute is Stability. Taobao rules remain in an experimental stage and are constantly evolving. Nonetheless, our interviews show that Taobao has strong incentives to ensure the stability of the rules for two reasons. First, frequent rule changes triggered several large-scale protests in the past,<sup>57</sup> which the firm seeks to prevent from happening again.<sup>58</sup> Second, frequent rule changes created confusion among platform users, leading to inadvertent rule violations. Taobao's rule makers therefore try to keep the rules relatively stable to ensure effective governance.<sup>59</sup> Taobao has strong incentives to make sure its rules conform to these legal attributes because they are fundamental to any incentive system to promote rightful behavior.

As for the second characteristic – a set of rules governing how the rules are chosen (i.e., “the common logic”) – Taobao is still experimenting with the institutions for rules. It is not clear whether the employees who judge disputes have assembled a set of rules by which to make such

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<sup>57</sup> Taobao experienced several protests from vendors. The largest online protests, “Taobao October Rising,” 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 businesses use its platform. Details about the protests can be found at [http://www.chinadaily.com.cn/bizchina/2011-10/13/content\\_13881570.htm](http://www.chinadaily.com.cn/bizchina/2011-10/13/content_13881570.htm).

<sup>58</sup> Author Interview with a Taobao employee, who was in charge of rulemaking, in Hangzhou, Zhejiang Province, June 13, 2018.

<sup>59</sup> Author Interview with a Taobao employee in San Francisco, California, July 1, 2017.

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 they remain proprietary? Answers to these questions would go a long way toward explaining the extent to which Taobao has created law, Chinese style. The more its system incorporates these features, the more law-like is the process. Here too, Taobao has strong incentives to address these questions in the affirmative.

The third characteristic, enforcement, is central to Taobao's operation. As noted in Sections 4, Taobao has a range of punishments it can employ, including adjusting a trader's reputation, assessing fines applied to money held in escrow, banishment from the platform, and even prosecution using the local police system. Only the last sanction involves state coercion; the others involve third-party enforcement through Taobao, and indirectly through the reactions of the community of traders.

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

Therefore, Taobao's system of rules has already met all of these characteristics defined by the "what-is-law" framework, at least to a degree. It seems inevitable that the platform's future involves refining the system to increase its lawfulness. Markets need stable expectations so that traders know what practices are legal and illegal – and the consequences of their choices. This seems to require Taobao to further strengthen the legal attributes in its rules. Further, the firm 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 there is a common knowledge system for adapting

existing rules to changing or novel circumstances. The more certain users are of the rules and their implications, the easily they can obey them. Finally, Taobao will inevitably refine the system via which the rules are chosen.

## **6. The Political Logic of Outsourcing**

In order to serve as a proper alternative route to legal development, law, Chinese style relies not only on the presence of a workable private legal system (discussed in Sections 3–5), but also on the state’s willingness to outsource legal authority, either implicitly or explicitly. This section discusses the political logic of outsourcing from the perspective of the central government.

The primary reason for the Chinese government to acquiesce in Taobao’s assertion of authority is: outsourcing as an approach to legal development is much less politically constraining than direct reforms to formal law. Importantly, the reach of the law, Chinese is limited in scope to traditional areas of private law – especially property and contracting. It allows the central government to foster experiments and innovation in private law while decreasing the chances that the legal development will challenge government authority in the area of public law.

Additionally, outsourcing authority to the platforms helps conquer the technical complexities associated with building a workable legal system, allowing multiple legal experiments to emerge and compete. In some ways, the current outsourcing parallels the delegation of many reforms earlier in the process of marketization, in which the Chinese central government allowed provincial governments to conduct policy experiments to stimulate local economy.<sup>60</sup>

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<sup>60</sup> See Shirk 1993 and Montinola et al. 1995.

At the same time, the central government is not directly responsible for any failures of the system. Outsourcing allows the central government to stand above the provision of services, distancing itself from any public dissatisfaction that may arise from bad governance by platforms.<sup>61</sup> If need be, the government can more easily curtail failing experiments.<sup>62</sup> Private actors therefore bear the risk of failure and buffer the tensions that could have been directed towards the state.

One may still wonder why the central government has outsourced institutional functions to *private platforms* rather than to agents of the state, such as local governments. There are two major reasons. First, since the platforms control the flow of valuable resources (e.g., information, data, and search rank) that affect the economic livelihoods of other market participants, they can serve as *points of control* for the central government.<sup>63</sup> In other words, the government can potentially achieve *indirect yet cost-effective* ruling over the citizenry by simply controlling a small number of platforms that hoard data on a giant number of individuals and businesses. 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 foster a national common market. By breaking down internal trade barriers, online platforms furthermore weaken local governments' authority, revenue, and rent creation.<sup>64</sup>

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<sup>61</sup> Compared with the previous delegation that typically occurred between the central and local governments, delegating authority to private actors can distance the entire state from public dissatisfaction and political pressure.

<sup>62</sup> For example, in 2010, around 300 sellers initiated a physical protest against Taobao. They gathered in front of Alibaba's headquarters 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>.

<sup>63</sup> This echoes Henry Farrell's (2006) argument about how some key private actors can serve as "points of control" for the state in international relations.

<sup>64</sup> Liu and Weingast (2018) has investigated 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.<sup>65</sup> First, Taobao must commit not to abuse its power, and in particular, not to make confiscatory demands on its users. Otherwise, Taobao risks losing its users, which may cause its market to collapse from within. Second, the Chinese state must commit not to expropriate Taobao or revoke its tolerance of the platform's private ruling over the online market. Otherwise, Taobao will stop providing the legal market infrastructure. We argue that there are limits on both the state and Taobao that prevent them from acting arbitrarily. These constraints bestow outsourcing (from the state to Taobao) with a degree of durability, making reversal costly, if not entirely impossible.

### 7.1 Limits on Taobao's Arbitrary Acts

One major mechanism that constrains Taobao's arbitrary power is competition. Most traders, especially buyers, use multiple platforms; the low cost of switching platforms means fierce competition between Taobao and other rivals (e.g., JD and Pinduoduo). Of course, the efficacy of this competition mechanism over time remains uncertain. Due to network effects, platforms may exhibit *increasing* returns to scale; thus, a platform industry is often dominated by one or a handful of giant platforms.<sup>66</sup>

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<sup>65</sup> 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 keeps investing in its market, the state must somehow credibly commit to not confiscate the platform. Similarly, to give its traders the confidence to make transactions on the platform, Taobao needs to credibly commit to not confiscate their wealth.

<sup>66</sup> Eisenmann, Parker and Alstyne 2006.

But there are also reasons to believe that platform competition can persist in the long run. As internet platforms are fast evolving, monopoly status is often transient.<sup>67</sup> Large platforms face stiff competition not only from similar platforms, but also from companies offering entirely different services. As remarked by Google's former executive chairman Eric Schmidt, Google's biggest competitor in search is Amazon, rather than another search engine.<sup>68</sup> Growing studies also suggest that a platform monopoly behaves differently from traditional monopolies,<sup>69</sup> and that a platform's market power does not justify a traditional-style antitrust regulation.<sup>70</sup>

Given the debate above, it is still too early to conclude whether platform competition will subside in the long run. At least for the time being, vibrant competition still exists in e-commerce, and Taobao is not yet a monopoly. Even in the long term, it seems unlikely that an authoritarian state would allow one private company to monopolize the market.

The second -- perhaps more important -- mechanism is that, platforms' power is still checked by the authoritarian government. The government has ultimate control over internet connection in China. According to the 2016 Cybersecurity Law, the government can cut off, or limit internet service during crisis for national security.<sup>71</sup> Even before this law was drafted, the Chinese government had already demonstrated its ability to take such action. Internet access was blocked in the entire Xinjiang Region for 10 months following a violent ethnic riot in 2009.<sup>72</sup>

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<sup>67</sup> Evans 2003.

<sup>68</sup> <https://www.businessinsider.com/eric-schmidt-says-amazon-is-googles-biggest-search-competitor-2014-10#:~:text=Eric%20Schmidt%20and%20Amazon%20CEO,search%2C%20the%20Financial%20Times%20reports>.

<sup>69</sup> Consider pricing, choice and network effects. As opposed to traditional monopolies known for charging the customers a higher-than-competitive price, platform monopolies -- as they are two-sided or 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. They collect user data rather than charging user a fee for its service. Owing to network effects, platforms also appear to offer more (rather than fewer) choices, and better (rather than worse) services to users as the platform size increases. See Rochet and Tirole 2003, and Evans 2003 for more discussion.

<sup>70</sup> See <https://qz.com/1310266/nobel-winning-economist-jean-tirole-on-how-to-regulate-tech-monopolies/>

<sup>71</sup> See Clause 58 of the law here: [http://www.npc.gov.cn/npc/xinwen/2016-11/07/content\\_2001605.htm](http://www.npc.gov.cn/npc/xinwen/2016-11/07/content_2001605.htm).

<sup>72</sup> <https://www.reuters.com/article/us-china-xinjiang-internet/china-allows-internet-access-in-xinjiang-10-months-after-riots-idUSTRE64D0MB20100514>.

The authoritarian state has many other ways to regulate platforms, mostly not through coercion, but via legal and regulatory means. For example, the state can block entry when platform economies prove to be too disruptive to traditional business. In 2014, the central bank suspended Alibaba and Tencent's plans to issue virtual credit cards, a move that directly challenged the credit card business of state-owned banks.<sup>73</sup>

The fact that platforms' power is constrained by the state, however, leads to another side of the coin. If the authoritarian government is so powerful, how can it assure the platforms that it would not subvert platforms' private institutions?

## **7.2 Limits on Government Expropriation**

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.

The first factor working against the threat of subversion is the sheer size of Taobao and other major platforms. Because the number of users is large – more than half a billion – the government would generate public anger if it attempted to shut down Taobao or expropriate a major portion of its value. In particular, the recent literature on “regulatory entrepreneurship” suggests that tech companies have inherent advantages – e.g., being scalable and highly connected with users – to leverage popular support against resistant officials or overly protectionist rules.<sup>74</sup>

Second, the interests of the state and those of Taobao are strongly aligned. Neither has an incentive to deviate from their collaboration, at least in the short term. The authoritarian state has

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<sup>73</sup> See <https://www.nytimes.com/2014/03/15/business/international/china-virtual-credit-cards.html>.

<sup>74</sup> Barry and Pollman 2016.

been able to maintain social stability during the recent economic downturn, largely owing to the jobs created by e-commerce platforms. In 2012 alone, the e-commerce industry directly created more than 2 million jobs, and indirectly generated an additional 12 million, both of which were mainly contributed by Taobao and Tmall.<sup>75</sup> E-commerce is also critical to China's transformation from an investment- and export-driven economy to one that relies on domestic consumption and innovation. In 2015, consumption contributed to 66.4% of China's GDP growth,<sup>76</sup> and 30% of all growth in Chinese consumption from 2010 to 2015 was driven by e-commerce.<sup>77</sup> This means that the expropriation of Taobao would curtail its job-creating ability, threatening the country's future economic growth, and even harming the Communist Party's legitimacy which largely rests on sustained economic prosperity.

The central government faces another cost from expropriation due to the ownership structure of Alibaba, Taobao's parent company. Alibaba was incorporated in the Cayman Islands, and its two largest shareholders are non-Chinese firms: Softbank and Yahoo. It is also listed on the New York Stock Exchange. 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, major tech platforms including Alibaba have forged political ties by accepting investments from funds that are government-backed or run by the scions of Chinese leaders. According to the New York Times, "most of Alibaba's new investors in 2012, including the

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<sup>75</sup> Data is extracted from <https://www.ft.com/content/722e6f0c-bac7-11e2-b289-00144feab7de>.

<sup>76</sup> Data is extracted from <http://www.reuters.com/article/us-china-economy-gdp-idUSKCN0Y70X9>.

<sup>77</sup> 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>.

sovereign wealth funds CITIC Capital and CDB Capital, were...state-owned.”<sup>78</sup> Around the same time, Alibaba also received investments from a subsidiary of Boyu Capital, of which former President Jiang Zemin’s grandson was a partner; Boyu’s investment of \$400 million gained more than \$1 billion after Alibaba’s IPO.<sup>79</sup> More recently, China’s National Social Security Fund has invested in Ant Financial, the company that runs Alipay.<sup>80</sup> In a nutshell, these government-related institutions have economic stakes in Alibaba’s success. It is in their interests to safeguard the platform, rather than expropriating it.

In short, a wide range of factors implies that the Chinese government would pay a high price for expropriating Taobao as long as the firm succeeds. The high costs of either the company acting arbitrarily or the government expropriating it make Taobao’s private legal system relatively durable for the time being.

## **8. From Implicit to Explicit Outsourcing**

In previous sections, we have discussed how and why the Chinese government has delegated some aspects of the development of law to Taobao. To the extent that credible commitments protect Taobao’s efforts to create law, Chinese style, it is not crucial whether the outsourcing is *de jure* or *de facto*. Nonetheless, in recent years, this outsourcing seems to have become more explicit and institutionalized. We report direct evidence of outsourcing here.

(1) *Official recognition*: The e-commerce law passed in 2018 has recognized the role of platforms as an important market entity. In particular, it stipulated their legal obligations to regulate online businesses and buyers. The implementation of the law follows the principle that

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<sup>78</sup> 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/>.

<sup>79</sup> *Ibid.*

<sup>80</sup> See <https://www.techinasia.com/alibaba-confirms-investment-alipay-and-online-banking-business>.

“the state regulates the platforms, and the platforms regulate online businesses.” In other words, platforms have become proxies of the state to regulate the online market.<sup>81</sup> At the same time, platforms still maintain substantial autonomy to regulate the market. For example, the law encourages platforms to establish online dispute resolution systems and other online institutions (Articles 58-63).<sup>82</sup> It stipulates that the state will establish “a collaborative governance system” that involves multiple players including the state, e-commerce platforms, online businesses, and customers (Article 7).<sup>83</sup>

(2) *Official outsourcing 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. The first is *curbing commercial bribery*. In May 2017, the Anti-Corruption Bureau of the Supreme People’s Procuratorate signed a memorandum with Alibaba “to create a clean, credible, rule-of-law market environment.”<sup>84</sup> It offered Alibaba access to information about individuals and businesses with a history of commercial bribery so that Alibaba can “legally prosecute” these individuals/businesses when they engage in online economic activities.

The second partially-outsourced legal function is *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 restricting them from buying high-priced items online. As of 2017, Alibaba alone had punished 730,000 debtors, 50,000 of whom have since repaid their debts in a few months.<sup>85</sup>

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<sup>81</sup> Ding 2018.

<sup>82</sup> For the full text of the law, see [http://www.npc.gov.cn/npc/xinwen/2018-08/31/content\\_2060172.htm](http://www.npc.gov.cn/npc/xinwen/2018-08/31/content_2060172.htm).

<sup>83</sup> Ibid.

<sup>84</sup> For the full text of the memorandum, see [http://www.spp.gov.cn/xwfbh/wsfbt/201705/t20170509\\_190120.shtml](http://www.spp.gov.cn/xwfbh/wsfbt/201705/t20170509_190120.shtml).

<sup>85</sup> See, respectively, from [http://www.sohu.com/a/129962460\\_115443](http://www.sohu.com/a/129962460_115443) and <http://news.163.com/16/0217/07/BG0RBH3R00014Q4P.html>.

(3) *Formal institutional development through formalizing platform rules*: The state has formalized some components of platform rules. One example is a return policy stipulating that “consumers shall have the right to return the commodities within seven days of receipt 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 Administrative Measures for Online Trading* released by the State Administration for Industry and Commerce.<sup>86</sup> The most recent development is that many local governments have attempted to expand this return policy to brick-and-mortar stores.<sup>87</sup>

The existing platform rules have also strongly influenced the making of the E-commerce Law.<sup>88</sup> The China Electronic Commerce Association (CECA) – a business alliance representing the interests of e-commerce companies – was authorized to make one of the four draft proposals. The final draft law is an amalgamated version that synthesizes four drafts that were proposed, respectively, by CECA, academics, central government ministries, and local governments. The practice of having different interest groups, especially a business alliance, make a draft proposal of a national law is very rare in China.<sup>89</sup>

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

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<sup>86</sup> See Article 16 of the Administrative Measure at <http://lawinfochina.com/display.aspx?id=16309&lib=law>.

<sup>87</sup> <http://xiaofei.people.com.cn/n1/2020/0521/c425315-31717686.html>.

<sup>88</sup> See, <http://www.isc.org.cn/zxxz/hlwzl/listinfo-32505.html> and [http://jiangsu.sina.com.cn/news/general/2020-05-29/detail-iirczymk4127428.shtml?from=jiangsu\\_cnxh](http://jiangsu.sina.com.cn/news/general/2020-05-29/detail-iirczymk4127428.shtml?from=jiangsu_cnxh).

<sup>89</sup> For details, see <http://www.mofcom.gov.cn/article/shangwubangzhu/201603/20160301274283.shtml>.

## 9. Conclusion

In this paper, we explore the authoritarian's legal dilemma, which refers to the desire to develop private law to govern commerce without creating an independent judicial system capable of challenging the state. In the case of law, Chinese style, the government has opportunistically if subtly embraced the development of law by key private actors. Online market platforms are central to this process, building digital legal institutions that evolve rapidly and can easily be scaled up. These platforms hence have established a national market with legal infrastructure that the central government has found it difficult to provide.

Assuming that this experiment succeeds in some form, China will have provided a novel solution to the authoritarian's legal dilemma – allowing the creation of an online system of private law that is difficult to expand into public law. In fact, the rise of private legal systems online may *even delay the formal development of public law*. The data accumulated from this private legal system makes it possible for the state to strengthen its surveillance apparatus.

Law, Chinese style is not without limitations. The outsourcing of 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. Its existence still relies on maintaining a benign relationship with the state, despite that various costs of intervention can constrain the state's arbitrary acts to some extent. Moreover, although 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 rules. Competition among platforms can contain, but not eradicate, the potential abuse of power by business elites.<sup>90</sup> Lastly, the emergence of law, Chinese style marks a partial shift from human enforcement to digital enforcement of market rules. While

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<sup>90</sup> 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 substantially from the general interests of the users.

digital enforcement decreases the chance of human errors and manipulation, algorithms themselves are not free of problems such as algorithmic bias and interpretability issues.

We are well aware of these limitations. By no means are we suggesting that law, Chinese style is a Pareto-efficient or normatively-superior approach to developing a legal market infrastructure. Nor do we contend that government-initiated legal reforms are unnecessary. Rather, we posit that law, Chinese style presents one of the few options to strike a balance between economic efficiency and political feasibility, which is important for legal development in authoritarian countries. Essentially, our theory proposes a “second-best institution,” which, according to Rodrik,<sup>91</sup> 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; the state can then formalize the private rules that work best. Competition among private systems of governance is especially valuable for states where the governance deficit is rooted in the dearth of political competition. After all, most Chinese people cannot cast a vote or “vote with their feet,” yet they can “vote with clicks.” The key is that the state needs to *prevent* one single platform from becoming a state-franchised monopoly in order to keep the competition among platforms vibrant. This model draws wisdom from past claims that governance is not necessarily

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<sup>91</sup> Rodrik 2008.

provided by centralized governments,<sup>92</sup> and that competition among private providers of governance facilitates innovation and the discovery of new rules.<sup>93</sup>

This paper has broader implications. It sheds light on other major developments in Chinese politics. Beyond legal development, Beijing has also outsourced *political* and *coercive* functions to private actors such as tech companies. For instance, censorship is often carried out by private social media platforms rather than the state.<sup>94</sup> The Chinese state has also increasingly outsourced *social* functions. During the recent battle with the coronavirus, the Ministry of Civil Affairs openly requested tech companies such as Tencent and Alibaba to develop community epidemic control apps, and the companies quickly did so.<sup>95</sup> The parallel state outsourcing activities in different realms indicate a crucial change in China's state-private sector relations. Experimentation by internet platforms appears to be changing China's legal, political, and economic foundations.

Finally, this paper has implications for market and legal development for other countries. Many developing countries – especially authoritarian states – confront the same issue: political obstacles have impeded the development of strong rule of law in markets. With the global rise of online markets and institutions and the diffusion of online institutional practices across country borders, “law, Chinese style” may no longer be unique to China. Will the state's outsourcing of authority to digital platforms become a generalizable path to legal development? It may hold the potential for such a transformation.

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<sup>92</sup> Dixit 2004, 2009.

<sup>93</sup> Stringham 2015.

<sup>94</sup> Miller and Gallagher 2020.

<sup>95</sup> See [https://www.thepaper.cn/newsDetail\\_forward\\_5914934](https://www.thepaper.cn/newsDetail_forward_5914934).

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