

THE IMPACT OF JOINING WTO ON CHINA'S ECONOMIC, LEGAL AND POLICAL INSTITUTIONS*

Gregory C. Chow
Princeton University, Princeton, NJ 08544

Abstract: This essay applies a historical-institution approach to assess the impact of WTO membership on China's economic, legal and political institutions. In each case historical and institutional trends are described, and the effects of WTO membership on these trends are examined. The topics include changes in economic structure and the rate of growth of GDP, formal legal institutions and legal behavior of the Chinese people, and the forces toward the development of democratic political institutions.

- *Address for correspondence:* Department of Economics, Princeton University, Princeton NJ, 08544, USA. Email: gchow@princeton.edu.
- Running head: WTO membership and China's institutions.

Journal of Economic Literature classification numbers A12, O11, P2

*This paper is an invited speech delivered at the International Conference on Greater China and the WTO, March 22-24, 2001, organized by the City University of Hong Kong. For helpful comments the author would like to thank David D. Li, Lynn White and a referee, as well as participants of the Visiting Fellows Seminar of the Center for International Studies at Princeton University and of the above International Conference.

1. INTRODUCTION

The purpose of this essay is to assess the impact of WTO membership on China's economic, legal and political institutions. Unlike articles ordinarily found in economics journals, the approach of this essay is historical-institutional rather than theoretical-quantitative. Economic, legal and political institutions have characteristics that are not conveniently quantified; the effects of WTO membership on these characteristics are more conveniently assessed by the general trends which are qualitative. I will describe

the historical-institutional characteristics and explain how WTO membership may affect these characteristics.

Joining WTO is a very important event for the development of China at the beginning of the 21st Century. This important event is preceded by the establishment of permanent normal trade relations with the United States in 2000, twenty one years after the normalization of diplomatic relations between the two countries. These two events are significant because they mark the Chinese economy coming of age as China is recognized by the United States and the world economic community as an equal partner. They also signal the continued forward movement of the economic globalization process. China has become an important member of the world economic community and plays an important role in the global economy.

WTO membership opens up China's market for more international trade and investment, and opens up the world economy for China's exports. Some observers see it as a positive force for China's economic development while others are concerned that the competition of foreign imports and foreign enterprises in China might destroy important domestic enterprises in China's agricultural, manufacturing and service sectors. How the economic institutions will be affected is a topic to be addressed in this paper. In addition I will discuss the impact on China's legal and political institutions.

Section 2 summarizes the provisions of WTO membership and discusses the impact on China's economic institutions. The discussion touches on structural shifts in China's industries and changes in the nature of China's economic institutions. The first topic is concerned with the relative growth of the three sectors of agriculture, industry and service, especially telecommunication and finance. Besides the impact on industrial structure and the aggregate rate of growth I will examine the impact on the nature of China's industrial and financial institutions. Opening the economy further is expected to affect China's legal institutions also, a topic for section 3. Changes in economic and legal institutions will influence China's political institutions, as will be discussed in section 4. Section 5 contains some conclusions.

2. IMPACT ON ECONOMIC INSTITUTIONS

Conditions for China to enter WTO include (1) the lowering of tariffs for imports, (2) the permission of foreign firms to sell directly in the Chinese domestic markets and (3) the opening of the telecommunication and finance sectors to more foreign competition. China agreed to lower its tariffs on agricultural products from 31.5 percent to 14.5 percent overall by January 2004. Tariffs of industrial products would be lowered from 35 to 17 percent in a period of five year. Foreign manufacturers, including automobile companies, would be able to sell their products directly to domestic consumers without having to go through Chinese trade organizations. Foreign investors would be able to own up to 40 percent of shares of commercial banks in China, and up to 48 percent of telecommunication firms. Foreign banks can offer services in local currencies to Chinese corporations. Foreign firms can hold minority shares in securities fund management joint ventures, at 33 percent initially and increasing to 49 percent three years after joining. Foreign firms can also provide accounting, management consulting, architecture and engineering services. In return, quota on China's textile and clothing exports will be removed by 2005.

Lower tariffs would increase in the imports of both agricultural and industrial products. Competition from foreign imports will force Chinese producers to lower their prices and improve the quality of their products, both to the benefit of Chinese consumers. Those firms that cannot compete will have to adjust, some possibly going bankrupt. Foreign manufacturers operating in China will also provide competition. Local foreign producers have the advantages over importers by being able to use the low-cost labor in China and to save the cost of transporting the final products to China. Financial firms and telecommunication firms in China will have to upgrade their products to survive foreign competition.

Consider first the effects of lower tariffs and competition by foreign firms on economic structure, including changes in the relative importance of different industrial sectors and of the state versus non-state sectors. WTO membership will hasten the relative decline of the agricultural sector and the relative rise of service sectors dealing with financial services and telecommunication. Secondly, the state sector will decline relatively to the non-state sectors and efficiency in Chinese enterprises will increase with foreign competition when tariffs are lowered and foreign firms can enter the Chinese

market. The historical trends of the relative growths of the major sectors can be found in *China Statistical Yearbook 1999* which provides the following statistics on China's gross domestic product and its major components (in 100 million yuan). Total output is divided into primary industry (mainly agriculture and forestry), industry (mainly manufacturing), construction and tertiary or service industry. Table 1 shows the distribution of these four components of output in 1978, 1988 and 1998.

Table 1

Industrial Composition of Gross Domestic Product

	GDP	Primary Industry	Industry	Construction	Tertiary Industry
1978	3624.1	1018.4 (0.281)	1607.0 (0.443)	138.2 (0.038)	860.5 (0.237)
1988	14928.3	3831.0 (0.257)	5777.2 (0.387)	810.0 (0.054)	4510.1 (0.302)
1998	79395.7	14599.6(0.184)	33429.8(0.421)	5262.0(0.066)	26104.3 (0.329)

As common in the process of economic development the share of primary industry consisting of agriculture and forestry continued to decline from 0.281 (figure in parentheses after the output value) in 1978 to 0.184 in 1998 while the fraction of tertiary industry continued to increase from 0.237 to 0.329. During the period from 1978 to 1998, the 10 percentage point reduction in the share of primary industry can be accounted for almost entirely by the 9 percentage point increase in the share of tertiary industry, with the combined industry-construction sector increasing by 1 percentage point. During the first ten years, there was a 6 percentage point increase in the tertiary industry. This came from trade, transportation and communication, sectors that had been grossly neglected during the period of economic planning before 1978 and recovered rapidly in the first decade of economic reform. The slower increase in the relative share of the tertiary industry in the second decade was made up of activities such as banking, finance and telecommunications.

The tertiary industry is expected to increase its share of China's GDP partly as a result of stimulus from foreign competition and expected foreign investment in this industry. The high-technology component of the manufacturing sector will increase in importance partly because of expected increase in foreign investment. The domestic manufactures of

consumer durables especially automobiles will suffer from increase in imports while increased foreign investment in the automobile industry will help increase domestic production of automobiles. The net effect is likely to be a slower growth in the domestic automobile industry because domestic producers cannot produce automobiles of equal quality as cheaply as the competing imports. The expected growth in both the service and the manufacturing sectors will lead to a further decline in the share of agriculture which will take place even without the entry to WTO. The relative decline in the agriculture sector is hastened by foreign competition from the lowering of tariffs on agricultural products. The magnitudes of the effects of WTO entry on China's industrial composition are limited, however, as will be suggested below.

The main motivation of Premier Zhu Rongji in promoting China's entry into WTO was to use foreign competition to speed up economic reform in both the industrial and service sectors. In the late 1990s reform in both sectors was slow because of the inertia coming from vested interests of a group of formerly appointed managers holding on their positions. Simply by formally changing the state enterprises to share-holding companies does not lead to the replacement of former managers and the adoption of new ways of managing the enterprises. As pointed out in Chow (2002, p. 391) private ownership is neither sufficient nor necessary for enterprise efficiency. Rather, necessary and sufficient conditions for managers to work hard for the benefit of the enterprise are (1) they cannot receive substantial economic benefits (such as bribes) without working hard for the enterprise, and (2) they can reap substantial marginal benefits from the profits of the enterprise. I have termed the Chinese economic system a bureaucratic market economy. The bureaucrats in many state enterprises are politically protected. They can receive substantial gains without working hard for the enterprise. The same bureaucracy applies to the banking sector.

Foreign competition could provide a powerful force to combat bureaucracy and inertia in Chinese economic institutions. Firms that fail to compete will have to find ways to downsize, to reorganize or to adopt new technology and new ways of management in order to survive. But how successful such outside pressure will be depends on how strong the inertia is. In addition, for fear of creating too much social instability the government does not and will not allow foreign competition to come in too

rapidly. The slow speed in allowing foreign competition to enter China's market is openly and formally recognized in the stated schedules to lower tariffs gradually and to permit foreign firms to enter China's financial and telecommunication industries in steps. Informally there are red tapes and other means to delay foreign competition to be exercised by central, provincial and local government officials. These officials have the power to approve foreign economic activities in China. They may use their power with or without the direction of the central government in Beijing which signs the agreement to enter WTO.

Such possible delays are recognized by Western observers, as in an article published in the web site [wysiwyg://241/http://seatlepi-i.nwsourc.com/business](http://www.seattlepi.com/business) on November 18, 1999, entitled "Companies could wait years for China benefits." This article quotes less than enthusiastic remarks from executives of Boeing, Motorola (the largest U. S. investor in China) and Daimler-Chrysler. Bankers say that their prospects of increasing business in China are unclear. The only concrete gain expected is from the reduction of agricultural tariffs from 31.5 percent to 14.5 percent overall by January 2004 and the termination of subsidies to Chinese exports. U. S. farm exports to China are expected to increase.

Li, Wang, Huo and Xu (1999) applied a dynamic computational general equilibrium model of the Chinese economy consisting of 41 sectors and 10 types of households to study the impact of WTO membership. Four aspects of WTO membership are discussed: 1) tariff reduction; 2) abolishment of non-tariff barriers to industrial products in steps; 3) increase in import quota of agricultural products and abolishment of all import quota eventually; 4) phasing out quota on China's export of textile and clothing to developed economies. The impact of WTO membership on economic growth comes from two sources. The first is the gain from specialization through international trade. This gain is achieved by a change in the composition of outputs. With lower tariffs and more foreign goods made available in domestic markets, total products for consumption will increase. Increased exports will also stimulate the growth of GDP. The second is the gain from increase in efficiency within each industrial sector. Competition from imports and from foreign owned enterprises in China will force domestic firms to become more efficient.

The study estimated that China real GDP in 2005 would be 1.5 percent higher from the first source due to the above policies. This increase is derived from increased specialization from trade according to China's comparative advantage as WTO entry will allow more imports of agricultural products and exports of textiles and clothing in particular. If the gain in total factor productivity is incorporated, the average annual growth rate in GDP from 1997 to 2010 has been estimated to be 1 percent higher from the entry into WTO. This estimate should be viewed from the approximately 7.5 percent annual growth rate projected for this period. It appears reasonable to state that it might serve as the upper bound on the effect of WTO entry because it takes a substantial change in institutions to raise the already high GDP growth rate. There will be inertia to inhibit the forces that promote both sources of output growth. In fact these forces have already been operating in the 1990s and are expected to operate even without WTO membership. The total effects on the growth rate resulting from WTO membership agreements might be only moderate, with one percent increase in the annual growth rate as an upper bound.

3. IMPACT ON LEGAL INSTITUTIONS

The impact on legal institutions encompasses changes in formal institutions and laws, and secondly in the legal behavior of Chinese people. Concerning the former, in the last two decades many new commercial laws governing corporate behavior, bankruptcy, behavior of banks and other financial institutions have been enacted by Chinese People's Congress. Furthermore, the Chinese judicial system for law enforcement has been modernized and improved. The practice of litigation is now more wide spread and the number of lawyers has dramatically increased. The number of legal personnel had increased to about 305 thousand by 1999, including 130 thousand judges and 175 thousand lawyers. The number of lawyers is expected to grow to 200 thousand by 2010 according to Alford (1999).

WTO membership is expected to assert a positive effect on China's modernization of its legal system as the Chinese will have to deal with foreign firms more frequently. However, the inertia in the people's lack of respect for commercial law may be strong enough to make the change in their legal behavior slow. One example is the lack of respect for intellectual properties. On October 5, 2000, the *New York Times*' financial

section reports that there was wide-spread pirating of a popular film produced by the central government itself and the pirated copies were being shown in theatres all over the country, but the government could not stop it. This suggests that some Chinese people do not always follow the laws regarding matters related to money and business, although they appear to respect criminal codes to a larger extent.

Concerning legal behavior of the Chinese people, it follows a historical and cultural tradition that can hardly be affected simply by changes in formal institutions such as the enactment of new laws, and the introduction of new legislative procedures, new courts and new enforcement systems. In traditional Chinese culture, ethics had more influence than laws in guiding people's behavior. Confucian ethics was more dominant than teaching of the legal school of Han Fei who was a contemporary of Confucius in about 250 BC. Chinese children in school were taught to obey the ethical rules of Confucius more than the law of the government. If there is a conflict between law and ethics the correct behavior should be to follow Confucian ethics. To settle disputes, the parties' honor and credibility guided by Confucian ethics were more important than the legal system. An oral agreement or a written agreement without court enforcement was sufficient in most circumstances. Social pressure and mediation by elders in an established social network took the place of settlement by lawyers and courts.

In the Song Dynasty beginning in 960AD commerce, trade and manufacturing flourished in an early form of capitalism. Such a market economy was functioning under the traditional social tradition without a modern legal system. As China attempted to modernize and to join the international economic community since 1978, the government has attempted to modernize the legal system as indicated above. Some scholars including Alford (1999) have questioned the benefits of adopting a Western and especially American legal system at the expense of the traditional system. While the traditional system depends too much on human relations and operates without clearly defined provisions for an agreement, the American-style legal system is very costly. Under the American legal system people are prone to sue in a variety of circumstances when people under a European or Chinese system would not. The number of lawyers per 1000 persons in the U. S. is very high as compared with Japan. The legal fees as a fraction of GDP in the US is high. One has to consider the benefits of adopting a Western legal

system in China in relation to its costs. The legal system before 1949 was functioning fairly well in spite of the lack of political stability between 1911 and 1949. Perhaps that system contained a reasonable compromise between traditional Chinese values and modern legal norms.

Modernization of China's legal system since 1978 included changes in the law enforcement system and the legislation of many new laws useful for the proper functioning of a market economy. The legislative system has remained formally the same but has become more effective and less subject to political influence than before. To the extent that WTO membership will expose the Chinese economy to more participation by foreign investors, traders and manufacturers the modern legal system in China will be subject to more tests and will have to improve gradually. As people are beginning to settle their disputes through legal rather than informal social channels, the legal behavior of the people will change also. The Chinese may gradually become more law-abiding in economic transactions through such practices and through the improvement in their standard of living. As the people become richer there is less need to violate the law for economic gains.

On a fundamental level, the rule of law has not been established in China. In traditional China as in other countries under imperial rule, the emperor or ruler had power over the life and properties of the subjects, and the society was ruled by people and not by law. Today under a one-party rule in China the loyalty to the Communist Party and to its leaders is considered supreme. The rule of law can come into conflict with the rule by people or by the Party. This conflict has manifested in numerous cases when Chinese citizens sued the government for violating their economic and other personal rights protected by law. To the extent that entry into WTO promotes the rule of law, it will weaken the practice of rule by people and the absolute power of the Communist Party. Accordingly the political system will also be affected.

4. IMPACT ON POLITICAL INSTITUTIONS

If we consider the government as consisting of three branches, its judicial and legislative branches are a part of both the legal and the political institutions. The effects on these branches of government are already described in the last section. Both

economic changes and the changes in the above two branches will affect the government and the Communist Party of China.

. An explicit goal of the current Communist Party leadership is to promote democracy. This goal has been stated many times, including a statement in the Report of Premier Zhu Rongji to the People's Congress on national economic development delivered on March 5, 2001. Yet the Chinese government has not made as much progress in developing its democratic institutions as in developing its market institutions partly for historical reasons. Many countries, in the East or the West, have or had to go through a process of transformation from imperial rule to democratic government. In China, beginning with imperial rule in the Qing Dynasty, there was no period of political stability between 1911 and 1949 for democratic institutions to develop, as a result of different political factions in China struggling for power and of Japanese invasion (see Chow, 2002, pp.16-21) . The Communist Party rule since 1949 has had both positive and negative effects on the development of democratic institutions in China. On the positive side, it has provided China with political stability and a unified government which could foster the development of democratic institutions. Given political stability under a unified government the Communist Party has led China through successful economic reforms since 1978 from the inefficient economic institutions which the Party itself had created. Since the reforms the Party has provided economic conditions favorable to the development of democratic institutions. On the negative side, the strict one-party rule has destroyed some of the initial growth of democratic institutions developed under the Republic of China and has turned the clock backward on the movement toward democracy.

The balance of the two sets of forces just mentioned has been positive since economic reform started in 1978. Progress towards democracy has already taken place to some extent in China although perhaps to a lesser degree than the progress in economic development. First, the representatives to the People's Congress have always been elected, though indirectly. The representatives at the lowest level in village or city blocks are publicly elected. Representatives at a higher level are elected from and by representatives of the level immediately below. However, before the early 1980s the representatives at the National People's Congress automatically passed the legislation

proposed to them by the executive branch under the direction of the Central Committee of the Chinese Communist Party. Since the 1980s representatives in the People's Congress have increasingly exercised their own power by casting negative votes to proposed legislation. Part of their autonomy is derived from the need to legislate new laws for a market economy. The new legislation has required experts in the Congress to form committees of specialists to draft the law.

A second most noticeable change is the wide spread village elections for government officials in thousands of villages all over China. After the Commune system was abolished in the 1980s, many public services formerly administered by the Communes were neglected, including public security, protection of public land and other resources, etc. People in villages decided to elect their government officials publicly to make sure that such services are provided. The election is open and fair. Many observers believe that these directly elected village government can serve as the beginning of the establishment of democratic governments at higher levels. The position of the Central government at the turn of the 20th century was to protect and even encourage these village elections for they serve a useful social function but to limit them to the village level.

Concerning the future development of democratic institutions, one can expect that as the Chinese people become richer and more educated, they will be more interested in and more able to participating in democratic activities. Thus the demand for democratic institutions has increased and will continue to increase. On the supply side, institutional changes can come from the initiative of the government and/or from political upheavals. The latter possibility appears unlikely since the Chinese people by and large appear to be happy with their economic conditions, and the minority of dissatisfied people do not seem to have the will nor the power to replace the present government and establish their own government. Corruption, unemployment and economic disparity are three of the important causes of dissatisfaction but the number of people affected and the degree of dissatisfaction are not sufficient to generate political disruption of a national scale. Assuming no large-scale political disruption, the question is whether and how the current government will be willing to institute democratic reform.

In answering this question, one can reasonably assume that the Chinese Communist Party, like any political party in the world, is most concerned with maintaining its

political power. Democratic institutions will be initiated or accepted only if these institutions do not threaten the political power of the Communist Party. Here the term democratic institutions means institutions that guarantee the citizens certain basic rights and allow them to participate in the election of representatives to the legislature and of top officials in the executive branch of the government, leaving aside the particular details of the participation. Such democratic institutions began to develop at the end of World War II under the one-party rule of the Kuomintang.

The positive forces for the development of democratic institutions include (1) the changing world view of political leaders in China and (2) the changing environment in which the leaders have to exercise their political power. All top political leaders in China have traveled abroad and learned to some extent how modern democratic institutions function. New leaders have studied world affairs more recently and some have been trained abroad and will assume more political power in the future. The changing environment includes the inefficacy of the old-fashioned political control by manipulating the news when the news media have improved technologically to include radio and TV receptions from Hong Kong and Taiwan and especially the internet. Not only will the population demand more democratic institutions, but the willingness of the government to promote democratic institutions will also increase, provided that they are consistent with the one-party rule. Working against these positive forces is the desire of the bureaucrats to hold on to their power under existing rule.

Membership in WTO could increase both the demand for and the supply of democratic government. On the demand side the further economic development and economic modernization made possible under WTO will increase the people's interest in a democratic government and their ability to participate in it. On the supply side the view of government leaders will become more global and modern oriented. For example, speeding up the growth of the telecommunication industry will help to promote the development of a more open society. Furthermore the room for corruption will be decreased when more economic transactions are protected by the rules of the WTO. Such effects on the political institutions in China are positive, but one cannot expect rapid changes because of inertia from the historical, social and bureaucratic tradition of China.

To accommodate the social changes resulting from economic modernization and to maintain political stability, the Party needs to make appropriate adjustments. Without losing its political control one solution would be to share some of its political power and responsibility with wider segments of the Chinese society. One example is the announcement on July 1, 2001, the 80th anniversary of the founding of the Party, by General Secretary Jiang Zemin to allow capitalists to join the Party. Other means to increase democratic participation are to encourage or support nonparty candidates in elections for offices at higher than village levels and to nominate or appoint nonparty members for important government positions. In the mean time the old ideology suitable for a revolutionary period has to be modified by principles which are required to lead and govern a modern society, including democratic principles that allow for more freedom of expression.

5. CONCLUSIONS

I have suggested reasons for the WTO membership to have positive impacts on China's institutions. The impacts are small because the provisions of the WTO membership are limited in scope. The effects are expected to be gradual not only because the terms of the membership agreement are introduced gradually but because economic, legal and political institutions are difficult to change. There is inertia in all three sets of institutions to slow down any efforts to change them. Besides the formal provisions to open China's economy gradually, the central government will monitor the speed of changes to avoid social instability. At the same time the local governments and bureaucrats will slow the changes by red tapes if they find them too threatening to the local economic institutions.

Slow changes in China's institutions may be desirable. Sudden changes in economic institutions may generate a level of unemployment which is politically disruptive. Additional unemployment can be caused by the failure of domestic manufacturers such as those in the automobile industry to compete with foreign imports. Rapid changes in legal institutions may involve breaking down the social fabric of the Chinese people as they abandon their former ways to settle disputes and attempt to adjust to the new legal system. As political stability is important in promoting changes toward democratic institutions, rapid changes in political institutions may generate political instability and be

harmful to the adoption of democratic institutions. Perhaps the social changes which have taken place in China since 1978 have been as rapid as the Chinese people could absorb.

Besides the substantive provisions for entry, WTO membership has a symbolic significance. Symbolically, China's position in the world economic community is openly recognized. What is agreed upon as conditions to enter WTO will serve as a blueprint for China's institutional changes for at least a decade even if the agreed upon provisions do not take effect as early as the formal statements stipulate. In the mean time, helping the Chinese leaders project a better image of themselves in the world community will improve their own confidence to govern and in the confidence of the Chinese people in their leaders. The psychological effects resulting from the status of membership may make the leaders more willing to adopt democratic reforms and make the Chinese citizens more willing and patient in following their leaders in guiding the gradual political changes in China towards a more democratic government. In making this positive concluding statement I assume that the most important objective of the Chinese political leaders is to make their political power secure, and that, if their political power is assured, the Chinese political leaders will try their best to modernize China and to fulfill the aspirations of several generations of Chinese people since the Opium War of 1840, subject to the bureaucratic inertia underlying the one-party rule in China.

REFERENCES

- Alford, William (1999) "Does the rule of law really rule?" paper presented before the Conference on Policy Reform in China, Center for Research on Economic Development and Policy Research, Stanford University, November 18-20, 1999.
- Chow, Gregory C. (2002) *China's Economic Transformation*. Oxford: Blackwell Publishers.
- Li, Shantong, Wang, Zhi, Huo, Fan and Xu, Lin (1999) *WTO: China and the World* (in Chinese), Beijing: China Development Publishing Company.