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**Property Rights and “Original Sin” in China:
*Transaction Costs, Wealth Creation, and Property Rights Infrastructure***

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1. Introduction

This is one of a series of papers by the authors examining how China can reform its capital and financial markets by drawing lessons from the experiences of Hong Kong and other market economies. The first paper was presented in this conference series at Stanford last year and examined the development experiences in other economies². The second paper, presented in Beijing and Shanghai looked at the need for a property rights infrastructure as a pre-condition for efficient capital market development and good corporate governance³. This paper presents for the first time in English a Chinese version of a paper on property rights disputes in China presented in Beijing, Shanghai, and Hong Kong⁴. An overview of the role of property rights infrastructure (PRI) and the function of efficient markets was presented recently in Beijing⁵. There is a further paper, as yet unpublished, that examines the historical reasons why China did not evolve its own property rights infrastructure⁶.

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² Sheng, Xiao and Wang (2003b).

³ Sheng, Xiao and Wang (2004b).

⁴ Sheng, Xiao and Wang (2003a).

⁵ Sheng (2004).

⁶ Sheng, Xiao and Wang (2004d).

China's economic reform has now advanced to a stage in which more attention should be turned to developing an integrated property rights infrastructure so as to derive lasting benefits to the economy. Hong Kong, which has a well functioning PRI including very effective regulatory and anti-corruption institutions, could serve as a live knowledge base for building and maintaining a modern PRI in China. The historical experiences of U.S. and other matured economies could also provide useful lessons for China.

2. What is a Property Rights Infrastructure?

A market is actually a property rights delineation, transfer and protection system. It depends on an infrastructure, comprising information and accounting services, legal and regulatory services and the judicial system, together with other supporting institutions, that gives legal protection of property rights. The concept, role and functions of PRI are discussed elsewhere in detail.⁷ The PRI comprises three broad categories of institutions/ processes:

(i) Institutions/processes for delineation of property rights:

- Central registry of property rights for land, property, shares, and other assets. The formal record of property rights is crucial in reducing the costs of enforcing property rights and of resolving property rights disputes.
- Accounting and legal process to define property rights in complicated forms of assets such as shares, bonds, options, and other ownership instruments.

(ii) Institutions/processes for exchange of property rights:

- Trading process such as retail and wholesale markets, auction houses, stock exchanges, futures markets, banks and insurance companies.
- Regulated intermediaries to facilitate complicated financial and non-financial transactions, including lawyers, accountants, auditors, credit rating agencies, credit bureaus, sponsors and other information service providers. These intermediaries are used for identifying, providing and verifying information about the value and quality of property rights, which is indispensable for due diligence when the property rights are traded.
- Clearing, settlement and payment systems to complete financial and non-financial transactions safely, timely, efficiently, and conveniently.

(iii) Institutions/processes for protection, enforcement, adjudication, and fine-tuning of property rights:

- The general rules of the game that forms the legal and economic system of a market economy: laws, regulations, standards, codes, and norms that protect property rights of all participants across space and time.
- Independent and transparent judiciary to adjudicate disputes over property rights and fine-tune property rights as necessary.
- Enforcement infrastructure including police, regulators, and armed forces that can enforce the judicial decisions and protect property rights firmly and fairly at a cost that is lower than the benefits to the society and the market.

⁷ Sheng, Xiao and Wang (2004c).

- Mandatory disclosure regimes to ensure that important information about property rights, such as the financial statements of listed companies, are independently verified and accountable so as to facilitate self, regulatory and market disciplines on the corporate sector.
- Active and independent public watchdogs such as media, consumer councils, councillors/parliamentarians, and other civil society organizations to promote proper conduct and behaviour and accountability through public pressures and reputations.
- A well-functioning government with effective checks and balances that can provide basic political and social order.

A well-functioning PRI helps to build and maintain proper market behaviour and good credit culture and is the foundation for good governance in corporations, government agencies, market regulators and other market participants. The ultimate result of strong PRI will be reflected in the quality of corporate decision-making and government policy-making that is essential for risk management at all levels. Specifically good PRI leads to good capital market, which then provide low-cost financing to good corporations.

3. “Original Sin” and Relationship with Property Rights

Since its opening up strategy was implemented in 1979, China has enjoyed rapid growth and unprecedented wealth creation. China’s economy has expanded at around 8% per annum for more than two decades. From a position where most property was owned by the state, the sale of state-owned enterprises to the private sector, the leasing of land use rights to individuals and foreign firms, as well as the establishment of the stock market have resulted in the emergence of private sector wealth. The private sector has expanded to a scale which is now as large as accounting for about three quarters of the employment, two thirds of GDP, one half of industrial and residential property value, one third of stock market capitalisation, and one fifth of bank loans. China’s constitution now protects private property rights.

This rapid emergence of private sector wealth happened in China before the pre-conditions for a robust and efficient property rights infrastructure was firmly established. The resulting uncertainty about property rights has led to many disputes on the legitimacy and clarity of ownership. How did the private sector obtain this wealth? Was it through corrupt practices, tax evasion, smuggling, fraud or other illegal activities? The lack of clarity in ownership of property rights for the private sector is commonly called “original sin” within China, as the entrepreneurs or owners of private business are unable to explain clearly the origin of such accumulated wealth.

The concern on “original sin” has created huge moral and political debates. At one extreme, there is moral outrage over such illegally gotten wealth that should be confiscated and those responsible charged criminally. At the other extreme, there are calls for amnesty in the same way that some Western countries give tax amnesties to enable past defaulters to start afresh. This paper does not attempt to get into the moral or political issues, but uses a Coasian new institutional economics framework of transactions costs to examine the economic dimensions of “original sin” and its

possible resolution. It concludes that there is ample Western experience in dealing with this but all requires the pre-condition of a robust PRI.

One of the key difficulties in dealing with “original sin” and the associated property rights disputes lies in the confusion about the substantive differences between two types of economic behaviour: criminal wealth transfer activities and non-criminal property rights disputes. The confusion of the two creates dilemmas in government policy-making, judicial decisions, and enforcement actions. To analyse the problem of “original sin” in China objectively and find constructive solutions, some clear and useful principles to distinguish the two categories of behaviour are needed.

Applying new institutional economics,⁸ this paper develops an analytic framework to distinguish “original sin” of criminal nature from non-criminal property rights disputes based on two principles: the transaction cost principle and the wealth creation principle. Our analysis suggests:

- When transaction costs are high and there is net wealth creation, the conflicts between the private businessmen and the state/public should be treated as property rights disputes and should be dealt with according to principles similar to the “liability rule” as applied to the non-criminal cases in the western legal system. The persons inflicting harms or losses to others should pay damages but should not be punished.
- When transaction costs are low and there is no net wealth creation, the conflicts should be treated as criminal cases and should be dealt with according to principles similar to the “property rule” as applied to the criminal cases in the western legal system. The persons inflicting harm or losses to others should be punished and pay damages.

The above economic and legal principles on dealing with “original sin” and property rights disputes could be useful in guiding the design and implementation of reforms in China’s judicial system, which is one of the key pillars for well-functioning PRI. These conceptual principles could also contribute to current debates in China on the issues of reform of state-owned enterprises and state asset management and the improvement of corporate governance⁹.

4. Wealth Creation, Wealth Transfer, and Social Cost

We need to define a few key concepts before developing the analytic framework for studying “original sin” and property rights disputes. Let’s separate conceptually the costs related to “original sin” into two parts: Wealth Transfer (α) and Social Cost (β). Let’s also separate conceptually the Private Sector Value Added (ϵ) from the “original sin” related Wealth Transfer (α).

Wealth Transfer (α): Transfer of wealth and benefits related to private taking of state-owned assets or other stealing and rent-seeking activities.

⁸ Werin (2003).

⁹ Sheng, Xiao, and Wang (2004b).

Social Cost (β): The money, time, and other resources spent on getting α . β is a social cost, or a waste of society's resources, from wealth transfer activities. It is a burden on the society and increases the cost of doing business.

Private Sector Value Added (ϵ): The net creation of wealth from the legitimate business of the private sector.

In the above definition, α could involve both state-owned and privately owned enterprises and it can lead to quasi-fiscal costs such as non-performing loans in the state banks and unfunded pension liabilities for the government. This transfer is clearly inequitable and discourages legitimate wealth creation activities. But the wealth transfer itself is just redistribution and would not directly destroy wealth. It is difficult to avoid α when property rights are not defined clearly and when there is too much unnecessary regulation. α , if getting out of control, may become a threat to social stability.

Now let's look at a simplified national income account. We break national income into net state sector income and net private sector income.

Net State Sector Income = Tax Revenues + State Sector Value Added – α ;

Net Private Sector Income = ϵ + α – β ;

National Income = Tax Revenues + State Sector Value Added + ϵ – β ;

Since Wealth Transfer α is simply a transfer from the state sector to private sector, it does not appear in the consolidated National Income equation. In other words, the size of α does not affect directly the size of National Income.¹⁰ To increase National Income, it is necessary to reduce social cost β .

But β is closely related to α . α is what motivates “original sin”-related activities such as stealing, tunnelling, asset stripping and other rent seeking. These activities then will generate Social Cost β . If there are no effective measures to stop people from rent-seeking, the competition among people who are trying to get Wealth Transfer α would increase Social Cost β to the extent that β could be greater than α .

Hence, to increase National Income, we need to minimize not only β but also α . If there are no state assets and no regulation-induced opportunities for wealth redistribution, α would be zero and β would also fall to zero automatically. One must recognize that “original sin” involves two parties: the state sector and the private sector. Opportunities for committing “original sin” exist because of discretionary authority by government officials. The greater the market distortion caused by laws and administrative rules, the greater the opportunity for wealth transfer (i.e. larger α).

¹⁰ For simplicity, we assume here there are no income effects.

The “original sin” problem in China is complicated because wealth transfer-related criminal activities are often mixed up with non-criminal property rights disputes. Conceptually the total accumulated wealth of private businessmen in China can be represented by $\Sigma(\epsilon + \alpha)$, which includes both $\Sigma\epsilon$ and $\Sigma\alpha$. While $\Sigma\epsilon$ is conceptually “clean” of criminal activities, $\Sigma\alpha$ is often related to illegal or “extra-legal” gains from private usage of state-owned assets, evasion of taxation, smuggling, gambling, vice, fraud in IPOs, and market manipulation etc.

However, in reality, it is difficult to measure $\Sigma\epsilon$ and $\Sigma\alpha$ separately without a well-functioning PRI. A transparent and equitable “due process” is needed to unravel the historical legacy of “original sin” and this cannot be done purely by administrative or political means because of the moral issues and perceived inequities this brings. This is the dilemma in resolving the “original sin” of private entrepreneurs in China. There is a national interest in promoting $\Sigma\epsilon$ as it creates employment, growth, and tax revenues, but there is also public “bad” with respect to $\Sigma\alpha$ as it is related to rent-seeking, unfair practices and corruption. Depending on which component of $\Sigma(\epsilon + \alpha)$ is larger, you can have dramatically different views on the “original sin” problem in China. The analytic framework we propose here however provides a more objective and constructive, and perhaps less emotional approach to look at the issue. We regard the “original sin” in China as a problem of co-existence and conceptual confusion between criminal wealth transfer activities and non-criminal/civil property rights disputes.

Clearly China needs to develop institutions that are able to distinguish $\Sigma\epsilon$ from $\Sigma\alpha$. Good systems for property rights registration and accounting would make it easier to measure $\Sigma\epsilon$. Given the complexity of both criminally oriented “original sin” and non-criminal property rights disputes, China needs a strong, independent, and transparent judicial system to resolve the two categories of conflicts through non-political, routine, and case-by-case processes. The judiciary in the western legal and economic system plays this function routinely without much interaction with its executive and legislative arms of government.

The lawyers and judges in the common law tradition have to identify which categories of the law would apply to each case (criminal or non-criminal laws such as tort). Facts have to be sorted out before they move to next stage of adjudication. Hence, problems of original sin have to be resolved on a case-by-case basis, and cannot be resolved on the basis of “broad principles”. This is where experienced lawyers and judges are needed to separate the criminal elements from civil cases. Clearly China can learn a lot from the development experiences of the legal and economic system in the mature Western market economies.

Putting aside the difficulties of developing PRI in general and a well-functioning judiciary in particular, we still need some clear principles on how to make proper distinctions between “original sin” of criminal nature and the non-criminal property rights disputes. Traditionally, we use the existing legal and regulatory rules as the only criteria when investigating corruption, criminal behaviour and property rights disputes. But this approach has a serious problem: the existing rules may be outdated and inconsistent with efficiency and equity principles. In fact,

China's reform in the past decades is clearly a history of how the outdated rules inherited from the central planning era are changed gradually over time. To move from such a regime to a full market-based regime where property rights are clearly delineated and protected would require a clear institution-building path that involves a clear vision on how the PRI can and should be built.

5. Property Rule versus Liability Rule: The Transaction Costs Principle

We need to distinguish “original sin” of criminal nature from non-criminal property rights disputes conceptually in order to differentiate the two categories of behaviour more effectively in practice. A problem with property rights enforcement in China is that historically, the system is based on criminal sanctions, which is not necessarily the most appropriate in market-based property disputes.

The Western legal tradition distinguishes between civil and criminal cases, through what is now in economic terms called the property rule and liability rule. Swedish economist Lars Werin in his survey of law and economics literature provides the following definition on property rule and liability rule based on the concept of transaction costs¹¹:

Property Rule: “If a person wants to expose someone else to the risk of harm or loss under circumstances where the transaction costs associated with a voluntary agreement are low, then he should buy the right to do so from the other person. If he inflicts a harm or loss without having bought this right, he will be punished, provided the court finds a sufficiently close connection between the harm or loss and his act. He may also have to pay damages to the victim.”

Liability Rule: “If a person wants to expose someone else to the risk of harm or loss under circumstances where the transaction costs associated with a voluntary agreement are high, then he may do it. If he inflicts a harm or loss, he will have to pay damages to the victim, provided the court finds a sufficiently close connection between the harm or loss and his act. A court determines the size of the damages, in principle calculated so as to correspond to the harm or loss. The acting person will not be punished.”

Many judges in the Western legal system apply the property rule and liability rule in their adjudication, without totally understanding the economic concept of transaction costs, as expounded by Nobel Laureate Ronald Coase.

In the context of transitional economies, where property rights need to move from state-dominated holdings to private holdings, it is important to understand that the lower the total transactions costs (including taxes and rent-seeking activity costs), the greater the ability of the market to function efficiently. In many emerging markets, such wealth transfers as theft, fraud, false accounting, corruption and the like result in huge unreported transaction costs. Accordingly, the move towards efficient market economies requires the building of PRI that reduces transaction costs.

¹¹ Werin (2003), pg 204.

The transaction costs principle being articulated explicitly in the property rule and liability rule can be abstracted from common sense practices through a simple example:

- A person stealing some medicine from a drugstore would face criminal charges of stealing. The reason is there is an open market with zero transaction costs for the person to buy the medicine, but he preferred to steal it for personal use at a loss to the drugstore.
- If, however, the person rushed into the drugstore, and without paying, took and used the medicine in order to save life of some other person on the street, he may not only not be punished for stealing, but could be rewarded for being a public-spirited hero. The transaction costs of paying immediately for the medicine were high relative to the urgency of saving a human life.

6. The Wealth Creation Principle

The Western legal tradition, which operated on the basis of the need to protect individual property rights, including against interference from the state, has intuitively operated on the basis of lowering market transaction costs. When transaction costs are low, people would prefer to use the market to obtain the resources they want in order to minimize the total costs to the society. When transaction costs are high, using the market to obtain resources may be too costly, hence there may be an incentive to engage in criminal activities, i.e. steal or cheat. Hence, the transaction costs principle ultimately is consistent with the wealth creation principle. Lars Werin uses the wealth creation principle to describe the judge-made law in the common law tradition:¹²

- “Property rights and rules on rights of transfer instituted by judge-made law tend systematically to produce incentives that promote efficiency, that is, encourage wealth-increasing acts and counteract wealth-decreasing acts, with no direct consideration of the consequences for the distribution of wealth.”
- “Property rights and restrictions on rights of transfer instituted by politically-based law are of two kinds. They either concern “constitutional” and “night watch” matters, basic to any society and which require a purely political decision process; they then tend to be efficiency promoting. Or else they are framed so as to promote distributional objectives, with no regard to efficiency. The latter category dominates.”

The above analysis suggests that any market reforms, including the building of the PRI, would require a clear vision or social objective of reducing transaction costs and maximizing wealth-creation risk-taking by the private sector. This implies that the appropriate institutional framework, such as the judicial and regulatory structure (and in enforcement work), should be built with these objectives in mind.

What the above analysis suggests is that whilst economists can explain these conceptual issues, the resolution of these complex property rights disputes lies in the realm of law and regulation. This is why we conclude that China needs to focus on developing a well-functioning PRI and especially an effective judicial system that is specialized in handling these complicated cases. The function of PRI is not just to resolve “original sin” and property rights disputes. As the historical

¹² Werin (2003), pg 61.

issues are resolved, the gap between the actual practices and the existing laws and rules will be narrowed, reducing the probability of new “original sin” from emerging. Each society has to go through this stage of development when it is modernizing its legal and economic system.

7. Historical Lessons from U.S.

Finally, it is important to point out that the presence of “original sin” happens in all societies. Each dealt with this problem through its own evolving legal, economic and political systems. Entrepreneurs with “original sin” will want to legitimize themselves in order to preserve their wealth. As Hernando de Soto correctly pointed out¹³, the United States confronted this problem in the 19th century. The U.S. opened up new frontier territory, e.g. the Wild West, before proper title deeds were registered and law and order were imposed. As a result, most settlers became illegal squatters or miners. In this extra-legal situation, the lawlessness or extra-legality at the grass-root level conflicted with actual laws in the established society:

“The crucial change had to do with adapting the law to the social and economic needs of the majority of the population. Gradually, Western nations became able to acknowledge that social contracts born outside the official law were a legitimate source of law and to find ways of absorbing these contracts¹⁴.”

English common law, which the U.S. was originally based on, did not have means of handling transfers of dubious property titles, such as squatting rights. The common law protected established landlords against illegal squatters. However, in a situation of mass migration into new lands with unclear title and boundaries, the squatters in the U.S. became the majority, and their rights had to be legitimized. This situation is not unlike the mass migration of rural labour into China’s urban areas where the property title has not yet been made clear, since all land belonged to the state. It is also conceptually equivalent to the situation where entrepreneurial individuals created net wealth for society by using state-assets, that were inefficiently managed under state-owned enterprises. If there are any disputes over such property rights, how should we deal with it?

In America’s Wild West, attempts by the established landlords to enforce their rights created huge squatter/homestead owners’ rebellion and disorder. When the squatters became the majority, new laws were passed to legalize their extra-legality. The legal device to legitimise their newly accumulated wealth $\Sigma(\epsilon + \alpha)$ was the concept of “pre-emption”, which was an innovation to allow a squatter to buy the land that he had improved on (e.g. pay $\Sigma\alpha$ to the original land owner to legitimize $\Sigma\epsilon$)¹⁵. By legitimising extra-legal activities, the frontier states could then collect tax revenues and enforce property rights to land. This was a win-win situation for all concerned.

In other words, faced with the conflicts between the existing landowners and the extra-legal activities of the squatters, who became a strong political force by sheer numbers, “American politicians thus had three choices. They could continue to try to thwart or ignore extra-legal

¹³ This section draws heavily from de Soto (2000), Chapter 5, The Missing History of US History.

¹⁴ de Soto (2000), pg 106.

¹⁵ Op cit, pg 120.

activities, grudgingly make concessions, or become champions of extralegal rights¹⁶.” The U.S. Congress gradually consolidated the diffuse and conflicting land laws that were out of touch with reality on the ground into a more consistent property rights system that recognized “the two great principles of equity in [American] statutory law: The right of occupants . . . to their improvements and the right of settlers on privately owned land, unchallenged for seven years and paying taxes thereon, to a firm and clear title to their land no matter what adverse titles may be outstanding.¹⁷”

Indeed, “it took the [U.S.] politicians some time before they awakened to the fact that alongside the official law, extralegal social contracts for property had taken shape and that they constituted an essential part of the nation’s property rights system. To establish a comprehensive legal system that could be enforced throughout the nation, they would have to catch up with the way people were defining, using and distributing property rights¹⁸.” For example, in addressing illegal mining on state land, the U.S. Mining Law of 1866, which legalized individual mining, was “an explicit recognition that value added to assets was something the law needed to encourage and protect¹⁹.”

To sum up, “the recognition and integration of extralegal property rights was a key element in the United States becoming the most important market economy and producer of capital in the world²⁰.” “The American experience is very much like what is going on in Third World and former communist countries. The official law has not been able to keep up with popular initiatives, and government has lost control.” For law to be obeyed, it must respond to the needs of the people. “In the long and arduous process of integrating extralegal property rights [into a new formal property law system], American legislators and jurists created a system much more conducive to a productive and dynamic market economy²¹.”

Even today, the method to resolve “original sin” in the US is evolving and innovating. The U.S. courts use “plea bargaining”, or a legal settlement of their past sins by bargaining for a lower fine, to recognize and resolve economic misconduct quickly and efficiently. This is fiscally efficient because it takes considerable tax resources to investigate and determine the scale of “original sin”. For example, in the investigation of securities analyst misconduct after the technology bubble, the U.S. Courts settled for a US\$1.4 billion fine on 10 investment banks, which did not admit the liability involved but acknowledged that they had to pay for their misconduct. This was a legal device to settle economic issues of disputes over property rights that harmed society that is largely consistent with the liability rule.

The experience of other Asian economies shows that if corruption and market misconduct cannot be stopped, businesses will begin to legitimize themselves by taking over politics. The Asian experience is that business cartels may choose to “backward integrate” into political parties in

¹⁶ Op cit, pg 130.

¹⁷ Op cit, pg 130.

¹⁸ Op cit, pg 136.

¹⁹ Op cit, pg 146

²⁰ Op cit. pg 148.

²¹ Op cit. pg 150.

order to achieve “regulatory capture”. This has created the unhealthy “crony-capitalism” that was one of the causes of the Asian financial crisis.

Hernando de Soto sums up the situation very well: “Today in many developing and former communist nations, property law is no longer relevant to how the majority of people live and work. How can a legal system aspire to legitimacy if it cuts out 80 percent of its people? The challenge is to correct this legal failure. The American experience shows that this is a threefold task: We must find the real social contracts on property, integrate them into the official law, and craft a political strategy that makes reform possible²².”

The historical experiences of U.S. are consistent with both the transaction costs principle and wealth creation principles. Outdated laws make property rights unclear and transaction costs high and they should not stop entrepreneurs from creating new wealth. China can learn from the U.S. experience by focusing on resolving the historical conflicts with clear principles and practical reform action.

8. Next Steps

Historian Ray Huang described the process of China’s modernization and the establishment of a market economy in China as completing three parts of the Chinese word “*立*” (e.g. meaning “standing up” in English), which consists of (1) the superstructure (the central bureaucracy), (2) the connecting networks and channels (property rights infrastructure), and (3) the grass-root organizations and individuals.²³ According to Huang, China has already built up the upper and bottom parts but still needs to develop the middle part, e.g. the connecting networks and channels between the central bureaucracy and the grass-root organizations and individuals in order to make China mathematically manageable. Put in another way, China needs to build an effective property rights infrastructure to resolve property rights disputes and deter/reduce corruption and rent-seeking activities related to “original sin”.

The concept of PRI can be likened to a highway. A PRI is an institutional highway for the flow of wealth and the creation and exchange of property rights. Recurring symptoms of economic and financial crisis, such as bad loans, corruption, commercial fraud, poor corporate governance, market manipulation and property rights disputes are rooted in the flaws of the PRI. When an accident happens in the institutional highway, the immediate reaction is to blame drivers or cars. Any investigation will look at the driver (the individual), the vehicle (the enterprise), the traffic rules (policies and regulations), and even whether traffic police were on the beat. But they often forget two fundamental factors: the quality of the highway (property rights infrastructure) and the brightness of street lamps (transparency), both of which are necessary conditions for a market economy. In other words, the design of the PRI is a pre-condition for a well-functioning market economy.

²² Op cit. pg. 151.

²³ Huang (1999), Chinese edition, page 3.

In 2000, China had one lawyer per 11,000 citizens, compared with one per 300 in the US, one per 700 in the UK, and one per 6,300 in Japan. Similarly, China had one accountant per 9,650 persons, compared with 412 in Hong Kong and 166 in US. In 2001, China had 28% employment in the service sector, considerably less than above 70% in U.S., France, U.K., Singapore and Hong Kong. China today therefore has considerable way to go towards building capacity in its service (or property delineation, transfer and protection) sector.

The United States spend over US\$1 trillion on regulatory activities, which is roughly 10% of GDP. Above-the-line transaction costs are expensive, since legal, accounting and regulatory costs are high. However, the market works, because below-the-line transaction costs are relative low compared to many emerging markets, where such costs are estimated at more than 10% of GDP, although they spend considerably less on regulatory activities. What is unseen is the “lost opportunity” in wealth creation and growth, which is held back by costly wealth transfers or criminal activities.

The advantage of the judge-made common law system in a market economy is that this is a pragmatic and empirical system that is truly “feeling the stones, as you cross the river.” The market place or social system throws up every day very special and complex situations of property disputes that are tested at different levels of courts. The written law requires objective interpretation. When new situations or knowledge arises, judges have to make a decision on the legal or social principles that define such issues. The accumulation of knowledge of cases and their judicial decisions forms an empirical base for society to resolve conflicts, build stable expectations and make decisions that have social legitimacy.

The robustness and durability of common law system in resolving conflicts lies in its transparency and legitimacy. Every judge knows that he needs to know the law and the precedent decisions made by his predecessors. The opposing sides must present both the evidence and the legal principles for the judge to decide. If the judge makes an error of judgement, it can be appealed to a higher court, to clarify matters of legal principle.

The Chinese judiciary has made considerable progress in recent years in evolving case law precedents. However, considerable resources must be devoted to this area in order to match the urgent need to complement the rapid progress to a market system.

The National People’s Congress has also made considerable progress in adapting new laws. But, copying law is easy. During last two decades, China has copied considerable best-practice legislations from advanced economies, such as contract law, company law, securities law, and banking laws. The problem lies in enforcement. The current judicial system is not yet able to apply these laws efficiently and fairly since the judges have very limited independence from the local party and government bureaucracy. Some judges, who came from such background as retired army officers or party officials, have little professional trainings in the legal principles. The Chinese bureaucracy is efficient in providing basic social and economic order but it attempts to define and enforce property rights through administrative instruments. For a market economy

to function efficiently, an independent judiciary and regulatory structure [key components of PRI] is vital.

China needs to review the development of the accounting profession to strengthen audit and disclosure quality. Areas such as a national credit reference agency, national network of property title registry, and market-based rating agencies, professional valuation agencies, and related infrastructure and services are all urgently needed to build the PRI.

After a quarter of century of reforms, China has reached the stage of economic development where the macroeconomic conditions provide a favourable opportunity for the next stage of reform: construction of a robust PRI to allow more efficient and orderly exchange and protection of property rights. China is no longer in shortage of savings and funds. Indeed, arguably it is suffering from an excess of savings. China's advantage as a latecomer to the market economy is that there is already enough experience and "software" to bring in the people, processes and experiences, so that a sustainable and equitable market economy can be built to global standards.

Since Hong Kong is already an international financial centre with a PRI competitive and transparent by world standards, Hong Kong can bring in a wealth of market experience in building the PRI to facilitate China's transition to a fully competitive market economy that operates on global standards. Building PRI will take time and political will. China should not under-use and under-estimate the value of the Hong Kong PRI in its reform efforts. How to build a modern and institutional property rights infrastructure is an important but complex task. Further research and discussion are needed before a clear action plan could be mapped out.

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