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Article

## Taobao, Federalism, and the Emergence of Law, Chinese Style

Lizhi Liu\* & Barry R. Weingast†

### INTRODUCTION

When a startup in the West invents a new form of consumer electronics and creates a website from which to sell its products, all of national law stands behind it, helping to reduce various forms of fraud, theft, and encroachment on intellectual property. Similarly, disputes that arise between the firm and its customers, suppliers, or competitors are negotiated in a rich legal and commercial environment. Because China lacks a strong legal infrastructure,<sup>1</sup> a similar venture attempting to sell by website is far riskier. The inchoate, variable, and sometimes corrupt nature of the Chinese legal system makes the prevention and resolution of legal problems much harder.<sup>2</sup> Chinese startups and small and medium firms that sell products by their own website are considerably more vulnerable than similar ventures in Europe or the United States.

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1. See SUSAN L. SHIRK, *THE POLITICAL LOGIC OF ECONOMIC REFORM IN CHINA* 1–7 (1993) (discussing the government's persistent refusal to create legal institutions in China).

2. *Id.*

Enter Taobao (which means “searching for treasure”), an online trading platform that hosts over 400 million active traders.<sup>3</sup> Created by Alibaba, Taobao is China’s largest online trading platform.<sup>4</sup> At first glance, Taobao’s online trading platform appears to be the Chinese version of eBay or Amazon. As with these popular American online-trading sites, Taobao serves as an exchange mechanism matching buyers and sellers.<sup>5</sup> We argue, however, that Taobao is far more. It has begun to develop many aspects of market infrastructure that the Chinese government has been unwilling or unable to provide;<sup>6</sup> that is, it has been forced to create law. To clarify, this is not to say that Amazon or eBay have no rules governing exchange, dispute, and fraud. Rather, the underlying legal environment in China compared to Western countries differs so considerably that online trading platforms in China must be far more developed in their legal functions than Western analogs in order to sustain a functioning market. As this legal function of Taobao has become more complex and systematic, the central government appears to have acquiesced in Taobao’s assertion of authority to experiment with various components of private law, including contracts, property rights relevant to the platform, prevention of theft and fraud, and especially the resolution of disputes.<sup>7</sup>

Taobao’s efforts to create law address a perennial problem facing most developing countries, including China: How to foster market transactions in the absence of strong formal institutions—in particular, those indispensable to the rule of law? The path for the West, which involved parliaments and independent

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3. See ALIBABA HOLDING GRP., LTD., ALIBABA FISCAL REPORT (2016) [http://www.alibabagroup.com/en/news/press\\_pdf/p160505.pdf](http://www.alibabagroup.com/en/news/press_pdf/p160505.pdf) (showing that in fiscal year 2016, Taobao hosted more than ten million active sellers and 423 million active buyers). In this paper, we use Taobao to refer to both Taobao.com and its spinoff site, Tmall.com. Alibaba owns both sites and both have nearly identical institutional arrangements. Tmall.com hosts fewer, but larger, businesses and brands because it is the business-to-consumer version of Taobao.com.

4. Thomas DiFonzo, *What is Taobao?*, WALL ST. J. (May 28, 2014), <https://www.wsj.com/video/what-is-taobao/69BD4B54-0417-4075-A54D-5FC895B5B3F3.html>.

5. *Id.*

6. See *infra* Parts I, III.B (discussing, in Part I, why the Chinese government has been unable to or unwilling to develop aspects of market infrastructure and showcasing, in Part III, how Taobao provides a private substitute for state-provided market infrastructure).

7. *Tao Bao Wang Ge Xiang Wei Gui Kou Fen Hui Zong* (淘宝网各项违规扣分汇总) [*Rules for Punishment on Taobao*], (淘宝) TAobao (Jan. 21, 2014) [hereinafter *Rules for Punishment*], <https://rule.taobao.com/detail-143.htm>.

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judiciaries, often proves to be too politically constraining to duplicate in the developing world.<sup>8</sup> The case of China's thriving online market, however, suggests that it has taken a considerably different path from that of the West.

In this Article, we propose that an alternative approach to establishing legal market infrastructure has emerged in China. We call this approach "law, Chinese style." We argue that facing tremendous political barriers to establishing legal market infrastructure, the state can effectively transfer a part of the development of law to private actors that are limited in scope. Using as context China's e-commerce market, we observe a private building of legal market infrastructure sponsored by online platforms. We argue that Taobao is not simply an exchange platform, but one in the process of developing a modern legal system that enforces contracts, resolves disputes and prevents fraud. As a private supplier of market legal infrastructure when formal institutions are lacking, Taobao essentially provides a means for creating law, Chinese style.

The development of law, Chinese style, parallels previous instances where the central government delegated reform authority during the reform period from the early 1980s through the early 1990s.<sup>9</sup> In part, our argument builds on important precedents for the private development of law when economic agents in a range of markets provided private rules and adjudication mechanisms, such as the diamond and cotton industries,<sup>10</sup> cattle ranchers,<sup>11</sup> nineteenth-century settlers on the American

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8. See SHIRK, *supra* note 1, at 333–37.

9. See *infra* Part II.

10. See Lisa Bernstein, *Opting out of the Legal System: Extralegal Contractual Relations in the Diamond Industry*, 21 J. LEGAL STUD. 115, 155–57 (1992); Lisa Bernstein, *Private Commercial Law in the Cotton Industry: Creating Cooperation Through Rules, Norms, and Institutions*, 99 MICH. L. REV. 1724, 1736–45 (2001).

11. See ROBERT ELLICKSON, *ORDER WITHOUT LAW: HOW NEIGHBORS SETTLE DISPUTES* 22–28 (1991).

frontier,<sup>12</sup> medieval merchants,<sup>13</sup> pirates,<sup>14</sup> nineteenth-century American railroads,<sup>15</sup> and stock exchanges.<sup>16</sup>

To expound the argument, we identify a parallel between the law, Chinese style that we currently observe, and “federalism, Chinese style,” that helped create markets in China’s early reforms (1980s–1993).<sup>17</sup> We argue that both serve as institutional underpinnings for markets and economic growth in the absence of a strong, public legal system. Both approaches involve the delegation of a limited set of institutional functions from the central government to certain domestic actors: in federalism, Chinese style, the central government delegated reform authority to local governments;<sup>18</sup> and in the case of law, Chinese style, the central government has in effect offloaded legal functions to platforms.<sup>19</sup> We further suggest that the political logic of delegation is consistent for both cases.

In addition to the parallels identified above, both forms of delegation involve the ability to affect the institutional structure of the state. In federalism, Chinese style, provinces gained authority to reform and change policies, but also to experiment with institutional features of the state in the form of subnational governments.<sup>20</sup> In law, Chinese style, platforms have asserted authority to affect legal institutions. One of the weak aspects of federalism, Chinese style, has been the lack of the common market condition. The central government has been unable to ensure the mobility of products and factors across provincial borders, and many of the interior provinces have erected internal trade

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12. JAMES WILLARD HURST, *LAW AND THE CONDITIONS OF FREEDOM IN THE NINETEENTH-CENTURY UNITED STATES* 3–12 (1956).

13. See AVNER GREIF, *INSTITUTIONS AND THE PATH TO THE MODERN ECONOMY: LESSONS FROM MEDIEVAL TRADE* 309–12 (2006); Paul R. Milgrom et al., *The Role of Institutions in the Revival of Trade: The Law Merchant, Private Judges, and the Champagne Fairs*, 2 *ECON. & POL.* 1, 4–6 (1990).

14. See PETER T. LEESON, *THE INVISIBLE HOOK: THE HIDDEN ECONOMICS OF PIRATES* 45–81 (2009).

15. See ALFRED D. CHANDLER, *THE VISIBLE HAND: THE MANAGERIAL REVOLUTION IN AMERICAN BUSINESS* 175–88 (1977); JAMES W. ELY, *RAILROADS AND AMERICAN LAW* 155–56 (2002).

16. EDWARD PETER STRINGHAM, *PRIVATE GOVERNANCE: CREATING ORDER IN ECONOMIC AND SOCIAL LIFE* 61–78 (2015).

17. Gabriella Montinola et al., *Federalism, Chinese Style: The Political Basis for Economic Success in China*, 48 *WORLD POL.* 50, 52 (1995).

18. *Id.* at 61–63.

19. *Id.* (detailing how different provinces had the authority to approve or deny projects that would usually require outside legal approval).

20. *Id.* at 79–81.

barriers.<sup>21</sup> As a national market, Taobao holds the promise of breaking down internal trade barriers erected by the provinces. Local governments currently lack effective means to regulate market platforms.

In Part I, we discuss the importance of legal infrastructure for the development of markets, and the common political obstacles that prevent developing states from establishing legal infrastructure. Part II discusses federalism, Chinese style, a previous phase of delegation in the early reform period. Part III provides the necessary background on Taobao, its platform operation, and its legal creation. We then, in Part IV, analyze Taobao's effect on the national common market, and on China's institutional structure of economic governance.

### I. DEVELOPMENT AND LEGAL MARKET INFRASTRUCTURE

The process of development involves building a set of legal infrastructure to support efficient markets, including commercial law, contract enforcement, and secure property rights.<sup>22</sup>

Law is central to the prevention of fraud, the resolution of disputes, and, generally, to foster agents to act within the rules. Adam Smith, the father of economics and author of the monumental *Wealth of Nations*,<sup>23</sup> recognized the importance of legal underpinnings for markets over two centuries ago. Without law, Smith explained, "men are continually afraid of the violence of their superiors, they frequently bury and conceal a great part of their stock."<sup>24</sup> Smith suggested that to solve this problem, "[l]ittle else is requisite to carry a state to the highest degree of opulence from the lowest barbarism, but peace, easy taxes, and a

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21. See Montinola et al., *supra* note 17, at 65; Chenggang Xu, *The Fundamental Institutions of China's Reforms and Development*, 49 J. ECON. LITERATURE 1076 (2011).

22. See DARON ACEMOGLU & JAMES A. ROBINSON, *WHY NATIONS FAIL: THE ORIGINS OF POWER, PROSPERITY, AND POVERTY* 70–95 (2012); Barry R. Weingast, *Adam Smith's Theory of Violence and the Political Economics of Development*, in *ORGANIZATIONS, CIVIL SOCIETY, AND THE ROOTS OF DEVELOPMENT* 51, 63–65, 74 (Naomi R. Lamoreaux & John Joseph Wallis eds., 2017); Timothy Besley and Torsten Persson, *The Origins of State Capacity: Property Rights, Taxation, and Politics*, 99 AM. ECON. REV. 1218, 1218–44 (2009).

23. 1 ADAM SMITH, *AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS* (R. H. Campbell et al. eds., Liberty Classics 1981) (1776) [hereinafter SMITH, *WEALTH OF NATIONS*].

24. *Id.* at 285.

tolerable administration of justice.”<sup>25</sup> But how is a tolerable administration of justice established?

The Western approach to legal development involved legislatures and independent judiciaries, often with jurisdiction over both public and private law.<sup>26</sup> Courts came to protect various citizen rights and are one of many checks against government predation.<sup>27</sup> These institutions—all backed by strong, explicit constitutional foundations—ultimately constrain executive discretion.<sup>28</sup>

But for developing countries, following the Western path of legal development has proven to be remarkably difficult.<sup>29</sup> The main challenge is not the lack of technical knowledge, but a variety of political obstacles that prevents developing countries from providing legal market infrastructure through formal means.<sup>30</sup> For example, Acemoglu and Robinson observe that various innovations, including a legal system, are likely to make incumbent political officials worse off (e.g., by raising the likelihood they will be replaced).<sup>31</sup> Incumbents are therefore reluctant to foster a legal system that they cannot control.<sup>32</sup> Similarly, Cox, North, and Weingast argue that, in all developing countries there exist powerful groups with the potential to threaten the regime.<sup>33</sup> Regimes typically buy these groups’ cooperation through privileges.<sup>34</sup> An effective legal system typically threatens these groups, and so they will not support it.<sup>35</sup> Therefore,

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25. DUGALD STEWART, *Account of the Life and Writings of Adam Smith, LL.D.*, in 7 THE WORKS OF DUGALD STEWART 64 (Hilliard & Brown 1829) (1827).

26. See F.A. HAYEK, *THE CONSTITUTION OF LIBERTY* 167–75 (1960).

27. See Douglass C. North & Barry R. Weingast, *Constitutions and Commitment: The Evolution of Institutions Governing Public Choice in Seventeenth-Century England*, 49 J. ECON. HIST. 803, 812–14 (1989).

28. See F.A. HAYEK, *supra* note 26, at 212–14.

29. See Barry R. Weingast, *Why Developing Countries Prove So Resistant to the Rule of Law*, in GLOBAL PERSPECTIVES ON THE RULE OF LAW 28, 50 (James J. Heckman et al. eds., 2010) [hereinafter Weingast, *Developing Countries*].

30. See *id.* at 46–49.

31. See Daron Acemoglu & James A. Robinson, *Economic Backwardness in Political Perspective*, 100 AM. POL. SCI. REV. 115, 129 (2006).

32. See *id.*

33. See Gary W. Cox et al., *The Violence Trap: A Political-Economic Approach to the Problems of Development* 1–3 (Sept. 2017) (unpublished manuscript) (on file with authors); see also Weingast, *Developing Countries*, *supra* note 29, at 46–47.

34. See Weingast, *Developing Countries*, *supra* note 29, at 50.

35. *Id.* at 46.

rulers of developing states find it difficult to establish the rule of law necessary to support thriving, competitive markets.<sup>36</sup>

Political obstacles intrinsic to the developing world lead to an undersupply of legal market infrastructure.<sup>37</sup> In the case of China, the steadfast refusal of the Chinese Communist Party (CCP) to impose direct constitutional constraints necessary for a legal system has foreclosed the Western route to legal development through an independent court system and the rule of law.<sup>38</sup> The question becomes: How to foster market growth in the absence of a strong, preexisting or newly emerging public legal system? China's path to economic development has indicated at least two potential solutions: federalism, Chinese style, which was the philosophy behind China's early reforms in the 1980s and 1990s, and law, Chinese style, the philosophy behind the changes we currently observe.

## II. FEDERALISM, CHINESE STYLE: DELEGATION AND THE ORIGINS OF CHINESE POLITICAL AND ECONOMIC REFORM, 1981–1993

In China's early reforms between the early 1980s and 1993, federalism, Chinese style, provided an institutional underpinning for China's spectacular growth in the absence of a rule-of-law system.<sup>39</sup> China's political system during this period shared much in common with Western federalism, especially that of nineteenth-century United States, as the Chinese central gov-

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36. See *id.* at 46–47; Cox et al., *supra* note 33, at 20–21.

37. This does not mean that developing countries do not have legal systems or would never engage in legal reforms. But due to the political obstacles aforementioned, their legal systems are often cumbersome, corrupt and beset with enforcement problems.

38. The Chinese government has long resisted the Western-style rule of law. For example, Zhou Qiang, head of the Supreme People's Court, made this point forcefully in a speech to legal officials: "We should resolutely resist erroneous influence from the West: 'constitutional democracy,' 'separation of powers' and 'independence of the judiciary.' . . . We must make clear our stand and dare to show the sword." Michael Forsythe, *China's Chief Justice Rejects an Independent Judiciary, and Reformers Wince*, N.Y. TIMES (Jan. 18, 2017), <https://www.nytimes.com/2017/01/18/world/asia/china-chief-justice-courts-zhou-qiang.html>.

39. See Hehui Jin et al., *Regional Decentralization and Fiscal Incentives: Federalism, Chinese Style*, 89 J. PUB. ECON. 1719, 1721–22 (2005); Montinola et al., *supra* note 17, at 51–53; Yingyi Qian & Barry R. Weingast, *Federalism as a Commitment to Preserving Market Incentives*, 11 J. ECON. PERSP. 83, 86–88 (1997).



ernment allowed provincial and local governments to have primary control over economic matters within their jurisdictions.<sup>40</sup>

The key of federalism, Chinese style, is a combination of the delegation of reform authority from the central to local governments, high-powered fiscal incentives for local governments, and active experimentation by local governments. In the following, we briefly go over each component of federalism, Chinese style.

Perhaps the most significant reform steps taken by the Chinese central government were its delegation of authority from the central to local governments. It did so in a series of steps, the first allowing Guangdong Province the ability to undertake market reform “one step ahead” of other provinces, and then allowing the latter to reform as well.<sup>41</sup> This process of decentralization granted provincial and local governments a wide range of authority within their own jurisdictions to make economic policies.<sup>42</sup> Foreign capital, for example, flowed into businesses and projects that were not controlled by the central government.<sup>43</sup>

Coupled with the delegation of authority from the central to local governments were high-powered fiscal incentives for local governments to compete with one another. The fiscal system during this period allowed provinces and lower governments to capture a substantial portion of marginal tax revenue generated within their jurisdictions.<sup>44</sup>

Starting in 1980, China implemented a fiscal revenue-sharing system between any two adjacent levels of governments. Although schemes var[ie]d across both regions and time, the basic idea [was] that a lower-level regional government contract[ed] with the upper-level regional

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40. Also in parallel with nineteenth-century American states, the Chinese reform provided a partial basis for a special kind of federalism called market-preserving federalism, which provided considerable political protection for the reforms—including limits on the central government—and produced remarkable growth. For more discussion, see Barry R. Weingast, *The Economic Role of Political Institutions: Market-Preserving Federalism and Economic Development*, 1 J.L. ECON. & ORG. 1, 21–24 (1995) (comparing, as others have done, federalism, Chinese style, with federalism in Industrial Revolution-era England).

41. See SHIRK, *supra* note 1, at 166–68; Montinola et al., *supra* note 17, at 61–63.

42. See Montinola et al., *supra* note 17, at 62–63.

43. “The total foreign investment [that] China [attracted] increased from \$4.5 billion in 1985 to \$19.2 billion in 1992 . . . [Meanwhile,] the share of foreign investment [controlled] by provinces (rather than ministries of the central government) increased from 35 percent in 1985 to 68 percent in 1992.” *Id.* at 62.

44. This system was maintained until the end of 1993, when another round of reform centralized the fiscal system. Christine P.W. Wong, *Central-Local Relations Revisited: The 1994 Tax Sharing Reform and Public Expenditure Management in China*, CHINA PERSP., Oct.–Sept. 2000, at 52, 54–55.

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government on the total amount . . . of tax and profit revenue . . . to be remitted for the next several years; the lower-level government kept the rest [of the tax and profit revenue].<sup>45</sup>

These new fiscal arrangements “induce[d] a strong positive relationship between local revenue and local economic prosperity . . . thus providing local officials with . . . incentive[s] to foster prosperity.”<sup>46</sup>

With both significant authority over their jurisdictions and considerable incentives to develop their own economies, local governments adopted political and regulatory policies that were favorable to growth.<sup>47</sup> The competition among jurisdictions for exports and growth encouraged active experimentation within each subnational unit, which facilitated policy innovation from the bottom up.<sup>48</sup> Failed experiments were terminated either by the subnational government or through bankruptcy while successful ones were scaled-up and imitated.<sup>49</sup>

The above summary of federalism, Chinese style, suggests the importance of delegation of authority by the central government in its efforts to launch the early stages of economic reform.<sup>50</sup> In this period, local governments, not the central government, undertook the major market-reform effort and engaged in

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45. Montinola et al., *supra* note 17, at 63. Most provinces and cities at the margin retained 100 percent of local revenues or nearly so. *Id.*; see, e.g., Jean C. Oi, *Fiscal Reform and the Economic Foundations of Local State Corporatism in China*, 45 *WORLD POL.* 99, 103 (1992) (describing the advent of the revenue-sharing process in China and how it allowed many localities to retain all, or most, of their revenue remainders).

46. Montinola et al., *supra* note 17, at 64. Generating a larger economy meant growing resources for subnational governments. The fiscal system therefore provided local governments with strong incentives to make economic reform succeed.

47. *See id.* at 73 (describing how successful experiments and policies were expanded).

48. *See id.* at 73–76 (demonstrating, through three cases, how experimentation led to more effective market methods).

49. *Id.* at 73. Price reforms illustrate this kind of policy experimentation. “The dual price system was a common practice in China in the 1980s, with one planned price and another market price.” *Id.* at 62. For many goods, local governments made the decision to move that good “from a dual price system to a single price system.” *Id.* Many governments used “their authority to pursue reform to liberalize the prices.” *Id.* In the case of grain prices, in 1992, Guangdong was the first province to liberalize it. *Id.* Guangdong’s success led many other provinces to follow suit. *Id.*

50. *See* SHIRK, *supra* note 1, at 127 (finding that, in order to work out economic policies, higher political authorities will delegate to lower ones); Jin et al., *supra* note 39, at 1725 (finding central governments delegate “to local governments because the later have better local knowledge”); Montinola et al., *su-*

policy experiments on which the modern Chinese economy was built.<sup>51</sup> This strategy of delegating reform authority proved advantageous to the central government for several reasons. First, no one knew in the beginning the best way to reform, and delegation to provinces and lower governments allowed multiple and independent approaches and experiments.<sup>52</sup> Once reform strategies proved successful, they could be shared with and imitated by other local governments, initially allowing many provinces to adopt a wait-and-see approach.<sup>53</sup> Second, delegation afforded the central government the opportunity of blame-ducking—that is, to disassociate itself with failures if the reform experiments did not produce results.<sup>54</sup> A massive failure to produce growth would likely have resulted in the reversal of delegation of authority by the central government.<sup>55</sup> Third, since the delegation was limited in scope, the central government was able to reap

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*pra* note 17, at 62 (stating many reform policies were delegated to local governments and provinces); Oi, *supra* note 45, at 102 (stating that the reforms had many objectives, some of which were to make local governments “fiscally self-sufficient” and reduce the central government’s fiscal burden); Qian & Weingast, *supra* note 39, at 86 (“China has emphasized economic reform through devolution of authority from the central to local governments . . .”); Weingast, *supra* note 40, at 22 (stating that China’s decentralization efforts “afford[] local governments considerable discretion over economic policy”); Xu, *supra* note 21, at 1100 (“Given that Chinese regions are alike in their economic compositions, which implies that shocks to regimes are highly correlated, by assigning similar tasks to regional officials and delegating power to them in order to carry out regional reforms, regional competition among them can serve as an effective incentive scheme.”).

51. See Montinola et al., *supra* note 17, at 74 (describing this process in Heilongjiang).

52. See SHIRK, *supra* note 1, at 336 (“Reforms were enacted in a gradual, piecemeal fashion, not according to a comprehensive plan.”).

53. See *id.* at 129 (describing the reformists as being “extremely cautious” and employing a slower approach, “taking one step forward and looking around before taking another” (internal quotations omitted)).

54. In China’s decentralized system, local officials often bear the blame for violating central spirits and policies. This explains the “hierarchical government trust” among Chinese citizens, that is, citizens on average have more trust in central government than in local governments. See Lianjiang Li, *Political Trust in Rural China*, 30 MOD. CHINA 228, 232–33 (2004) (showing how three-fourths of respondents of a survey of 1259 people trusted central government more than local government); Zhengxu Wang, *Before the Emergence of Critical Citizens: Economic Development and Political Trust in China*, 15 INT’L. REV. SOC. 155, 158 (2005) (stating that a survey conducted in China from 1999–2001 found that “a total of 81 percent of the respondents expressed ‘relatively high’ or ‘very high’ levels of trust in the central government”).

55. See SHIRK, *supra* note 1, at 121 (finding that, in the 1980s, “[p]roblems that once were solved at lower levels” were escalated to higher levels of government).

the economic benefits without losing political grip.<sup>56</sup> The delegated authority focused on economic reform and did not extend to political reform.<sup>57</sup> Provinces did not in effect become new, independent nations, and their continued authority depended on the success of the reforms.<sup>58</sup>

This important precedent helps us to understand the political logic underlying law, Chinese style, which also involves implicit delegation of authority from the central government. In both cases—federalism, Chinese style, and law, Chinese style—delegation allowed actors other than the central government to engineer reform. Further, in both cases, the presence of competition—other subnational governments in the early reforms; other platforms in the current era—led these actors to provide institutional infrastructure for markets in the absence of a strong, state-run legal system.

### III. TAOBAO AND LAW, CHINESE STYLE

Recently, there has been an additional movement to develop institutional infrastructure for markets. We call this new effort law, Chinese style. Similar to the reform period during the 1980s, law, Chinese style, also depends upon delegation.<sup>59</sup> The difference is that in the present circumstances the central government has allowed specific private actors, rather than provinces, to play a substantial role in the development of market infrastructure, especially, legal infrastructure. This development is limited in scope and focuses on e-commerce.<sup>60</sup> It also interacts with the ongoing process in China aimed at producing elements of a body of e-commerce law.<sup>61</sup>

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56. See *id.* at 117 (describing that “leaders loathe to lose the advantages of delegation” and “do not want to alienate their bureaucratic constituents”).

57. See *id.* at 118 (“The Chinese government has been making economic policies according to delegation . . . at least since the early 1980s.”).

58. See *id.* at 335 (finding that Chinese-style economic reform embodied the transferring of power from higher levels of government to lower levels, generating extensive economic growth).

59. See generally John Ohnesorge, *Chinese Administrative Law in the Northeast Asian Mirror*, 16 *TRANSNAT’L L. & CONTEMP. PROBS.* 103, 111 n.24 (2006) (noting that delegation of authority in investment law occurred in China).

60. See Jörg Binding & Kai Purnhagen, *Regulations on E-Commerce Consumer Protection Rules in China and Europe Compared—Same Same but Different?*, 2 *J. INTELL. PROP. INFO. TECH. & ELEC. COM. L.* 186, 193 (2011) (“China . . . increasingly recognizes private regulatory mechanisms to govern the e-commerce market.”).

61. First, the state has incorporated components of Taobao’s platform rule

Importantly, law, Chinese style, serves as an alternative route to legal development that is much less politically constraining for the central government than the Western approach, and yet it is still effective to foster market growth. Taobao is one of those private actors that is in the process of developing a modern legal system that enforces contracts, resolves disputes, and prevents fraud. For all of its users, Taobao's system functions in places where the Chinese law is inadequate.

#### A. EVOLUTION OF LAW, CHINESE STYLE

Law, Chinese style, had emerged in the context of looming tensions between two primary stances of the Chinese government: (1) an unwavering devotion to economic development,<sup>62</sup> and (2) an unremitting refusal to create the institutions typically associated with the rule of law.<sup>63</sup> These two ideas conflict because, scholars argue, fostering long-term economic prosperity requires the rule of law.<sup>64</sup> The rule of law as part of market infrastructure has come to matter more, especially as China's

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into its own regulations on online trading. A case in point is its return policy, which gives consumers the right to return any commodities within seven days of receipt, without cause. This policy was first made and enforced by Taobao on its clothing category. Telephone Interview with a Taobao employee (June 1, 2017). In 2014, this regulation was recognized as an industry standard, and written into Article 16 of The Administrative Measures for Online Trading released by the State Administration for Industry and Commerce. Second, China Electronic Commerce Association (CECA)—a business alliance that represents the interests of e-commerce companies including Alibaba—was authorized by the state to complete one of the four draft proposals of the e-commerce law. See *Qian Fang Li Zhu Ren Tan Dian Zi Shang Wu Fa: Yi Lie Ru 2016 Nian Li Fa Ji Hua* (蹇芳莉主任谈电子商务法：已列入 2016 年立法计划) [*Director Fangli Qian Talked About the E-Commerce Law: It Has Been Included in the 2016 Legislative Work Plan*], MINISTRY COMM. CHINA (中华人民共和国商务部) (Mar. 14, 2016), <http://www.mofcom.gov.cn/article/shangwubangzhu/201603/20160301274283.shtml>. The practice of allowing the business alliance to make a draft proposal of a national law is very rare in China. See Lizhi Liu, *From Click to Boom: The Political Economy of E-Commerce in China* (2018) (unpublished Ph.D. dissertation, Stanford University) (on file with authors).

62. Economic development has long been a key government priority, as it generates not only economic and fiscal resources but also performance-based legitimacy for the authoritarian state. See Hongxing Yang & Dingxin Zhao, *Performance Legitimacy, State Autonomy and China's Economic Miracle*, 24 *J. CONTEMP. CHINA* 64, 82 (2015) (discussing how "the state's performance-based legitimacy compels the government to keep its focus on promoting economic development").

63. See generally Eric W. Orts, *The Rule of Law in China*, 34 *VAND. J. TRANSNAT'L L.* 43, 59–64 (2001) (describing generally how China has instituted the rule of law in recent years).

64. See, e.g., DOUGLASS C. NORTH, *INSTITUTIONS, INSTITUTIONAL CHANGE,*

economy has become more complex and integrated.<sup>65</sup> This is because, first, China has gradually shifted away from a state-led, investment-driven economy.<sup>66</sup> The rule of law helps consolidate a fair business environment for market economy to develop,<sup>67</sup> one with considerably less opportunism. Second, the lack of the rule of law disproportionately hurts the growth of private businesses (small- and medium-sized enterprises in particular),<sup>68</sup> which constitute the main driver of China's economic growth.<sup>69</sup> But, as we argued in Part I, the authoritarian government has been unwilling to establish a rule-of-law system, as a strong legal system involves a variety of mechanisms that will inevitably limit the central government's power.<sup>70</sup>

In the absence of a strong public legal system, private actors have begun to provide substitutes. The central government has acquiesced to the authority exercised by private actors to create

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AND ECONOMIC PERFORMANCE 111 (1990) ("We have long been aware that tax structure, regulations, judicial decisions, and statute laws . . . determine specific aspects of economic performance."); Ronald Coase, *The New Institutional Economics*, 88 AM. ECON. REV. 72, 73 (1998) (finding that costs of exchange—which specialization and the larger productivity of the economic system depend on—is rooted, in part, in the legal system); Dani Rodrik et al., *Institutions Rule: The Primacy of Institutions over Geography and Integration in Economic Development*, 9 J. ECON. GROWTH 131, 149 (2004) (noting some scholars "argue that the legal system historically adopted in a country . . . has an important bearing on the development of institutions and hence on income levels").

65. See *id.* at 63 (describing how China has created certain statutes "represent[ing] a concerted effort by the government to adopt a modern legal framework to support a market economy").

66. See SHIRK, *supra* note 1, at 335 ("[T]he Chinese strategy effectively moved the country from central planning to partial marketization.").

67. See Orts, *supra* note 63, at 69 ("[China] has committed itself to a strong effort to establish a modern legal regime marked by relatively stable rules to allow China's emerging market economy to flourish.").

68. Too often these enterprises lack the resources and political ties to advance their interests. See Yuen Yuen Ang & Nan Jia, *Perverse Complementarity: Political Connections and the Use of Courts Among Private Firms in China*, 76 J. POL. 318, 319 (2014) (finding that these firms traditionally depend on "personal ties with bureaucratic patrons for economic survival").

69. See Zheng Song, *Growing like China*, 101 AM. ECON. REV. 196, 200–01 (2011) (describing how private sector development has fueled China's fast and stable growth).

70. See, e.g., Daron Acemoglu et al., *Institutions as a Fundamental Cause of Long-Run Growth*, in HANDBOOK OF ECONOMIC GROWTH 385, 461 (Philippe Aghion & Steven N. Durlauf eds., 2005) (describing that repression "is still the preferred option for current political elites in China"); Douglass C. North & Barry R. Weingast, *Constitutions and Commitment: The Evolution of Institutions Governing Public Choice in Seventeenth-Century England*, 49 J. ECON. HIST. 803, 814–17 (1989) (describing the beginnings of the rise—and supremacy—of the rule of law over the king during England's Glorious Revolution).

markets with rule-of-law characteristics. An important feature of the delegation of the development of law, Chinese style, is that the reach of this law is limited in scope to the traditional areas of private law: property, contracting, and, perhaps, torts. The private provision of private law, therefore, allows the central government to foster experiments in law as it relates to the economy while lowering the probability that this form of legal system will challenge the central government in the area of public law, such as citizen rights.

This implicit delegation helps conquer the technical complexities in building a workable legal system. The current delegation parallels the delegation of many reforms earlier in the process of marketization, such as allowing Guangdong Province to reform markets by being “one step ahead,” as we discussed in Part II. As with these earlier reforms, the central government’s delegation to create law also allows it to stand above the provision of services, in part, to allow multiple experiments and, in part, so that it is not directly responsible for any failures of the system. Delegation allows the central government to distance itself from any public dissatisfaction that may arise and, if need be, curtail failing experiments.<sup>71</sup> Private actors, on the contrary, bear the risk of failure and buffer the tensions that could have been directed towards the state;<sup>72</sup> but they also reap the profits if the experiments succeed.

Enter Taobao.

#### B. TAobao CREATES A MARKET

Since its launching in 2003, Taobao has been growing at a stunning rate. By fiscal year 2016, Taobao has already hosted more than ten million active sellers and 423 million active buyers.<sup>73</sup>

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

72. For example, in 2010, around three hundred sellers initiated a physical protest against Taobao. They gathered in front of Alibaba’s headquarter in Hangzhou with banners. See *Sellers Protest Against Taobao*, PEOPLE’S DAILY ONLINE (July 14, 2010), <http://en.people.cn/90001/90778/90860/7065181.html> (stating that protesters fought against new rules because the rules resulted in order losses and traffic plunges).

73. Press Release, Alibaba Group, Alibaba Group Announces December Quarter 2016 Results, at 31 (Jan. 24, 2017), [http://www.alibabagroup.com/en/news/press\\_pdf/p170124.pdf](http://www.alibabagroup.com/en/news/press_pdf/p170124.pdf); Press Release, Alibaba Group, Alibaba Group Announces March Quarter 2016 and Full Fiscal Year 2016 Results, at 1 (May 5,

With respect to Gross Merchandise Value (GMV),<sup>74</sup> Taobao currently surpasses Amazon and eBay combined.<sup>75</sup> As of May 2017, Rural Taobao—a rural expansion initiative—has also opened over 30,000 e-commerce service points in remote villages, many of which had no prior access to commercial parcel delivery.<sup>76</sup> These service points afford access to those without online payment methods or who are not internet savvy.<sup>77</sup>

The most fundamental service Taobao provides is access to a market supported by a private legal system in the process of developing the rule of law.<sup>78</sup> Taobao has the means to create law, Chinese style, because it is a private supplier of legal infrastructure for its market and users when the state-run legal institutions are weak.<sup>79</sup> Of course, to gain the protection of this legal infrastructure, traders must join and trade using Taobao. For its users, Taobao can provide private institutions to enforce contract, resolve disputes, and prevent fraud.<sup>80</sup> Private legal institutions partially explain why platforms dominate e-commerce retailing in China but not in the United States. In the United States, where the strong legal environment makes the substituting effects of platforms less necessary, retailers can sell their goods and services directly through their own websites. But as we noted earlier, the absence of a legal system makes the same approach in China riskier. Consistent with this view, platforms in 2011 accounted for ninety percent of the e-commerce retailing

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2016), [http://www.alibabagroup.com/en/news/press\\_pdf/p160505.pdf](http://www.alibabagroup.com/en/news/press_pdf/p160505.pdf).

74. GMV is the total value of merchandise sold through an exchange site over a given period of time. It is a measure of the size of an online market.

75. See generally R. J. HOTTOVY ET AL., MORNINGSTAR EQUITY ANALYST REPORT: ALIBABA GROUP HOLDING LTD (2015), [https://invest.firsttrade.com/ms/equity\\_reports/sr/0P00013K81\\_20151009\\_RT.pdf](https://invest.firsttrade.com/ms/equity_reports/sr/0P00013K81_20151009_RT.pdf) (providing data and analyses of Taobao's parent company).

76. See *Nong Cun Tao Bao Fu Gai Yi Chao 3 Wan Ge Cun, Fan Xiang Chuang Ye Xian Gun Xue Qiu Xiao Ying* (农村淘宝覆盖已超 3 万个村, 返乡创业现滚雪球效应) [*Rural Taobao Has Covered over 30,000 Villages; Snowball Effect of Entrepreneurship Among Return Migrants*], ALI RESEARCH INST. (阿里研究院) (Mar. 21, 2017), <http://mp.weixin.qq.com/s/xoYep2mtWmlXWUqZWzbLAg>.

77. Each service point has a manager to help villagers conduct e-commerce. Villagers can buy and sell products through the manager's online account. They can also pay in cash when the products arrive at the store for pickup. In this way, the villagers who do not have online accounts or the technical know-how can use e-commerce. Information obtained from fieldwork in Donghan Village of Mengzhou, a county-level city of Henan Province, August 8, 2015.

78. Lizhi Liu & Barry R. Weingast, *Law, Chinese Style: Solving the Authoritarian's Legal Dilemma Through the Private Provision of Law 13* (Aug. 2017) (unpublished manuscript) (on file with authors).

79. *Id.*

80. See discussion in Part III.C.



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market in China and only twenty-four percent of e-commerce retailing in the United States.<sup>81</sup> The demand for Taobao's legal and trading services is bigger in China than it would be in a rule-of-law country.

### C. TAobao'S PRIVATE LEGAL SYSTEM

We now draw on our earlier work<sup>82</sup> to address how Taobao's private legal system works in the absence of strong formal institutions administered by the state. Taobao's private legal system is comprised of institutions that address various types of problems associated with market transactions. In this Section, we focus on how Taobao addresses three major problems intrinsic to trade: (1) contract enforcement; (2) fraud prevention; and (3) dispute resolution.

#### 1. Contract Enforcement Through Institutionalized Reputation Mechanisms: The Online Rating System

Traders throughout human history face a similar problem regarding contract enforcement known as the assurance problem; when trading parties strike a deal, how do they ensure that each party honors the agreed upon terms? The assurance problem is especially acute when an exchange is a two-step process in which one party to the contract has performed her obligations and awaits the second party to perform his. States in the developed West foster two complementary classes of mechanisms to enforce contracts. The first involves a legal system with the power to sanction individuals for breach of contract. The second involves reputation mechanisms whereby other market participants shy away from doing business with those individuals or firms who develop reputations for fraud, cheating, opportunistic behavior, et cetera. The threat of sanctions is therefore only one piece of contractual enforcement, and is not necessary for a legal system to prevent contractual problems.<sup>83</sup>

Taobao's online feedback and rating system is at the center of Taobao's attempt to mitigate the assurance problem. As with

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81. See Liu & Weingast, *supra* note 78, at 13.

82. See *id.*

83. Hadfield and Weingast explore these ideas in their What Is Law project. See Gillian K. Hadfield & Barry R. Weingast, *Law Without the State: Legal Attributes and the Coordination of Decentralized Collective Punishment*, 1 J.L. & CTS. 3 (2013); Gillian K. Hadfield & Barry R. Weingast, *What Is Law? A Coordination Model of the Characteristics of Legal Order*, 4 J. LEGAL ANALYSIS 1 (2012).

other online trading systems, such as eBay, Taobao's rating system creates incentives for all trades to maintain a good reputation.<sup>84</sup> But Taobao's system goes well beyond that used by eBay and Amazon. Taobao's rating system consists of two main parts: (1) credit rating (a rating for buyer or seller over the entire past history); and (2) store rating (a rating for sellers).<sup>85</sup> To capture the changing dynamics of service quality, Taobao uses store rating to complement credit rating for sellers.<sup>86</sup> The store rating is based on three aspects of the seller over the past six months: (1) the accuracy of product description; (2) customer service; and (3) shipping time.<sup>87</sup> In addition to the overall reputation of sellers, buyers can also check all past reviews of each product.<sup>88</sup> Information about the reliability of trading partners is thus central to policing Taobao's market exchange system.

Taobao's fraud prevention program,<sup>89</sup> which we will discuss next, allows users to have access to reliable information that addresses some of the fear inherent in commercial transactions. Further, relevant punishment is enforced through an escrow system embedded in Alipay,<sup>90</sup> which we discuss below. Because the Chinese legal system is weak and cumbersome, state-sponsored sanctions are not central to Taobao's enforcement mechanisms. Taobao has therefore been forced to enhance the power of other forms of enforcement, such as Alipay and various forms of ratings and reputation mechanisms.

## 2. Fraud Prevention Through Risk Framework: Big Data, Manual Review and State Coercion

Fraud must be limited, lest trade stalls. Fraud in online markets includes online payment fraud, account hacks, attempts to manipulate online reviews, and counterfeit products.<sup>91</sup> To

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84. See Liu & Weingast, *supra* note 78, at 15.

85. See *id.*

86. See *id.* at 16.

87. See *id.*

88. See *id.* Nonetheless, the rating system still suffers from multiple limitations. For example, sellers can manipulate reviews by placing fictitious orders to inflate ratings, or they can take fraudulent actions that hurt competitors' reputations.

89. See *infra* Part III.C.2.

90. See *infra* Part III.C.4.

91. Jidong Chen et al., *Big Data Based Fraud Risk Management at Alibaba*, 1 J. FIN. & DATA SCI. 1, 2 (2015).

help identify fraud, Taobao utilizes big-data analytics and manual review to identify suspicious cases.<sup>92</sup> Taobao's system relies on a high volume and variety of information generated by the platform (e.g., user behavioral data, network data, delivery details, and IP addresses).<sup>93</sup> The trove of proprietary data enables Taobao to use big-data models to detect suspicious activities and to counter fraud risks.<sup>94</sup> Manual review assists big-data analytics.<sup>95</sup> For example, consider how this system would handle online payment fraud. Taobao uses five layers of checks to identify fraud beginning with account check—a process that leverages big-data analytics to examine account information of both the seller and the buyer, including whether these accounts have exhibited suspicious activities—and ending with manual review, if necessary.<sup>96</sup>

After detecting a case of fraud, Taobao can punish fraudulent behavior through online and offline means. Online, Taobao can lower the user's rating, make the fraudulent store unsearchable for a certain period, or, in extreme cases, ban the accounts.<sup>97</sup> A party who deems the judgment to be unfair can appeal to Taobao.<sup>98</sup> Offline, Taobao has cooperated with the state police. For example, to combat counterfeit products fraud at its source, Taobao uses its massive datasets (e.g., shared phone numbers, chat histories, product return and delivery addresses) to track the location of offline warehouses and producers involved in counterfeiting.<sup>99</sup> Taobao has shared this location information with the police and has helped them arrest suspects who produce and sell counterfeits.<sup>100</sup> In 2014 alone, Alibaba's collaboration

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92. *See id.* at 3–4.

93. *See id.*

94. *See id.*

95. *See id.*

96. *See id.* Obvious fraud cases are immediately sent for auto-decision (i.e. machine automatically decides on the case). *Id.* at 4. If the case is suspicious but not obvious enough for auto-decision, the case will enter the next layer of checks. *Id.* From layer 1 to layer 4, the fraud risk management system checks different information of the transaction. *Id.* Borderline cases after four layers of checks are sent to the fifth layer, manual review, in which Taobao employees may phone the involved parties to get additional information. *Id.*

97. *See Rules for Punishment, supra* note 7.

98. Users can appeal to Taobao through the Complaint Center (申诉中心) in the Taobao system.

99. Taobao was able to track these producers because it has business connections with its online sellers.

100. *See* Catherine Shu, *Alibaba Removed 90M Suspicious Listings from Its Sites Before IPO*, TECHCRUNCH (Dec. 23, 2014), <https://www.techcrunch.com/2014/12/23/alibaba-listings-purge>.

with the state enforcement agencies in over one thousand counterfeiting cases led to the arrest of four hundred suspects and the shut-down of two hundred brick-and-mortar stores, warehouses or factories.<sup>101</sup> Although the state apparatus suffers from many liabilities, such that it is slow, cumbersome, and can be highly corrupt, the state can help in punishment of the most egregious traders.

### 3. Dispute Resolution Through Crowd-Sourcing Justice: User Dispute Resolution Center

Dispute resolution is an indispensable aspect of a workable legal system. Every functioning market needs mechanisms to handle disputes. Taobao resolves two types of disputes: (1) disputes between pairs of market participants (e.g., a seller and a buyer; or two competitors); and (2) disputes between market participants and Taobao, as embodied in its function as market owners or regulators. When a dispute occurs, the party initiating the case may choose from two channels: (1) asking a designated Taobao employee to adjudicate, or (2) using a jury-like panel of public assessors to arbitrate.<sup>102</sup> Launched in 2012, Taobao's User Dispute Resolution Center, which we call a jury-like system, has been crowd-sourcing minor, everyday disputes to an online panel of jurors.<sup>103</sup> Most of these disputes are of two types: (1) buyer-seller disputes, which often involve contract violations (e.g., complaints about items received that fail to match store descriptions); and (2) platform-seller disputes in which a seller believes that Taobao has unfairly penalized it for violating certain rules.<sup>104</sup>

In the jury system, Taobao chooses thirteen public assessors randomly from a pool of nearly two million volunteers.<sup>105</sup> Taobao selects these assessors from experienced users who have volunteered to serve.<sup>106</sup> Qualified candidates for the public-assessor

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101. *See id.*

102. Telephone Interview with a Taobao employee, *supra* note 61.

103. Jim Erickson, *How Taobao Is Crowdsourcing Justice in Online Shopping Disputes*, ALIZILA (July 17, 2014), <http://www.alizila.com/how-taobao-is-crowdsourcing-justice-in-online-shopping-disputes>.

104. Telephone Interview with a Taobao employee, *supra* note 61.

105. In 2016, the total number of jurors for a panel was reduced from thirty-one (sixteen votes will win the case) to thirteen (seven votes will win the case). *Id.*

106. *See Tao Bao Jiao Yi Yin Ru Da Zhong Ping Shen Yuan Ji Zhi* (淘宝交易引入大众评审员机制) [*Taobao Transactions Introduced the System of Public Assessors*], HANGZHOU DAILY (杭州日报) (Dec. 31, 2013) [hereinafter *Taobao*].

pool must have high reputations based on Taobao's system of rating.<sup>107</sup> The public assessors' principal responsibility is to review the evidence submitted by disputing parties and then vote within forty-eight hours.<sup>108</sup> The public assessors decide which party wins by a simple majority vote.<sup>109</sup> This system allows Taobao to address a large and growing number of complaints. As of March 29, 2018, 2,028,307 public assessors have resolved 2,632,553 disputes in total.<sup>110</sup>

Importantly, Taobao has several means of enforcing decisions from both employee adjudicators and public assessors. Taobao can freeze the payment in dispute, take money from the store deposit (for sellers only), lower the rating of the users involved, or deny the losing party's privileges to use the platform.<sup>111</sup>

#### 4. Supporting Institutions: Payment and Escrow

"Taobao's private legal system . . . relies on several supporting institutions. Although these institutions do not specifically address any of the major issues in trade (i.e., contract, fraud, and dispute), they ensure that platform rules are interconnected, adaptable, and easier to enforce."<sup>112</sup> Alipay, in particular, is an important part of the Taobao system.<sup>113</sup> Alipay provides online payment and escrow services.<sup>114</sup> Alipay works similarly to PayPal, except that Alipay also provides escrow service.<sup>115</sup> Escrow

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*Transactions*], [http://hzdaily.hangzhou.com.cn/hzrb/html/2013-12/31/content\\_1648670.htm](http://hzdaily.hangzhou.com.cn/hzrb/html/2013-12/31/content_1648670.htm).

107. See *Ali Zhao Kai Hu Lian Wang Da Hui, Bai Wan Da Zhong Ping Shen Liang Xiang* (阿里召开互联网志愿者大会, 百万大众评审亮相) [*Alibaba Held the Internet Volunteers Conference, Millions of Public Assessors Debut*], IWANGSHANG (天下网商) (Oct. 12, 2016), <http://www.iwshang.com/Post/Default/Index/pid/247679.html>.

108. See *Taobao Transactions*, *supra* note 106.

109. Communication is prohibited between disputing parties and the anonymous assessors as well as among assessors. Assessors also provide written comments about this case. If unsatisfied with the jury decision, a disputing party can request Taobao employees to intervene and reexamine the case. Telephone Interview with a Taobao employee, *supra* note 61.

110. Ali Da Zhong Ping Shen (阿里大众评审) [*Alibaba Public Assessors*], TAOBAO (淘宝), <http://pan.taobao.com> (last visited Apr. 26, 2018).

111. Telephone Interview with a Taobao employee, *supra* note 61.

112. See Liu & Weingast, *supra* note 78, at 20–21 (discussing two additional mechanisms: sesame credit scores and the House of Representatives, a system that allows qualified users to participate in rule changes).

113. See *id.*

114. See *id.*

115. See *id.* at 16.

service means that the buyer's payment for each order is held by Alipay until the goods are received, and the funds are released only when both trading parties are satisfied with the transaction.<sup>116</sup>

While Alipay does not enforce contracts on its own, its escrow service enhances Taobao's enforcement capability. Alipay can directly freeze or deduct from the money that a user has in her account if she violates platform rules.<sup>117</sup> When a dispute over a trade arises, Alipay can freeze the payment in escrow, forcing feuding parties to choose between losing the money or engaging in, and complying with, Taobao's dispute resolution system.<sup>118</sup> Thus, Alipay supports Taobao's legal system because it provides a means of enforcement of decisions and a means of forcing people to operate within the system.

#### IV. TAOBAO AND THE EVOLUTION OF FEDERALISM, CHINESE STYLE: RECENTRALIZATION

The preceding Parts allow us to draw a parallel between law, Chinese style, and federalism, Chinese style. Both approaches involve delegation of central government authority to particular domestic actors with a limited scope; both serve as institutional bases for markets in a weak-rule-of-law environment; and both induce the domestic actors to experiment with policies and rules that can help foster growth.

Despite the similarities between federalism, Chinese style, and law, Chinese style, the two sets of delegation differ considerably in how they affect the national common market. Taobao has helped foster a common, national market, which did not happen in the initial model of federalism, Chinese style.<sup>119</sup> Earlier reform efforts did not support the national market because the central government was unable or unwilling to ensure the mobility of factors (such as capital and labor) and products across regions.<sup>120</sup> First, federalism, Chinese style, was an entirely of-line movement.<sup>121</sup> Second, as we will argue in this Part, local

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116. *See id.*

117. Telephone Interview with a Taobao employee, *supra* note 61.

118. *Id.*

119. *See* Montinola et al., *supra* note 17, at 65–66 (describing that the failure in the common market condition leads to a scenario in which local governments erect trade barriers).

120. *See id.* (providing examples of obstacles to internal factor mobility).

121. *See supra* note 40 and accompanying text (comparing Chinese federalism to nineteenth-century federalism in the United States).

governments are less able to resist and reverse a common market achieved online than one formed offline. This Taobao-induced process of market integration has political implications. Because Taobao has provided a potential instrument for the center to strengthen its ability to monitor and discipline local powers, it may influence the power balance between the central and local governments in favor of the former.

#### A. DECENTRALIZATION AND THE INCOMPLETE COMMON MARKET

Since its inception, federalism, Chinese style, has lacked a common market, because the Chinese national government does not have an effective means to police the internal common market—that is, to ensure the mobility of goods and factors across subnational jurisdictions.<sup>122</sup> The absence “explains in part why many local governments have focused on trade barriers and aggressive antimarket policies within their jurisdiction.”<sup>123</sup> Alternatively stated, decentralization of authority creates the incentives and political means for the local governments to erect trade barriers. In the absence of an effective central means to contain local protectionism, many problems occur, including localized corruption and patronage networks and beggar-thy-neighbor policies.<sup>124</sup> This is especially true of interior provinces that have had only limited participation in reform and exports.<sup>125</sup>

The common-market condition is difficult to achieve. While the central government retains important personnel control over local governments,<sup>126</sup> local governments can resist a common market through multiple means: for example, (1) by not fully implementing central policies (such as policies in which the local governments are the main enforcers);<sup>127</sup> and (2) by misrepresenting the information about central policy implementation (be-

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122. *See id.* at 55 (describing national authority to ensure factor mobility as a “principal characteristic” of “market-preserving federalism”).

123. *Id.* at 53.

124. *See id.* at 58 (“Market-preserving federalism . . . diminishes the prevalence of rent-seeking and patronage systems.”); Xu, *supra* note 21, at 1134 (“[P]rotectionism can eventually lead to serious political problems, such as disintegration of the country.”).

125. *See* Xu, *supra* note 21, at 1137 (discussing growing urban-rural disparities that some attribute to decentralization).

126. *See id.* at 1082.

127. *See id.* at 1095 (describing local government discretion in policy implementation).

cause, for example, local governments enjoy information advantages over the center).<sup>128</sup>

Federalism in China has not guaranteed a common market. In a decentralized fiscal and economic system, local governments have to compete for scarce capital and labor and for fiscal revenues.<sup>129</sup> In addition, provinces in China have had to compete for business on the international market, as the Chinese economy has long been export-driven.<sup>130</sup> These two sources of political and economic competition—among lower jurisdictions and on the international market—have generated the incentives for China’s economic growth; they have also created problems for the rise of a national common market.<sup>131</sup> In the absence of a central authority to ensure factor mobility, decentralization may, in fact, hinder the creation of a common market, putting economies of scale in peril.

#### B. TAOBAO AND THE FORMATION OF A COMMON MARKET

While the central government in China has struggled to create and support a national market, Taobao has been able to foster a common market for the exchange of certain products and services. Taobao’s system facilitates market integration for two reasons. First, Taobao lowers the entry barrier to the national market, facilitating interprovincial trade. In particular, it allows small or rural sellers and buyers to participate in the national market, access that they otherwise would not enjoy in the offline setting.<sup>132</sup> This development parallels the access to markets in mid- and late-nineteenth-century United States when mail-order catalogs greatly expanded rural citizens’ access to consumer goods, and at far lower prices.<sup>133</sup> Second, Taobao has strong

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128. *See id.* at 1079.

129. *See* Montinola et al., *supra* note 17, at 58.

130. *See id.* at 76–77 (discussing examples of competition among regional governments).

131. *Id.* at 59.

132. The “Rural Taobao” Program aims to grant e-commerce access to one thousand counties and one-hundred thousand villages in the next three to five years. *Make a Better Rural China*, ALIBABA GRP., <http://www.alibabagroup.com/en/ir/pdf/160614/09.pdf> (last visited Apr. 26, 2018). By the end of March 2016, the project had covered 14,000 villages. ALIBABA GRP. HOLDING LTD., ANNUAL REPORT 60 (Form 20-F) (2016).

133. *See* DAVID BLANKE, *SOWING THE AMERICAN DREAM: HOW CONSUMER CULTURE TOOK ROOT IN THE RURAL MIDWEST* 186 (2000) (describing mail-order catalogs’ role in integrating rural consumers into the mass market); CHANDLER, *supra* note 15 at 209, 230–33 (same).



vested interests in keeping the platform free of trade and regulatory barriers across regions, so as to facilitate market exchange.<sup>134</sup> No matter whether a seller or buyer lives in Beijing or Tibet, she is governed by the same set of platform rules.

As a result, Taobao facilitates the cross-regional mobility of goods and capital. It intensifies national economic competition, and it breaks down monopolies, such as physical stores benefiting from geographical isolation and internal trade barriers.<sup>135</sup> All of this creates a virtuous circle. The larger market increases the demand for market infrastructure, such as roads, power plants, railway lines, electric power, and so on.<sup>136</sup> The improvement of infrastructure, in turn, facilitates the rise of a national common market.

Local governments have limited means to resist or reverse these advances in the common market achieved by online exchange. First, Taobao's private market infrastructure is independent of those provided—or restrained—by local governments. Taobao's system is largely self-sufficient.<sup>137</sup> Even if local governments want to intervene and regulate the online market, they need to first address a coordination problem among themselves. For example, consider a situation where a seller lives in Beijing, her factory is in Hebei, and she has a dispute on Taobao with a buyer in Guangdong. Which local government should take the lead to address the dispute, and how do they coordinate with the other local governments who may or may not agree with the lead government's decisions?<sup>138</sup> This confusion makes it difficult for provinces to hinder or restrict Taobao.

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134. Cf. Montinola et al., *supra* note 17, at 65 (describing how regional protection impedes the exchange of manufactured goods).

135. Facing strong competition from online stores, the physical stores that previously benefited from geographical isolation can no longer reap monopoly rents. Again, this is analogous to the development of mail-order catalogs in the nineteenth-century United States. See CHANDLER, *supra* note 15, at 233 (describing rural retailers' opposition to legislation that would advantage mail-order catalogs).

136. As Taobao fosters market development—for example, by lowering the costs of production in rural provinces—it facilitates the growth of enterprises seeking to participate in markets beyond their locality. As more enterprises participate in the national market, and as more commodities are exchanged nationwide, there will be a greater demand for infrastructure. See Montinola et al., *supra* note 17, at 58 (noting that a national market promotes competition, inducing regional jurisdictions to provide infrastructure).

137. See *supra* Part III.C.

138. This problem is actually a consequence of federalism. For example, the railroads raised similar problems with regulation in the nineteenth-century American common market. See ELY, *supra* note 15, at 90–93 (discussing the

Additionally, Taobao creates an information barrier for local governments. Local governments have scant information about the online market,<sup>139</sup> and they do not have sufficient power to bargain for full information against a transcendent platform. For example, if local governments do not know who within their jurisdictions is selling and buying, those transactions are difficult to tax and regulate. This lack of information makes it difficult for local governments to tax and regulate online platforms.

Taobao's market platform therefore seems a potentially important mechanism for improving the common market. Because local governments have great difficulty regulating national market platforms, Taobao and similar platforms provide a means around internal trade barriers. The platforms may, therefore, allow a wide range of products to take advantage of economies of scale that trade barriers had prevented.<sup>140</sup> Further, market exchange on platforms enhances interprovince competition.<sup>141</sup> Local firms, protected under internal trade barriers, often cannot survive competition in a common market.<sup>142</sup>

### C. TAOBAO AND RECENTRALIZATION

As shown above, in its politically and economically decentralized system, China's central government has faced, and continues to face, difficulties in policing the internal common market. But Taobao raises the possibility for the central government to use Taobao as an indirect means to monitor and discipline local governments.<sup>143</sup> Indeed, Taobao and its parent company, Alibaba, have started to collaborate with the central government on a variety of issues, including credit scoring, poverty reduction,

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origins of federal railroad regulation).

139. Interview with a City Government Official, Suzhou City, Jiangsu Province (Aug. 26, 2014); Interview with a Township Government Official, Shaji Township, Jiangsu Province (Aug. 26, 2014).

140. See Barry R. Weingast, *Second Generation Fiscal Federalism: The Implications of Fiscal Incentives*, 65 J. URB. ECON. 279, 281 (2009) (noting the role of trade barriers in hindering factor mobility).

141. See *id.* at 281–82 (describing the benefits of competition between sub-national governments).

142. See *id.*; cf. Montinola et al., *supra* note 17, at 66 (noting that, in the absence of trade barriers, market pressure makes it difficult to sustain local governments' corrupt activity).

143. Two assumptions underlie this suggestion: (1) central and local governments are in a constant tug-of-war over information and power; and (2) because Taobao prefers large to small markets, it favors collaborating with the center against local authorities, rather than the other way around. See *infra* note 144.

and e-government.<sup>144</sup>

Taobao helps strengthen central authority in three ways. First, as a powerful, centralized tool of collecting market information, Taobao can reduce, and even reverse the information disadvantage of the central government, which has limited information about economic activity. In the past, the central government has had to rely on economic data provided by the local governments, but local governments are known for faking economic numbers.<sup>145</sup> Online transaction data, in contrast, can provide a real-time, objective barometer about a region's economic vitality. For example, Alibaba invented Alibaba Shopping Price Index (aSPI), an index based on the price changes of a particular basket of goods and services.<sup>146</sup> The index can be used as an alternative to the central government's consumer price index to reflect real-time inflation and price fluctuations.<sup>147</sup> Increasingly, there will be more data collaboration between Alibaba and the central government, including the establishment of a national credit-information-sharing platform.<sup>148</sup>

Second, Taobao helps enforce central policies and provide public goods, including poverty alleviation and rural develop-

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144. For collaboration on credit scoring, see *Guo Jia Fa Gai Wei Yu Alibaba Gong Jian Shang Wu Ling Yu Cheng Xin Ti Xi Jian She* (国家发改委与阿里巴巴共建商务领域诚信体系建设) [National Development and Reform Commission Works with Alibaba Jointly To Establish a Credit Rating System in the Commercial Area], CHINA ECON. NET (中国经济网) (Dec. 2, 2016) [hereinafter *National Development and Reform Commission*], [http://www.ce.cn/xwzx/gnsz/gdxw/201612/02/t20161202\\_18347172.shtml](http://www.ce.cn/xwzx/gnsz/gdxw/201612/02/t20161202_18347172.shtml). For collaboration on poverty reduction, see Julie Makinen, *Chinese E-Commerce Giant Alibaba Connects Rural Residents to Online Shopping*, L.A. TIMES (Apr. 2, 2016), <http://www.latimes.com/world/asia/la-fg-china-rural-economy-20160403-story.html> (describing government financial support for Alibaba's rural expansion). For e-government, see Huanqiu Tech, *Chinese Central Government Procurement Platform Uses Alibaba Cloud*, MARBRIDGE DAILY (Mar. 9, 2015), [http://www.marbridgeconsulting.com/marbridgedaily/2015-03-10/article/81778/chinese\\_central\\_government\\_procurement\\_platform\\_uses\\_alibaba\\_cloud](http://www.marbridgeconsulting.com/marbridgedaily/2015-03-10/article/81778/chinese_central_government_procurement_platform_uses_alibaba_cloud).

145. See Jeremy L. Wallace, *Juking the Stats? Authoritarian Information Problems in China*, 46 BRIT. J. POL. SCI. 11, 12–13 (2016) (“Sub-national leaders may be rewarded on the basis of manipulated data, since monitoring costs make it expensive . . . for central authorities to know the real situation . . .”).

146. See *The Price Changes in Online Shopping in December, 2015*, ALI RES. INST. (Jan. 29, 2016), <http://www.aliresearch.com/en/news/detail/id/20807.html>.

147. Tom Orlik, *Inflation Deflated? Evaluating the “Alibaba Index,”* WALL ST. J.: CHINA REAL TIME REP. (May 20, 2013), <http://blogs.wsj.com/chinarealtime/2013/05/20/inflation-deflated-evaluating-the-alibaba-index> (comparing aSPI with China's official consumer price index).

148. See *National Development and Reform Commission*, *supra* note 144.

ment. For example, the Rural Taobao Program subsidizes logistics services to rural markets, and helps people in poor, rural areas sell agricultural products to urban consumers through sales on Taobao's platform.<sup>149</sup> This initiative was, in part, financially backed by the central government. By 2016, the Ministry of Commerce and the Ministry of Finance offered two hundred counties a total of \$300 million for expenditures on e-commerce training, warehouses, and other related facilities and services that could advance the project.<sup>150</sup> As of May 2017, Rural Taobao had opened e-commerce service points in over 30,000 villages, many of which had no access to commercial parcel delivery services prior to its arrival.<sup>151</sup> As the central government continues to rely on positive economic performance for its legitimacy, the prospect of bringing market infrastructure, markets, and jobs to rural areas furthers this government's goals.

Third, as discussed in Part IV.B, Taobao weakens the authority, revenue, and rent-creation by local governments by breaking down internal trade barriers. It therefore has mixed effects on federalism. By bringing national markets to provinces with trade barriers, Taobao strengthens market-preserving federalism by contributing to the common market. Yet it has the opposite effect with respect to the power of the central government vis-à-vis the provinces.

### CONCLUSION

We asked two questions at the outset: (1) What is the scope of Taobao's law-creation? and (2) What effects is Taobao likely to have on federalism, Chinese style, and the common market?

Online market platforms, such as Taobao, appear to be changing the politics, economics, and legal infrastructure of China. We argued that Taobao has created far more than an exchange system; it has created a national market platform, including the market infrastructure necessary to sustain markets that the central government has found it difficult to provide. We called this phenomenon law, Chinese style.<sup>152</sup>

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149. See Makinen, *supra* note 144 ("Government officials and Alibaba executives say Rural Taobao jibes neatly with national goals . . .").

150. *Id.*

151. *Nong Cun Tao Bao Zai Sheng Ji Kai Qi Nong Cun Dian Shang Xin Shi Ming* (农村淘宝再升级开启农村电商新使命) [*Rural Taobao Has Been Updated Again and Will Begin a New Mission on Rural E-Commerce*], CHINA DAILY (中国日报网) (May 30, 2017) [http://caijing.chinadaily.com.cn/2017-05/30/content\\_29547904.htm](http://caijing.chinadaily.com.cn/2017-05/30/content_29547904.htm).

152. See *supra* Part III.

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Law, Chinese style, has emerged because the central government in China has effectively delegated the authority to develop this infrastructure to private parties. This delegation gives the central government several advantages: it provides an institutional basis for markets in a weak rule-of-law environment; it permits experimentation; and it also allows the central government to distance itself from any failures. We drew connections between these benefits and the advantages that characterize federalism, Chinese style—one that existed during the early reform efforts in the 1980s and early 1990s.<sup>153</sup>

But, unlike federalism, Chinese style, this new system of creating a national market through private online platforms seems to tip the power balance towards the central government, rather than the other way around. On the one hand, Taobao holds the potential to circumvent internal trade barriers between provinces by fostering a national online market. While the rise of a national common market is likely to generate substantial economic growth,<sup>154</sup> it has begun to challenge the regulatory power of local governments, as now many problems are no longer localized. On the other hand, the rise of national platforms such as Taobao seems to help reinforce the power of the central government. The central government can use national platforms as centralized tools to collect market information and to enforce central policies.<sup>155</sup>

As Taobao grows, however, it will become a force that can potentially demand concessions from the central government. Were the central government to shut down and expropriate Taobao's assets, it would face 400 million doomed citizens whose interests the government has trampled. Even if Taobao may not intend to challenge the central authority, its growing influence may invite unwanted suspicions from the latter. It is not at all clear whether these two parties will collaborate or end up in conflict. It is too early to tell whether these trends will continue and add up to something important and transforming. But law, Chinese style, holds the potential for such a transformation.

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153. See *supra* Part IV.

154. Taobao is likely to generate substantial economic growth in China through the sources first emphasized by Adam Smith, notably, through the process of market integration and greater division of labor and exchange. See SMITH, WEALTH OF NATIONS, *supra* note 23, at 679–81 (predicting that China would have the capability “to support very great manufactures, and to admit of very considerable divisions of labour”).

155. See *supra* Part IV.C.