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

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

Using China’s online market as the context, this paper explains how new institutional rules are devised in a weak legal environment, and how Taobao – a Chinese online trading platform – has the means to create what we call “law, Chinese style.” We argue that the Chinese government has effectively off-loaded a substantial part of the development of law to private actors. Taobao – China’s dominant online trading platform with over 400 million users – is not simply an exchange platform, but one in the process of developing a modern legal system that enforces contracts, resolves disputes, and prevents fraud. As a private supplier of market infrastructure when formal institutions are lacking, Taobao provides a means for creating law, Chinese style. We argue that the delegation implicit in law, Chinese style, parallels China’s earlier reforms (1980s-early 1990s) which helped create federalism, Chinese style, delegating policy authority to subnational governments to engineer China’s initial reform effort. In parallel with the earlier delegation, the new form of delegation also involves a combination of the delegation of authority and policy experimentation. This Chinese approach to legal development is much less politically constraining on the central government than the Western approach.

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We also argue that Taobao’s market platform is having important political effects on the common market aspect of Chinese federalism. Taobao grants remote villages without major markets access to internet ones. Further, Taobao appears to be able to end-run various internal trade barriers.

1. Introduction

At first glance, Taobao’s online trading platform appears to be Chinese version of popular American online trading sites, such as eBay, Amazon, or Craigslist. Taobao does perform some of the same functions as these sites. But we argue Taobao is far more: Taobao has become a market in the sense of providing many aspects of market infrastructure normally associated with the state.

To see the nature of our claim, consider an American startup that makes specialty components for bicycles and creates a website from which to sell its products. All of American law stands behind this website, helping to prevent various forms of fraud, theft, and the encroachment on intellectual property. Similarly, disputes that arise between the firm and its customers, suppliers, or competitors will be negotiated in this rich legal and commercial environment.

The weakness of this legal market infrastructure in China makes a similar venture riskier. The incipient nature of the Chinese legal system makes the prevention and resolution of legal problems much harder. Chinese startups and small firms that sell products by their own website are considerably more vulnerable than similar ventures in the United States.

Enter Taobao (“Searching for Treasure”), an online trading platform that hosts over 400 million active traders. As with eBay, Amazon, and Craigslist, Taobao serves as an exchange mechanism matching buyers and sellers. More importantly for our
purposes, it has begun to develop many aspects of market infrastructure that the Chinese government has been unwilling or unable to provide. Of necessity, Taobao has been forced to create systematic rules governing exchange, disputes, and fraud; that is, they have been forced to create law. As this function of Taobao has become more complex and systematic, the central government appears to have, in effect, delegated some authority to Taobao to experiment with various components of law; relevant legal issues include the forms of property rights relevant to the platform, contracts, prevention of theft and fraud, and especially the resolution of disputes.

Important precedents exist for the private development of law. First, consider the central government’s delegation of market design and reform in the early reform period dating from the early 1980s through the early 1990s. At this time, the central government delegated authority to reform to the provinces, allowing them to take the initiative in market design. As is well known, this delegation resulted in spectacular results; China experienced double digit growth rates during the three decades following the initiation of reform. Second, economic agents in a range of markets provide private rules and adjudication mechanisms, such as the diamond and cotton industries (Bernstein 1992, 2001, respectively), cattle ranchers (Ellickson 1991), medieval merchants (Greif 2006, ch 9, Milgrom, North, and Weingast 1990), pirates (Leeson 2009), 19th century American railroads (Ely 2002, Chandler 1977), and stock exchanges (Stringham 2015, chs 4-6).

The purpose of this paper is to address a series of questions about the seemingly implicit delegation in the last few years to Taobao in its design and provision of legal and other market infrastructure. In particular, we ask: what is the likely scope of
Taobao’s legal-creation? What effects is Taobao likely to have beyond its own platform, especially with respect to federalism, Chinese style (Montinola, Qian, and Weingast 1995), and the common market? And why would the central government delegate this authority – or at least implicitly encourage this authority?

It is too early for a full evaluation of any of these questions. Yet we can point in important directions for each. The central government delegation to the provinces in the early reform period created federalism, Chinese style, creating striking incentives for the provinces to succeed at reform and marketization. Similarly, we argue, Taobao has strong incentives to make delegation of authority to create commercial law, Chinese style, in a manner that would allow its platform to expand. A big unknown is how far Taobao is likely to go in creating law. As exchanges on Taobao’s platform become more complex, so too will disputes. An important component of law underlying markets is that it creates common knowledge expectations of how various types of disputes and crimes will be handled. This knowledge requires the development of rules with various legal attributes that are commonly associated with the rule of law; namely, that the rules are known in advance, general, consistent, feasible, etc.\(^2\) Further, the system of legal rules must have a transparent and predictable system for extending the rules to new and unforeseen circumstances.\(^3\) The system producing rules may vary, as in the Anglo-American common law system, the continental system, or a hybrid.

In answer to the second question, one surprising effect of Taobao on China has been on federalism, Chinese style. One of the weakest aspects of federalism, Chinese

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\(^2\) Fuller (1964) and Raz (1977) are classics on these legal attributes; Hadfield and Weingast (2014) provide a recent survey.

\(^3\) This understanding of the law draws on Hadfield and Weingast (2012, 2014) who develop the “what-is-law” framework.
style, has been the lack of the common market condition (Montinola, Qian, and Weingast 1995, Qian and Xu 1992). The central government has been unable or unwilling to ensure the mobility of products and factors. As a national market, Taobao holds the promise of breaking down internal trade barriers erected by the provinces. Local governments simply lack the means to regulate market platforms. Moreover, because market platforms collaborate with the central government against local governments, the latter are not likely to gain the means for regulating the platforms.

We also provide a possible answer to the third question, why the central government is tolerating or even encouraging the private development of law. First, were the central government to create a traditional independent judiciary, it might not be able to constrain that court system to what is known as private law (for example, property rights, contract, torts, and family law). Private law stands in contrast to public law, which involves the “constitution,” such as the legal limits on the central government’s powers; public law also includes the nature of citizens’ rights and the rules governing public administration and the bureaucracy. A national court system, even with a mandate restricted to private law, might well attempt to constrain the central government, for example at the intersection of property rights and the powers of the central government.

Second, it is not obvious how to design a legal system from scratch, and most attempts in the developing world fail. As with the delegation of market reform in the early reform era, the implicit delegation of power to Taobao allows the central government to stand apart from the experiment so that it may readily be abandoned if the experiment fails without tarnishing the central government.
Although this paper situates itself within the Chinese context, it points to a central and perennial problem facing all developing countries in building markets: how to foster market transactions in the absence of strong institutions, in particular, those indispensable to the rule of law? The obvious answer – transplanting strong institutions into the developing world – has repeatedly proved infeasible due to active resistance from the ruling elites (Weingast 2010). Instead, the heavy reliance on personal connections (e.g. kinship ties and friendships) has prevailed as an informal assurance to facilitate trade. This, however, has jeopardized the expansion of impersonal exchange, which is central to long-term economic growth (Greif 2004).

Our paper proposes a rising alternative, which we label, “law, Chinese style”: the private building of legal market infrastructure sponsored by online platforms, which can bolster impersonal exchanges over long distance, including those between small traders who otherwise lack sufficient resources and credibility to engage in cross-regional trade. With the surging popularity of e-Commerce worldwide including in developing countries, this alternative approach to legal development may become increasingly available in other developing states besides China.

This paper proceeds as follow. In the next section, we discuss the importance of market infrastructure for the development of markets. Section 3 discusses a previous phase of delegation in the early reform period. Section 4 provides the necessary background on Taobao, its operation, and its platform. The following section evaluates

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4 Quite a few developing countries have a vibrant growing e-Commerce market. In 2013, China, Indonesia, Mexico, and India were the four fastest growing states in eCommerce sales in the world, with an average annual growth rate of more than 50% (Authors’ calculation based on data from eMarketer, January 2014, Global B2C Ecommerce Sales to Hit $1.5 Trillion This Year Driven by Growth in Emerging Markets. Retrieved from https://www.emarketer.com/Article/Global-B2C-Ecommerce-Sales-Hit-15-Trillion-This-Year-Driven-by-Growth-Emerging-Markets/1010575).
the degree to which its platform can be said to produce law. We then, in section 6, analyze Taobao’s effect on federalism, Chinese style. Our conclusions follow.

2. Market Infrastructure

To work efficiently, markets require various forms of infrastructure, including a legal system. More specifically, the process of development involves building the state capacity to provide law, secure property rights, and protection from predation (Acemoglu and Robinson 2012, Besley and Persson 2009, Weingast 2016).

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

The developed West approach these problems by creating strong economic and political institutions, limited government, and rule of law, all constraining the executive. In building this state-capacity, China has faced – and continues to face – the many of the same problems as the developed West faced in an earlier stage of development. Indeed, China’s pragmatic approach, as indicated by the saying, “market reform with
socialist characteristics,” appears to have taken Smith’s advice exhibited in the second quote in this paragraph.

Problems to be solved include the following. First, how to design a system of rules that have the characteristics of law, that is, legal attributes, such as generality and stability; second, what are the procedures by which disputes under the law are resolved; and third, how will China prevent government predation and expropriation? Two systems developed in the West to produce law, the Anglo-American common law; and the continental system. Both systems are backed by strong, explicit constitutional foundations, and have an independent judiciary to enforce law, and which can ultimately constrain executive discretion.

As with so many aspects of China’s reform process, the Chinese path to a legal system has not followed that in the West (see Oi and Walder 1999). Ideological and political constraints rule out the Western path through a constitutional government, an independent court system, and the rule of law at the national level. Instead, China’s path to legal development has been largely decentralized, partial, and often substituted by a great use of non-law-based, administrative rules, and measures (Xu 2011).

Under China’s economically decentralized system, local governments of all types participated in writing and enforcing law and regulations. During the early reform process, those on the coast led the reform effort. Local governments faced powerful fiscal incentives to compete with one another, and to provide political and legal

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5 In this paragraph, we draw on the approach of “federalism, Chinese style” (Montinola, Qian, and Weingast 1995, Jin, Qian, and Weingast 2005, and Qian and Weingast 1997).

6 For example, Guangdong issued a provincial law “Regulations on Special Economic Zones in Guangdong Province,” which was approved for implementation in 1980.
environments in which businesses could thrive. Those that failed to provide hospitable institutional environments for enterprises lagged behind.

This process of competition-driven, decentralized legal development has continued through present times. Some major setbacks of this decentralized process lie in the conflicts between national laws and regional laws (Xu 2011), in the decentralized and anomalous interpretations of private law (Chang and Xu 2017), and in that laws are not uniformly enforced across jurisdictions, often shown as local governments’ selective implementation of national laws (Peerenboom 2002; Tanner and Green 2007). While under certain conditions, competition between local governments can lead to partial rule of law (Wang 2015), a strong consensus exists that China’s formal legal system remains weak, expensive to use, and subject to the whims of political elites. To fill in the governance vacuum left by a weak legal environment, local governments also use a great deal of non-law-based, regional administrative measures to supply market infrastructure (Pistor and Xu 2005). Moreover, China has enacted made improvements in its legal system, including several laws required to sustain a functioning market (e.g. the Contract Act of 1999, the Property Act of 2007, the Labor Contract Act of 2007, and the Tort Liability Act of 2009); and this year has seen a renewed interest in putting all these Acts into one civil code (Chang and Xu 2017). Nonetheless, while the state-supplied legal infrastructure maybe more than minimum to offer some protections for market participants, it remains insufficient to support efficient markets.7

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7 First, due to all the problems specified in the last paragraph, especially, the lack of an independent judiciary, the private laws are often enforced differently from what is on paper. Second, the lack of rule of law means that market participants are not on equal footing in receiving legal protections (in particular when dispute arises), which typically disadvantages small sellers and those without political connections. In this environment, trade can still happen with the help of repeat dealing and personal ties, but a national market consisting of impersonal exchanges over long distance, particularly those between small traders, is largely discouraged.
To sum up, throughout the market reform process, the local governments provided various aspects of the market infrastructure, and their approached differed across jurisdictions. Many interior provinces adopt very different strategies from those used by coastal areas. The reform process, however, did not provide a strong legal system of law to underpin market exchange.

Over time, the various difficulties facing China have evolved. The economy has become much bigger (more players, higher stakes); firms have become more complex and integrated; and the nature of disputes become more complex. All of these trends have raised the value of a formal, national-level legal infrastructure.

A major problem facing any country seeking to build a legal system is the problem of government predation – called the exercise of the “arbitrary power” by early modern political theorists, such as Locke, Montesquieu, Adam Smith, and James Madison; and “executive moral hazard” in the modern literature on the political-economics of development (Besley 2005, Besley and Persson 2009, Cox, North, and Weingast 2017). By way of illustration, Montesquieu (1748:157, 162, 164), Adam Smith (1762-63: 325-27), and the American Federalists (1788:F46:307) all argued, executives face incentives to abuse the court system when the latter’s ruling conflict with the executive’s interest. To prevent this type of executive moral hazard qua encroachment on the judiciary, two features are necessary: first, a series of now-well-known institutions, such as judges with life terms, fixed salaries, etc.; and second, a set of institutions that credibly commit the government to honor these restrictions, such as the separation of powers system.
As a common dilemma facing all developing countries, China confronts a dual problem with respect to creating an independent judiciary that would supply \textit{and only supply} private law. First, how to design the judiciary in a way that it restrains itself to private law, that is, an independent judiciary that will not unilaterally expand its jurisdiction to include public law; and second, how would the central government commit not to intervene in the courts’ rulings when the government’s interests are at stake? Especially problematic is the inherent tradeoff in this dual problem. The stronger the institutions committing the government not to intervene to protect its interests, the greater the ability of the judiciary to expand its jurisdiction to include public law and therefore become a major source of restrictions on the central government’s powers. In other words, it seems difficult, if not impossible, to compartmentalize a national legal development process that limits an independent judiciary’s jurisdiction to private law only. If China is to continue to grow at high rate, market infrastructure will become increasingly important.


The purpose of this section is to suggest the central importance of delegation of authority by the central government in its efforts to launch the early stages of economic reform.\footnote{This section draws on the work of Montinola, Qian, and Weingast (1995), Jin, Qian, and Weingast (2005), Oi (1993), Qian and Weingast (1997), Shirk (1993), and Weingast (1995), and Xu (2011).} Provinces, not the central government, undertook the major market-reform effort in the 1980s and early 1990s on which the modern Chinese economy is built.
In the common parlance, political reform in China refers to democratization and hence the separation of the Chinese Communist Party (CCP) from the state (e.g. Harford 1985; Saich 1991). On this important component of reform, China has made little progress. But it is misleading to identify political reform solely with democracy because democratization does not encompass all aspects of political reform.

Indeed, China engineered several dimensions of political reform during the initial reform period (1981-93). We list three dimensions. First, political decentralization not only delegated important powers to local governments, it altered center-local government relations in several critical ways (Shirk 1993). Second, a major shift in ideology underpinned the reforms, as the CCP moved from a dogmatic emphasis on the Maoist version of Marxist-Leninism to a pragmatic, market-oriented approach. Third, China for the first time under the Communists opened its economy.

These changes resulted in a new political system characterized as federalism, Chinese style. (Montinola, Qian, and Weingast 1995, Jin, Qian, and Weingast 2005, and Qian and Weingast 1997). This system, in turn, provided considerable political protection for China’s reforms, including limits on the central government. China’s political decentralization shares much in common with Western federalisms, especially that in 19th century United States during its rise to the richest country in the world. As with 19th century American states, federalism, Chinese style, granted local governments primary control over economic matters within their jurisdiction. Also in parallel with 19th century American states, the Chinese reform provided a partial basis for a special kind of federalism called market-preserving federalism (Weingast 1995, McKinnon 1997, and
Montinola, Qian, and Weingast 1995). The definition of market-preserving federalism focuses on the political relationships among levels of government.

3.1 Delegation of authority

Perhaps the most significant reform steps taken by the Chinese central government in the initial reform period were its delegation of authority from the central to local governments. Decentralization in the 1980s combined financial incentives, reliance on market mechanisms, increased control for lower governments over their economies, and a new openness to international markets. These features generated far reaching consequences for political institutions and economic performance. Provincial and local governments under the market-oriented reforms enjoyed a wide range of authority within the market environment. Foreign capital, for example, flowed into firms and projects that are not controlled by the central government.

Many reform policies were also delegated to provinces and local governments. The competition among jurisdictions encouraged active experimentation within each subnational unit, which facilitated policy innovation from the bottom up. Failed experiments were terminated while successful ones were scaled-up and imitated. Take the example of price reforms. China did not liberalize prices in one stroke. The dual price system was a common practice in China in 1980s, with one planned price and the other a market price. For many goods, moving from a dual price system to a single price system was not carried out by the central government, but by local governments. Decisions about prices were largely delegated to lower level governments (exceptions included some nationally important goods like energy and transportation services).
Many governments extended their authority to pursue reform to liberalize the prices. In the case of grain prices, Guangdong took the lead in 1982 to liberalize it. Guangdong’s success led many other provinces to follow suit.  

3.2 Fiscal incentives: the fiscal contracting system

The fiscal contracting system during the initial reform period allowed provinces and lower governments to capture a very large portion of marginal tax revenue generated within their jurisdictions. This system provided local governments with strong incentives to make economic reform succeed (Jin, Qian, and Weingast 2005). Starting in 1980, China implemented a fiscal revenue sharing system between any two adjacent levels of governments. Although schemes varied both across regions and time, the basic idea was that a lower-level regional government contracted with the upper-level regional government on the total amount (or share) of tax and profit revenue (negative values imply a reverse flow of subsidies) to be remitted for the next several years. The lower-level government kept the rest.

Consider fiscal contracting schemes between the central and provincial governments (lower level fiscal contracting is similar). In the first step, revenue income in each province was divided between "central fixed revenue," all of which was remitted

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9 In 1984, the central government declared 14 coastal cities as "coastal open cities," which conveyed new authority to them that paralleled that granted earlier only to special economic zones. In the early 1990s, treatment of special economic zones was extended to some inland regions.

to the center, and "local revenue," which was subject to sharing. In the second step, a particular formula of sharing was determined.

The importance of these new fiscal arrangements is that for all provinces and cities they induced a strong positive relationship between local revenue and local economic prosperity, thus providing local officials with incentives to foster prosperity. Most provinces and cities, at the margin retained 100 percent of local revenues or nearly so. Hence, these governments possessed both significant fiscal autonomy from the central government and considerable independent authority over their economies.

One result of China’s reform in the 1980 was the spectacular growth and flourishing sector of township-village enterprises (TVEs), which are owned by township and village communities and controlled by township and village governments.\textsuperscript{11} By the end of 1993, TVEs produced 30% of the total industrial output in China. This remarkable success of TVEs can be understood from the incentives facing these firms. First, the structure of these firms afford residual claim rights (in essence, the rights to profits) to township and village governments. Second, two forms of limits are imposed upon the township and village governments and their firms; the inability to enact protectionist policies; and a hard budget constraint. Not only may they go bankrupt, but the local governments, in contrast to the central government which can print money, cannot endlessly bail them out.\textsuperscript{12}

\textsuperscript{11} A large body of literature has studied this topic. See, e.g., Byrd and Lin (1990); Nee and Sijin (1990); Qian and Xu (1993); Chang and Wang (1994); Oi (1999).

\textsuperscript{12} In 1989, for example, about three million TVEs went bankrupt or were taken over by other TVEs. In the same year almost all loss-making state-owned enterprises were bailed out by the state (People’s Daily, Overseas Edition, March 23, 1990). This shows why TVEs and SOEs are so different. Although both types of enterprises are "owned" by governments, their incentives and hence their behavior differ considerably.
This system was maintained until the end of 1993 when another round of reform centralized the fiscal system (Wong 2000).

3.3 Advantages of the Delegation Strategy to the Center

The strategy of delegation of authority for economic reform proved advantageous to the central government for several reasons. First, the central government was able to limit the scope of delegation. Provinces did not in effect become new, independent nations; and their continued authority depended on the success of the reforms. Second, in the beginning, no one knew the best way to reform, and delegation to provinces and lower governments allowed multiple and independent approaches and experiments. Reform strategies that worked better could be spread as other local governments sought to imitate the more successful reforms. Delegation also allowed many provinces to adopt a “wait and see” approach; then to imitate successful experiments. Third, delegation afforded both the CCP and the central government the opportunity of “blame-ducking” – that is, to disassociate itself with failures if the reform experiments did not produce results. A massive failure to produce growth would likely have resulted in a reversal of delegation of authority.  

4. Taobao and Law, Chinese Style

The development of law is the key to addressing several fundamental issues facing all states in building impersonal and efficient markets. Law is central to the

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13 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 (Li 2004; Wang 2005).
prevention of fraud, the resolution of disputes, and, generally, to foster agents to act within the rules. The Western approach of legal development involved independent judiciaries, often with jurisdiction over both public and private law. Courts also serve as a major protection of various citizen rights, serving as one of many checks against government predation.

In the face of tremendous impediments to creating a modern judicial system, China has had to devise an alternative route to legal development that is much less politically constraining (than is the Western approach) and yet still effective, at least partially, so as to foster market growth.

In this section, we use the phrase, law, Chinese Style, to describe China’s alternative approach to legal development. An important aspect of law, Chinese style, is that the central government has in effect allowed specific private actors a substantial role in the development of law. As we argue, the scope of this development is limited and focuses on e-commerce. It also interacts with the on-going process in China aimed at producing elements of a body of e-commerce law.14

We argue that Taobao – China’s dominant online trading platform with over 400 million users – 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.

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14 First, the state has incorporated components of Taobao’s platform rule into its own regulations on online trading. A case in point is the return policy that “consumers shall have the right to return the commodities within seven days of receipt of them without cause.” This policy was first made and enforced by Taobao on its clothing category. In 2014, this regulation was recognized as an industry standard, and written into the Article 16 of The Administrative Measures for Online Trading released by the State Administration for Industry and Commerce (see http://en.pkulaw.cn/display.aspx?cgid=218557&lib=law). 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. The practice of allowing the business alliance to make a draft proposal of a national law is very rare in China. (See http://www.mofcom.gov.cn/article/shangwubangzhu/201603/20160301274283.shtml)
Because China lacks a strong formal legal system, Taobao has come to serve as a private supplier of market infrastructure for its traders that undergirds the competitive, impersonal online market.

4.1 Evolution of Law, Chinese Style

To begin consideration of law, Chinese Style, we first call attention to the looming tensions between two primary stances of the Chinese government: (1) an unwavering devotion to economic development, and (2) an unremitting refusal to create the rule of law, including the institutions necessary to sustain it, namely, an independent judiciary.

Generally speaking, the rule of law has argued to undergird long-term economic prosperity (e.g. North 1990; Coase 1998; Rodrik et al., 2004) through a variety of mechanisms including the security of property rights and contract enforcement (e.g. Knack and Keefer 1995; Acemoglu and Johnson 2005, Besley and Persson 2009), and limits on government discretion (e.g. North and Weingast 1989; Weingast 1995; Acemoglu et al. 2005). Economic development has long been a key government priority, as it provides not only economic rents but also performance-based legitimacy for the authoritarian state (Yang and Zhao 2015).

The rule of law as part of market infrastructure has come to matter more as China’s economy has become more complex and integrated. First, China has gradually shifted away from a state-led, investment-driven economy. The rule of law helps consolidate a fair business environment for market economy to develop, one with considerably less opportunism. Second, the lack of the rule of law disproportionately hurts the growth of private businesses (SMEs in particular), which constitute the main
driver of China’s economic growth. Too often these enterprises lack the resources and political ties to advance their interests (Ang and Jia, 2014).

The absence of the rule of law has certainly raised transaction costs with forgone growth potential. There remains the economic demand for and value of a legal system as a means of aligning incentives, coordinating expectations, resolving disputes, preventing opportunism and predation, and punishing wrong-doers.

The value of a legal system and the central government’s reluctance to provide this market has fostered a new approach noted above in the form of law, Chinese style. We argue that, in the absence of a public legal system, private actors have begun to provide substitutes.

Delegating authority to create markets with rule of law helps conquer the technical complexities in building a workable legal system. The current delegation parallels the delegation of many reforms earlier in the process of marketization, such as allowing Guangdong to reform markets by being “one step ahead,” as we summarized in section 3. As with these earlier reforms, the central government’s delegation to create law 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 public

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15 Despite the advantages of the rule of law, the national government has resisted creating a modern court system capable of establishing the rule of law. The refusal is recurrently expressed. Qiang Zhou, head of the Supreme People’s Court, recently made thesis point forcefully. In January 2017, Zhou said 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 (2017, January 18). China’s Chief Justice Rejects an Independent Judiciary, and Reformers Wince. Retrieved from https://www.nytimes.com/2017/01/18/world/asia/china-chief-justice-courts-zhou-qiang.html

16 Compared with the previous delegation that typically occurred between the central government and the agents of the state (e.g. the provinces), delegating authority to private actors can distance the entire state from public dissatisfaction and political pressure.
dissatisfaction and, if need be, curtail failing experiments.\textsuperscript{17} Private actors, on the contrary, bear the risk of failure and buffer the tensions that could have been directed towards the state; but they also face the prospect of large profits if the experiments succeed.

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 torts. Put differently, the private provision of private law allows the central government to foster experiments in law as it relates to the economy while lowering the probability that this form of legal system will challenge the central government in the area of public law.

Enter Taobao.

\section*{4.2 Taobao Creates a Market}

Taobao is China’s largest online shopping platform, owned by the Alibaba Group. Taobao does not sell products but provides a virtual marketplace through which individual buyers and sellers can trade with each another. Launched in 2003, Taobao has been growing at a stunning rate. In fiscal year 2016, Taobao and its spin-off Tmall together hosted more than 10 million active sellers and 432 million active buyers, amassing an annual gross merchandise volume (GMV) of $US485 billion.\textsuperscript{18} With respect to user base and GMV, Taobao (including Tmall) currently surpasses Amazon

\textsuperscript{17} For example, in 2010, around 300 sellers initiated a physical protest against Taobao. They gathered in front of Alibaba’s headquarter in Hangzhou with banners: “(We) protest against Taobao’s ‘July 8th Pseudo Rules’ and Taobao’s imperialism, (and we) appeal to the state to improve online shopping regulations.” See details from http://en.people.cn/90001/90778/90860/7065181.html

and eBay combined; it also eclipses Walmart Global, the world’s largest brick-and-mortar retailer.\textsuperscript{19} Up to March 2017, Rural Taobao (Alibaba’s rural expansion initiative) has also opened over 30,000 e-Commerce service points in remote villages, many of which had no access to commercial parcel delivery service prior to the arrival of Rural Taobao. These service points afford access to those without online payment methods or who are not internet savvy.\textsuperscript{20}

We have noted that, beyond an exchange platform, Taobao’s more fundamental function is the creation of market infrastructure. The absence of a Chinese legal system with many dozens or even centuries of years of experience means that such a system must be invented largely from scratch. Just as with Europeans in the Middle Ages (Greif 1989; Milgrom et al. 1990), post-reform China has had to devise an alternative approach, especially if the state was unwilling to create an independent court system that, ultimately, had the power to create law. We argue that the most fundamental service that Taobao provides is access to a market supported by a private legal system in the process of developing the rule of law. Taobao thus has the means to create law, Chinese style, as it has become a private supplier of legal infrastructure for the market in the absence of formal, state-run legal institutions.


\textsuperscript{20} The number of Rural Taobao service points is reported in the news, retrieved from http://mp.weixin.qq.com/s/xyep2mtWmlXWUqZWzLAg. To give access to villagers who do not have online payment methods or who are not tech-savvy, Alibaba installs a taobao terminal in the center of a village where villagers can buy and sell products through the Taobao account of a terminal manager – who is often a young villager with previous online shopping experience. Villagers can pay in cash upon receipt of their products or pickup of their shipments at the Taobao service point.
Table 1: Platforms vs. Independent Websites: China vs. the United States (2011)

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<th>Online Retailing in 2011 (%)</th>
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<td>Platforms</td>
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<td>China</td>
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Platforms like Taobao can serve as private substitutes for the lack of strong legal institutions to enforce contract, resolve disputes, and prevent fraud. We argue that this partially explains why platforms dominate e-tailing in China but not in the United States, where the strong legal environment makes the substituting effects of platforms less necessary than they are in China. In 2011, platforms accounted for 90% of the e-tailing market in China; in the United States, only 24% of e-tailing transactions were conducted on platforms, as opposed to 76% on independent websites (see table 1).

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

5. Taobao’s Private Legal System

We now address two questions about Taobao’s market platform. First how does its private legal system work in the absence of strong formal institutions administered by the state; and second why does it display some features of law?

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

Our analysis begins with how Taobao addresses three major problems intrinsic to trade: contract enforcement, fraud prevention, and dispute resolution. We show that Taobao has developed systems that help it identify dishonest traders but also impose various forms of decentralized and centralized punishment. We then discuss several supporting institutions vital to improving the stability, effectiveness, and adaptability of Taobao’s legal system.

5.1 Contract Enforcement through Institutionalized Reputation Mechanisms: The Online Rating System and Escrow Service

Traders throughout human history face a similar problem regarding contract enforcement known as the assurance problem: when trading parties strike a deal, how do they ensure that each party honors the agreed upon terms? The assurance problem is especially acute 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. The Taobao platform has several mechanisms designed to address this and related problems.

22 We use the term “ecosystem” slightly different from the business literature that treats ecosystem as the network of institutions and agents guided by these institutions. We use the term to only refer to the institutions that are interconnected.
First, the online feedback and rating system lies at the center of Taobao’s attempt to solve this problem. As with other online trading systems, such as eBay, Taobao’s rating system creates incentives for all trades to maintain a good reputation by honoring contracts, gathering information, and resolving disputes.\(^{23}\) But Taobao’s system goes well beyond those used by eBay and Amazon.

Taobao’s rating system consists of two main parts: credit rating (i.e. a rating for buyer/seller over the entire past history) and store rating (i.e. a rating for seller only, over the past six month). Both ratings are complex sums of user reviews from each transaction and displayed publicly on buyers/sellers’ web profile. Credit rating reflects the overall reliability of the seller/buyer over the entire past history.\(^ {24}\) Yet this rating is cumulative over time and discriminates against new sellers/buyers. To capture the changing dynamics of service quality, Taobao uses another indicator – store rating – to complement credit rating for sellers. Store rating is based on three aspects of the seller over the past six months: the accuracy of product description, customer service, and shipping time.\(^ {25}\) In addition to the overall reputation of sellers, buyers can also check all past reviews of each product. Customers can rate, write reviews about, and take photos of the product. Taobao can then use text analysis to summarize individual comments, helping users internalize product reviews.

\(^ {23}\) In using a reputation mechanism, Taobao echoes some of the historical institutions in Medieval Europe. For example, the Maghribi traders (Greif 1989). See also Milgrom et al. (1990).

\(^ {24}\) In terms of credit rating, the seller and buyer can evaluate each other, by giving a positive (+1 point), or a neutral (+0 point), or a negative rating score (-1 point) within 15 days after a transaction is concluded. The total credit score is the sum of these user reviews from each transaction, and can be translated into different grades. For example, sellers have four grades, from the lowest to the highest level: heart, diamond, crown and golden crown; each grade is further disaggregated into five levels. It becomes increasingly difficult when one tries to upgrade to higher levels. See https://service.taobao.com/support/seller/knowledge-847753.htm.

\(^ {25}\) For each aspect, the seller is evaluated on a 1(very unsatisfied)-to-5(very satisfied) scale. The overall store rating is the average of all evaluations from each transaction happened in the past six months.
Nonetheless, the rating system suffers from multiple limitations: sellers can manipulate reviews by placing fictitious orders to inflate ratings, or they can take fraudulent actions that hurt competitors’ reputation; the rating is product/store specific so that it cannot prevent frauds in payment. This is where Taobao’s centralized coercive power and big data analysis can aid the rating system, topics we discuss in the next subsection (5.2).

Second, Taobao maintains a huge escrow system. When a buyer initiates a purchase from a seller, she pays her funds into an escrow account, not to the seller. The money is released to the seller only after all parties to the exchange are satisfied.

Third, a large portion of transactions involve Alipay. As with Paypal, Alipay is a mechanism that reduces the risk of fraud involving cash or credit cards. We discuss Alipay in subsection 5.4 below. To sum up, Taobao’s rating system and escrow service seek to deter dishonest and fraudulent behaviors on the platform.

5.2. Fraud Prevention through Risk Framework

*Big data + Manual Review + State Coercion*

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

To identify fraud, Taobao utilizes big data analytics and manual review to identify suspicious cases. In terms of punishment, besides platform coercive measures (e.g.
lowering the store rating; remove the product listing), Taobao also cooperates with the state police. Although the state apparatus suffers from many liabilities, it can help in punishment of the most egregious traders, but this system is slow and cumbersome and can be highly corrupt.

A crucial pillar of the system is the high volume and high variety of information stored on Taobao’s platform (e.g. user behavioral data, network data, delivery details, and IP addresses). The trove of propriety big data possessed by Taobao enables it to use big data models to detect suspicious activities and to counter fraud risks. The big data analytics are assisted by manual review to improve the accuracy of fraud detection; they provide the basis for Taobao’s fraud prevention monitoring system functions under a multi-layer risk prevention framework (Chen et al. 2015).

Consider online payment fraud. Taobao uses five layers of checks to identify fraud. The first layer – account check – leverages big data analytics to examine account information of both the seller and the buyer, including whether these accounts have exhibited suspicious activities. Obvious fraud cases are immediately sent for auto-decision (i.e. machine automatically decides on the case). If the case is suspicious but not obvious enough for auto-decision, it will enter the next layer of checks. From layer 1 to layer 4, the fraud risk management system checks different information of the transaction, sending obvious fraud cases to auto-decision and declining highly suspicious transactions. Borderline cases after four layers of checks are sent to the fifth layer: manual review, in which Taobao employees may phone the involved parties to get additional information.
To identify another type of fraud – counterfeit products fraud, Taobao has devised experiments that crowd-source the review work to a group of experienced Taobao users – the public assessors\textsuperscript{26} – who vote and decide whether a case actually involves counterfeiting.

After detecting a case of fraud, Taobao can punish fraudulent behavior through both online and offline means. The online means include lowering the user’s rating, making the fraudulent store unsearchable for a certain period, or in extreme cases, banning the accounts. A party who deems the judgment to be unfair can appeal to Taobao with evidence to support his/her claim; such an appeal leads to a reexamination of the case.\textsuperscript{27}

5.3. Dispute Resolution through Crowd-Sourcing Justice

User Dispute Resolution Center

Apart from contract enforcement and fraud prevention, dispute resolution is an indispensable aspect of a workable legal system. Every functioning market needs mechanisms to handle disputes. We consider two types of disputes: (1) disputes between any pair of market participants (e.g., a seller and a buyer; or two competitors);

\textsuperscript{26} For information about public assessors, see our discussion in the next subsection “Dispute Resolution through Crowdsourcing Justice.”

\textsuperscript{27} Taobao has also extended its coercive power beyond the online arena. To combat counterfeit products fraud at its source, Taobao collaborates with the state’s coercive apparatus (i.e. police and courts at the local level). Taobao’s massive datasets (e.g. shared phone numbers, chat histories, product return/delivery addresses) help track the location of offline warehouses and producers involved in counterfeiting, at least for producers that have business connections with online sellers on Taobao. Taobao shared this information with the police and helped them trace suspects who produce and sell counterfeits. In 2014 alone, Alibaba’s collaboration with the state enforcement agencies in over 1,000 counterfeiting cases led to the arrest of 400 suspects and the shut-down of 200 brick-and-mortar stores, warehouse or factories. See Catherine Chu (2014, December 23). \textit{Alibaba Removed 90M Suspicious Listings From Its Sites Before IPO}. Retrieved from \url{https://techcrunch.com/2014/12/23/alibaba-listings-purge/}
(2) disputes between market participants and market owners/regulators. Taobao deals with both types.

When a dispute occurs that the feuding parties fail to resolve themselves, the relevant parties can resort to judicial channels provided by Taobao. The party initiating the case may choose from two channels: asking a designated Taobao employee to adjudicate, essentially a one-person decision that usually takes 3-5 days; or using a jury-like panel of public assessors to arbitrate, which takes less than 48 hours.

Launched in 2012, Taobao’s User Dispute Resolution Center (pan.taobao.com) or jury system has been crowd-sourcing jury talent to deal with minor, everyday disputes. Most of these disputes are of two types: a buyer-seller disputes which often involve contract violations (e.g. complaints about items received that fail to match store descriptions); and platform-seller disputes in which a seller believes that Taobao has unfairly penalized it for violating certain rules.

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

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28 http://www2.alizila.com/how-taobao-crowdsourcing-justice-online-shopping-disputes
29 For these details, see http://www.iwshang.com/Post/Default/Index/pid/247679.html. Specifically, pool members need to have a registered account for more than a year; and a sufficiently good “sesame credit rating.” We discuss sesame credit in the subsection below on “supporting institutions. These thresholds screen out inexperienced users who lack basic knowledge about platform rules; and they prevent discount traders from forging fake accounts and manipulating the votes. Finally, as to payment: the assessors are motivated by gaining more “experience points” that can translate into different levels and titles, and that can also be donated as real money to charity (source: http://www.chinaeclaw.com/show.php?contentid=20385).
For each dispute, the system randomly draws 31 public assessors. Their principal responsibility is to review evidence submitted by disputing parties, and then vote within 48 hours. The public assessors decide which party wins by a simple majority vote. There is no communication between dispute parties and the anonymous assessors 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.

The beauty of this jury-like system is twofold. Taobao can shrug off a substantial part of the burden to address the complaints, which have been mounting in number as a result of rising trade volumes on the platform. As of February 8, 2017, 1,126,140 public assessors (i.e. the jurors) have resolved 2,295,511 disputes in total. The system also helps Taobao refine its rules. In 2013 alone, feedback from public assessors improved more than 140 Taobao rules governing online stores.

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

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30 In 2016, the total number of jurors for a panel was reduced from 31 (16 votes will win the case) to 13 (7 votes will win the case).
31 In some cases, several assessors may fail to vote within the time limit, making the total number of assessors less than 31. If that happens, as long as one side receives support from more than 16 assessors, the voting result remains valid. If neither side receives more than 16 votes, and result will be considered invalid and a Taobao employee will take over the case.
32 According to updated statistics on pan.taobao.com.
5.4. Supporting Institutions:  
*Payment and Escrow, Credit Scoring, and Voting for Rule-making*

Taobao’s private legal system also relies on several supporting institutions. While 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. In this subsection, we focus on three institutions that contribute to Taobao’s legal system, Alipay (the payment and escrow service provider), Sesame Credit (credit scoring service provider), and House of Representatives for Taobao Rules (where users can vote for rule changes).

Alipay, the provider of online payment and escrow services, is the key to law enforcement on the platform. Alipay works similarly as Paypal, except that Alipay also provides escrow service. Escrow service means that the buyer’s payment for each order is kept in escrow by Alipay until the goods are received and both trading parties are satisfied with the transaction.

Alipay’s escrow service enhances Taobao’s enforcement capability in both direct and indirect ways. First, Alipay can directly freeze or deduct from the money that a user has in her account if she violates platform rules. When dispute over a trade arises, Alipay can freeze the payment in escrow, forcing feuding parties to choose between losing the money or engaging in, and complying with, Taobao’s dispute resolution system. Second, Alipay indirectly improves the law enforcement on Taobao by collecting valuable data to identify (potential) rule-violators. The payment data collected

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34 Escrow service means that, after the order is placed, the buyer will first send payment to Alipay; only after Alipay receives the money will it inform the seller to ship the product concerned. Alipay, as a third party, keeps the buyer’s payment in escrow and releases the money to the seller only when the buyer has confirmed reception of the goods with satisfaction.
from each transaction going through Alipay provides objective information about Taobao users: how much they earn and spend each month; whom they send money to and receive money from. Based on this user data, Alibaba can then leverage behavioral analysis to detect fraud (as discussed earlier in fraud risk management) and to evaluate each user’s trustworthiness and creditworthiness. Most importantly, knowing that Alipay makes rules/contracts enforceable, in turn, incentivizes users to respect rules/contracts. This produces a positive feedback loop that improves the performance of contracts.

Another important supporting institution is Taobao’s Sesame Credit Management. As China’s first credit-scoring system, sesame credit uses transaction data from 300 million registered buyers and 37 million sellers who trade on Alibaba-owned platforms (e.g. Taobao, Tmall, Alibaba.com), and assigns each user or business a credit score ranging from 350 to 950.\(^{35}\) The idea parallels a U.S. individual’s FICO score determined by his/her eBay rating or Amazon feedback.

Sesame credit assists Taobao’s legal system in the following way. First, many of the benefits from Taobao are tied to a high sesame score.\(^ {36}\) This provides additional and strong incentives for users to maintain a good reputation on Taobao. Sesame credit score provides a simple, comparable measure of a trader’s overall trustworthiness and creditworthiness. Sesame credit ratings help distinguish dishonest traders from others, augmenting Taobao’s power to monitor suspicious transactions and to lower the risks from market violations.

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\(^{36}\) Benefits include loans to small businesses, a fast track in visa applications and at airports, and even a better reputation on several online dating websites that Taobao partners with.
Taobao has begun experimenting with a “House of Representatives” for adopting rules in a manner that gives Taobao users a voice in rule-making. For now, it has opened unessential platform rules to voting, which helps adapt the platform rules to the changing demands of users. When Taobao proposes a rule change or a new rule at the House of Representatives, all buyers and sellers with a decent “sesame score” can vote on, as well as express their opinions about the rule. The buyer/seller who has voted at least once becomes an ordinary representative. Besides ordinary representatives, Taobao also invites legal professionals and scholars to become senior representatives or expert representatives. These experts provide elite cues to ordinary voters. Within a certain period after each voting, Taobao makes public the results and adjusts the rule accordingly. From June 2015 to February 2017, there were 42 rules voted at the House, each of which involved over 10,000 voters.

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37 The following is an example. In September 9, 2015, Taobao proposed to raise the penalty on one type of contract violation: if the seller fails to ship the product by the promised deadline, he now needs to pay the buyer 5RMB as compensation instead of 1RMB. The case webpage includes the following contents. (1) It explains the reason for this rule change – improving the satisfaction of the customers and regulating the sellers’ shipping behavior. (2) It outlines the key points of this rule change – raising the compensation from 1 RMB to 5RMB in all products except for a list of special product categories (e.g. service, education, restaurant coupon, etc). (3) At the bottom of the webpage, it asks how the user thinks about this rule change, whether they will vote “(A) the rule change is appropriate” or “(B) it should be re-considered.” The voting took place between Oct. 16 and Oct. 22, 2015. On Oct. 28, 2015, Taobao published the results: the majority of votes go to A, so A is made into the rule. In the same announcement, Taobao also acknowledged some reasonable concerns raised by the minority group who voted for B – an increase in compensation to buyers will only increase buyer’s incentive to abuse the right - and in response, Taobao listed the existing constraints on buyers to avoid this from happening.

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

5.5. Evaluating Law, Chinese Style

Law, Chinese style, remains at an early stage. Because China lacks a reliable legal system that provides the sufficient legal services or infrastructure necessary for markets, Taobao has begun to experiment with the provision of legal infrastructure, and it has made significant progress on solving the assurance problem for its traders.

To this end, Taobao has begun to devise a complex system of institutional components designed to provide many of the services supplied by formal, public legal institutions in the developed countries. We have detailed the elements of the new institutions in section 4 and previous subsections of section 5. They include a reputation score, a Sesame credit score, a fraud detection program, and a multi-faceted dispute resolution system. Taobao have also begun a system that draws on user experience and preferences in an experimental “House of Representatives” that allows traders input into choosing new rules. Taobao also metes out various punishments for violations of the rules.

The main difference between platforms in developing countries and those in the developed West is this. We observe that many online exchange platforms in the West, such as Amazon and eBay, have devised and begun experimenting with many of the same elements as Taobao. But the underlying legal system – China vs. the United States – differs so considerably that exchange platforms in China must be far more complicated than their American counterparts, and their substitution effects for state’s legal function much more elaborate. For example, Taobao’s reputation mechanism is far more complex than that of eBay.
Taobao’s system has begun to have aspects of law. To see this, we draw on the “what-is-law” framework of Hadfield and Weingast (2012, 2014). For a set of rules to be considered law, they must have three characteristic. First, the rules must be characterized by the various familiar legal attributes (Fuller 1964, Raz 1979). These include:

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

Second, there exists a common knowledge set of rules that govern the choice of new rules and the adaptation of old ones (Hart 1961). Third, there exists a third-party enforcement mechanism. Notice that the third characteristic does not require, as in so many approaches to law, that government coercion is the principal component of legal enforcement. As Hadfield and Weingast argue, they key is third-party enforcement, which may involve state coercion; but in most states enforcement also, even primarily, involves decentralized enforcement by citizens and traders.

We briefly consider Taobao’s system with respect to these three characteristics of law. Consider the various legal attributes of the first characteristic. **Stability**: The rules
remain in an experimental and are evolving. The basic approach to fraud appears to be
general. As we detailed, Taobao is constantly updating its means of detecting fraud, as
in the use of big data and refining algorithms. But the rules about what constitutes fraud
seem stable over time, promulgated, known in advance, consistent, and feasible.
Because these characteristics are fundamental to any incentive system promoting
rightful behavior, Taobao has every incentive to make sure its rules conform to these
attributes.

We make two further points about stability. First, Taobao has incentives to keep
the laws more stable, as they paid costs in the past for rule changes that unleashed
several large-scale protests against Taobao.  

Second, for many reasons, online markets evolve much faster than offline
markets. Therefore one should not use the same time measurement for offline market to
assess whether an online market regulation is stable or not. Regulations for offline
markets took hundreds of years to form; online market started less than two decades
ago, and yet online markets face the same problems as the offline markets, plus some
new problems. The regulations have to be designed in a much shorter time frame.
Consider the cycle of rule changes: rule/law implementation => feedback => new
rule/law. The feedback for online market regulation is much faster to obtain than that of
offline market policies, because everything is digitalized. Because it is easy to see the

40 Taobao experienced several protests from vendors. The largest online protests –“Taobao October Rising”(shi yue
wei cheng) took place in October 2011 after Taobao announced a new fee schedule. Nearly 50,000 small merchants
coordinated and initiated various digital protests. Finally, the government stepped in to mediate; Taobao conceded
and offered 1.8 billion RMB to help small business use its platform, as well as
. More details about the protests can be found in various online sources, such as
http://www.chinadaily.com.cn/bizchina/2011-10/13/content_13881570.htm,
tmall-end-digital-protests.
regulation outcomes, which makes policy changes more frequently, Taobao can run experiments and obtain quick results. In other words, when talking about stability for online market, we should use a more compressed unit of time to make the judgment.

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

The third characteristic, enforcement, is central to Taobao’s operation. As noted above (in section 4 and earlier parts of section 5), Taobao has a range of punishments. These actions including adjusting a trader’s reputation, assessing fines applied to money held in escrow, banishment from Taobao, and even prosecution using the local, if inefficient, legal system. As emphasized in the what-is-law framework, all of the punishment elements except the last do not involve state coercion. They do involve third-party enforce through Taobao and, hence, indirectly, through the reactions of the community of traders.

It seems clear that the future of Taobao involves refining the system so that it meets the three characteristics of law. Markets require stable expectations so that traders know what practices are legal and illegal; and, further, they know the consequences of their choices. This seems to require that Taobao move in the direction
of establishing the various legal attributes. Further, Taobao is likely to create a system of precedents to ensure widespread promulgation of the rules, that like cases are treated in a like manner, and that traders can establish expectations about how they will be treated under the rules. Finally, Taobao will inevitably refine the rules by which the rules are chosen.

Many of the elements of each of these characteristics are already in place. Resolution by Taobao employees who specialize in adjudicating cases could evolve into a judicial system with Chinese characteristics. Needed is a mechanism – a set of incentives – that would ensure these specialists establish and apply rules with the legal attributes. The jury system is another possible source of rules and even case law. Finally, the House of Representatives may well prove the start of a systematic means of adding new rules to cover particularly troublesome circumstances.

The assessment above shows that Taobao’s system has begun to have aspects of law. This raises a question fundamental to the resilience of Taobao’s private legal system: can Taobao’s system survive in a politically dangerous environment and where government predation and expropriation are real possibilities? Regardless of the quality of its dispute resolution mechanism, Taobao is of no use to its traders if the government finds Taobao a significant threat and decides to expropriation or close down the firm.

Working against the threat of expropriation is Taobao’s sheer size. With over 400 million users, the platform has a huge support base that could be used to turn on the government were it shut down Taobao. This is not to say that Taobao and its users are safe; but that the central government would pay a high price for shutting down the firm.
6. Taobao and the Evolution of Federalism, Chinese Style: Recentralization

The preceding sections draw a parallel between Law, Chinese Style and Federalism, Chinese Style, showing that both involve delegation of central government authority to particular domestic actor(s) with a limited scope.

Yet the two sets of delegation differ considerably in how they affect the formation of a national common market. In this section, we argue that delegating a part of legal functions to online platforms such as Taobao has helped foster a common market, a condition left incomplete in the model of federalism, Chinese style (due to the central government’s inability or unwillingness to ensure factor and product mobility across regions). The key to this difference is that local governments are less able to resist and reverse a common market achieved online than to one formed offline; we will explain why.

This Taobao-induced process of market integration has deep political implications. It tips the power balance between the central and local governments. As we start to observe, Taobao provides an instrument for the center to strengthen its authority, so that the fragmented local powers can be monitored and disciplined.

6.1. Decentralization and the Incomplete Common Market

As noted by Montinola, Qian and Weingast (1995), a key component of market-preserving federalism – the common market condition - is missing in federalism, Chinese style. The Chinese national government does not have the authority to police the internal common market, that is, to ensure the mobility of goods and factors across sub-national jurisdictions (Montinola, Qian and Weingast 1995:55). The absence
“explains in part why many local governments have focused on trade barriers and aggressive antimarket policies within their jurisdiction” (Montinola, Qian and Weingast 1995:53).

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, beggar-thy-neighbor policies, and in an extreme form, the rise of a dukedom economy.

The common market condition is difficult to achieve. While the central government retains important control over local governments (e.g. personnel control), local governments can still resist a common market through two means: (a) by not fully implementing central policies (since local governments are the main enforcers); (b) by misrepresenting the information about central policy implementation (because local governments enjoy information advantage against the center).

In a nutshell, federalism in China has not guaranteed a common market. 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. Still provinces and local governments have had to compete for business on the international market. These two sources of competition – among lower jurisdictions in China and on the international market – have generated the incentives for China’s economic growth.

6.2 Taobao and the Formation of a Common Market
Taobao creates a common market, a process that, especially at the initial stage, bypassed the local governments. Taobao’s effect on market integration is threefold. First, it lowers the entry barrier to the national market, making trade more inclusive. In particular, it allows small or rural sellers/buyers to participate in the national market, an access that they otherwise would not enjoy in the offline setting. This parallels the access to markets in mid-and-late 19th century United States when mail-order catalogs greatly expanded access rural citizens’ access to consumer good, and at far lower prices (see Chandler 1977, ch.7; and Blanke 2000). Second, Taobao has strong vested interests in keeping the platform free of trade/regulatory barriers across regions. No matter whether a seller/buyer lives in Beijing or Tibet, she is governed by the same set of platform rules. Third, having 400 million users also means political clout with the central government. Were the national government to shut down and expropriate Taobao’s assets, it would face 400 million angry citizens whose interests the government has trampled. As a result, Taobao facilitates the cross-regional mobility of goods and capital (i.e. online payment). It intensifies competition at the national level, and breaks down natural monopolies, e.g. physical stores benefiting from geographical isolation. All of this, in turn, increases the demand for infrastructure, such as roads, power plants, railway lines, and so on.

Importantly, local governments have limited means to resist and reverse a common market achieved online. First, as argued earlier, Taobao creates a set of private market infrastructure independent of those provided by local governments.

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41 Taobao’s Rural Expansion Plan was launched in October 2015, aiming to grant e-Commerce access to 1,000 counties and 100 Thousand Villages in the next 3-5 years. By the end of March 2016, the project had covered 333 counties and 16,500 villages. Alibaba’s Annual Report for the Fiscal Year ended March 31, 2016. Retrieved from http://www.alibabagroup.com/en/ir/pdf/agm160524_ar.pdf
Taobao’s system is largely self-sufficient. Even if local governments want to intervene and regulate the online market, they need to first address a coordination problem among themselves. Consider an example about the difficulty to coordinate local governments. A seller lives in Beijing, but her factory is in Hebei; she has a dispute on Taobao with someone in Guangdong; the headquarter of Alibaba (Taobao’s parent company) is located in Zhejiang. 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?42

Second, Taobao creates an information vacuum for the local governments. Local governments have scant information about the online market, and they do not have sufficient power to bargain for full information against a transcendent platform. For example, local governments do not know, within their jurisdictions, who are selling/buying what and where they are selling/buying it.

Taobao qua market platform seems a potentially important mechanism for ensuring the common market. Because local governments have great difficulty regulating national market platforms, Taobao and like 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.

6.3 Taobao and Recentralization

The central government lacks the will or the means to police the internal common market. But can the government use Taobao as an indirect means to monitor and

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42 The railroads raised similar problems with regulation in the 19th century American common market.
discipline local governments? Two assumptions underlie this suggestion: (a) central and local governments are in constant tug-of-war over information and power; (b) Taobao prefers large to small markets, it hence favors colluding with the center against local authorities, rather than the other way around.

So far Alibaba/Taobao has started to collaborate with the central government on a variety of issues, including national security, credit scoring, poverty reduction, job creation, e-government, and economic information sharing.

Taobao helps strengthen central authority in three ways. As a powerful, centralized tool of collecting market information, Taobao can reduce, and even reverse the center’s information disadvantage towards local governments. While local governments are known for faking economic numbers (Wallace, forthcoming), online transaction data can provide a real-time, objective barometer about a region’s economic vitality. For example, Alibaba invented Alibaba Shopping Price Index or aSPI - an index based on the price changes of a particular basket of goods and services. The index can be used as an alternative to CPI to reflect real-time inflation and price fluctuations.43 Increasingly there will be more data collaboration between Alibaba and the central government, including the establishment of a national credit information sharing platform.44

Second, Taobao helps enforce central policies and provide public goods, including poverty alleviation and rural development. For example, the Rural Taobao

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Program subsidizes logistics services to rural markets, and helps poor areas to sell agricultural products to urban consumers.

Third, by breaking down internal trade barriers, Taobao weakens the authority, revenue, and rent-creation by local governments.

Finally, as Taobao grows, it will become a force that can potentially demand concessions from the central government. It is not at all clear whether these two parties will collaborate or end up in conflict.

7. Conclusions

We asked three questions at the outset: what is the scope of Taobao’s law-creation? What effects is Taobao likely to have on federalism, Chinese style, and the common market? And why would the central government delegate this authority – or at least acquiesce in Taobao’s assumption of this authority?

In this paper, we developed a framework for addressing each of these questions. Online market platforms, such as Taobao, appear to be changing the politics, economics, and legal basis of China. We argue that Taobao has created far more than an exchange system; it has created a national market platform, including the market infrastructure necessary to sustain markets that the central government has been reluctant to provide. We summarize this infrastructure in the phrase, law, Chinese style.

In contrast to the developed world where government provides much of the familiar market infrastructure, the central government in China has effectively delegated the authority to develop this infrastructure to private parties. The advantage to the center of this delegation is that it allows experimentation; and, further, it allows the
central government to distance itself from any failures. Whether this experiment will succeed, and how far it may go in producing law, has yet to be seen.

We also argue that this system of creating a national market is having important political and economic effects, especially with respect to federalism. From the beginning of the reform process, the Chinese common market has been hindered by internal trade barriers. By providing an online national market, Taobao holds the potential to circumvent these trade barriers. Online trading platforms qua markets hold the potential to grants tens of millions of people access to markets previously beyond their grasp. For example, where the market has been a small force in many rural areas, online platforms can initiate a dramatic change. This process will also generate substantial demand for traditional infrastructure, such as roads, railroads, and electricity.

The common market associated with Taobao is likely to have important political effects as it reduces the power of local governments as it collaborates with the central government. After all, Taobao provides a national solution to the rising national problems, which are beyond the reach of any local government. Taobao therefore holds the potential power to generate substantial Smithian sources of economic growth through greater division of labor and exchange within Chinese economy.

Taobao has another potentially valuable service, namely, that the firm may well travel to other developing countries. Undoubtedly many of Taobao’s rules are uniquely situated for the Chinese culture, political setting, and economy. But the structure itself – the platform, the dispute resolution system – is not limited to China. In principle, we may see emerging “Taobao India,” “Taobao Bolivia,” and “Taobao Ukraine.”
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.

References


