

# **Law, Commerce And Knowledge In 18-20<sup>th</sup> Century China: An Institutional Perspective On The “Great Divergence”**

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## Abstract:

In the West, the legal tradition was generally characterized by the use of external and relatively fixed rules and standards, executed by independent third parties. In China, the legal structure was part of the government bureaucracy and relied on the use of vaguely and flexibly defined legal and ethical principles and intermediation to resolve civil and commercial disputes. This paper provides a review on China's traditional legal system in comparative perspective and examines the organizational evolution of two major Chinese merchant groups in the 18-20<sup>th</sup> century. It shows that reputation mechanism and informal and internal rules played a major role by these merchant groups to surmount information and moral hazard problem incurred in commercial transactions. This paper argues that as the Western type of rule-based system could exhibit scale economies with rising efficiency at higher volumes of exchange, particularly impersonal exchange, divergent legal traditions could give rise to differential patterns of long-term economic growth between China and the West.

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The rise of the East Asian miracle economies, particularly in their heydays of the 1980s and 1990s, has spawned a copious amount of literature on the so-called East Asian model of growth. Often, the East Asian model, based on factors such human capital accumulation, export-orientation, close cooperation between government and the private sector, and extensive reliance on internal, long-term relationships was presented as an alternative or a challenge to the neo-classical free-market, private property rights model based on the Western historical experience (citation here).

China's remarkable economic growth since her emergence out of political isolation from the late-1970s became a further endorsement to the East Asian model with the weight of a billion people. It is now widely recognized that the crucial set of institutional factors that accounted for the two decades of economic miracles in China – ranging from household responsibility system, the township and village enterprise, to the overseas Chinese networks of FDIs to China - were largely informal, spontaneous and often ad-hoc. Yet they brought an enviable growth record in the past two decades in outstanding contrast to the economic collapse and dislocation in the formerly Communist countries of Russia and Eastern Europe that opted for the so-called “shock therapy,” an ideology more in tune with the orthodox Western neoclassical economic ideal.

These historically unprecedented phenomena were also stirring up intellectual currents on the historical front. In the 1970s and 1980s, a revisionist view both inside and outside Japan emerged to challenge the long-held Marxist oriented view of a stagnant and backward Tokugawa era

(1600-1867). According to this view, there occurred cumulative social and economic progress in the Tokugawa era that laid the social, economic and institutional foundation for the rise of economic growth since Meiji Japan.

The last few years saw the emergence of a revisionist school on the 18<sup>th</sup> century China, now also known as the California school.<sup>1</sup> As an antithesis to the prevailing Malthusian portrait of a Chinese economy in long-term stagnation since the economic revolution of the Southern Song (1126-1278), the California school argued for a case of substantial progress in industrial and agricultural technologies, expansion of regional trade, urbanization, and perhaps even demographic transition. The nearly 300 years of economic expansion particularly in China's most advanced region of Lower Yangzi, characterized by intensification in land and resource utilization, development of energy-saving technology and expansion of regional trade, constituted the core of the so-called Smithian growth, a pattern akin to the "industrious revolution" which were claimed for Tokugawa Japan and early modern Europe. This partly gave rise to Kenneth Pomeranz's claim that the level of development and the standard of living in the 18<sup>th</sup> century China, at least in the advanced region of Lower Yangzi, could be comparable to northwest Europe.<sup>2</sup>

Were the initial conditions in China or East Asia as high as claimed, how did industrial revolution eclipse East Asia? For this age-old question,

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<sup>1</sup> The California school include scholars like Kenneth Pomeranz, James Lee, Bozhong Li and Bin Wong and others.

<sup>2</sup> For studies emphasising the importance of early modern development in European economic history, see Jan DeVries "The Industrious Revolution." For a balanced summary of the optimistic revision of Tokugawa economic history in Japan, see Yasuba, "The Tokugawa Legacy: A Survey."

Pomeranz fall back on the resource endowments – the absence of coal deposits in the Lower Yangzi *versus* the natural resource windfall from the discovery of New World for Europe – as the explanation for the ultimate divergent paths between China and Europe after the 18<sup>th</sup> century. Economic institutions hardly factored at all in this historical debate.<sup>3</sup>

It was the recent Asian financial crisis that brought the whole issue of institutions and governance to the fore. The scrutiny and revaluation on the once highly regarded East Asian model of corporate governance with its characteristic features of cross-share holding, internal finance, group-dominance and high level of integration spawned a new literature on the relationship between legal system and economic institutions. Unfortunately, the parochial focus of this so-called “legal origins” literature on the Western legal traditions – whether common or civil law systems were more efficient in promoting economic growth – largely neglected pre-existing non-Western legal traditions, which, for most developing countries today, formed their basic underlying structure of economic and political institutions often under the guise of Western legal lexicon. More importantly, in traditional societies, it was usually the informal institutions and norms that played a much larger role in regulating people’s economic lives. Studies focusing exclusively on “formal” legal sectors were bound to be insufficient and even misleading.<sup>4</sup>

This paper examines the relationship between China’s traditional

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<sup>3</sup> Pomeranz (*Great Divergence*, p.14) treads lightly on Douglas North’s thesis on economic institutions.

<sup>4</sup> Ohnesorge (China’s economic transition) provides a summary and criticism of the ‘legal origins’ literature.

legal system, merchant organization and economic growth. It shows that in distinction from the Western legal tradition defined by the use of transcendental and fixed legal rules by an independent legal class, the Chinese legal system for civil and commercial affairs relied on vaguely defined general principles and the mutual compromise of litigants. As a partial substitute to a vaguely defined formal legal structure, a strong social order of communities, networks based on long-term relationships developed in China to help secure properties and contracts, and reduce information and transaction costs for trade and growth.

This paper proposes that, as the Western type of rule-based system exhibit scale effects, being more economically efficient at larger volumes and scales of transactions and thus more conducive to impersonal exchange, divergent traditions in legal knowledge and institutions carry important implications on the “great divergent” thesis on the paths of long-term growth between China and the West. This difference is also equally relevant for understanding both the absence of industrial revolution in East Asia in the early modern period and its spectacular catch-up since the late 19<sup>th</sup> century.

In the next section, I focus on the traditional Chinese legal system in a comparative perspective. The third part provides a narrative of two major Chinese merchant groups. The fourth section discusses the comparative economic efficiencies of rule-based versus relations-based regimes and their possible impact on long-term growth trajectories.

## **i. Law And Legal System In Traditional China**

To examine the traditional Chinese legal system, the distinction by Max Weber between formal and substantive justice appears to be a more useful starting point. Under formal justice, legal adjudication and process for all individual legal disputes are bound by a set of generalised and well-specified rules and procedures. Substantive justice, on the other hand, seeks the optimal realisation of maximal justice and equity in each individual case, often with due consideration to comprehensive factors, whether legal, moral, political or otherwise. Formal justice tends to produce legal outcomes that are predicable and calculable, even though such outcomes may often clash with the substantive postulates of religious, ethical or political expediency in each individual case. Formal justice, as argued by Weber, reduces the dependency of the individual upon the grace and power of the authorities, thus rendering it often repugnant to authoritarian powers and demagoguery. Weber's framework, extended by influential scholars like Roberto Unger in the U.S, formed the theoretical foundation for explaining the rise of legal order and the rule of law in the West.<sup>5</sup>

Influenced by Weber and Unger, post-WWII Japanese legal scholarships on traditional Chinese justice system, as exemplified by the work of Shuzu Shiga and others, is most notable for their careful analysis based on the reading of archived legal cases.<sup>6</sup> Shiga started out with the well-known fact that the Chinese legal apparatus was an integral part of the

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<sup>5</sup> Weber, *Economic and Society*, vol.II, p.812. Unger, *Law in Modern Society*.

<sup>6</sup> See Shiga *et al.*, *Ming Qing Shiqi*, Huang, *Civil Justice*.

administrative system; the administrative bureaucracy within the hierarchy – from the county level all the way to the emperor – were the final arbiter in criminal cases. This feature is crucial for understanding that the Ming and Qing penal codes, despite their reputed elaboration and comprehensiveness, were decision rules designed for the bureaucrats to meter out punishments proportionate to the extent of criminal violations. Similarly, legal rulings can be reviewed and changed only through the multiple layers of bureaucracy within the administrative hierarchy. Legal statutes or sub-statutes were not open to contestation and interpretation by the litigating parties or independent third parties. In this regard, legal studies in China – if such a term applies in the Chinese context – are more a study of codes.

The fundamentally penal nature of the Chinese legal codes was not amenable to dispute resolution of commercial and civil nature. However, the county magistrates, the lowest level bureaucrat did handle and rule on legal disputes that did not entail any corporal punishment. It has been shown now that a vast number of civil and commercial cases were actually brought to and settled at the court of the county magistrates.<sup>7</sup> But Shiga's main contribution, based on his reading of the rulings of the magistrates, is to point out that these county-level trials were something more akin to a process of 'didactic conciliation', a term he borrowed from the studies of Western scholars on the Tokugawa legal system in Japan. The decisions of the magistrates were not legal 'adjudication' as in the Western legal order.

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<sup>7</sup> For the extent of average people utilising the county level civil trial system, see Susumu Fuma's article in Shiga *et al.* and also Huang, *Civil Justice*.

Shiga demonstrated that the ruling by the magistrate invoked general ethical, social or legal norms, but they rarely relied on or cited any specific codes, customs or precedents as its legal basis. In accordance with its intermediation characteristics, the magistrate's ruling showed less concern for the adoption of a reasonably uniform and consistent standard than the resolution of each individual case with full consideration to its own merits. Furthermore, his ruling, effective only upon the approval by the litigants, seemed to lack the kind of binding and terminal force as the legal adjudication in the modern sense.

The crucial distinction between the traditional Chinese legal system and the Western legal tradition has often been grossly misunderstood. Modern Western legal system had its origin in the 13<sup>th</sup> century papal revolution which won the Church legal autonomy from the secular authority. It was the Church's jurists - the Canonists - that began the systematic compilation and testing of legal codes, which were to evolve into a new and independent science of law. Their codification and rationalization of the diverse and extensive customs in the Medieval West helped turn customary laws into relatively consistent legal standards for the rulings by the court and claims by the litigants. Western legal tradition evolved over time with major intellectual and political revolution such as the Reformation and the Enlightenment movement. The modern Civil Law came about through the rise of modern nation-states that amalgamated and reinterpreted the traditional customary laws in different territories of jurisdiction (Harold Berman, Toby Huff, Jerome Bourgon, 53-55).

On the other hand, "customs" in China, as emphasized by both Shiga



and Jerome Bourgon, were largely un-codified, informally defined with no clear territory delimitation. They might at times serve as a reference but almost never stood as the specific legal basis upon which the county magistrates made their decisions or the litigants made their claims. The nature of the “customs” in China is consistent with the absence of a formal civil and commercial code or professional legal class until after the 20<sup>th</sup> century under the Western impact. In fact, the legal gaps between the systems were, as Bourgon argued, so large that the application of the Western terminologies such as “customary law” to the Chinese context became the source of much of our confusion about the traditional Chinese legal system.<sup>8</sup>

This divergence in legal systems, as Shiga emphasised, should not be viewed as an illustration of the shortfalls of the Chinese legal system in the Western perspective, but on the contrary, they were the intended consequence of the divergent cultural value systems. In the West, while the ideals of legal rules, standards or precedents used to define the rights and claims of individuals and groups strived to be consistent, replicable, transcendental and inflexible; in China, the relative vagueness and generality in China’s legal system provided flexibility for resolving disputes in accordance with the Confucian ideals of social harmony. Inculcated in Confucian classics, the wise and venerable magistrates or any other

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<sup>8</sup> Huang (*Civil Justice*), based on his archival legal cases, challenged Shiga’s thesis and argued that the rulings of magistrates were binding and had basis in formal legal codes. However, such conclusions, as argued in Shiga and Terada’s replies to Huang, were based on a questionable methodology, as Huang ‘rediscovered’ and matched the formal penal codes with the original legal rulings of the magistrates based on his own assessment. See Terada (1995).

“arbitrators” would be deemed as a better embodiment of social, legal and ethical justice than the external rules that concern only legal rights and obligations. Thus, a perennial theme in Chinese legal thoughts and legends had been the emphasis on the cultivation of the character and capability of bureaucrats.

Such a person-based legal system was clearly vulnerable in many ways. In cases when the character and the ruling of the magistrate were thrown into doubt, a process of endless appeals through the hierarchy of bureaucracy could often ensue. In other cases, the system became highly susceptible to bureaucratic abuse and the rule of arbitrary power. But how is it that for most parts of her history, social order in China did not disintegrate. Hiroaki Terada, a former student of Shiga, attempted such an answer through the reconstruction of a traditional Chinese social order where rights were vaguely defined and rules flexibly interpreted and thus disputes over properties and contracts often resolved or regulated through the interplay of social norms, power, compromise and rational recognition of long-term benefit and cost (Terada, Chuanli and Yuanyan). More importantly, beneath the thin layer of “formal” social order were the more prevalent informal and internal rules in the form of family bylaws, lineage rules and guild regulations which helped ensure properties and contracts within the organization.

This mechanism is not particularly unique to China as revealed in the study by Avner Grief on the role of a group of Muslim traders, the Magribis, in the late-Medieval Mediterranean. Adopting a game-theoretic framework, he argued that the Magribi traders organised their group as an

information sharing coalition with multilateral or collective punishment strategies to deter opportunistic behaviour and sustain long-distance trade on a long-term basis in the absence of formal legal mechanism. This strategy, known in the theory of repeated games as reputation mechanism, was the key to the revival of commerce in Mediterranean Europe during the late-Medieval period.

We know that inter-regional trade, the core of the Smithian growth, greatly expanded in Ming and Qing. The long line of research on market integration based on statistical correlation of regional grain prices in China seem to confirm a reasonably high degree of market integration and efficiency in 18<sup>th</sup> century China, possibly rivalling or even exceeding that of contemporaneous Europe.<sup>9</sup> In the following, I show that two of the largest merchant groups originating in Huizhou and Shanxi succeeded precisely by group solidarity and their penetration into the government bureaucracy.<sup>10</sup>

## **ii. Merchant Groups And Bureaucracy**

### *The Huizhou Merchants*

Ironically, the two prominent merchant groups originated from among the poorest inland provinces China today, Anhui and Shanxi. The first group, from around Huizhou city area of Anhui province, also called the

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<sup>9</sup> Wang, Secular trends, Li, Integration and disintegration, Shiue, Transport costs, Shiue and Keller, Markets in China.

<sup>10</sup> See Zhang Zhongmin (1995) for the ten merchant groups.

Hui Merchants, had been known as early as the Song period. They began to thrive during the Southern Song following the southward relocation of Chinese capital to Hangzhou, Zhejiang province, which is within their easy access through the Xin-an River. They rose to commercial prominence possibly from the middle of Ming.

Although the bulk of the trading activities of the Hui merchants were along the Yangzi, especially the Lower Yangzi region, their reach extended nationwide and even overseas to Japan.<sup>11</sup> The treacherous and mountainous geography of Huizhou supplied them with meagre arable land but abundant isolation, providing for effective shelter from outside aggression and stable village communities and – most fortunate of all – leaving us an astounding trove of historical documents ranging from private contracts, land deeds, genealogies, travel logs and account books, enough to give birth to a new academic discipline; Huizhou Studies (Huixue).<sup>12</sup>

Geography may be linked to another Huizhou phenomenon; its elaborate and sophisticated lineage system. Recent research revealed that Chinese lineage as a form of social and economic organisation was far more dynamic and flexible than previously understood. For example, David Faure pointed out that lineage, as distinguished from family, has a distinctive ‘corporate’ character: properties were owned in the name of

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<sup>11</sup> The most dramatic overseas activities of the Hui merchants evolved around Wang Zhe who, using island bases along coastal Japan and China, dared to challenge Ming’s banning of overseas trade in the 16<sup>th</sup> century. His rebellious military and commercial activities have been mistakenly attributed to Japanese pirates. Wang (*Huizhou Shehui*, pp.519-578) recently showed that Hui merchants continued to play an important role in trading activities in Japanese ports such as Nagasaki even in the 19<sup>th</sup> century.

<sup>12</sup> Yao, *Huizhou Xue*.

lineage with perpetuities lasting beyond the lives of any individual members; rights to partake in the distributions of lineage assets were regarded as shares (*fen*) that depended on contributions rather than descent; the managers had the rights and responsibilities, to manage, but not to dispose of the property without the consent of the lineage segments concerned.<sup>13</sup>

More intriguingly, lineages could expand or contract through the so-called lineage union (*lianzhong*) – different lineages combining their genealogies (*tongpu*) and amalgamating under a common ancestor, who, in most cases, was actually fictitious. Sometimes a lineage union could result in the formation of giant lineage encompassing several tens or even hundreds of thousands members across counties or even provinces governed by elaborate rules. The motivation behind lineage union, as most scholars agree, seemed economic and political more than anything else. Resources pooled by lineages provided important local public goods: charities for the poor, education funds for the young and promising, and opportunities for commercial and financial expansion.<sup>14</sup>

Thus, a region's degree of commercialisation seemed to positively correlate with its strength of lineage organisation. For example, lineage practices were most widespread in the Pearl River and the Lower Yangzi

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<sup>13</sup> Faure, *Lineage*, pp.84-87. A fascinating study by Chung (Cultural foundations) reveals the intriguing legal dilemma confronted by the British legal system in Hongkong on whether or not lineage asset holding qualified as an equivalent of the Western 'corporation'. Chung shows that most of the Chinese business registered as corporations in Hongkong operated under the name of lineage within China.

<sup>14</sup> See Qian (*Xuyuan*) for detailed research on the nature and extent of lineage and lineage unions. A careful study by Pyo Yuan-Gao (*Ming Qing*) shows that a lineage in Huizhou, through union and amalgamation had expanded from 10 branches in 1608 to 65 branches by 1753 (p.211-212).

delta. But the Huizhou lineage seemed to top all. Therefore, trust among Hui lineages provided credit, capital and business partnership. Lineage members and very often their domestic servants were the main staff members of the firms: managers, accountants, runners or agents across distant trading towns. The careful compilation and constant update of lineage genealogies served the important function of information gathering and commercial networking. Genealogies, as one scholar put it, were the practical roadmap for the Hui migrant merchants.<sup>15</sup>

The organisational strength brought them unmatched competitiveness. In Nanjing, the coordination of 500 Hui merchant pawnshops drove out Fujian merchants with below-market interest rates. In Yangzhou (Northern Jiangsu), Hui merchants usurped the once dominant share of the Shanxi group in the highly profitable salt trade under government monopoly. Soon, trade in ink and printing products in Shanghai, grain and lumber in Wuhu, Anhui province and textiles in the Lower Yangzi, was to become their mainstay. Along the Yangzi, particularly the Lower Yangzi, their presence has become so ubiquitous as to give rise to the saying that 'no Hui, no market towns' (*huhui bu chengzheng*).<sup>16</sup>

### *The Shanxi Bankers*

The Shanxi merchant group, from a region with a fair share of barren land, achieved commercial fame possibly even earlier than that of the Hui.

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<sup>15</sup> Pyo Yuan-Gao (*Ming Qing*) and Sachiko Usui (*Kishu Shounin*)

<sup>16</sup> See Zhang *Qianjindai Zhongguo*, pp.156-168, Ye, Huizhou he jujiang, and Zhang et al., *Huishang Yanjiu*. For lineage organisation in Huizhou, see Xiong, *Shindai Huishu*.

Their trading routes, more in the North-South direction, extended nationwide and reached Russia through the caravan land-routes. But what brought them unprecedented prosperity was their nationwide money remittance service from the 19<sup>th</sup> century. The legend has it that it all started around the 1810s when a paint and dye merchant started China's first *piaohao*, a banking firm that provided merchants and long-distance travellers with drafts that they could exchange for cash at a specified branch after they reached their destination, thus effectively reducing the cost and risk of carrying bulky metallic cash.

By the mid-19<sup>th</sup> century, dozens of *piaohao* firms based in three Shanxi counties were setting up branch offices throughout major commercial cities in China, and turning, of all the places in China, a remote, little-known city, Pinyao, into the financial hub of a nationwide network of money remittance. After the turn of the century, they reached into Japan and Korea. Thus, for an entire century until the fall of Qing in 1911, the Shanxi bankers had locked up the money transfer business in China.<sup>17</sup>

The Shanxi bankers developed a distinctive set of organisational features that made little use of lineage ties, professedly weaker in Northern China. While the capital of a *piaohao* is based on business partnership or individual proprietorship with unlimited liability, the daily operation of a *piaohao* was actually run by outside managers and staff with minimal or no

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<sup>17</sup> For Shanxi bankers' branch offices in Japan and Korea, see Hamashita (*Financial Networks*). The city of Piaoyao became a classic class of agglomeration of other complementary services to support the Piaohao service. These services, all privately owned and operated, included professional bodyguard service (Biao Ju) which offered protection for long-distance transport of silver and mail delivery (Ming-Xin Ju). For a narrative of Shanxi bankers, see Shi Roumin, *Shanxi*.

interference from its owners. In fact, as Zhang Zhongmin pointed out, many firms had an explicit exclusion clause barring the hiring of staff related to their owners.<sup>18</sup>

The second feature of *piaohao* is its reward structure. The assets of a *piaohao* consisted of capital share (*ninggu*) from owners and labour shares (*shenggu*) from managers and staff. Labour shares entitled staff to partake in the share of dividends from profits, a scheme in striking resemblance to the modern profit-sharing scheme designed as a way to provide incentives that align the interests of employees with the long-term interest of their company.

Finally, what made this surprisingly ‘modern’ system tick was the addition of a third, very ‘traditional’ element: all hiring were restricted to Shanxi natives only. Usually an apprentice system was used to recruit staffs locally (including those to be sent to branch offices outside Shanxi) after careful background checks and often with their families or other reliable third parties as their guarantors. Any staff member caught and dismissed for fraudulent behaviour, as was reported, would be denied future employment opportunities by all Shanxi bankers. Clearly, the peace of mind of those who willingly parted with their silver taels – sometimes their life-savings’ worth – for a piece of a draft paper, rested almost solely on the incorruptible reputation of the Shanxi bankers.<sup>19</sup>

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<sup>18</sup> Zhang Zhongmin, *Jiannan*, pp. 36-7. Shi Roumin, *Shanxi*, chapter 2. For a comparative study that characterize the Hui merchants as lineage based versus Shanxi merchants as native-place based, see Liu Jianshen and Liu Pengshen, *Jinshang*, pp.342-348.

<sup>19</sup> Huang, *Shanxi Piaohao*, p. 608.



### *Merchant Groups and Bureaucracy*

The fate and fortune of Chinese merchant groups were also intimately linked with another distinctively Chinese political system: the relatively open and formal access to the political power structure through the taking of the highly competitive, arduous and impartial Civil Service Examination based on Confucian classics. Successful examinees who became gentry or bureaucrats were entitled to taxation and legal privileges. In view of the status of bureaucrats as administrators, tax collectors and legal arbiters, this system generated enormous incentive effectives – or rather distortions - for Chinese society, particularly merchant groups whose accumulated wealth was most vulnerable to the damages of arbitrary power.<sup>20</sup>

It is precisely in this area that the Hui merchants scored the highest in beating the system. For long, scholars have long been mystified by the passion for Confucian learning in Huizhou, which took pride in its numerous academies, schools, and literary associations. The emergence of a particular Huizhou school for the study of Confucius that upheld the social status of merchants has led some to question the old adage that that Confucian ethics were anti-commerce. Instead, Confucian values supplied ethical standards and moral motivation for Hui's commercial success.<sup>21</sup>

But beneath all this passion lies hard economic rationality: Huizhou had a proven track record in turning out successful candidates for the Civil Service Examination and Huizhou natives claimed a disproportionate share

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<sup>20</sup> See Chang's (*Chinese Gentry*) classic study on Chinese gentry and Civil Service Examination. For an argument that the Civil Service Examination as a retarding factor on the growth of scientific knowledge in China, see Justin Li "Needham Puzzle."

<sup>21</sup> Ye Xian-en, Rujia.

in Chinese bureaucracy.<sup>22</sup> Chinese society overall, also responded to incentives. Passion for studying Confucius, as others have argued, was not a distinctively Huizhou phenomenon – it was a common trait of all major merchant groups. In Guangdong, Lower Yangzi and elsewhere, lineage properties, lineage union and other social organisations were invested and formed deliberately to enhance the chances of success at the examination by their own candidates.<sup>23</sup> The bureaucrat-merchant nexus is important in accounting for the dominant position of the Shanxi and Huizhou merchants in salt trade under government monopoly and later Shanxi bankers' role as Qing's official agents of money remittance.

### **iii. Law, Knowledge And Economic Growth: A Discussion**

The above shows that internal and informal rules enforced through collective and community based mechanism played a key role for Chinese merchant group to surmount the pervasive contractual and information hazards in commercial transactions. This strategy is further complemented by merchant groups' investments in Confucian education to enhance their offsprings' chances for passing the Civil-Service Examination system, thus gaining access to the formal bureaucratic structure. Such a dual strategy may have helped bring certain security

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<sup>22</sup> For academies and schools and successful candidates of Civil Service Examination in Huizhou, see Ye, *Huizhou he jujiang*, pp. 34-37. For literary association in Huizhou, see Xiong, *Shindai Huishu*, pp.117-121.

<sup>23</sup> For the importance of bureaucrat-merchant nexus, see Zhang, 'Jiaer haoru', p.15 and Ye *Huizhou he jujiang*, p.36-7.

and stability to their contracts and properties, which were crucial for the rise of Smithian growth.

What is the economic efficiency implication of such a strategy, particularly in comparison with that of merchant organization operating under a rule-based system in the West. In a relation and group-based mechanism, the extent of exchange and scale of operations may be subject to sharply rising costs of information and coordination as the group and extent of trade expands. In contrast, an enforceable legal system with a set of codified and transparent standards and rules, subject to the interpretation and contestation of independent third parties may be more costly to set up initially but could exhibit strong scale economies to sustain larger volumes of trade, thus conducive to the rise of large-scale impersonal exchange beyond the internal groups (John Li).

This point comes out clearly in Greif's comparative study of Magribi traders and the Genoa merchants. In contrast to the Magribi traders who persisted in the use of informal mechanism of collective retaliation and community-based information sharing to respond to the information and agency problems in long-distance trade, the Genoa merchants based in the Italian city-state of Genoa gradually evolved towards formal political and legal organisations such as state and courts to solve similar sets of problems in a comparable business environment. The Magribi type of merchant organization required less costly formal organization and thus was efficient in supporting personal-based exchange. But diminishing returns could set in quickly with the rise in the cost of information-sharing and coordination among a larger group. Thus, the rule-based regime

such as that of the Genoa merchants became more effective over time and eventually won out as trade expanded.<sup>24</sup>

Contrasts in legal traditions and their relative efficiency implications also help shed light on economic and organizational changes after mid-19<sup>th</sup> century when China was forced to open by Western colonialism. The imposition of extraterritorial rights and transplantation of a Western legal system in China's treaty ports from the mid-19<sup>th</sup> century – with all due condemnation for their demoralizing and destabilizing consequence on Chinese sovereignty – served an indispensable function for guaranteeing the security of Western private banking and trading houses whose scale of capital and transactions by then far exceeded those of the traditional Chinese merchants. But an unintended consequence of this transfer was that those treaty port territories dominated by Western legal justice system had spawned a class of Chinese industrial and financial entrepreneurs, whose fortune and capital by the early 20<sup>th</sup> century had reached a level and scale unparalleled throughout Chinese history. More importantly, the organization of merchant groups began to evolve in new directions.<sup>25</sup>

In Shanghai, for example, the so-called Ningbo clique, merchants from around the city of Ningbo in Zhejiang province, acquired a dominating presence in Shanghai's rapidly growing native and later modern banking sectors through the cultivation of lineage and native-place ties.<sup>26</sup> But by the early 20<sup>th</sup> century when Shanghai became a full-fledged Western style

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<sup>24</sup> See Greif, Contract enforceability, and Greif, Cultural beliefs.

<sup>25</sup> See Ma. "Modern Economic Growth" for the Shanghai-based industrialization and the role of City-state institutions.

<sup>26</sup> Susan Mann, "The Ningbo *Pang*"

city-state, institutional changes were coming to the Shanghai Native Bank Association dominated by the Ningbo financial clique.

In a recent study based on newly opened archive materials, Du Xuncheng analyses the elaborate rules and regulations designed by the Shanghai Native Bank Association to ensure the rights and creditworthiness of its member banks in an era of political and national disintegration. In particular, he notes that the Association's rules for entry and exit of member native banks were entirely based on a bank's financial position. Moreover, the Association rules on disputes resolutions, being formally published and distributed, very often formed the legal principles for financial litigation in the relatively independent Shanghai mixed court. In cases when the legitimate rights of its member native banks were violated by other agents outside Shanghai and negotiation for settlement failed, the Association often resorted to the multi-lateral punishment strategy by notifying all its member banks to suspend any future transaction with that agent. Overtime, their rules were gaining increasing recognition and often become the guiding principles for native banks outside Shanghai.<sup>27</sup> It was possibly this mix as well as the transition between informal and formal mechanism of contract enforcement that supported the rapid growth of native banks in Shanghai, which were became the most important agent of industrial finance in Shanghai's so-called golden 1920s.

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<sup>27</sup> Du Xuncheng, "A Preliminary Study."

## Summary

Our debate on the “great divergence” should integrate the divergent traditions in legal traditions and institutions between China and the West in the early modern period. To the extent that those institutional and epistemological elements that underlay the legal revolution in the 11<sup>th</sup> and 12<sup>th</sup> century – the separation between Church and the state, the emergence of independent territorial jurisdiction, the pursuit of transcendental, objective and rectifiable standards – were also relevant, as argued by Toby Huff, for the rise of scientific revolution in early modern Europe, one needs to take seriously the linkage between legal institution and the origin of industrial revolution.

China’s traditional legal institutions had been firmly embedded in the bureaucratic structure of a centralized empire. The dominance of the Civil Service Examination in the traditional education system ensured that the government and bureaucratic ideology dictated the orientation of intellectual disciplines. This is a clear contrast to the increasing distance, autonomy and independence that intellectual and academic disciplines had achieved from political and religious authorities in a fragmented West. The distinction between formal and substantive justice in the Weberian sense have varying implications for the security of properties and contracts. The differential scale economies in formal and informal institutions for resolving commercial and civil disputes may matter little in the short run when trade and exchange were limited, but could potentially give rise to sharply divergent patterns of commercial and industrial organization, monetary and financial system over the long-run.

Our China-Europe comparison should go beyond their respective resource endowments. In fact, resource endowments inherited from China's past had not become the ultimate constraint to modern economic growth in China or East Asia as many had feared, they did become distinctive features of the East Asian path of growth, characterised by agricultural intensification and rural industrialisation.

In fact, the inherited cultural and institutional endowments may have left a larger imprint. Zeal for learning, which survived far beyond the collapse of the Civil Service Examination in 1906, formed the cultural foundation for the rapid accumulation of human capital in much of Confucian East Asia. The long experience of social networks, communities and informal institutions accumulated in East Asia helped reduce transaction costs and supplied trust to enable economic growth to occur in the 19<sup>th</sup> and 20<sup>th</sup> centuries even before the clarification and reform of formal rules and institutions. These lend us crucial insights on the spontaneous emergence of institutional innovations of a highly experimental and often ad-hoc nature in the 1980s China.

However, too often we tend to forget that the success of modern East Asia cannot be explained by the resilience of traditional institutions and ideology alone. On the contrary, what probably distinguished East Asia from the rest of the developing world today was the massive learning, borrowing and adaptation of technology, but more importantly, formal institutions - from legal system, to state-building and to monetary regimes – from other civilizations, particularly from the West since the mid-19<sup>th</sup> century. But even within East Asia, learning did not take place at the

same pace everywhere. As I argued elsewhere, much of the economic divergence in today's East Asia could be traced to the differential patterns of political and institutional response to the Western challenge in the mid-19<sup>th</sup> century.<sup>28</sup> Thus, the East Asian economic miracle is as much a testimony to the strength of its own tradition as it is to the viability of a rule-based legal regime borrowed from the West.

In this light, the argument that, had the resource endowments been right, the 18<sup>th</sup> century China or East Asia could have engineered an industrial revolution all on their own, way before all the learning that had taken place in the 19<sup>th</sup> and 20<sup>th</sup> century, seems like a tough one.

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<sup>28</sup> Ma, Why Japan, not China?



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