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An Institutional Perspective on the  
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MA, Debin / 馬, 德斌

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# Law and Commerce in Traditional China : An Institutional Perspective on the “Great Divergence”

Debin MA\*

Decades of historically unprecedented growth in the Post-War era in Japan and the East Asian tigers has not only physically transformed the region but also engendered a profound intellectual shift. Once the backwater trapped in long-term poverty and stagnation, East Asia today becomes the buzzword of miracles and models. This has led to the general formulation of an East Asian model of growth founded on factors such as human capital accumulation, export-orientation, close cooperation between government and the private sector, and the cultivation of internal and long-term relationships as an alternative or a challenge to the neo-classical free-market, private property rights model based on the Western historical experience. China’s remarkable economic growth since her emergence out of political isolation from the late-1970s brings a further endorsement to the East Asian model with the weight of a billion people. It is often argued that the crucial institutional factors that accounted for the two decades of economic miracles in China-ranging from household responsibility system, the township

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\* I benefited from discussion with Larry Neal, Sevket Pamuk, Osamu Saito, Masayuki Tanimoto and also comments at the Global Economic History Network (GEHN) workshop at Leiden, Holland in Sept. 2004 where I presented an earlier version of this paper. I alone remain responsible for all the errors.

and village enterprise, to the overseas Chinese networks of FDIIs 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 had opted for the so-called “shock therapy,” an ideology more in tune with the orthodox Western neoclassical economic ideal.

Waves of historical revisionism seem to come in tandem with cycles of economic growth. In the 1970s and 1980s, a revisionist view emerged to argue that the origin of modern economic growth in Japan should be traced all the way back to the pre-Meiji period (before 1868), which had long been dismissed by the dominant Marxist school as stagnant and backward. On the contrary, cumulative social and economic progress in the Tokugawa era (1600-1867) prepared Japan far better than other developing countries (including China) to embark on a path of modernization and industrialization<sup>1)</sup>.

With the Japanese economy faltering for the last two decades, revisionist impulses have shifted to 18th century China. In recent years, revisionist scholarship has taken to task the long-term stagnation thesis on Chinese economic history. They contend for a case of substantial progress in industrial and agricultural technologies, expansion of regional trade, growth in urbanization, and perhaps even demographic transition for early modern China. In his influential book, “Great Divergence,” Kenneth Pomeranz singled out China’s most advanced region of Lower Yangzi, which through intensification in land utilization, development of labor-using, energy-saving technology and expan-

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1) See Nakamura and Miyamoto (1982). For a balanced summary of the optimistic revision of Tokugawa economic history in Japan, see Yasuba (1987).

sion of regional trade, had experienced the so-called Smithian growth, comparable to that in Tokugawa Japan and early modern Europe. He went on to claim that the nearly 300 years of economic expansion may have put the level of development and living standard for the Lower Yangzi on par with northwest Europe in the 18th century.

Were the initial conditions in China or East Asia as high as claimed, how did industrial revolution eclipse East Asia? For Pomeranz, the answer to this age-old question seems to lie in differences in resource endowments: it was the absence of coal deposits in the Lower Yangzi for China coupled with the natural resource windfall from the discovery of New World for Europe that set off the great divergence after the 18th century<sup>2)</sup>.

Do institutions matter? Yes, they do but the revisionists claimed that property rights or the freedom to contract in traditional China was no less secure or flexible than in Western Europe. Recent scholarships on the traditional Chinese legal system challenges the Weberian interpretation and conjures up a portrait of pre-modern China where property rights were reasonably secure, the freedom to contract were pervasive, and public enforcement of contracts was by and large rule-based<sup>3)</sup>.

The causal link between legal institution and economic growth has been extensively explored in the so-called “legal origins” literature among growth and development economists. Unfortunately, their parochial focus on Western legal traditions-whether common or civil law

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2) See Ma (2004c) for a review of this revisionist scholarship. For recent quantitative studies that show real wages in major urban centers in China and Japan are closer to those in Southern and Central Europe rather than Northwestern Europe, see Allen et al (2005) and Bassino, Ma and Saito (2005).

3) See Pomeranz (2000) on the flexibility of traditional Chinese factor markets. See Philip Huang, Zelin et al for these revisionist studies on traditional Chinese legal system.

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 are bound to be insufficient and even misleading<sup>4</sup>).

This paper makes a preliminary step to fill this lacuna and contributes to the “Great Divergence” debate by bringing a comparative analysis of the differential evolution of Chinese and Western legal institutions. It shows that in contrast to the Western legal tradition which evolved towards the use of transcendental and fixed legal rules or precedents by an independent legal class, the Chinese formal 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 social order of lineage or native-place based merchant communities emerged in China to help secure properties and contracts, and reduce information and transaction costs for trade and growth. This article proposes that, as the Western type of rule-based system exhibits 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 for the “Great Divergence” thesis between China and the West. This difference

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4) Ohnesorge (2003) provides a summary and criticism of the ‘legal origins’ literature.

is also equally relevant for understanding both the absence of an industrial revolution in East Asia in the early modern period and its spectacular catch-up since the late 19th century.

The rest of the article is divided into three sections. The first section reviews the traditional Chinese legal system in a comparative perspective. The second section examines the strategies of Chinese merchant groups to ensure property rights and contract enforcement. The third section compares the relative 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 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 any 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 believed that formal justice is unique to the European legal

system. The European legal organization was highly differentiated, separate from the political authority and characterized by the existence of specialized and autonomous professional legal class. Legal rules were consciously fashioned and rulemaking was relatively free of direct interference from religious influences and other sources of traditional values. Above all, the rule of law born out of the Western legal tradition supplied what Weber termed as calculability and predicability, elements essential for explaining the rise of Western capitalism and its absence in other civilizations<sup>5)</sup>.

Influenced by Weber and Unger, post-WWII Japanese legal scholarship on the traditional Chinese justice system, as exemplified by the work of Shuzo Shiga and others, is most notable for their careful analysis based on the reading of archived legal cases. Shiga started out with the well-known fact that the Chinese legal apparatus was an integral part of the administrative system; the administrative bureaucracy within the hierarchy-from the county level 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. In fact, as pointed out by the Chinese legal scholar, Liang Ziping, the text of the Qing legal codes was structurally organized along the lines of the ministerial divisions under the Imperial bureaucracy (Liang, 1996, p.128-9). Similarly, legal rulings can be reviewed and changed only through the multiple layers of the bureaucracy within the administrative hierarchy. Legal statutes or sub-

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5) Weber (1978), vol.II, p.812. Unger (1976) and Trubek (1972), p.721.

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 compilation or editing of codes rather than an independent intellectual discipline.

The fundamentally penal nature of the Chinese legal codes was not amenable to resolution of disputes of a commercial and civil nature. However, the county magistrates, the lowest level bureaucrats, 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 courts of the county magistrates<sup>6)</sup>. But Shiga pointed out that these county-level trials were something more akin to a process of 'didactic conciliation', a term he borrowed from the studies by Western scholars on the Tokugawa legal system in Japan. The decisions of the magistrates were not legal 'adjudications' as in the Western legal order.

Shiga emphasized that the Western concept of "adjudication" was simply absent in Chinese legal thinking and procedure. The magistrate's ruling was effective and a legal case was considered as resolved or terminated only to the point that both litigants consented to the settlement and made no further attempts for appeals. Although not common, Shiga did point to cases where a legal dispute dragged on indefinitely when one of the litigating parties reneged on-sometime repeatedly-and refused to fulfil his or her original agreement to the settlement. Thus, ruling lacked the kind of binding and terminal force as the legal adjudication in the modern sense. Shiga was also interested in the legal

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6) 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 (1996).



basis of magistrate's rulings and found that although invoking general ethical, social or legal norms, they rarely relied on or cited any specific codes, customs or precedents. 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<sup>7)</sup>. In fact, as also argued by Liang Ziping, the magistrate would not hesitate to issue rulings that could result in the alteration or simplification of the original agreements between the litigant parties if this would help "quiet both parties" (pp.134-8).

This Weberian interpretation of traditional Chinese legal system was vigorously contested by the recent legal revisionist scholars most notably, by Philip Huang. Based on his reading of Qing archival legal cases of civil disputes, Huang challenged Shiga's thesis and demonstrated that the rulings of magistrates were far from being arbitrary but rather, rooted in formal legal codes and seemed legally binding for most of the cases. Huang's sharply contrasting interpretation of the traditional Chinese legal system based on similar legal archives studied by Shiga and others were both striking and puzzling. In a series of rebuttals, Shiga and his former student, Hiroaki Terada, seriously questioned the methodology that Huang adopted to arrive at his conclusion. For example, Terada pointed out that even though there was no evidence to show that the original rulings by the magistrates cited any legal statutes or local customs as their legal basis, Huang's claim that the magistrates ruled according to law was based on his own "discovery" and matching of their rulings with what he deemed as the relevant

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7) For Shiga's analysis, see Shiga *et al*(1998), Shiga (2002, 1996).

codes in the formal Qing legal penal code (Shiga 1996 and Terada 1995).

Both the origin and evolution of the Western legal system present a sharp contrast to that of China. The modern Western legal system had its origin in the 13th 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 (Harold Berman, Toby Huff, Jerome Bourgon 53-55).

Nonetheless, formal law especially in commercial affairs evolved slowly partly because commercial disputes tended to be highly specialized and formal legal litigation and enforcement could be extremely costly. Merchants in Medieval and early modern Europe relied extensively on private solutions such as mediation and arbitration to resolve commercial disputes. But over time, commercial customs and practices became increasingly codified and unified especially in major trading centers, often under the jurisdiction of relatively autonomous local government or independent city-states. Major intellectual and political revolutions such as the Reformation and the Enlightenment movement, particularly the rise of modern nation-states became a major force that propelled the formation of modern Civil Law through the amalgamation and standardization of traditional customary laws in different territories of jurisdiction<sup>8</sup>.

The fundamental but subtle distinction between the traditional

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8) See Oscar Gelderblom (2005) for the rise of private and public institutions for resolving commercial disputes in the Low Countries.

Chinese and Western legal tradition has often been grossly misunderstood. In fact, as Bourgon argued, there is no equivalent legal term in Chinese that corresponds exactly to the Western terminology for “customs.” The direct transliteration of “custom” using the Chinese word “xiguan,” which invoked a different social and cultural context, may have accounted for our misconception over the fundamental gap between the two legal traditions. “Customs” in the West was not merely a sociological phenomenon but also a judicial artifact, asserted by witnesses, or appreciated by the jury. They were codified and had clear territorial delimitation. In contrast, “customs” in China, according to Shiga and Bourgon, identifies only loose, mostly unwritten social practices without territorial delineation. They might at times serve as a reference but almost never formed the specific legal basis upon which the county magistrates made their decisions or the litigants made their claims.

If neither customs nor precedents formed the legal basis for a magistrate’s ruling and if ruling was more like mediation rather than adjudication, then the path which saw the gradual and cumulative evolution from private customs and customary laws to formal and public laws in the West, as argued by Shiga, became a cul-de-sac in traditional China (Shiga et al, p.13-15). Liang Ziping made similar points on what he termed as an insurmountable gulf between private and customary rules and public laws in traditional China. His explanation centres on the nature of the Chinese state whose paramount interest was the maintenance of a largely agrarian-based fiscal base and social stability and had little interest in private commercial matters. Thus, when it comes to the resolution of highly complex commercial disputes, the state or local magistrate leaned towards

simplistic and flexible means rather than attempt to establish consistent and generalizable rules or precedents (Liang, pp.138-140). In the centralized empire with no other independent power structures such as city-states or autonomous corporate bodies, the gulf between private and public laws was impossible to close<sup>9)</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 "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 history had been the emphasis on the cultivation of the character and capability of bureaucrats.

## II . Chinese Merchants and Government Bureaucracy

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

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9) For the linkage between political decentralization and development of legal tradition in Western Europe, see Greif (2005).

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, in fact, 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 18th century China, possibly rivalling or even exceeding that of contemporaneous Europe<sup>10</sup>.

Terada attempted 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 (Shiga et al, pp. 191-279). 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. Adopting a game-theoretic framework, Avner Greif pointed out that a Jewish trading group in the late-Medieval Mediterranean, 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

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10) See Shiue and Keller (2004) for a comparison of degree of market integration in China and Europe.

commerce in Mediterranean Europe during the late-Medieval period.

A key feature to the Chinese commercial organization in traditional China is the lineage or native place-based merchant groups<sup>11</sup>). 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 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.

Lineages could expand or contract through the so-called lineage union (*lianzhong*) -different lineages combining their genealogies (*ton-gpu*) 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 internal 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.

Thus, a region's degree of commercialisation seemed to positively correlate with the strength of its lineage organisations. For example,

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11) See Zhang Zhongmin (1995) for the ten merchant groups.

lineage practices were most widespread in China's most commercialized Pearl River and the Lower Yangzi delta. The most prominent and sophisticated lineage-based merchant group is from around Huizhou city area of Anhui province, also called the Hui Merchants. 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 often served as the practical roadmap for the Hui migrant merchants.

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 became so ubiquitous as to give rise to the saying that 'no Hui, no market towns' (*huhui bu chengzheng*).

The second largest merchant group originated in Shanxi province from Northern China, where lineage ties were professedly weaker. Through a native-place-based network, the Shanxi merchants became well-known for their operation of a nationwide money remittance service from the 19th century. The so-called piaohao, was 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-19th 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.

While the capital of a *piaohao* was 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 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.

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 was restricted to Shanxi natives only. Usually an apprentice system was used to recruit staff 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>12)</sup>.

In spite of the legal “disconnect” or gulf between the private order and public institutions under China’s centralized bureaucratic system, the linkage between the Chinese merchant group and the government evolved on a trajectory distinctive from the West. The highly competitive Civil Service Examination system provided Chinese people a relatively open and impartial, albeit highly competitive access to the formal bureaucracy and power structure. 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 incentives-or rather distortions-for Chinese society, particularly merchant groups whose accumulated wealth was most vulnerable to the damages of arbitrary power.

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. It is precisely in this area that the Hui merchants scored the highest. In Huizhou, residents took pride in their long

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12) The narrative is based on my review article. See Ma (2004c) for details and full references.

tradition of Confucius learning and their proven track record in turning out successful candidates for the Civil Service Examination. Huizhou natives claimed a disproportionate share in Chinese bureaucracy. 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<sup>13)</sup>.

Therefore, the contrasting political structures between China and the West had generated differential linkages between the private order and public institutions. Clearly, if Chinese merchants could not shape public or formal rules, they resorted to penetration into the formal political structure through their investments in Confucian education.

### III. Law and Economic Growth

What is the relative economic efficiency implication of such a strategy? From a societal resource allocation point of view, the massive investment in the preparation of government Civil Service examination clearly entails efficiency loss<sup>14)</sup>. But in pre-modern societies, such efficiency loss was probably not unique to China and was possibly far outweighed by the benefits gained from more secure property rights and contract enforcement. In fact, Bin Wong argued that if the informal mechanism adopted by Chinese merchants had served well its intended purpose, there was after all, no basis to view the European type of transition to public enforcement as necessarily superior (Wong, 2001,

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13) See Ma (2004c) for reference and review of the bureaucrat-merchant nexus.

14) For an argument that the Civil Service Examination as both resource misallocation and a retarding factor on the growth of scientific knowledge in China, see Justin Li (1995).

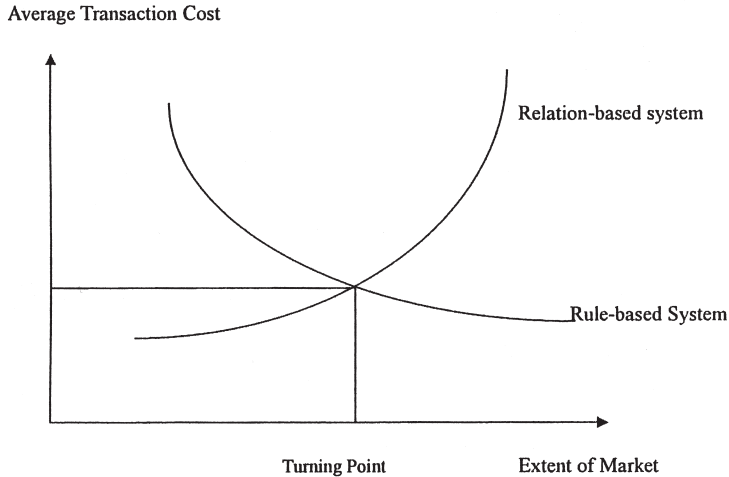
pp.399-401).

However, this neglects at least two more important efficiency losses. First, as is true everywhere, bureaucratic-merchant coalitions are highly prone to monopoly and rent seeking, leading to dead-weight loss to the society in general. Second and most important, as argued by Greif and others, in a relation and group-based mechanism, the extent of exchange and the 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 (Greif, 2002, 2004, John Li).

Figure 1, adapted from John Shuhe Li's paper, illustrates the two average transaction cost curves for what he termed a relation-based system versus a rule-based system. With relatively low fixed cost and high marginal cost, the relation-based transaction cost curve is upward sloping and starts out with lower average cost than the downward sloping rule-based cost curve characterized by high fixed cost and low marginal cost. However, over time as the scale of transactions or the extent of market grows, average transaction costs for the relation-based system increase sharply and exceed those for the rule-based system beyond the turning point.

This diagrammatic illustration of the diminishing returns to scale nature of the informal or relation-based mechanism has also been noted by sociologists and legal scholars on China. Liang Ziping quoted an analogy by the eminent Chinese sociologist Fei Xiaotong who likens the

Figure 1. Average Transaction Cost for Relation-based System versus Rule-based System



reach and influence of Chinese social order as circles of ripples stirred up by a stone thrown into the water: the farther away from the center, the weaker their strength becomes (Liang, pp.157-8). Liang's own extensive study of various private contracts and customs leads him to emphatically conclude that Chinese local rules and customs were only binding and effective within their existing social networks (p.165-6).

Further research is needed before we can begin to identify or test empirically the relative efficiency hypothesis. However, some casual comparison could provide us a beginning towards formulating a testable hypothesis. For example, most of the modern financial and commercial instruments such as paper money, bills of exchange, bills of lading, joint-stock shares or insurance contracts as well as forward or futures markets could be found in their embryonic form in East Asia. However, it was only in Western Europe that these instruments and markets developed to a large scale and later diffused worldwide while they

remained highly localized and segmented in East Asia. Is it possible that the differential scale effects from the divergent legal traditions may have mattered?

In fact, contrasting patterns of economic and organizational transformations in East Asia under the impact of Western influence from the mid-19th century provide an illuminating test case of the relative efficiencies in legal systems. One of the pillars of Meiji reform in Japan was the adaptive introduction of Western legal institutions ranging from constitution to commercial law, to modern accounting and joint stock corporation. In China, legal reform was much delayed until after the turn of the 20th century when the first set of civil and commercial codes were being compiled with the aid of Japanese legal specialists. But with the collapse of the Qing empire and the nation thrown into civil disorder after 1911, the implementation of legal and institutional reform was severely curtailed. 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-19th century (Ma 2004a).

Institutional and legal change did take place in early 20th century China in an very different context. The imposition of extraterritorial rights and the transplantation of a Western legal system in China's treaty ports from the mid-19th 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 a Western legal justice

system had spawned a class of Chinese industrial and financial entrepreneurs, whose fortune and capital by the early 20th 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>15)</sup>.

In Shanghai, for example, the so-called Ningbo clique, merchants from around the city of Ningpo 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 (Susan Mann 1974). But by the early 20th century when Shanghai became a full-fledged Western style 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 dispute resolution, 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

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15) See Ma (2004b) for the Shanghai-based industrialization and the role of City-state institutions.

to suspend any future transaction with that agent. Over time, their rules gained increasing recognition and often became the guiding principles for native banks outside Shanghai (Du Xuncheng 2004). 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 became the most important agent of industrial finance in Shanghai's so-called golden 1920s.

### 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 underpinned the legal revolution in the 11th and 12th century in the West-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.

The divergent legal traditions are not an independent phenomenon but rather the historical outcome or derivative of contrasting differences in the political and social structures, namely, the political fragmentation and separation between religion and the secular in the West versus the dominance of a centralized bureaucratic empire in China. But different legal traditions in turn would exert varying impact on the security of properties and contracts. The differential scale economies in formal and informal institutions for resolving commercial and civil

disputes may have mattered 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. However, it is important to note that this relative economic efficiency implication of divergent legal traditions is itself a positive statement and should not be viewed as a normative verdict on the relative merits of comparative civilizations.

The Western experience shows that private social order not only constitutes the evolutionary basis for public institutions but also continues to play an indispensable role even in modern economies. In East Asia, the inherited cultural and institutional endowments are essential to the making of economic miracles. 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 19th and 20th centuries even before the clarification and reform of formal rules and institutions. The traditional preference for flexibility over fixed rules may have helped Chinese reform in the early 1980s to successfully evade much of the ideological rigidities with little social tension and contributed to the spontaneous emergence of institutional innovations of a highly experimental and ad-hoc nature often missing in other transitional economies.

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. What probably distinguished East Asia from the rest of the developing world today, or what Max Weber had failed to anticipate, is her learning capacity to absorb not only Western technology but also formal institutions—from legal system, to state-building and to monetary



regimes. Both China's current difficulties encountered in transition to the rule of law and the recent Asian financial crisis are a timely reminder of the continued need for institutional learning and innovation.

Consequently, the economic success of modern East Asia cannot be explained by either the slavish imitation of Western institutions or the resilience of traditional ideology or institutions alone. Rather it is reminiscent of a more universal historical phenomenon: the renaissance of ancient civilization through the infusion of external influence. In this light, the claim by the revisionists that, had the coal deposits been located in the right spot, or had new territories been discovered and opened up, the 18th century China or East Asia-way before all the wrenching ideological and institutional revolutions under the 19-20th century Western impact- could have engineered an industrial revolution all on their own, is pressing its luck too hard.

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Law and Commerce in Traditional China: An  
Institutional Perspective on the “Great Divergence”

Debin MA

《Abstract》

In the West, legal tradition was generally characterized by the use of external and relatively fixed rules or precedents with independent third party enforcement. In China, the legal structure was part of the government bureaucracy that often relied on the use of general and flexible legal and ethical principles to mediate civil and commercial disputes. This paper provides a review on the debate on China’s traditional legal system in a comparative perspective. It shows that lineage and native-place based Chinese merchant groups resorted to a reputation mechanism and informal and internal rules to enforce contracts and secure property rights. As the Western type of rule-based system exhibits scale economies with rising efficiency at higher volumes of exchange, particularly impersonal exchange, I argue that divergent legal traditions shed crucial insights to the differential patterns of long-term economic growth and the “great divergence” between China and the West in the modern era.