

# Culture, Rationality and Economic Institutions in East Asia: The Chinese Family Firm

Sun-Ki Chai  
Department of Sociology  
University of Hawai'i

*Abstract: Explanation of economic interactions within East Asia has long been split between those who view action as an outcome of rational decision-making by an autonomous state and those who view it as a result of cultural patterns ingrained in Confucianism and other elements of traditional culture. This paper shows how these two approaches can be used in a complementary rather than conflicting manner to explain the origins of the Chinese family firm. It does so by examining ways in which cultural norms can provide points of convergence for rational actors in situations of strategic uncertainty which would otherwise induce multiple equilibria. Cultural norms will be particularly important at those points in history when new institutions are being formed, and can lead to distinct institutional forms. Once created, however, the institutions themselves can structure incentives in a way that leads to self-perpetuation.*

Social science analysis of economic and political phenomena within the East Asia, and particularly among predominately-speaking Chinese societies of the "Greater China", is divided into two competing and largely self-contained bodies of theory. The first, drawing from broad traditions of political economy analysis and

institutional economics, focuses on the political institutions which structure the economic choices of actors in these countries, and how changes in these institutions have affected behavior over the past several decades. The dominant portion of this literature is aimed at explaining how states in China (Shirk 1993; Oi 1989; Walder 1986), Taiwan (Gold 1986; Aberbach, Dollar, and Sokoloff 1994; Amsden 1985), and the other East Asian societies<sup>1</sup> have intervened in their economies through authoritarian or semi-authoritarian but generally growth-promoting institutions.<sup>2</sup>

The second, drawing upon an equally broad tradition of cultural and sociological analysis, focuses on the core values and beliefs that are thought to characterize Chinese culture, and argues these values and beliefs have shaped the distinct structure structure of economic<sup>3</sup> and political<sup>4</sup> institutions in the Greater China. It then examines these structures have influenced and economic growth in recent decades.

One of the notable characteristics about these two theoretical literatures until recently has been their relative lack of engagement with each other. References to one another have tended to be rare, and when they occur often brief and dismissive. Recently, however, there has been some movement in East Asian studies towards comparing and contrasting between these two literatures and analyzing the relative weights to place upon each (Dickson 1992; Buck 1991; Redding 1990: chap. 1; Berger 1988; Hsiao 1988; Winckler 1988).<sup>5</sup> Furthermore, recent theories have been developed which blend elements of cultural and institutionalist arguments in a nuanced manner (Hamilton and Biggart 1992; Redding 1988).<sup>6</sup>

However, what such theories do not attempt to incorporate is the explicitly actor-oriented and rationalist component of the first body of literature. What remains to be done, therefore, is to attach this integrative culturalist analysis onto an actor-oriented model, one that is rationalist, but boundedly so. Over the past two decades, the debate over culture vs. rationality (institutionally-determined or not) has been the primary dimension of a wider theoretical debate between idiographic approaches that attempt to capture the unique characteristics of each particular set of individuals and nomothetic approaches that apply a single model of human action over a wide range of areas. However, there has been a recent surge of theoretical comment in economics, sociology and political science has begun to

argue that culture and rationality are not at odds, but can be seen as part of a complementary research agenda. According to this new line of thinking, coherent, culturally determined preferences and beliefs may be seen as a precondition to rational decision-making rather than its antithesis, particularly when actors possess incomplete information about their circumstances and those of other actors.<sup>7</sup> Furthermore, there have been a number of efforts to develop models of various substantive areas of human conduct that integrate cultural and rational choice analysis (Akerlof 1983; Akerlof and Yellen 1993; Hechter, Jasso, and Ranger-Moore 1999; Ferejohn 1991; Lane 1992; Chai and Wildavsky 1994).

Within East Asian Studies, however, the field remains highly polarized over the question of rational choice and its merits compared to other approaches.<sup>8</sup> This is unfortunate, because the East Asia is perhaps a paradigmatic case where culture and rationality have interacted in to generate new, and in most cases, adaptive economic institutions. Culture alone cannot explain recent economic successes in East Asia, because the same culture presided for centuries over general stagnation. At the same time, rationality alone cannot explain why particular distinct economic institutions arose as a response to changing conditions, nor why these institutions were not adopted in other parts of the world.

This paper, building on previous integrative work, will attempt to more clearly delineate causal paths by bringing culture into an explicitly individualist, rationalist model of action. In doing so, it will also counter arguments that incorporating culture into a model of economic action inevitably means abandoning rationalist assumptions, or that assuming rationality requires that culture be seen as irrelevant. The model will use the idea of culture as a *template* to show how mutually understood norms of action can provide points for coordination of expectations during times of rapid structural change and novel circumstances, when new institutions are being formed. These templates allow rational individuals to anticipate the action of others in a way that in turn allows them to determine their own optimal actions. Once established, these patterns of action become institutionalized, shape incentives and can survive over time independently of the cultural milieu that led to their creation.

In particular, the paper will argue that Confucian norms (broadly defined) of action played a major role in the design of new

institutions during the early stages of capitalist development in China, when structural changes created “space” for private entrepreneurship but did not generate the requisite political infrastructure for rationalized, contractually-based cooperation. It does not assume that all individuals at this point in history had internalized Confucian norms and followed them regardless of their rationality. Instead, it focuses on how the norms provided templates for cooperative action under conditions where available information provided insufficient guide for rational decision-making. It will be argued that these early stages provided individuals with new opportunities for economic gain, but that this gain was contingent on repeated cooperative interactions under structural conditions which allowed for multiple equilibria. At these points, individuals called upon shared knowledge of existing norms as a basis for the design of new institutions, using this knowledge to shape expectations about each other’s actions under various institutional designs. It was this knowledge that led to the formation of the distinctive, “post-Confucian” family firm that is the fulcrum of economic interactions in the contemporary Greater China.

### **Weak Confucian Norms and Action**

Unsurprisingly, most past and current literature on traditional Chinese culture focuses on Confucianism and its modern manifestations. However, the doctrines that get labeled “Confucianism” are varied and often vaguely specified (Pan 1988) and are difficult to separate conceptually and empirically from traditional Chinese values in general (Berger 1988: 8-9; Ebrey 1991: 45). Nonetheless, certain common cultural characteristics can be drawn out from studies of Confucian culture, particularly those relating to social norms, i.e. explicit rules for action under specified conditions. Put very briefly, they center around mutually recognized dyadic relationships, with kinship as the main determinant of the strength of such relationships.

This is the main emphasis in Fei’s work describing the nature of traditional Chinese culture. He stresses that, unlike Western culture, where norms revolve around loyalties to organizations with distinct boundaries, Chinese culture is based upon diffuse networks of dyadic ties centering around individuals, with closer ties being given precedence over more distant ones. Furthermore, the most important basis for such ties is kinship, which can generate mutually

recognized connections among people across great distances (Fei 1992 [1947]: 62-3). In general, he notes, social norms focus on maintaining loyalty and cooperative action among those who share such relationships (Fei 1992 [1947]: 74).

Similar ideas have been echoed by a number of authors, with emphasis on the importance of perceived ties between individuals in maintaining trust, and the importance of kinship and the norm of loyalty between kin in creating of such perceptions (Redding 1990: 66-7; Hamilton 1992: 53-4; Tu 1984: 5, 80-1; Pye and Pye 1985: 70-1; Ebrey 1991: 48-9; Tai 1989a: 14-16; O'Malley 1988: 332; Hofheinz and Calder 1982: 45).<sup>9</sup> From these interpretations, it can be seen that the key to Chinese behavioral norms is not so much a clearly demarcated "group consciousness" as a loyalty to persisting relations between individuals, with the extent of loyalty declining with kinship distance. Though individuals may act in the interests of a collectivity, the boundaries of relevant collectivities differ for each individual since each individual's network of dyadic ties is unique. As Tu Wei-ming notes, "Modern Confucianism emphasizes the self as a centre of relationships (Tu 1984: 84)".<sup>10</sup>

These interpretations allow us to place Confucian social norms within an individualistic, choice-theoretical model of action, rather than one that strips away individual agency within the stifling boundaries of groups with fixed boundaries. However, this brings up the question of whether such norms can be seen as consistent with instrumental, rational action. Despite the frequent tendency to see social norms and rationality as two mutually exclusive mechanisms for choice,<sup>11</sup> increasing attention is being paid to the conditions under which norms may be consistent or even necessary for rational decision-making.<sup>12</sup> Particular focus has been put on the role of social norms in determining behavioral equilibrium when individuals have insufficient information to calculative optimal choices among given alternatives. Such analysis is becoming popular in non-cooperative game theory, a bastion of rational choice analysis, where numerous theorists have examined the effect of norms under conditions of strategic uncertainty, i.e. when each actor's optimal choice depends on the unobserved actions of others. Absent a role for norms, analysis of such situations generates multiple equilibria, i.e. a wide range of outcomes that could conceivably occur, rather than a clear prediction.<sup>13</sup>

Hence the conditional complementarity between norms and rationality is not a revolutionary idea. However, in order for such complementarity to exist, it is important to locate the relevant norms within the interstices of rationality decision-making, i.e. to define them in such a way that they do not force individuals to make choices they know to be suboptimal. This means that they should be relevant mainly under conditions of uncertainty (i.e. inability to calculate expected utilities for different choices), while at other periods they should either be inapplicable or point in the same direction as rational optimization.

The following rules for action are an attempt to distill a portion of Confucian social norms in such a manner. They can be called “weak Confucian norms” in the sense that they are not meant to encapsulate all the myriad components of Confucian culture, but also in the sense that they do not make strong demands on individuals, applying only in those cases where there is no clear rational choice of action given an individual’s existing preferences and beliefs. This is not to deny that preferences and beliefs may themselves be influenced by culture, but rather to argue that even when culture does not fully socialize individuals into an internalized tendency to cooperate regardless of personal gain, it can nonetheless play an important role in determining action. The exact nature of personal utility functions will be left exogenous here, and the norms described will apply regardless of whether individuals are completely selfish or hold some degree of altruism towards others. Of course, it will not be *assumed* that people are sufficiently altruistic to one another to assure cooperation.

Weak Confucian norms, very simply, call upon individuals to act in a way that benefits those with whom they share a personal relationship, but only in those situations where 1) they will not suffer any clear personal loss from doing so, 2) where doing so will have not have an adverse impact on someone with a closer relationship than the potential partner, and 3) where their potential partner has not acted in a non-cooperative manner in the past under such circumstances. Kinship will be seen as the primary determinant of relationship closeness.

It is clear that these norms require far less of an individual than extreme filiality, a “stronger” version of Confucianism would demand that individuals be willing to act cooperatively under conditions of kinship connectiveness, even at cost to themselves.

In that sense, I am not assuming that Confucian norms are the sole or even the primary determinant of action. Moreover, I do not assume that the entire Chinese population has internalized even the weak norms (i.e. that they act unconditionally according to the norms' dictates), only that there is common knowledge that such norms exist and that they have formed the basis for past behavioral patterns throughout much of Chinese history.

In doing so, I hope to counterarguments that cultural arguments force individuals to act irrationally or that they depend on *ad hoc* assumptions about the internalized preferences of an entire population of individuals. Neither of these is the case for the model being presented here. Instead, I will argue that even where weak Confucian norms of action are prevalent over strong ones, and where some of the population has not even internalized the weak norms, such norms can under particular conditions be the determinant of behavioral equilibria.

The remainder of this paper will attempt to explore more specifically the conditions under which weak Confucianism can become a determinant of behavioral equilibria, and attempt to show how these conditions were present during the historical periods of early capitalist development in late Imperial China. More specifically, it will be argued that the period of early capitalist development provided conditions under which strategic uncertainty allowed for multiple possible equilibria in interactions among rational actors, and that weak Confucian norms determined the particular equilibrium that was chosen: one that generated the distinctive institutional structure of the kinship-based Chinese firms. These institutional arrangements have then structured incentives in a way that has allowed them to survive into the period where rationalized, non-particularistic capitalism became possible.

### **Political Change and the Creation of New Institutions**

As has been noted, social norms are particularly relevant under conditions of multiple equilibria, when interactions between individuals are sufficiently unstructured that each individual cannot determine her or his optimal choice. Such conditions can most often be found during historical periods of rapid social and technological change, where existing institutions no longer shape incentives sufficiently to

determine the actions of rational individuals, but where newer institutions have yet to be created. In such a situations, interactions between individuals may take place within an effective anarchy within many realms of action, before certain patterns of action become regularized and form a new institutional equilibrium.

It is precisely in explaining the emergence of new institutions where conventional economic models are at their weakest. Although the new institutional economics has made great strides in analyzing action within institutional constraints, it has been far less successful in accounting for institutions themselves. Most explanations that are offered in this literature for institutional formation tend to take a functionalist bent, arguing that certain institutions exist because they solve problems of cooperation among individuals. However, this literature does not generally explain the mechanisms that allowed these institutions to be generated from the actions of rational actors. Nor does it adequately address the possible existence of multiple institutional forms or the mechanism by which one form is chosen over another (Shepsle 1989: 140-1; Calvert 1994: 34; Granovetter 1992a: 58-63; Baron and Hannan 1994: 1140-1).

Hence, existing theories in institutional economics do not provide much leverage in explaining the phenomenon analyzed here: the distinctive form of economic institutions in within the Chinese cultural sphere. The basic nature of these institutions are not in question: Firms tend to be of small and medium size, and are generally under the control of a single family. Rather than expanding vertically, firms that succeed financially tend to split up into autonomous subunits, although control of remains in the hands of family members (Redding and Whitley 1990: 85-6; Hamilton 1992: 187-8, 192-3; Orru, Biggart, and Hamilton 1991: 383-6; Tu 1991: 120-3; Greenhalgh 1988; Wong 1988: 142-3; Wong 1989: 173-80; Wong 1985; Tam 1990: 168- 79).

The similarity between traditional Confucian norms and the structure of family firms is clear enough. However, the argument that such a linkage is inevitable cannot be sustained. Whatever its similarities to Confucian norms of action, the set of practices known as the Chinese family firm began to develop only during the late imperial era (Hamilton 1992: 56-7) and has reached its full flowering only during the past century. The question thus arises: Why did this particular form of production come into being at this time, and what particular structural conditions caused it to arise?



Furthermore, how long will the institution survive, and under what conditions? Clearly, a specification of the structural conditions necessary for the creation and maintenance of the Chinese family firm as an institution is required to make the picture cohere. As Hsiao states, “The question is not to identify the cultural traits *per se* but to identify the political and economic environment in which these cultural factors were able to make economic activity dynamic and lively (Hsiao 1988: 20)”.<sup>14</sup>

One way of dealing with these questions deductively is to examine the structural conditions under which social norms are relevant for determining equilibria within the realm of economic interaction. We will use a simple game theoretical apparatus for this analysis, not because such arguments cannot be made without game theory, but because the formal notation helps to clarify the causal processes that link norms to action.

As per usual game-theoretical practice, I will portray economic activity as a sequence of repeated interactions between individuals, in which each individual makes a choice that affects both his or her own utility and that of others. A single interaction between two individuals can be portrayed in game-theoretical “normal form” as in Figure 1 (see end of paper). Each individual has two choices: cooperation and non-cooperation. Cooperation requires that an individual in question provides a valued good to the other, and neither individual is able to observe the others’ choice prior to making her own. If both individuals cooperate, trade occurs. If one cooperates and the other fails to, exploitation occurs.

The value that individuals gain from an interaction will be determined not only by their decisions, but also the political conditions in which they find themselves, and more specifically by possible government intervention. Moreover, the cumulative incentives for cooperation are affected by the fact that interactions are repeated over time, since each individual’s future choices may be affected by the history of past and present interactions.

$a$  is the value of a good to an individual who produces it, while  $b$  is the value to the other individual.  $k > 0$  is the value of the leisure sacrificed to deliver the a good to the other individual, or alternatively, the value of the time and effort involved.  $1 \geq \alpha \geq 0$  is the proportion of an individual’s wealth that a government will tax or otherwise confiscate, and  $\phi$  is the amount that a government will transfer from one individual to another as compensation for

exploitation. It is assumed that comparative advantage allows for gains from trade, i.e.  $b > a + k$ .

If both individuals cooperate in a particular period, each individual receives  $x = (1 - \alpha)b$ . If neither cooperates, both receive  $w = (1 - \alpha)a + k$ . If only one individual cooperates, the exploiter receives  $y = (1 - \alpha)(a + b) + k - \phi$  and the victim  $z = \phi$ . Absent any government intervention, i.e. when  $\alpha = 0$  and  $\phi = 0$ , the ordering of values is  $y > x > w > z$ .

The time-adjusted utility of single future interaction is  $\delta^t$  times the value gained during that interaction, with  $t \geq 0$  being the time difference between the the period of the interaction and the present, and  $\delta < 1$  being a factor by which an individual discounts future gains and losses.

Given this, we can classify political conditions into three ideal types: The first is one in which government attempts to confiscate as much private wealth as it can, thereby maximizing its short-term revenue. Given this, it makes no attempt to transfer wealth to victims in cases of exploitation. Such governments have been widely analyzed in the literature on “predatory” rule, which seeks to analyze failures of economic growth in developing countries (Levi 1981; Levi 1988; Findlay 1983; Lal 1984). A predatory government will set  $\phi = 0$  and  $\alpha$  as high as is Feasible, but it need not be able to confiscate all wealth in order to decisively shape the incentives for cooperation.  $\phi = 0$  implies values of  $x = (1 - \alpha)b$  for cooperation,  $w = (1 - \alpha)a + k$  for non-cooperation,  $y = (1 - \alpha)(a + b) + k$  for exploitation, and  $z = 0$  for being a victim. It is then follows that any proportion of confiscation of  $1 \geq \alpha > (b - a - k)/(b - a)$  will generate an ordering of values for outcomes of  $y > w > x > z$ .

Given this, there is no way for individuals to gain from mutual economic cooperation, though it may be possible to gain from exploitation. Moreover, no rational individual will allow herself to be exploited in even a single period, even when the interaction is repeated for an indefinite number of times. The intuition behind this is as follows: The only thing that would make being a victim worthwhile would be if the exploiter responded by allowing himself to be exploited in return in a greater number of future periods. However, the other individual would thereby gain less utility overall than he would by simply failing to cooperate in all periods, hence a promise to respond in such a way would not be credible. Given this, allowing oneself to be exploited is never worthwhile, and each

individual will fail to cooperate in all periods. Thus no cooperation by any individual will occur.<sup>15</sup>

At the other extreme ideal type is one in which where a government is non-predatory and enforces contracts, imposing a penalty on exploitation sufficient to make its value less than that of mutual cooperation and awarding compensation to exploited parties sufficient to compensate them for their loss. Such an environment has been well covered in the new institutional economics, particularly the “neoclassical theory of the state” (North 1981: chap. 3).<sup>16</sup> and corresponds closely to what East Asia scholars would call a “Western” model of development (Redding 1990: 8-10; Hamilton 1992, 49-52; Tai 1989b: 10- 4). A contract-enforcing government can be modeled as one that sets  $\alpha < (b - a - k)/(b - a)$ , and  $\phi \geq (1 - \alpha)b$ . We will then have  $y \leq (1 - \alpha)a + k$  and  $z \geq (1 - \alpha)b$ . Since  $w = (1 - \alpha)a + k$  and  $x = (1 - \alpha)b$ , this implies that  $z \geq x > w \geq y$ .

As long as a government is willing and has the monitoring and coercive ability necessary to impose such a distribution, individuals can sign a contract which will cause government to fully compensate them for their loss if they are exploited and punish them if they fail to cooperate. Under such conditions, an individual signing a contract will be able to credibly commit to future cooperation in any set of future periods. By cooperating in each period, an individual can obtain a value of at least  $(1 - \alpha)b$  in each period, regardless of what the other individual does. Moreover, any pair of strategies over time that contains at least one act of non-cooperation by either individual will provide a lower cumulative utility to at least one individual compared to a strategy of cooperating in each period, and thus cannot be sustained in equilibrium. Hence cooperation will always occur between any individuals who can gain from trade and will occur in every period in which they interact.

One point highlighted by this analysis is the fact that the purportedly non-interventionist Western model of development depends on a government that has the will and ability to play a very active role in the adjudication of business agreements. In order to enforce contracts, it must directly shape the costs and benefits accruing to important economic decisions.

The final ideal type is one in which governments are neither predatory nor contract-enforcing, but rather do little to affect the overall calculus of individual interaction. Such governments are

typically those that are internally divided or preoccupied with other matters to shape economic activity, either for predatory or contract-enforcing purposes. Like a predatory government, such a government is indifferent to whether wealth was generated through cooperation or non-cooperation. However, it does not confiscate enough ( $\alpha < (b-a-l)/(b-a)$ ) to alter the value attached to different outcomes, which remains  $y > x > w > z$ . Such a government is thus more genuinely non-interventionist than a contract-enforcing government, since it therefore does not affect the relative incentives for each choice that would apply if government did not exist.

Effectively, this produces a set of interactions that is an iterated prisoner's dilemma. Under such conditions, it is possible to generate substantial gain through cooperation over repeated interactions, but it is inferior to non-cooperation in any single interaction. If the duration of such interactions is uncertain, no single strategy is a dominant one, and, as pointed out in the famous game theory "folk theorem", just about any set of strategies can be sustained as an equilibrium outcome among rational individuals.<sup>17</sup> Rational optimization, then, is insufficient by itself to predict whether or not individuals will cooperate over repeated interactions in this environment.

Throughout most of modern Chinese history on the continent, conditions seem to have shifted periodically between those found in the first structure and those found in the third, with the third predominating in the latter stages of the imperial era. There is evidence of an incremental loosening of government control over the market from the Tang and Song periods to the Ming and early Qing period, and the gradual growth in capitalist enterprise (Feuerwerker 1984: 322; Elvin 1973: 92-3; Mann 1987: 30-43).<sup>18</sup> By the late Qing period, many important sectors of the economy, such as tea, sugar, grain, and cotton were in private hands, and even those sectors that were officially in state hands were severely penetrated by the black market.<sup>19</sup>

Nonetheless, at no point during the imperial period can the state have been said to have supported a full-fledged set of market institutions. The basic legal and financial institutions for spreading risk and enforcing contracts were lacking (Berghere 1984: 330; Hamilton 1992: 52, 58; Redding 1990: 122); nor were there binding legal constraints to intervention by state officials into private

economic affairs, whether it be at the central or local level (Chan 1975: 11; Redding and Whitley 1990: 124). Hence while the state on the whole allowed considerable autonomy for private enterprise, it did not provide the positive basis for such enterprise to flourish.

Given the absence of a state that would or could fulfill a neoclassical role, part of the task for providing a stable environment for business was provided by merchant guilds, which oversaw standard-setting and dispute resolution among their members (Mann 1987: 23-5; Elvin 1973: 292-3; Hamilton 1992: 58-9). However, such guilds were limited in their scope, representing parochial interests, and were weak in authority compared to the state (Redding and Whitley 1990: 126). Nor did the guilds always act as defenders of merchant interests against those of the state, a tendency that was augmented by increasing mobility from the merchant class into the state gentry (Mann 1987: 21-3; Elvin 1973: 291-2) and, by the late 19th century, in the other direction (Chan 1977: chap. 6).

These conditions, given their correspondence to the third type of structure described above, can be used as the basis for an explanation why Chinese enterprises eventually came to be based on the kinship model,<sup>20</sup> and why they have exhibited the tendency to split into pieces rather than expand vertically. The third type of structure, as noted, can generate multiple equilibria from interactions among rational actors. And as noted earlier, it is in this type of situation which allows social norms to be relevant to the particular equilibrium behavior that is chosen.

It is reasonable to assume that virtually all economic actors during the early stages of Chinese capitalist development were aware of the existence of Confucian social norms, and that these were the most salient set of norms governing interactions between individuals. We can further assume that a sizable number of economic actors had in fact internalized such norms, at least in their weak form.

What, under such assumptions, would be the effect of weak Confucian norms on economic behavior? In any real world economy, there will be a limit to the number of partners with whom an economic actor can have simultaneous cooperative economic relationship, and any decision to choose particular partner will necessitate a non-cooperative (i.e. opting-out) decision at the first iteration of the game with all non-chosen partners. Effectively, this means that weak Confucians will choose as partners as many

of their closest possible kin with whom they can simultaneously have cooperative economic relations, as long as those partners have not violated weak Confucian norms in the past. For this, it is an important fact that the norms are “symmetrical” in the sense that norms which apply for actor A’s behavior towards actor B will also apply for actor B’s behavior towards actor A, otherwise actors may not be able to coordinate or choose partners. Though particularistic considerations in choosing business partners obviously raises the possibility of efficiency losses, these losses will be subsumed by the difference in payoff between cooperation and non-cooperation, and the decision to follow the norms will not be irrational.

Just as importantly, it follows that even those who have not internalized weak Confucian norms will have an incentive to act according to them as long as they believe others will act according to them. Since actors will realize that such a cooperative equilibrium can only be induced by weak Confucian norms in where there is a close kinship tie, they will have an interest in choosing close kin as business partners. Furthermore, since cooperation within weak Confucian norms is dependent on the past cooperative behavior of a potential partner (i.e. it does not allow for repeated exploitation by unfilial kin), it will be in their interest to cooperate in order to avoid a set of mutually non-cooperative outcomes after the first iteration of the repeated game.

In this sense, weak Confucian norms form a *template*, which can be defined as a type of social norm that is transportable across a wide variety of interactions. Despite having their historical origins within largely agrarian social structures, weak Confucian norms’ prescriptions for behavior remain clear within novel urban and/or industrial contexts. In this way, a template instructs actors on how to form strategies in new contexts. It is a meta-strategy, if you will. Furthermore, because the expectation that others will act according to weak Confucian norms makes such norms rational for oneself, this template can determine the particular Nash equilibria chosen under conditions of strategic uncertainty.

Even if *neither* potential partner in an economic interaction has internalized weak Confucian norms, and each is aware that this is the case, the norms can still play a role in inducing equilibrium. In this case, however, they will not induce a single dominant choice within iterated interactions, and cooperation depends in part on

both possible partners using some extra-rational (but not irrational) criteria as a predictor of the other's behavior. This can happen if templates act as a *focal point* (Schelling 1960: chap. 3) a prominent and commonly recognized pattern or landmark that allows actors coordinates expectations about each other's behavior. Focal points based on shared knowledge have been invoked in some recent economic literature to explain the ability of traders to engage in risky exchanges under conditions of uncertainty (Landa 1978; Landa 1995; Greif 1992; Greif 1994). Templates can be seen as a special type of focal point, in that they are based upon the extrapolation of a historical pattern onto novel circumstances.

Applying the template concept to structural conditions in China during the early stages of capitalist economic development helps to explain the origins the kinship-based enterprise system during this period. The failure of existing political institutions to enforce contracts made it irrational to rely on them to ensure economic cooperation. Furthermore, the existence of a norm that could instead serve as a template for cooperative behavior meant that it was rational for individuals to build enterprise structures that could take advantage of the template. This explains why economic institutions were largely based not upon a trust in institutions, but on trust between individuals based on shared awareness of a set of social norms.<sup>21</sup> The latter in turn implied less attention to formal rules, but rather the binding of an informal set of commitments built on relationships (Redding and Whitley 1990: 97- 8; Redding and Whitley 1990: 127; Tu 1991: 124-5; Hofheinz and Calder 1982: 43-5; Granovetter 1992b: 7-8).

Furthermore, this analysis helps to explain why family firms tend to split up rather than to expand vertically. This tendency can be linked logically to the logic of weak Confucian norms, which dictate that preference for cooperative interaction should be given in an order of precedence based on kinship closeness. After the passage of a single generation, there will be a inconsistencies between siblings with respect to the kinship closeness of their respective offspring.<sup>22</sup> Given this inconsistency between individuals, weak Confucian norms will not point to a clear rational strategy for the firm as a whole, a problem that can only be solve by splitting it up. This, of course, imposes significant restrictions on the kinds of economic expansion that can be supported by cooperation based upon these norms.

This particular failing of weak Confucian norms points out an important aspect of the preceding analysis. It is not assumed that weak Confucian norms existed because they were optimally functional for promoting economic cooperation. Instead, individuals acted upon their common awareness a pre-existing norm, one which turned out to have conducive effects towards business cooperation under certain circumstances.<sup>23</sup> One could easily think of alternative norms that could possibly have been just as or more conducive (e.g. the norm that individuals should never violate business promises), but these were not chosen because they were not available as templates in the traditional culture.

Neither is it argued that the kinship-based form of cooperation is the primary reason for economic growth in the Greater China. It should be noted that the Chinese family firm existed for centuries before the current economic takeoff began; hence its existence cannot be considered a sufficient cause for that growth. Instead, it provided an institutional pattern that could support cooperative behavior under much less hospitable political conditions than those that accompanied the development of the West during the industrial revolution.<sup>24</sup> Whether it is also an adaptive structure under more benign economic conditions is an open questions.

### **The Future of Kinship-based Confucian Capitalism**

Kinship-based Confucian capitalism, while based on an interaction between cultural and rational/structural factors, itself alters structure in a way that promotes its perpetuation. First, its availability as a pattern of economic growth under political conditions short of the “rationalized” state decreases political pressure to bring such a state into being. Both domestic pressure from groups who have an interest in economic development and external security pressures from countries who are developing faster will be lessened by the existence of this ameliorating pattern of growth. Hence, the relative success of these institutions can be used as one explanation for why China took so long to develop the type of market-supporting political institutions found in the West. To the extent that this damaged its prospects for long-term development, the availability of cooperation in the absence of such institutions could have constituted a political version of the “high-level equilibrium trap” (Elvin 1972; Elvin 1972, ch. 17).



This said, such a political trap, if it did exist, has not proven an unsurpassable barrier to the development of rationalistic capitalistic institutions of private property rights and contract enforcement in the post-World War II era, at least in countries with predominately Chinese populations outside of China. Given the origin of the Chinese family business under the particular conditions of strategic uncertainty, the question arise of how it will respond to changing structural conditions. Why hasn't the family firm structure broken down and been replaced by a less particularistic form of enterprise?

One logical implication of the model, however, is that the creation of the family firm itself alters the general economic environment as well as the political one. As long as most firms in an economy are run based on kinship principles, the kinship-based pattern of cooperation will act as a kind of Nash equilibrium, even in the presence of enforceable contracts. The reason for this is that contracts are only useful if there are potential partners. However, given the expectation that other economic actors will continue for the time being to act as weak Confucians, it will not be the interest of an actor to desert kinship- based partners, regardless of greater potential for profit, because it will not expect potential alternative partners to respond positively. Hence, as long as firms do not expect others to change their behavior in the short run, they will not change themselves, and this in turn will help prevent long-term change.

Another implication, however, is that this self-perpetuating quality will not exist where there are a large number of potential business partners under the control of individuals from non-Confucian backgrounds. In such a situation, a firm may be able to abandon a kinship-based partner and form a working relationship with a non- Confucian partner, knowing that it will not be refused by this new partner for doing so. Once a few firms successfully defect and exit, the system itself will begin falling apart, since stable expectations about the continuing weak Confucian behaviors of other firms will not act as a disincentive against defection from the norms. These conditions can exist either in multiethnic society with comparable economic vitality among non-Confucian groups (e.g. the U.S. or Europe) or in environments where opportunities for international partners are plentiful. Since the latter is increasingly true across a wide range sectors and countries, the model would predict that the opportunity for globalization will eventually sound the death knell for the family-based firm system.<sup>25</sup>

## **Conclusion**

This analysis has had a two-fold purpose, one substantive and one methodological. The substantive purpose was to explain the conditions under which the Chinese family-based enterprise originated, and to predict the conditions under which it will survive in the future. The methodological purpose was to help bridge what has up to now been a large divide between cultural and rational choice models in the analysis of East Asian politics. This is was done in large part by showing how it was not irrational under conditions of strategic uncertainty to favor one's kin in business transactions, even if this means sacrificing potential economic efficiency.

One conclusion arising from the all this analysis is that business practices based upon social norms will be most prevalent where the surrounding environment is neither so hostile as to prevent the accumulation of profit yet not benign enough to ensure that economic actors can be protected from exploitation by one another. It is also in such a climate that such norm-based practices are the only ones that can induce long-term cooperation among such actors. As structural conditions change, however, the survival of such a pattern is eventually brought into question, not merely by efficiency factors, but by the availability of partnerships with actors who do not share such norms.

## Notes

1. Cross-national studies that are largely in this tradition include Haggard 1990; Wade 1990; Appelbaum and Henderson 1992; White and Wade 1988; Deyo 1987.

2. Dissenting free-market oriented counterparts to these arguments can be found in Balassa 1991 and Rabushka 1987. See also Woo 1990 for a review of neoclassical arguments.

3. The recent boom in studies of “post-Confucian” Chinese capitalism was triggered in considerable part by MacFarquhar 1980 and various passages in Kahn 1979. A broad sample of recent work in the area can be found in Clegg and Redding 1990 and Hamilton 1991. See also Sinha and Kao 1988 and Tai 1989a.

4. Pye and Pye 1985; Pye 1988; Madsen 1984.

5. For more bounded comparisons between institutional and elite cultural/ideological arguments, see Haggard 1990: 46-7 and Wade 1993: 337-8.

6. These ideas are further developed in Hamilton 1992 and Redding 1990: chap. 6, 7.

7. For a representative sample of the growing literature on this issue, see Kreps 1990; Gellner 1985; North 1981: chap. 5: sec. 2 and North 1990a: chap. 3: sec. 3; Douglas and Wildavsky 1982: chap. 1-4; Elster 1989b: sec. 3.

8. For opposing points of view, see Little 1991 and Johnson and Keehn 1994. An explanation of why this debate is particularly fierce in East Asian studies may lie in the rapidity of its rise in popularity as a academic field and the shift in the weight of research from social and political towards economic questions, both changes resulting from East Asia’s rapid economic growth. This has brought a large number of generalists, many of them trained in microeconomic methods, into a field that was long dominated by area specialists, with predictable results.

9. See also the discussion in Hamilton and Wang in their introduction to Fei 1992 [1947]: 19-25.

10. See also Tu 1989: 91 for a similar comment.

11. For a discussion and critique of this tendency, see Elster 1989a: chap. 3.

12. See for instance the symposia on this subject in special issues of *Ethics* 100: 4 (July 1990) and the *European Journal of Sociology* 32: 1 (1991).

13. For the general theoretical literature on this subject, see Axelrod 1984; Ullman-Margalit 1977; Taylor 1987; Calvert 1994; Noll and Weingast 1991.

14. See also discussion in Woo 1990: 427-8.

15. This can be demonstrated formally by first noting that in an infinitely repeated interaction each individual can gain a minimum aggregate utility of  $\sum_{t=0}^{\infty} \delta^t w = w/(1 - \delta)$  simply by failing to cooperate in each period. We can then show that there is no pair of strategies containing even a single act of cooperation by either individual that can be sustained as a Nash equilibrium, i.e. where neither individual has an incentive to deviate from their strategy given the other's. For individual 1, let  $T_{1y}$  refer to the set of periods in which she receives  $y$ ,  $T_{1z}$  the set of periods in which she receives  $z$ , and so on. Given  $w > x$ , any sequence of interactions that provides aggregate utility greater than  $w/(1 - \delta)$  for her must have  $\sum_{t \in T_{1y}} \delta^t y + \sum_{t \in T_{1z}} \delta^t z > \sum_{t \in T_{1y} \cup T_{1z}} \delta^t w$ . Given that  $y > w > z$  and  $y + z < 2x < 2w$ , this implies that  $\sum_{t \in T_{1y}} \delta^t > \sum_{t \in T_{1z}} \delta^t z$ . However, by definition  $T_{2y} = T_{1z}$  and  $T_{2z} = T_{1y}$ , so individual  $b$  has  $\sum_{t \in T_{2y}} \delta^t < \sum_{t \in T_{2z}} \delta^t z$  and hence has aggregate utility less than  $w/(1 - \delta)$ . Hence he will do better by converting to a strategy of failing to cooperate in any period, regardless of individual 1's response.

16. See also North 1989; North and Weingast 1989; North 1990b.

17. Fudenberg and Maskin 1986.

18. See also Feuerwerker 1969 for a more general discussion.

19. Chan 1975: 3.

20. The general insight that the structure of the family firm is related to the insecurity present in late imperial China can be found in Redding and Whitley 1990: 12

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	Cooperation	Non-Cooperation
Cooperation	$x,x$	$z,y$
Non-Cooperation	$y,z$	$w,w$

Relation between values under different structural conditions:

Predatory Government:  $y > w > x > z$ .

Contract-Enforcing Government:  $z \geq x > w \geq y$ .

Neutral Government:  $y > x > w > z$ .

**Figure 1:** A Symmetrical Normal-Form Game Depiction of  
an Economic Interaction

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