Part V Concluding Comments

Chapter 12 Institutions, History, and Development

This chapter reflects on four issues central to this book. Two are methodological: the nature of institutions and the analytical and empirical methods with which to study them. Two are substantive: the insights from the empirical analyses of institutions and the implications of the overall analysis presented in this book regarding policy aimed at fostering development.

Institutions influence behavior and effect historical development because, as I argue in section 12.1, they constitute much of the structure that influences behavior, including behavior leading to new institutions. Their independent impact and their interrelations with social and cultural factors imply that we cannot study them as reflecting only environmental factors or the interests of various agents. Although institutions are not random and all institutions generating the same behavior respond to the same forces, their details and implications are not determined by these forces. Comparative and historical institutional analysis— the central aspects of which are reviewed in section 12.2— fosters our ability to capture and study institutions from the required broader perspective.

Section 12.3 dwells on the insights from the comparative and historical analysis of institutions in the European and Muslim worlds during the late medieval commercial expansion. It emphasizes that although the late medieval European institutions differed in form from those that followed, many of the elements and features of modern, welfare-enhancing Western-style institutions were already present or in the process of emerging during the late medieval period: individualism, man-made formal law, corporatism, self-governance, and rules reflecting a legitimate institutionalized process in which those who were subject to them had a voice and influence. To the extent that the Rise of the West is due to its underpinning institutions which support impersonal exchange and motivate political agents to act in a welfare enhancing manner, the roots of this rise may have begun to take hold as early as the late medieval period. The late medieval period seems to have been crucial in the path leading to the emergence of the modern economy in Europe.

Section 12.4 examines the implications of the perspective proposed here for the developmental challenges that so many countries still face. While all institutions supporting vibrant markets and welfare enhancing polities have to fulfil the same functions in providing the appropriate motivation, they can nevertheless take many forms. Socially beneficial policy aimed at beneficial institutional change has to accommodate the context, recognize that existing institutions are self-enforcing, take into account that institutional dynamics are a historical process, and consider the importance of institutional elements inherited from the past. Policy must rely on these four pillars to create institutions that are compatible with the context and to direct institutional dynamics toward better institutional equilibria.

12.1 Institutions and Black Boxes: the Good, the Bad, and the Messy

Whether a society's institutions achieve socially good or bad outcomes, they cannot be studied independently from the broader society of which they are an integral part. The components of institutions reflect and constitute the cultural and social world that members of a society share and internalize. Institutions are shaped by a society's social and cultural heritage, and they contain norms and internalized and behavioral beliefs. These norms and beliefs, in turn, reflect the cognitive models, knowledge, and coordination that were generated through a historical process of interactions, socialization, learning, experimentation, and leadership. Institutions also determine social positions and manifest themselves in formal and informal organizations, such as communities, ethnic groups, schools, firms, political lobbies, and bodies for collective decision making. Institutionalized rules, transmitted culturally, socially, and formally, convey and foster processes of norm and belief formation while reflecting norms and beliefs regarding the world around us, our interests, legitimacy, and human attributes.

Institutions do not merely influence behavior and outcomes—including policies—at a given moment in time. They are also the engine of history as they shape change. Institutions affect the timing and nature of institutional change and influence the details of new institutions. Institutions impose constraints and provide opportunities for intentional institutional change, as well as unleash processes of unintentional changes. Moreover, because the institutional elements inherited from the past are the properties of societies and individuals, history — encapsulated in institutional elements — influences selection among alternative institutions in new — not yet institutionalized — situations.

Existing institutions influence how institutional change can be effected and hence how and what interests can be pursued by altering institutions. Institutions determine whether or not it is easy to adjust them to serve a particular function, such as efficiency or the welfare of a particular group. Institutionalized rules, beliefs, norms, and the associated organizations influence the motivation and ability of various interests and functions to shape institutional development. The institutional histories of Genoa, Venice, and Pisa are different, not because of distinct functional needs or interests, but because of their different institutional heritages.[1] The Maghribi traders' coalition and the Genoese bilateral contract-enforcement institution were two distinct institutional responses to the same need.

Institutions serving the same needs are not random. They all reflect the same forces and considerations. Yet distinct institutions entail different dynamics. The mechanism for institutional change is a function of opportunities, constraints, and processes that the prevailing institutions imply. Once established as equilibria, institutions do not necessarily have built-in mechanisms to efficiently respond to changing circumstances as we have seen, for example, in the case of the Maghribi traders' coalition. Institutions do not necessarily induce a beneficial institutional change. Indeed, an institution can remain an self-enforcing even if the behavior it generates is no longer efficiency-enhancing. We have seen just that in the case of Genoa's political institutions. Similarly, an institution can undermine itself, even though a better alternative is not available, as the community responsibility system did in various parts of Europe. Finally, the function of an institution can change even if its form does not. The merchant guild, initially a welfare-enhancing institution that protected property rights, later used its abilities to reduce welfare by preventing competition.

Hence, whether the society under consideration is a nation, an ethnic group, or a business

[1] The establishment of, for example, the Commune of Genoa reflected interests, but Genoa's institutional foundations were built on and influenced by the heritage of particular shared beliefs, norms, and social structures, which prevented these clans from advancing the welfare of their members to the extent technologically possible. The opposition to abolishing slavery in the Muslim world likewise reflects internalized beliefs and illustrates the impact of institutional complexes on the direction of change.

enterprise and whether the institution under study is good or bad in generating a particular behavior, its analysis is likely to be messy. We have to leave the comfortable arena of traditional economic inquiry in which the economy is assumed as isolated from the broader society and its history. It is generally inappropriate to assume that a society's institutions are determined only by environmental factors to serve a particular function or the interests of individuals unconstrained by institutional heritage. Understanding the impact, origin, and persistence of distinct institutional trajectories necessitates recognizing the dynamic interplay between institutions, interests and the nature of institutional dynamics as a historical process.

The complex nature of institutions implies that a superficial study is likely to be misleading. Even with seemingly identical organizations, rules, and outcomes, institutions may differ by, for example, their underpinning behavioral beliefs. Genoa and Pisa appear to have had the same *podesteria* system, yet they had very distinct institutions. In the former the *podestà* provided a balance of power, whereas in the latter it represented the domination of one group over another. For markets to function, property rights must be secure, but we have to know the context to recognize potential predators. For example, the government, the local elite or bureaucracy, the police, the army, the neighbors, or even relatives are possibilities. Context-specific analysis going beyond studying institutions as rules is necessary.

Indeed, invoking distinct rules was found insufficient to account for why some economies are rich and others are poor, why some have effective markets and polities, why some societies fail or succeed in adopting new institutions, and why the same political rules entail different welfare-related outcomes. To account for such outcomes, students of institutions have argued the importance of complementing the study of formal rules with that of informal institutions (North 1990), social capabilities (Abramovitz 1986), social capital (Putnam 1993), social infrastructure (Hall and Jones 1999), and civil capital (Djankov et al. 2003). Advancing institutional analysis requires going beyond invoking these concepts parametrically in our models or using proxies to study their impact empirically. Comparative and historical institutional analysis contributes to achieving just that by studying the institutional elements influencing behavior on the microlevel of the interacting individuals.

12.2 Comparative and Historical Institutional Analysis

To cut through the Gordian knot of institutional analysis the method presented here—comparative and historical institutional analysis—advances a pragmatic definition that accommodates the variety in origins, functions, and manifestations of institutions. It encompasses, but goes beyond, various definitions commonly used by economists, sociologists, and political scientists. *An institution is a system of social factors that conjointly generate a regularity of behavior.* These factors are social in being man-made, nonphysical factors that are exogenous to *each* individual whose behavior they influence. The various social factors that constitute an institution —in particular, rules, beliefs, norms, and organizations —motivate, enable, and guide individuals to follow one behavior among the many that are technologically feasible.

The institutionalized rules, beliefs, and norms that generate behavior in social situations are exogenous to *each* individual whose behavior they influence, and they constitute and are formed by intertransactional linkages. A transaction is an action taken when an entity, such as a commodity, social attitude, or piece of information, is transferred between individuals or other social units and has an external effect on the recipient. Institutional elements generating behavior in the central transaction of interest (e.g., economic exchange) reflect the actual and expected behavior in auxiliary transactions. The institutional elements influencing behavior in auxiliary transactions imply the norms and beliefs that enable, motivate, and guide behavior in the central transaction. Behavior and expected behavior in auxiliary transactions make institutionalized rules commonly known, render particular beliefs possible and relevant, and lead individuals to internalize particular norms. These rules, beliefs, and norms, in turn, constitute the institutional elements that conjointly generate behavior in the central transaction.

The games we use to study institutions constitute statements regarding the intertransactional linkages underpinning the institutional elements that generate behavior in the central transaction of interest. Analyzing the game that captures these intertransactional linkages enables examination of their underpinning institutional elements. It further enables limiting the self-enforcing and reproducing institutional elements that generate behavior in the central transaction.

Institutions have a pervasive influence on behavior, because individuals seek cognitive, coordinative, normative, and informational guidance for their behavior. In situations in which institutions generate behavior, they find this guidance in institutionalized rules. Such rules provide shared cognition, articulate expected behavior, frame the situation, and specify normatively appropriate actions. Institutions span the domain that individuals understand, within which they can predict others' behavior, determine their interest, and specify the morally appropriate. Rule following is motivated by belief in the validity of these cognitive models, belief that others will follow the prescribed behavior, and the intrinsic motivation provided by the internalization of these behavioral standards. At the same time, because each individual responds to the commonly known rules and beliefs about behavior based on his innate preference, private information and knowledge, institutionalized rules aggregate these features of the situation and reflect the (potential) trade-off between the psychological and social benefits of normatively following sanctions and socially appropriate behavior and its materialistic cost.

Endogenous institutions are self-enforcing and reproducing in the sense that each individual, using his private knowledge and information, follows the behavior expected of him; the implied behavior does not refute the validity of the beliefs motivating behavior or erode its motivating norms. In situations in which institutions generate behavior, institutions and the behavior they generate constitute an equilibrium. Institutions reflect the actions of the interacting agents but constitute the structure influencing each agent's behavior.

Institutionalized rules, beliefs, and norms often manifest themselves in organizations. Organizations differ from other institutions, however, in that the associated beliefs and norms lead to distinctive behavior toward members and nonmembers. More importantly, organizations also constitute institutional elements. As such, organizations are a reflection of and a means for intertransactional linkages. Organizations specify, store, and disseminate rules; facilitate the internalization of norms; and alter the set of self-enforcing beliefs in the central transaction.

Recognizing that institutions provide the cognitive, coordinative, informational, and normative microfoundations of behavior highlights the factors causing institutions to persist in marginally changing environments. The cognitive content of institutions implies that even if the situation changes, regularities of behavior will remain unchanged as long as those who recognize the change do not convey it to others through action. The coordinative content of institutionalized rules similarly implies that following them is the best predictor of others' behavior in marginally changing or similar situations. Norms render institutionalized behavior robust to environmental changes, while the scarcity of cognitive resources and attention transforms institutionalized behavior into habits.

Behavior generated by an institution will therefore prevail as long as the relevant parameters are within its *institutional support,* the range of parameters within which this behavior is self-enforcing and reproducing. Exogenous parametric change causing an institution to be outside this support will lead to its demise. *Endogenous institutional change* reflects institutions' influence on the ability and motivation to experiment, to create organizations, and to develop new knowledge. Endogenous changes also reflect the influence of institutions on various aspects of the situation beyond generating behavior in the central transactions they govern. Often this influence is on *quasi-parameters*—aspects of the situation that are endogenously changed by the institution and impact the parameter set in which the institution is self-enforcing. When the impact of an institution on quasi-parameters increases the range of parametric values in which the institution is self-enforcing, the institution is *reinforcing.* If an institution reinforces itself, more individuals in more circumstances adhere to the associated behavior. When an institution is *self-reinforcing*—self-enforcing and reinforcing—exogenous changes in the underlying situation that otherwise would have led an institutional change do not have this effect.

Yet an institution can also undermine itself, causing it to be self-enforcing in a smaller set of parameters. A self-enforcing institution can thereby cultivate the seeds of its own demise. When an institution undermines itself, exogenous changes in the underlying situation that otherwise would not have led to institutional change can have this effect. Furthermore, endogenous institutional change will occur when the self-undermining process reaches such a critical level that past patterns of behavior are no longer self-enforcing. Whether the mechanism that brings about institutional change is unintentional or intentional depends on the nature of the quasi-parameters that delimit self-reinforcement.

Societies face new situations when an institution that governed a transaction is no longer self-enforcing, when it is perceived to be losing its self-enforcing characteristics, or when technological, organizational, and other changes bring about new transactions. In such situations, new institutions do not reflect merely interest and environmental factors but also the impact of institutional elements inherited from the past. History, encapsulated in institutional elements, influences the process leading to new institutions and influences their details.

The influence of past institutional elements on institutional selection reflects that they, rather than technologically feasible alternatives, are part of the initial conditions in processes leading to new institutions.[2] There is a *fundamental asymmetry* between institutional elements inherited from the past and technologically feasible alternatives. Creating new shared cognition, providing coordination by alternate means, generating new commonly known beliefs, and establishing a new morality is a time-consuming, uncertain, and costly undertaking. More consequentially, past institutional elements constitute what people perceive to be and desire to hold as the true, the expected, and the appropriate. Seeking to create alternative systems of the correct, the normatively appropriate, and the expected are inherently contradictory. If people believe that something is true and normatively appropriate, they do not seek to alter it. The extent of this fundamental asymmetry—the *transaction costs* of creating new institutional elements—depends on the details of existing institutions.

In contrast, as the social-level manifestations of the cognitive, coordinative, normative, and informational foundations of behavior, institutional elements inherited from the past are properties of societies and their constituting members. They are part of what individuals bring with them and carry within them when facing new situations. In these situations, one’s optimal action depends on the actions taken by others, implying that in new situations individuals will attempt to predict others’ behavior. Past institutionalized beliefs—particularly cultural beliefs that emerge without centralized coordination—are a natural “focal point” in new situations. Formal and informal organizations, such as clans, religious groups, firms, or parliaments inherited from the past constitute actors in the processes leading to new institutions and resources that these new institutions will draw upon. Even institutional elements that were central to institutions that are no longer effective in influencing behavior can influence behavior in new

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[2] Various implications of past institutions, such as the pattern of personal relationships, wealth distribution, military ability, or knowledge, are also part of these initial conditions.

situations. Past institutional elements constitute part of the historical—cultural, social, and organizational—heritage that influences selection among alternative institutions in new situations, integrates into them, and propagates as a result.

The impact of past institutional elements on new institutions expresses itself in the *environmental, coordination, and inclusion effects*. New institutions reflect the institutional environment within which they establish themselves, reflect coordination by past institutional elements, and include institutional elements inherited from the past. New institutions recombine existing institutional elements or reflect the refinement of existing institutions by marginally changing them. The sequentiality in institutional development implies that a society's institutions will *complement* one another, reflect common sources of coordination, and share institutional elements. A society's institutions will therefore be grouped in *institutional complexes* of such interrelated institutions, and this interrelatedness further influences institutional persistence and the direction of institutional change.

We do not have a single analytical framework to study endogenous institutions and their dynamic. But classical game theory enriched by insights developed elsewhere has proved useful. In a game-theoretic representation, the cognitive models regarding the structure of the situation, norms, and internalized beliefs are captured in the rules of the game, while behavior and behavioral beliefs are represented as strategies and the probability distributions over them. Game-theoretic analysis restricts the admissible set of institutional elements that can prevail as a system in equilibrium. It also reveals the institutional support of a particular behavior, namely, the parameter set in which the behavior is self-enforcing. We can also capture the fundamental asymmetry between institutional elements inherited from the past and technologically feasible alternatives by considering institutional heritage as part of the initial conditions in processes leading to new institutions. We study new institutions using *contextual refinement* in which game theory and history complement each other in restricting the set of admissible institutions.

The absence of a one-to-one mapping from the environment, interest, or function to institutions and the fact that some institutional elements are not observable challenges the use of traditional empirical methods in the social sciences. A theoretically informed, case-study approach based on interactive, context-specific analysis aimed at *identifying* institutions, however, is particularly promising. Contextual knowledge of the situation and its history, together with deductive reasoning and inductive analysis, facilitates the interactive process of formulating and evaluating a conjecture regarding a relevant institution.

It is often useful to present and evaluate the conjecture with the assistance of a context-specific model, whose details are based on evidence that constrains the set of possible models and whose appropriateness should be evaluated. Such a model has to recognize that the game relevant to the interacting actors and their behavior in it is contingent on what transactions had been linked, how, and to what effect. Equilibrium analysis, comparative statics, counterfactual analysis, and other predictions are used to evaluate —modify, reject, or accept —the conjecture. The process continues to use interactively contextual knowledge, theory, and modeling to evaluate evidence and evidence to evaluate the conjecture until theoretical comprehension and empirical confirmation of a conjecture are reached.

Historical knowledge is particularly important in such empirical analysis. The historicity of institutions implies that we can further develop and evaluate a conjecture, avoid "just so" explanations, and sort among observationally equivalent conjectures by tracing an institution's origins. New institutions incorporate knowledge gained in the past and reflect the environmental, coordination, and inclusion effects. We can therefore further develop and evaluate conjectures about relevant institutions using context-specific refinement. We refine the set of admissible institutions by requiring that they be self-enforcing, but we also build on the knowledge from history to rule out those that are possible yet contextually irrelevant. History mitigates the failure of the game-theoretic refinement literature, while game theory delimits claims regarding the influence of history.

Emphasizing the context-specificity of institutions and their historical contingency does not imply aborting the social-scientific tradition of seeking generalizations. In fact, the accumulation of comparative and historical institutional analyses has the promise of fostering our understanding of which institutions matter and why, which are conducive to generating welfare-enhancing outcomes, and which are more likely to adapt efficiently to changing needs. The reasons for and processes through which societies and economies develop along particular institutional trajectories and to what effect will be better understood.

12.3 The Late Medieval Commercial Expansion and the Rise of the West: The Origin of the Modern Economy

Indeed, each analysis of a particular institution presented in this book yielded general insights regarding the institutional foundations of markets and polities are related factors, mechanisms, and processes. The discussion here, therefore, focuses on the broader conclusion this analyses provide regarding the European institutional development.

First, these analyses highlighted that the institutional foundations of the late medieval commercial expansion did not depend on enforcement provided by a centralized state dispensing impartial justice. The common assertion (e.g., by North 1990) that market expansion and economic development require an effective state is not confirmed by the experiences reported here. Private-order, self-enforcing institutions were the hallmark of the late medieval expansion. Yet, this private order was not, as advocates such as Friedrich A. von Hayek and Milton Friedman would have us believe, a result of "spontaneous order" among economic agents. Rather, it was a product of intentional and coordinated efforts by many individuals who were often economic as well as political agents with coercive capabilities.

The second, and even more interesting general conclusion, is the particularities of the social structures in which these intentional and coordinated efforts took place. Historically, the social structures that substituted for an effective state had been kin-based, such as lineages or tribes. In late medieval Europe, however, at least in the towns, which were the center of economic and political change and the forerunner for future developments, the dominant social structures were self-governed, interest based, and intentionally established organizations among individuals unrelated by blood. They were self-governed in the sense that, directly or indirectly, their members participated in specifying the rules that regulated the ways in which they operated. Power was shared. In other words, economic and political *corporations* were central to the institutional underpinning of the late medieval commercial expansion in Europe. Corporations and the subsidiary organizations they established, such as courts, were central to all the European institutions examined here, the merchant guild institution, the political institutions of Genoa and Venice, and the community responsibility system.

Corporations reflect the intentional and coordinated effort to create institutions as well as a means for doing so. They produced rules and altered self-enforcing beliefs in a central economic or political transaction by linking them to other economic and coercive—legal or otherwise—transactions. Incentives were often provided by both economic reputation and coercion. This was also the case in the many other medieval corporations not examined in this work, such as monastic orders, military orders of knighthood, associations for mutual insurance, and universities.

One could argue that concluding the state was of limited importance and corporations were central to the institutional foundations of the late medieval commercial expansion, is biased by the focus on long-distance, interstate commerce. But self-governed corporations were also central to the merchant guilds and the community responsibility system, which were private-order institutions within existing states. Indeed, corporations such as craft guilds, merchant guilds and towns were also central to production, exchange, and taxation even within the large European states.

Indeed, even the European states of this period are best studied as institutions central to which are self-governed, non-kin-based corporations. Projecting the image of the later, more centralist and absolutist European state on the late medieval one is misguided.[3] The late medieval polities were, to a surprising degree, self-governed, political corporations; laws and rules were man-made; and citizens—albeit often not all of them—had a political voice and representation. Effective representation was backed by the economic importance and coercive power of the citizens who were often organized into corporations within the state. The general nature of these earlier European polities as self-governed, non-kin-based corporations is reflected in the rise of bodies for political representative throughout Europe, from England in the west to Hungary and Poland in the east, from Sicily and Spain in the south to Germany in the north. (Herb 2003). Even the Holy Roman Empire officially became a constitutional monarchy in 1356. (Ertman 1997; Spruyt 1994; Herb 2003; Greif 2004).

The conjoined influence of several factors contributed to the rise of corporations.

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[3] S.R. Epstein (2000) has similarly argued that projecting the nineteenth-century European state on earlier periods is misleading.

Centuries of invasions and internal defragmentation weakened the European states. The weakness of the state in the late medieval period provided an *opportunity* for economic agents to self-organize, but this does not *explain* the *particularities* of their responses. Why corporations? A kin-based organization of society or a theocracy were possible alternatives. Historically such societal organizations often emerged in the absence of an effective state. This was the case, for example, in the Islamic world during its first two hundred years when the weakness of the state, and other factors that will be discussed later, fostered tribal bonds. The particularities of the European response – the rise of interest-based, non-kin-based corporations - reflects various institutional elements inherited from the past.

The church had weakened kin-based social structures (such as clans and tribes) in Europe, as discussed in section 8.7 and contributed to cultural beliefs associated with individualism, as discussed in section 9.2. This hindered the establishment of institutions based on large-scale, kin-based social structures and collectivist cultural beliefs. The church itself, however, was not in a position to provide an effective alternative to the state in the late medieval period. Its administrative structure was weakened by the medieval warfare and upheavals and the later conflicts with the Holly Roman Emperor and various kings. Furthermore, the church had legitimacy to set rules only in a limited number of situations, as discussed in section 5.4.

The result was not, as Hobbes would have us believe, a war of all against all. Rather, the weakness of large scale, kin-based social structures and individualism enabled and motivated commoners to self-organize to gain from cooperation. (Although this cooperation was sometimes at the expense of others.) This enabled them to gain economic and political power alongside feudal lords and kings. Political development was marked by a republican movement and the increasingly corporate nature of the polity. (Greif 2004b.) In doing so, the Europeans built *on the beliefs and norms inherited from the Roman and Germanic legal traditions, which made explicit man-made (rather than divine) laws, self-governance and formal decision making processes a focal point (indeed, even European canon law is man-made). They also built on the idea of corporations, which after all, date back to the Roman time (e.g., Kuhn 1912).

The feudal view that political authority was contractual and nonterritorial also facilitated the creation of self-governed corporations with coercive power within the confines of existing political units. Even the establishment of the Hansa was not considered a revolt by the feudal lords in whose territory the Hanseatic cities were located.

The cultural beliefs and norms associated with individualism, corporatism, and man-made law in which those who are governed by them have an influential voice became central to European societal organization. Individualism and corporatism were the hallmark of institutions that supported the late medieval commercial expansion.

Rubeus de Campo, mentioned in chapter 1, lived in a period of remarkable economic growth due to this particular organization of society. For a long period of time, this organization of society supported impersonal markets and effective polities thereby fostering economic prosperity. The efficiency implications of particular insitutions, however, depended on their details and the broader context. The associated institutions were effective when those with coercive power cared about their economic reputations and were constrained from abusing their power by others with economic and coercive powers. They were socially beneficial when there was an intra-corporation uniformity of economic interests and the distribution of intra-corporation resources was such that coercion could have been used only to discipline members whose actions undermined cooperation and economic gains. Finally, they were efficient when inter-corporation interactions were confined to economic, rather than military, competition and when economic resources could not be used to forestall competition.

When these conditions did not hold, the associated institutions were not socially beneficial. The failure to create an effective, socially beneficial monopoly over coercive power in Genoa, for example, cost the Genoese dearly. When the German Hansa’s economic and military might sufficiently increased, it was used to restrict competition. The comparison between England and Italy illustrates another general force at work. In England, the monarchy was sufficiently effective to imply that inter-corporate competition among guilds and communes, for example, could not be conducted using coercion; inter-corporation economic competition was induced. At the same time, the English king had limited administrative and coercive powers relative to those of chartered towns, for example. Property rights were relatively secure. This was not the case in Italy. Once rents from overseas expansion declined, in the absence of centralized authority inter- and intra-communal conflicts over it ensued. (See Greif 2004b for further details, references, and discussion of other cases.)

More generally, although efficiency-enhancing and self-enforcing, the late medieval institutions were inherently self-undermining. Reputation was central to their operation, but the effectiveness of reputation mechanisms depended on rents (surpluses above and beyond those possible under perfect competition). The progression of the commercial expansion that the late medieval institutions enabled eventually eroded the rents that rendered the institutional foundations of these markets self-enforcing. Similarly, commercialization and specialization ended the homogeneity of interests within merchant communities and altered the distribution of coercive and economic resources. The economic process as a whole was self-undermining.

This institutional decline probably contributed a great deal to the fourteenth-century crisis that expressed itself in widespread economic, social, demographic, and political upheavals.[4] Europe had to create new institutions to regulate its commerce, production, and polity. It was a lengthy process, in which many of the organizations established during the late medieval period (the Hanseatic League, various merchant and craft guilds) were used to restrict competition, innovation, and expansion in order to maintain rents and increase profits. The decline provided an opportunity for the territorial state to use these organizations and establish new institutions to serve its interests.

Some of the state-centered institutions were efficiency enhancing, as the state was arguably in a better position to provide protection (North and Thomas 1973) and coordinate economic activities on a larger scale than it had been (S.R. Epstein 2000). However, the state and its institutions also imposed large inefficiencies, including destructive interstate warfare (Hoffman 1991); mercantilism and rent seeking (Ekelund and Tollison 1981; Root 1994); and absolutism and institutional rigidity (Rosenthal 1992). In any case, on the eve of their second growth phase during the modern period, European institutions seem to have been very distinct from those of the late medieval period.

[4] As Hatcher and Bailey (2001) noted theories of this decline—such as neo-Malthusian and Marxist theories—fail to account for it adequately.

There is nevertheless a striking commonality between the economic and political institutions that were central to Europe's late medieval commercial expansion and those that currently prevail in its modern economy. In both periods, the cultural beliefs and norms associated with individualism and corporatism have prevailed. The basic social unit is the individual or nuclear family rather than larger, kin-based social structures, such as clans or tribes. The predominate social structure is the economic and political self-governing corporation with legitimate institutionalized processes for setting rules in which those who are governed by them have a voice and influence.[5] These corporations were and are central to the European institutions enabling impersonal exchange and motivating the state to serve its citizens.[6]

In particular, individualism and corporations with statelike authority among nonkin were central to the late medieval institutions that supported increasingly complex and impersonal exchange. Individualism and corporations, albeit without coercive power, have remained central to European economic institutions to the present. Similarly, bodies for political representation, the legitimacy of rule setting by corporations, and the concept of a state as a corporation were central to the institutional foundations of the state in the late medieval period. This is also the case in the modern European state.

Is the similarity between the late medieval and modern European societal organizations a coincidence? Do modern institutions reflect the influence of the institutional elements inherited from the late medieval period, which, in turn, incorporated deeper cultural and social features?

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[5] Corporations in the modern West are everywhere. In the economic sphere the most notable ones are the business corporation but other corporations such as business associations and non-for-profit organizations. Similar to the new polities of the late medieval period, the state in the modern West is a self-governed, political corporation. The organizational foundations of the polity are such that—unlike in an absolute monarchy, a dictatorship, a fascist regime, or a theocracy—it does not have an independent objective function. Like various medieval corporations, the modern state also provides individuals with social safety nets beyond those provided by the family and private and religious charities.

[6] Interestingly, the institutions of both periods also reflect secularism although the moral authority of the church influenced social development as discussed in previous chapters. It is difficult to find a direct impact of religiosity on these institutions. Commerce related evidence reveal a shift toward religiosity following the crisis of the fourteenth century. This shift is reflected in names of ships following the Black Death (e.g., from such names as the Lion or Glory to such names as Santa Maria or Faith) (Kedar 1976). For opposite views, see Platteau (1994) and Lal (1998).

Were the late medieval institutions instrumental in reproducing these features through the institutional elements, knowledge, and history they implied? Was the late medieval period thus crucial to the subsequent institutional development of Europe? If the answers to these questions is yes, the age of absolutism and mercantilism may have been an exception rather than the rule in the path of European institutional development during the last millennium.

No one has evaluated these questions or traced exactly how earlier institutional heritage influenced later outcomes. But there is much to suggest that the late medieval institutional development had direct impact on later institutions. The modern business corporation grew out of the traditional legal form of the corporation, as developed for medieval guilds, municipalities, monasteries, and universities. The operation of the late medieval corporations led to the development of particular knowledge, laws, and other institutional elements that manifested in current practices such as trading in shares, limited liability, auditing, apprenticeships, and double-entry bookkeeping. European commercial law, insurance markets, patent systems, public debt, business associations, and central banks were developed in the context of medieval institutions.

In the political sphere, the medieval rise of the corporative form of societal organization contributed to the development leading to the modern European states. Corporations contributed to diminishing the challenge that large scale, kin-based social structures present to the state and to development central to the institutional foundations of the modern, effective European state, which is, after all, a corporation. Among these are the concept of corporations as legal personalities, the separation between personal and corporate property, the belief that corporations are to serve the interests of their members, and the process of collective decision making. These features are also central to modern economic corporations. More generally, corporations fostered both norms and beliefs in the appropriateness and possibility of self-governance, decision making through majority vote, and man-made law. (E.g., Berman 1983 and Korotayev 2003.)

Furthermore, states in Europe were established during the pre-modern period through a profess of bottom-up, organic formation. In building their states, rulers had to rely on the corporate bodies they inherited from the past, the local governance they enabled, and the resources they could provide. These corporations therefore had the ability to constrain the state from abusing its power and directing its policies. This institutional heritage thereby contributed to the rise of an effective state. (Ertman 1997; Tilly 1990; Greif 2004b.) More generally, the manifestations of the late medieval republican movement—its underpinning norms, beliefs, and organizations—have survived to modern times. The Hanseatic League, the Republic of Venice, and the Swiss Confederation lasted until the eve of the modern period. The causal relationships between the institutional foundation of the medieval and modern European states are well reflected in the many cases (notably the Dutch Republic, England, and France) in which medieval representative organizations and the associated shared beliefs and norms provided the institutional elements central to the later transition to more democratic, growth-oriented states. These institutional elements became an integral part of the institutional foundation of the modern Western polities which are better able to motivate their agents to pursue policies and take actions with relatively high social rate of return.

The rise of the Dutch Republic and the political supremacy of England's Parliament during and after the seventeenth century rest on their late medieval organizational and institutional foundations. The composition, form, and powers of the English Model Parliament, summoned in 1295, provided the springboard and mold for the modern one; the French Estates-General, which played a central role in the French Revolution, was established in 1302. Constitutional monarchy—which encompasses the idea that a ruler is subject to the law and members of the state pledge their loyalty to abstract principles rather than the person who led them—prevailed in the late medieval period, in which the modern theory of voting also originated. Legitimacy in the late medieval period and in the modern European state resides in the hands of surprisingly similar bodies, and institutional complexes in the two periods bear striking likeness.

The sources of modern European economic growth differ from those of its medieval predecessor. Medieval economic expansion relied on Smithian growth, which takes advantage of specialization and trade. Growth in the modern era relies on science and technology to alter production functions and transform useless resources into endowments. Changes in cultural beliefs about the nature, role, and possibilities of useful knowledge—science and technology—in the hundred years before 1750 directly contributed to this transition (Mokyr 2002).

Interestingly, however, individualistic pursuit and self-governed, non-kin-based corporations (such as the Lunar and the Royal Societies) were central to propagating these beliefs, mobilizing the resources to act on them, and rendering them effective in influencing outcomes. The objectives of these corporations were different from their medieval predecessors, but the institutional means were surprisingly similar.

Whether the similarities between European institutions in the late medieval and modern periods reflect a historical process or a common condition has yet to be evaluated. Be the result of this evaluation as it may, Europe seems to have been evolving along a *particular* institutional trajectory since at least that time.[7] Indeed, the limited comparative analysis between the European and the Muslim worlds conducted here suggests that Europe has been evolving along a *distinct* institutional trajectory; institutional distinctions between the two prevailed from at least the late medieval period.

The collectivism of the Maghribis reflects a broader cultural trait in Muslim society, in which large social units, such as clans, lineages, and tribes also have remained central until today and segregation along religious and ethnic lines is still common. Corporations did not emerge endogenously, nor were they recognized as legal entities.

Similarly, the relationship between the Maghribi traders and the state is representative. Laws and regulations of commercial activities were specified either by the religious authorities or by a state or both. Merchants in the Muslim world could not amend the law in a manner that combined private- and public-order institutions in the same way that European merchants could, nor could they use the resources of the state to formulate policies to advance their economic interests. Cities were not self-governed, and merchants had no political representation or voice. "True urban autonomies would have been unthinkable in [the Muslim] world" during the medieval period (Cahen, 1990, p. 520) and, more broadly, there was no interest-based

[7] If the conjecture regarding the importance of individualism and collectivism is substantiated, it would provide an important complement to Weber's (1958 [1904]) thesis regarding the importance of the Protestant ethic in Europe's economic growth. It would indicate the rationale for the particular organizational and institutional developments of Europe that differentiated it from other regions of the world before the rise of Protestantism. At the same time, it would account for why, despite Weber's assertion about the uniqueness of the Protestant ethic, non-Protestant economies developed as well, albeit within a distinct organizational and institutional framework.

organization of society along corporate lines (Crone 2004, p. 335-6). Indeed, “the authority of the universal Shari’a was likely to invalidate any local corporate convention” (Hodgson 1974, vol. 2, p. 122; and also see Kuran 2005). Furthermore, "there was very little contact between the world of the [Muslim or other] traders and that of the government" (Goitein 1973, p. 10).

Similar institutional complexes prevailed in the Muslim Mediterranean world in later centuries. Processes of rule making were not participatory, formal rules governing economic life were not in the hands of the economic agents, and the ability to incorporate was very limited. Surveying the extensive literature regarding the Ottoman Empire, Pamuk (2000) noted that “the influence of various social groups, not only of landowners but also of merchants and moneylenders, over the policies of the central government remained limited” (p. 10). Policies were shaped to a large degree by the priorities and interests of a central bureaucracy and the structure of the private economic sector was not dictated by its needs but by those of the state. Similarly, social segregation along innate, religious, ethnic, and other lines prevailed in Muslim cities at least until the early modern period.[8]

Do these differences in institutional complexes help explain different trajectories of economic prosperity and growth in these two great civilizations? This question is not easy to answer, as different institutions can fulfill the same function with equal efficiency. Furthermore, an institution often has a multidimensional influence on efficiency and welfare, making interinstitutional comparison difficult. Finally, we have no good measure for comparing an institution that is less efficient in the short run but more efficiently adaptive in the long run. Hence the extent to which the late medieval European institutions were more or less efficient than alternative ones at the time and the value of their contributions to distinctions in subsequent institutional development and outcomes remains to be examined.

There are, however, at least four theoretical reasons why intentionally created institutions based on individualism, corporatism, and self-governance are particularly conducive to efficiency, including adaptive efficiency. To the extent that the division of labor is a necessary

[8] On segregation, see Chapters 8 and 9, Lapidus (1984), and Hodgson (1974, pp. 105ff.). On institutions more generally, see Kuran (2004); Cahen (1990); B.Lewis (1991); and Lapidus (1984, 1989). Çizakça (1996), however, emphasizes the similarity in business partnerships in the European and the Muslim worlds.

condition for long-run sustained economic growth, formal enforcement institutions that support anonymous exchange facilitate economic development. Individualism fosters the development of such institutions, thereby enabling society to capture these efficiency gains. Similarly, economic prosperity requires institutions that lead to socially beneficial policies and the specification, protection, and adjustments of property rights. Individualism, corporatism, and self-governance on the level of the polity foster the development of such institutions, thereby enabling society to capture gains from cooperation. Third, an individualist society entails less social pressure to conform to social norms of behavior while the corporations are better able to mobilize resources and diversify risk than the individual or the family. Together, therefore, risk taking, initiative and organizational and technological innovations are encouraged.[9]

Finally intentional institutions centered around corporations foster beneficial institutional dynamics. No one institution is most efficient under all circumstances, implying that even those that were relatively efficient will gradually cease being so. Intentional institutional creation increases awareness of the operation of these institutions and the need for change. The flexibility of corporate structure, self-governance, man-made laws, and institutionalized processes of rule making with input from those governed by these rules provide the means for such beneficial change.

The European institutions and institutional dynamics that emerged as early as the late medieval period may have been more efficient than other societal organizations. To the extent that the particularities of the European institutions were instrumental in shaping economic, political, and social outcomes and reflect a historical process, late medieval society may have cultivated the seeds of the Rise of the West.[10]

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[9] This flexibility may have been crucial for the new ideas and beliefs that emerged during the Enlightenment, leading to the technological and scientific breakthroughs that made modern growth possible (Mokyr 2002).

[10] Hamilton (1991, pp. 1-2) is among the many scholars who have noted the institutional distinctions between Europe and China consistent with the preceding argument. "In the West, commercial organizations in the private sphere rested upon legal institutions and upon individualism, neither of which had central importance in China," he writes. "Kinship and collegiality in China play roles analogous to those played by law and individuality in the West, but with very different developmental trajectories and outcomes."

While an evaluation of this assertion has yet to be conducted, it is interesting to note that within Europe, the areas that experienced medieval institutional development were also early to embark on modern economic growth. The late medieval institutional revolution did not transpire in much of Eastern Europe, southern Italy, the Balkans, or various parts of Spain, the very areas that were late to industrialize. In contrast, the areas that became the Dutch Republic, Germany, and England led Europe in commercialization, industrialization, and the move toward centralized but limited government. As the experiences of France and northern Italy remind us, however, these outcomes were not historically determined. In France absolutism triumphed for a long period; Italy was devastated by civil wars and by conflicts with external foes.[11] Unlike areas that did not experience the late medieval institutional revolution, however, both northern Italy and France found it relatively easy later to adopt institutions that were conducive to modern growth.[12]

Whether the institutional roots of the Rise of the West go back to the late medieval period remains an open issue. So, too, does the issue of whether these institutions were more efficient than those of other societies. Yet claims that the Rise of the West is due to either predetermined factors (such as endowment) or later events (such as colonialism or the Industrial Revolution) face the challenge of demonstrating that the implications of these exogenous factors and these particular events were not reflections of the institutional particularities of Europe at the time.

12.4 The Challenge Ahead: Constructing Well-Functioning Markets and Polities

Understanding the late medieval commercial expansion—where, when, why, and among whom trade expanded—requires considering the micro-level institutions that enabled, guided, and motivated behavior in particular economic and political transactions. When successful, these institutions increased gains and reduced the costs of respecting property rights, mobilizing resources for commercially beneficial policies, employing the polity and its organizations to

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[11] England and the Dutch Republic may have been particularly fortunate in having institutions that restricted their corporations to competing only economically and not militarily, while the central authorities had limited ability to create institutions to extract rent for their own objectives (see Greif 2004b).

[12] Mokyr (2002) traces the origin of the institutions linking science and technology in the modern period to these areas.

foster welfare, and adhering to contractual obligations in personal and impersonal exchange.

Whether enabling, motivating, and guiding economic exchange, political behavior, or coercive actions—legal or not—and whether welfare-enhancing or not, these institutions were based on the same principle. Intertransactional linkages created reward (economic, political, social or normative) for a particular behavior and a penalty for failing to comply. The details of these intertransactional linkages, the related institutions, and hence the resulting extent of the markets and the effectiveness of polities reflected economic and political interests, as well as the social and cultural factors that provided initial institutional elements. These factors provided networks for information transmission, formal and informal organizations with various capacities and interests, and systems of norms and beliefs regarding expected behavior. When the resulting institutions were self-enforcing and reinforcing, they incorporated and perpetuated these social and cultural features.

The effectiveness of the resulting institutions depended on the broader context and institutional details. In Europe this effectiveness was enhanced by external military threats and economic competition among states and corporations on the one hand and institutions that created a relative internal uniformity of interests within corporations on the other hand. This effectiveness was further enhanced by the ability of the economic agents to link economic and coercive—legal or not—transactions. Economic reputations complemented by the ability to inflict coercive punishments fostered institutional effectiveness.

Coercive power was rendered economically productive, however, when and where the context and institutional details prevented those who controlled coercion from using it for their personal advantage. The weakness of the centralized state in Europe and of the large kin-based social units, and the wide distribution of military ability among the economic agents, contributed to this situation. The process of institutional and state development was done from below. Political actors and judges had limited ability to structure the market and the polity for their exclusive benefit. To enrich themselves, they had to contribute to welfare more generally.[13] When an institution motivated those courts, communes, clans, and individuals with coercive

[13] In particular, they catered for the welfare of those with coercive and economic power to the exclusion of others.

power to use it in a manner that was economically productive, markets expanded and welfare-enhancing policies were pursued.

The process of institutional development in Europe has been conducted in a context and through a process that was distinct from what has been experienced in most less-developed countries since World War II and at the end of colonialism. In modern developing countries, innate social structures predominated and the process of development has been conducted with the intention of first building an effective centralized state. This attempt was taken in the context of a world order, in which external threats were relatively muted, and a global economy, in which those who controlled the state could raise capital in the international capital markets and sell domestic minerals and other local products without relying on domestic economic agents.

When the state construction effort was successful, politicians, unconstrained by domestic economic agents or external threat and competition, used their power to construct institutions and pursue policies and pursue policies to serve their private—economic and political—gains (Easterlin 2001). When the effort failed, politicians were either unable to pursue or found it personally unrewarding to pursue welfare-enhancing policies or establish welfare-enhancing institutions.

More recent attempts have concentrated on development that circumvented the state and provided resources directly to the poor and to local communities. Often, however, resources provided by external, international agencies ended up serving the interests of community leaders who had access to them rather than contributing to social welfare more generally (Platteau and Gaspart 2003). State-centered and community-centered development faced the same challenges of providing governments, politicians, agents of the state, and representatives of communities with the appropriate incentives. In the absence of institutions motivating them to take welfare-enhancing actions and pursue policies aimed at facilitating welfare-enhancing institutional change, development has been lagging.

Such institutions are not necessary for promoting welfare, however. A period of economic growth, in fact, can be initiated without institutional reform—by little more than "an attitudinal change on the part of the top political leadership towards a more market-oriented, private-sector-friendly policy framework" (Rodrik 2003, p. 15)—but without an institutional reform growth runs out of steam quickly. Reforming institutions, however, is difficult. Attempts to reform them by imposing the West's "best practices" rules and regulations has accomplished less than was hoped for.

From the perspective developed here, this result is not surprising. European growth was neither state-centered nor based on communities embodied within effective states and benefitting from international aid. Furthermore, institutions are not rules but self-enforcing systems of rules, beliefs, norms, and organizations. Institutional development is a sequential process in which some institutions are prerequisites for others, an institution's implications depend on various conditions, that different institutions are better in different circumstances. Successful reform requires much more than a change of rules; it requires creating new systems of interrelated institutional elements that motivate, enable, and guide individuals to take particular actions. Reform must first empirically identify, rather than assume, the transactions that are important for improving welfare, as they depend on local conditions and institutions. We need to discover empirically, rather than assert deductively, whether, for example, the abuse of property rights by the police, the army, rebels, or the government is the source of property rights insecurity. Only then can we consider what institutional reform would be beneficial and feasible.

Such considerations entail recognizing that institutions are not rules, that institutional development is a sequential process in which some institutions are prerequisites for others, that an institution's implications depend on various conditions, that different institutions are better in different circumstances. Successful reform requires much more than changing rules; it requires creating new systems of interrelated institutional elements that motivate, enable, and guide individuals to take particular actions.

In pursuing institutional reforms by altering self-enforcing institutions, developmental assistance will have to shift its focus. Rather than focusing only on helping countries specify rules, it will have to seek to change organizations, beliefs, and intertransactional linkages. The challenge is to create new self-enforcing institutions so that when aid ceases, the institutions will persist. At the same time, these institutions have to be amenable to endogenous change when they are no longer beneficial.

Institutional reform involves replacing one set of self-enforcing institutions with another.

Not only do new institutions have to be created, existing ones have to be changed, because institutional reform does not begin with a *tabula rasa*. What we consider a state of anarchy, for example, is not necessarily devoid of institutions. Those involved may share beliefs regarding expected behavior and related outcomes, holds particular norms, and often are organized in well defined social structures. Initial conditions in processes of institutional change include existing self-enforcing institutions and their undesired outcomes.[14] Economies in need of institutional reform are not without institutions. Unless we understand the institutions that are generating outcomes, our ability to develop appropriate reform strategies will be limited. A prerequisite to successful institutional reform is understanding existing institutions, the complexes of which they are part, the forces that render them self-enforcing, and the transactions costs of institutional change they imply. The reform strategy itself has to learn from, work with, build on, and potentially undermine existing institutions while recognizing that institutional development is a historical process that may well be time-consuming.

When pursuing reforms, however, we have to recall that the very same cognitive, coordinative, normative, and informational factors that make institutions important determinants of behavior render institutional reforms difficult. Given a particular context, it is difficult to know what institutions are beneficial. Likewise, the long-term implications of introducing new institutional elements are hard to identify. Furthermore, we know little about how to devise institutions that are conducive to beneficial dynamic adaptability. An institution that represents a better fit with existing ones may be easier to implement, but it may reinforce other institutions that are better undermined.

Conducting context-specific institutional analysis; building on existing institutional elements; learning, experimenting, and measuring the impact of various changes are indispensable. The promise of an institutional reform strategy based on a context-specific analysis is suggested by the findings of Berkowitz, Pistor, and Richard (2003), who found that countries that developed their formal legal order internally and adapted imported codes to local

[14] The ability of those with political power to block institutional reforms is well recognized, but little attention has been given to the impact of beliefs, norms, formal and informal organizations inherited from the past, or the implications of past institutions on interests.

conditions ended up with much better legal institutions than those that adopted codes verbatim from the West.

The historical analyses in this book lend support to the claim that the institutional forms best fitted to achieving a particular outcome depend on the particularities of the situation and can differ from those currently prevailing in the West. In fact, current Western institutions are themselves different from those that prevailed there in the past (although as stressed already, they share much in common). The late medieval commercial expansion—the longest period of economic expansion Europe ever experienced—rested on a set of institutions that were distinct in form—although shared much in essence—from those that support modern growth in Europe. There was no democracy, no constitutional or balance-of-power restrictions on rulers, no effective territorial states, no universal protection of property rights, no independent judiciary.

Late medieval institutions, in Europe and elsewhere, may well have been better suited for their tasks than their modern counterparts, given the broader context and institutional heritage. The Maghribi traders' coalition was a beneficial institution given the state's inability to enforce contracts abroad. The merchant guilds secured property rights from the grabbing hand of the state by taking advantage of Europe's political fragmentation and communal organization. In Genoa the existing social structures and the associated beliefs and norms implied that the *podesteria* was better able to promote order and prosperity than the elected consuls, a seemingly more democratic system. Establishing an independent, territorial judiciary was well beyond the organizational and financial capacity of the late medieval state. The community responsibility system nevertheless provided impartial justice because of—not despite—its reliance on partial judges and localized law.

The challenge of fostering welfare through institutional reform is to build on institutional elements inherited from the past and the existing institutional environment to foster welfare in the short run while creating institutions conducive to beneficial endogenous change. Whatever form such institutions take, if they are to enhance material welfare, they must fulfill the same functions that the European institutions fulfilled in the late medieval period. They must render coercive power economically productive in securing property rights and provide contract enforcement while allowing for economic reputation to contribute to such security and enforcement. They must encourage beneficial economic behavior, such as saving, investment, and innovations, and discourage rent-seeking behavior. They must reinforce socially beneficial institutions while allowing others to undermine themselves and facilitate adaptive efficiency by reducing the transaction costs of institutional change.

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Multiple institutions can prevail in a given environment; institutional dynamics is a nondeterministic historical process. The theory that this book advances therefore constitutes a conceptual, analytical, and empirical framework for fostering understanding and the positive analysis of institutions. There is much to be done in advancing this framework, as well as in developing other analytical understandings of the mechanisms underpinning institutions and their dynamics.

Because institutional development is not deterministic, there is no unique history of institutions; there are many institutional histories. Learning about and from these histories will improve our understanding of distinct developmental trajectories and increase our appreciation of the many forms they can take, the forces that shape them, and the ways in which they can be harnessed.