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I

Introduction

ויאמר שמואל . . . זה יהיה משפט המלך אשר
ימלך עליכם . . . את שדותיכם ואת כרמיכם
וזיתיכם הטובים יקח . . . ואתם תהיו לו לעבדים

Samuel said "These will be the ways of the king who will reign over you . . . he will take the best of your fields and vineyards and olive orchards . . . and you shall be his slaves."

Samuel I, 8, 10–17.

This book attempts to explain how "the state" first emerged and to describe the forces that have shaped it over time. Relying heavily on property-rights tools, I propose a unique angle from which to view the state. The book focuses on the paths taken by states that came to be governed by the rule of law. The model I use starts at a time just prior to the advent of socializing by individuals, before any social trappings existed. Although the findings are illustrated by numerous examples that span much of history, my model does not take historical faithfulness as its starting point. Rather, the building blocks of my model consist of particular aspects of the most basic conditions of early human life.

In this model, the creation and functioning of the state are tightly bound up with the protection needs of individuals (and, later on, groups). The mechanism that individuals must create in order to make good use of such protection proves to play a major role in the formation of institutions. This is especially evident in the creation of rule-of-law institutions, which is the focus here. It will be shown that one of the offshoots of institutions that provide organized protection is a legal system that delineates and enforces legal rights.

The model I use reveals that the enforcement of agreements is a basic feature of the state, but that the state is not the only enforcer of

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agreements. The distinction between agreements enforced by the state and those enforced by other third parties, such as firms or religious institutions, determines the scope of the state. Moreover, I show that the nature of enforcement varies sharply between rule-of-law states and dictatorships. It emerges that the study of the state should be concerned not only with conventional political issues, such as voting, but also with conventional economic issues, such as contract choice and vertical integration. The property-rights angle adopted here for study of the state makes it clear that it is imperative to explore certain fundamental features of the state that have largely been overlooked in earlier studies.

My approach is Hobbesian (1991 [1651]), with Umbeck (1981) as a contemporary forerunner. The initial state of affairs considered here roughly corresponds to what Hobbes called a "state of nature." Individuals use their resources, including their ability to employ violence, to become better off. As in Hobbes, individuals here willingly install a specialist in the use of violence – a ruler resembling Hobbes's king – in order to constrain their predatory inclinations and to protect themselves from one another. In contrast, and echoing Samuel, I do not view the ruler as benign. Like everybody else, here the ruler is deemed self-seeking (what others sometimes characterize as "predatory"); he uses his power to make himself better off, whether others gain from his actions or not. The ruler may gain by confiscating subjects' wealth, including their wealth gained from specializing and from dealing with him.[1]

Hobbes gives a wealth-maximizing reason for the existence of monarchies, but he does not ask how they, or institutions in general, arose. Going beyond Hobbes, I propose that, given the opportunity, individuals will install a ruler to protect them *only after* they have created a collective-action mechanism. This mechanism will reduce the chance that the ruler will use his protection organization to confiscate their property. In Chapter 7, the creation and maintenance of such a mechanism emerge as fundamental features in the operation of the state governed by a rule of law.[2]

[1] Sened (1997, p. 15) similarly notes that, "a central flaw in this [Hobbesian] argument is that it assumes a benevolent sovereign who protects the right of his or her subjects, instead of explaining the motivation of the sovereign to do so."

[2] Popper (1962, vol. 1, pp. 124–5) recognizes the threat posed by the ruler to his subjects. He strongly asserts that to cope with the problem, institutions with the power to dismiss the ruler must be created. He states that the specific mechanism for effecting dismissal is "social-traditions." He recognizes that a mechanism using social traditions may be flawed, but does not explain how it operates.

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Besides curbing the ruler, the collective-action mechanism delineates, partly through legislation, the rights it wishes the protection organizations to protect. If individuals fail to create such a mechanism before they allow protection to become a specialty, a protection specialist may quickly become a dictator. By the model here, individuals take elaborate and costly steps to avoid being governed by dictators. When they are successful, the state will delineate rights and encourage contract trade (i.e., market transactions), along with the standards that facilitate such trade. It will also attempt, by treaty or by conquest, to expand the territory over which contracts are enforced.

The state enforces agreements by the threat of or use of violence. Violence, however, is not invariably the most efficient means of enforcement. Third parties that do not use violence have a comparative advantage, primarily in enforcing agreements regarding the provision of various services (as distinct from commodities) and intellectual properties, as well as agreements among individuals residing in different states. When the information the parties use for enforcement is subjective, self-enforcement has an edge. Throughout this book, and especially in Chapter 4, we explore reasons for the existence of diverse third-party enforcers and conditions under which different enforcers tend to flourish.

Many of the more prominent theories of the state are normative.[3] The model developed here, relying on the Coasean property-rights (or transaction-cost) framework and spiked with elements of game theory, belongs to the more recent trend that strives toward operationality. Such a framework also underlies, to a substantial degree, studies of the state and state institutions by other scholars, including Olson (1965, 1982, 2000), Umbeck (1981), and North (1981, 1990), as well as Greif (1989, 1994), Levi (1988), Weingast (1994), and Williamson (1999).[4] The present study emphasizes a neglected issue: the mechanisms that people must create if they are to control their violence-wielding protectors. In addition, it is argued that the methods chosen to enforce the diverse exchange agreements determine the size and character of the state.

In order to prevent being taken over by the protector, individuals in rule-of-law states will not relinquish control of their means for

[3] The authors of these theories wish, among other things, to bring "the greatest happiness to the greatest number" or "provide a legal context for good will and respect for people." Hobbes's theory itself, although offering a rationale for the institution of royalty, is also largely normative.

[4] Buchanan and Tullock (1962), terming their pathbreaking work as "normative," have also provided much positive analysis.

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collective action after the state is erected; rather, they will form institutions that will continuously protect their interests. In that, the present model diverges from, for instance, that of Olson (1965, 1982, 2000) and that of North (1981, 1990). Indeed, the individuals who decide on the rules of the game may change those rules to prevent the protectors they employ from confiscating their wealth.

Although some of the historical events and features of institutions I use for illustration are contemporary, the model's development stops short of reaching the present in at least one important respect. The services supplied by the modeled state include external and internal protection, legal services, and services that facilitate contracts, such as the formation of standards and the provision of currency. But the state in this model does not supply social services, nor does it provide services such as education or mail. Such limited government seems to have characterized much of Europe from the feudal period until the nineteenth century, but it does not seem to have continued beyond that period.

A model that is built in order to discover what people *actually do* must be operational. The state, then, has to be defined in such a way that pertinent competing theories can be tested. Because the literature does not provide a consensual definition of the state, and I find none of the existing ones satisfactory, I propose my own definition here.

> **Definition.** *The state consists of (1) a set of individuals who are subject to a single ultimate third party who uses violence for enforcement and (2) a territory where these individuals reside, demarcated by the reach of the enforcer's power.*

Note that I am making the simplifying assumption that the ultimate third party is treated here as a single entity, even though it may consist of many individuals. I shall briefly elaborate on this issue later. The state is commonly viewed as having exclusive control over the use of violence, and it is sometimes defined by such exclusive control. I, too, define the state by the use of violence. However, I argue that such control need not be exclusive – and my definition does not require it.

In Chapter 2, the definition of the state is reiterated, and its features, including its scope, are discussed in detail. Chapter 3 addresses third-party enforcement and the scale economies unique to the use of violence for enforcement. The relationships between the state and third parties and the jurisdictions of the various third parties are discussed in Chapters 4–6.

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In the model proposed here, as individuals begin to cooperate they specialize in production, but not in protection, and they form a collective-action mechanism to commit themselves to cooperate with one another. Only then will individuals allow specialization in protection. As discussed in Chapter 7, individuals acting collectively will constrain the specialized protectors and their organizations in order to reduce the chance that any of the protectors will take over.

What initially is a "state of nature," then, may gradually evolve into a rule-of-law state. The process consists of a series of self-enforced interactions, crucial among them being the creation of a collective-action mechanism.

As stated, I treat the state as a single entity, almost as a single person. All but the tiniest states, however, use the services of many individuals. I expect each of these individuals to do the best he can for himself, rather than fully catering to the state.[5] Only in two cases do I discuss the state's harnessing of individuals' motivations in order to attain its own goals. Both cases are discussed in Chapter 7, in connection with individuals' control over their protectors. One case concerns the way in which individuals are induced to participate in the collective action needed to prevent a specialized protector from taking over. The other case concerns the creation of multiple, partly independent, military forces. The desire of individual commanders not to fall prey to the others is exploited for its potential to prevent any of them from becoming a dictator.

In rule-of-law states the clients of the protection specialist are also his employers. Such clients face a trade-off between the probability that the specialist will take over and the efficiency of his operation (thus, its cost to them). Clients will prevent protectors from amassing the wealth necessary for a takeover by rewarding the protectors primarily by a wage. Clients will also constrain their protectors' actions in order to reduce the protectors' ability to gain full control of the protection resources. A protector's incentive to perform is weakened, however, when his reward is less than his full contribution to the outcome. To reduce shirking, clients will supervise protectors and supplement their wages with a partial residual claim to the protection outcome. Constraints imposed on protectors and inducements given to them are the focus of Chapter 8.

[5] Hechter (1987, ch. 7) discusses in detail the agency issues that arise as a result of the state not being a single person.

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The balance of power between clients and protectors is subject to shocks both from natural disasters and from the invasion of a state by an enemy. The more severe the shock, the more costly it becomes for protector and clients to collect information about each other. Disputes between protector and clients will be more likely, and their behavior will be more "arbitrary." When the opportunity arises, I expect protectors to gain at their clients' expense. Ensuring that dictatorships could *never* arise would be prohibitively costly, and thus dictators sometimes will emerge. The larger the shock, the greater the chance that a protector (or a set of them) will take over and become dictator. The evolution toward the rule of law, then, may be interrupted by a dictator's takeover. Dictatorship is the historically dominant form of regime, seemingly because such takeovers are not easily reversible.

The distinction between economic rights and legal rights is of fundamental importance to this analysis. As defined here, economic rights reflect individuals' ability to consume or exchange commodities. These rights may exist in the absence of legal rights, though the latter tend to enhance the former. Legal rights are rights delineated by the state. The state, as a rule, chooses to enforce the rights it delineates. The means of enforcing economic rights that are not backed by legal rights include long-term relations. Both economic rights and, by the present model, legal rights are the consequences of maximizing behavior. Individuals will spend resources to create and increase these rights only when, net of the cost of the enhancement, the enhanced rights will increase their wealth (or utility, when it diverges from wealth).

The state must delineate what it agrees to protect. Providing protection, therefore, entails the legal delineation of rights. In Chapters 3 and 8–10 I argue that the state, with its power-backed adjudication mechanism, is best suited for contract exchange that relies on comprehensive specification of the exchanged commodities and services.[6] Rule-of-law states (in contrast to dictatorships) will encourage such trade. The state's enforcement serves to delineate the rights stipulated in contracts by individuals. Because the state tends to provide legal services at no marginal charge, I predict that it will restrict the scope of contracts in order to prevent excessive use of its services.

Two types of scale economies can affect, in part, the size of the state (Chapter 11). One category includes the scale economies that arise in assembling the power needed for protection. The other is associated with

[6] The term "contract" is used here exclusively for agreements enforced by the state.

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contract trade. The trade of commodities requires territorial contiguity (or sea lanes), as does the use of force for contract enforcement. The larger the territory controlled by a state, the greater the gains from trade by contract. I conjecture that trading empires were created to take advantage of these economies.

The scale economies to the size of the state are tempered by individuals' efforts to constrain the state's protection power and by the intensification of incentive problems associated with larger states. These problems can be alleviated, in part, by enhancing local autonomy. As the state expands, subjects will encourage the protector to spin off some of his operations. This serves to reduce the concentration of power as well as the cost of bureaucracy, providing, among other things, for more local independence, making the state less of a leviathan (Chapter 12).

The agreements enforced by the state constitute what are usually considered market exchanges. These tend to be more impersonal than agreements enforced by other means. The latter types include agreements, or parts of them, supported by long-term relations and enforced by groups' various collective-action mechanisms. They also include the agreements taking place within organizations such as families and, most importantly in recent times, firms. Vertical operations within firms are one form of such activities. The interaction between contracts and merger is discussed in Chapter 5. Provisions enforced by a power-backed third party often accompany enforcement within organizations. Questions regarding when the exchange will take place in the market and when it will be within organizations, or will be backed by a brand name, are standard fare for economists. It emerges, then, that at least in part the study of the state falls squarely within the domain of economics.

The paths a dictatorial state may take are discussed here only peripherally. Elsewhere (Barzel, 2000a) I argue that as a dictatorial regime gains stability, the dictator can enrich himself by curbing *his own* confiscatory ability. One method of restraining himself is to form rule-of-law and voting institutions. A threat from the outside may induce him to do so.

In Chapter 15 I consider some of the attributes of dictatorship and compare dictatorial states with those governed by the rule of law. A dictator is more of a residual claimant to his own action than is an employed protector. A dictator, then, is not subject to the incentive problems of the employed protector. On the other hand, he has reason to fear rebellion and will take steps to avert it. One obvious measure in this direction that a new dictator will take is to dismantle or at least weaken the collective-action mechanisms that have been operating in his territory.

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I hypothesize that this weakening will reduce the level of non-state third-party-enforced agreements and that of all the agreements made in dictatorial regimes, the ratio of power-backed third-party-enforced agreements to all agreements will exceed that seen in rule-of-law regimes.

Of all the work on the state during the past few decades, mine may seem to resemble most closely that of Olson (1965, 1982, 2000). The resemblance, however, is only superficial, and actually there is almost no overlap between us. If anything, my work is complementary to that of Olson. It is useful, then, to point out the nature of the differences.

The most basic of these is with regard to institutions. By and large, Olson takes them as a given. He analyzes the problems that arise in the production of public goods and the need for collective action in order to resolve them. Whereas small groups may be able to take such action, large groups cannot voluntarily do so. Large groups need the coercive power of the (already existing) state. Olson also probes the difference in behavior between what he calls a roving bandit and a sedentary one, showing how the encompassing interests of the latter lead to non-confiscatory taxes and to the sharing of the fruits of public goods with subjects. The tools he uses are drawn primarily from traditional public finance and linear taxes. The fascinating discussion of the Soviet Union in *Power and Prosperity* (2000), Olson's posthumously published book, brings up non-linear taxes as well as some property-rights notions. These, however, seem to be afterthoughts and are not integrated into the earlier analysis.

In contrast, my starting point is the absence of institutions, and, correspondingly, the absence of legal rights. I explore how institutions emerge and the actions that individuals undertake to preserve them. In my model, constraining the protector from becoming a dictator (here one with exploitative powers) is a continuing concern to any rule-of-law society. A trade-off exists between specializing, especially in protection, and takeover by the protector. Depending on the prevailing conditions, people choose their preferred position. Many of the actions taken by such a society should be interpreted in this vein. Indeed, both the prevention of dictatorship and the creation of institutions are collective-action problems that I address explicitly. Olson, at best, addressed these issues only implicitly.

The costliness of information implies that neither legal rights nor economic rights are ever fully delineated. Enforcing agreements is costly, and the state has a comparative advantage in enforcement only under certain circumstances. The scope of the state, defined as the ratio of state-

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enforced agreements to all agreements (Chapter 2), then, is less than 100%. Olson and most other students of the state seem oblivious to the notion of the state's scope and to the possibility that it could be anything other than 100%.

I share with North (1981, 1990) the view that institutions are at the heart of the state. My view, however, differs from that of North in one important respect. North claims that some societies adopt wealth-enhancing institutions, whereas others adopt wealth-destroying ones. He does not show why a nation will adopt "bad" institutions. In my analysis, institutions emerge as a result of the actions of wealth-maximizing individuals. Subject to the costs of transacting, these individuals will always create institutions that will maximize wealth.

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PART I

The Emergence of Protection and Third-Party Enforcement

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