PART I

Preliminaries

1

Introduction

On March 28, 1210, Rubeus de Campo of Genoa agreed to pay a debt of 100 marks sterling in London on behalf of Vivianus Jordanus from Lucca.[1] There is nothing unusual about this agreement – in fact, there is evidence of thousands of such agreements in Europe at the time. But this agreement implicitly reveals why Rubeus lived in a period of remarkable economic growth measured by such proxies as urbanization, population growth, capital investment, and changing patterns of trade.[2]

First, this agreement reflects well-functioning markets. The institutional foundations of these markets were such that merchants trusted agents to handle their affairs abroad, even without legal contracts. Impersonal lending among traders from remote corners of Europe prevailed, and property rights were sufficiently secure that merchants could travel abroad with their riches. Second, it reflects well-functioning polities. The institutional foundations of polities throughout Europe during this time induced policies that were conducive to economic prosperity. Rubeus made his agreement in the Republic of Genoa, which had been established about a century earlier but had already pursued policies that made it a bustling commercial center. To understand why and how such well-functioning markets and polities came about in various historical episodes and what led to their persistence and decline, we have to study their institutional foundations.

Studying institutions sheds light on why some countries are rich and others poor, why some enjoy a welfare-enhancing political order and

[1] Lanfranco Scriba (1210, no. 524).
[2] This economic upturn has been documented by such scholars as and Britnell (1996); Lopez (1976); Persson (1998); Postan (1973); and Pounds (1994).

others do not. Socially beneficial institutions promote welfare-enhancing cooperation and action. They provide the foundations of markets by efficiently assigning, protecting, and altering property rights; securing contracts; and motivating specialization and exchange. Good institutions also encourage production by fostering saving, investment in human and physical capital, and development and adoption of useful knowledge. They maintain a sustainable rate of population growth and foster welfare-enhancing peace; the joint mobilization of resources; and beneficial policies, such as the provision of public goods.

The quality of these institutional foundations of the economy and the polity is paramount in determining a society's welfare. This is the case because individuals do not always recognize what will be socially beneficial nor are they motivated to pursue it effectively in the absence of appropriate institutions. A central question in the social sciences and history is therefore why societies evolve along distinct trajectories of institutional development and why some societies fail to adopt the institutions of those that are more economically successful.

This book draws upon detailed historical studies to motivate, illustrate, and present a new perspective – comparative and historical institutional analysis – that goes a long way toward advancing institutional analysis in general and addressing this question regarding the evolution of societies in particular. First, it provides a unifying concept of the term *institution* to integrate the many, seemingly alternative, definitions that prevail in the literature. Second, it studies institutions on the level of the interacting individuals while considering how institutionalized rules of behavior are followed even in the absence of external enforcement. Third, it advances a unified conceptual and analytical framework for studying the persistence of institutions, their endogenous change, and the impact of past institutions on subsequent institutional development. Finally, it argues that institutional analysis requires going beyond the traditional empirical methods in the social sciences that rely on deductive theory and statistical analysis. It then elaborates on a complementary method based on interactive, context-specific analysis. Central to this case study method is the use of theory, modeling, and knowledge of the historical context to identify an institution, clarify its origin, and understand how it persists and changes.

This new perspective makes explicit what institutions are, how they come about, how they can be studied empirically, and what forces affect their stability and change. It explains why and how institutions are influenced by the past, why they can sometimes change, why they differ so much from one society to another, and why it is hard to devise policies aimed at altering them.

This book puts forward the main aspects of this still-evolving perspective and illustrates its applicability by analyzing important issues in medieval economic history. Indeed, the limited ability to address these issues using the common approaches for institutional analysis led to the development of the perspective detailed here. It presents comparative and historical analyses of institutions in the European (Latin) and Muslim (Mediterranean) worlds. The analysis focuses on the late medieval period because the European economy and polity began its ascent to economic and political hegemony at that time. It suggests that even in this early period, institutional difference within Europe and between Europe and the Muslim world developed and directed subsequent institutional outcomes. This analysis leads to a conjecture regarding the institutional origin of the subsequent economic and political European ascendancy and intra-European divergence.

The rest of this chapter is organized in four sections. Section 1.1 briefly reviews the various lines of institutional analysis within economics to present their limitations. It argues that advancing our knowledge of the relationships between institutions and welfare-related outcomes requires mitigating three particular challenges. Section 1.2 provides a glimpse at how comparative and historical institutional analysis addresses these challenges and how it relates to various lines of institutional analysis, particularly outside economics. It also highlights why institutional analysis requires going beyond the empirical methods common in the social sciences and sketches the complementary empirical method developed here. Section 1.3 presents the reason this book focuses on institutional developments in Europe and the Muslim world during the late medieval period. Section 1.4 reviews the structure of the book and the substantive issues addressed in the empirical chapters.

1.1 THE CHALLENGES OF STUDYING INSTITUTIONS

Societies have different "technological" features, such as geographical location, useful knowledge, and capital stock, and these differences impact economic outcomes. Societies also have different "nontechnological" features, such as laws and enforcement methods, ways of allocating and securing property rights, and levels of corruption and trust. It is common to refer to such nontechnological features as institutions. I follow this convention here until I later redefine institutions and their relationships to such nontechnological features.

Economic theory suggests that institutional differences should influence economic outcomes because they affect decisions about work, saving, investment, innovation, production, and exchange. Econometric analyses suggest that they do. Although the results are tentative, they indicate that more-secure property rights, stronger rule of law, and greater trust are correlated with better economic outcomes (R. Hall and Jones 1999; Acemoglu, Johnson, and Robinson 2001; Rodrik, Subramanian, and Trebbi 2003; Zak and Knack 2001).

Econometric analyses and case studies also suggest the historical origins of differences in nontechnological features across societies. These differences were argued to reflect, for example, past cultures, social and power structures, and medieval republican political traditions (Greif 1994a; Glaeser and Shleifer 2002; Putnam 1993). In developing countries, such differences reflect the environment at the time of colonization (Acemoglu et al. 2001), the identity of the colonizing power (North 1981), and the initial wealth distribution (Engerman and Sokoloff 1997).

These findings, however, constitute a beginning, not an end result, for a research agenda aimed at understanding institutions. Understanding the causal mechanism behind these findings requires going beyond identifying correlations between measures of various nontechnological factors and outcomes of interest. It requires examining how the interacting individuals are motivated and able to behave in a manner that manifests itself in these various measures.[3]

It is useful to find out that corruption reduces investment, for example, but this finding does not reveal what motivates and enables people to behave in a corrupt manner. Similarly, discovering a correlation between the security of property rights and outcomes of interest does not *explain* differences in the levels or changes in security; asserting, as is common in economics, that the level of security reflects the function that property

[3] Djankov et al. (2003) argued that comparative economics should be used to understand the trade-off between the risk of private and public expropriation of property rights. Institutional arrangements, such as private order, judicial independence, a regulatory state, and state ownership are responses to this trade-off. The absolute level of efficiency possible under each arrangement in a country depends on its residents' capacity to cooperate. The perspective developed here presents a unifying framework with which to study the micro-level operation of such institutional arrangements as well as capacity to cooperate.

rights serve (e.g., efficiency or the interest of elites) does not explain *how* these rights become more or less secure. Understanding how property is secured requires knowing why those who are physically able to abuse rights refrain from doing so. Similarly, discovering correlations between historical events and differences in current nontechnological features does not reveal how and why past institutions influence subsequent institutional development.

Understanding the impact, persistence, and change of nontechnological features requires examining the micro-mechanisms underpinning their emergence, stability, and dynamics at the level of the interacting individuals. This requires, in particular, considering the *motivation* (incentives) of these individuals to act in a manner leading to or manifesting itself in these particular nontechnological features.

The main conceptual and analytical framework used in economic neoinstitutionalism, however, does not focus on this motivation.[4] It often identifies economic institutions with politically determined rules that are imposed "top down" on economic agents by the polity. These rules govern economic life by, for example, assigning property rights and specifying taxes due. Political institutions – rules regulating the election of leaders and collective decision making – and political organizations, such as interest groups and labor unions, are therefore central to the analysis. Political institutions and organizations matter, because economic institutions are established and changed through the political process (North 1981, 1990; Barzel 1989; Sened 1997; G. Grossman and Helpman 2002). Transaction cost economics complements this analysis by postulating that economic agents, responding to rules, choose contracts and, through them, also establish organizations to minimize transaction costs (Coase 1937; O. Williamson 1985, 1996).

This "institutions-as-rules" framework is very useful in examining various issues, such as the rules that politicians prefer and the contractual forms that minimize transaction costs. Yet behavioral prescriptions – rules and contracts – are nothing more than instructions that can be ignored.

[4] For recent discussions of neoinstitutionalism in the social sciences, see Eggertsson (1990), Bardhan (1991), Furubotn and Richter (1997), G. Hodgson (1998), and Greif (1996b, 1997a, 1998a, 1998b) in economics; P. Hall and Taylor (1996) and Thelen (1999) in political science; and W. Powell and DiMaggio (1991), Smelser and Swedberg (1994), Scott (1995), and Brinton and Nee (1998) in sociology. The perspective developed here is neoinstitutionalist in focusing on the micro-foundations of behavior.

If prescriptive rules of behavior are to have an impact, individuals must be motivated to follow them.[5] Motivation mediates between the environment and behavior, whether the behavior is rational, imitative, or habitual. By motivation I mean here incentives broadly defined to include expectations, beliefs, and internalized norms.

The institutions-as-rules framework, however, is not well suited for considering the motivation to follow behavioral instructions embodied in rules and contracts. As a first approximation, and for various analytical purposes, it may be sufficient to assert that people follow a rule of behavior because other rules specify punishment if they do not. But this assertion merely pushes the question of institutional effectiveness one step backward, by assuming that those who are supposed to enforce the rules do so. Why would this be the case? Who watches the watchman?

To understand behavior, we need to know why some behavioral rules, originating either inside or outside the state, are followed while others are ignored – something that is not possible within an analytical framework in which motivation is taken as exogenous. A comprehensive understanding of prescriptive or descriptive rules requires examining how the motivation to follow particular rules of behavior is created.

Considering motivation at the level of the interacting individuals as endogenous is crucial to addressing many important issues. It is crucial to understanding what is referred to as "private order" – that is, situations in which order prevails despite the lack of a third-party enforcer of that order. In such situations, the prevalence of order or its absence reflects the behavior of the interacting individuals rather than what transpires between them and a third party. Indeed, order characterized by some security of property rights and exchange sometimes prevails when there is no state, when economic agents expect the state to expropriate rather than protect their property, or when the state is unwilling or unable to secure property rights and enforce contracts. Even in modern market economies with effective states, private order is an essential ingredient.

Because institutions reflect human actions, we ultimately must study them as private order even when a state exists. For some analytical purposes, it is useful to assume – as the institutions-as-rules does – that the state has a monopoly over coercive power and can enforce its rules. But political order and an effective state are outcomes. Political actors can and sometimes do resort to violence and invest in coercive power, the use of

[5] I use the term *motivated* (rather than *enforced*) because actions can be induced by both fear of punishment and reward for compliance.

which can lead to political disorder or revolution. Studying political order or disorder requires examining the motivation of political actors to abide by the particular rules. Moreover, the effectiveness of state-mandated rules depends on motivating agents within the bureaucracy and judiciary to enforce them. Understanding the impact of the state requires examining the motivation of the agents involved. In other words, a comprehensive understanding of political order or its absence and of the behavior of the state's agents requires considering the motivation that influences the behavior of the relevant individuals.

Apart from its limited ability to study motivation, the institutions-as-rules approach is also limited in analyzing institutional dynamics. In accounting for institutional stability and change, it focuses only on the important, but partial, impact of politics and efficiency. When institutions are identified with politically devised rules or efficient contracts, institutional change is considered to result from an exogenous shift in the interests or knowledge of the political actors who set the rules or the efficient contracts (see Weingast 1996; O. Williamson 1985). Institutions contribute to change only to the extent that they alter the interests and knowledge underpinning the prevailing rules or contracts.

Institutional persistence has been attributed mainly to frictions in the process of institutional adjustments (e.g., the costs of changing rules) or to the impact of exogenous informal institutions, such as customs and traditions. These informal institutions are considered immutable cultural features whose rates of change are so slow as to be immaterial (North 1990). This leaves much to be explained, because persistence and change are attributed to forces other than the institution under study (O. Williamson 1998, 2000).

Classical game theory has been used extensively to expand institutional analysis to the study of endogenous motivation. Game theory considers situations that are strategic in the sense that the optimal behavior of one player depends on the behavior of others. A game-theoretic analysis begins by specifying each player's set of possible actions and information and the payoffs each will receive given any combination of actions that can be taken by all the players. Given these rules of the game, classical game theory focuses mainly on equilibria in which each decision maker correctly anticipates the behavior of others and finds it optimal to take the action expected of him. (The basic concepts of game theory are explained in Appendix A.) This framework enables endogenously motivated behavior to be considered; motivated by the actual and expected behavior of all other players, each player adopts the equilibrium behavior.

Cambridge University Press
0521480442 - Institutions and the Path to the Modern Economy: Lessons from Medieval Trade
Avner Greif
Excerpt
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Game theory thus allows the relationship between the rules of the game and self-enforcing behavior to be studied.

Economists, in particular, have used game-theoretic equilibrium analysis to consider why individuals follow particular rules.[6] Such analysis has been applied to the study of private order, particularly one in which property rights are secured and contracts are fulfilled in the absence of an effective legal system administered by the state (O. Williamson 1985; Greif 1989, 1993; Ellickson 1991; Dixit 2004). Related research examines the endogenous motivation to adhere to various contracts despite asymmetric information and limited legal contract enforceability (Townsend 1979; Hart and Holmstrom 1987; Hart and Moore 1999). In the game-theoretic approach, institutions are considered as either equilibria (Schotter 1981; Greif 1993; Calvert 1995), the shared beliefs motivating equilibrium play (Greif 1994a; Aoki 2001), or the rules of the game (North 1990).

When institutions are defined in these ways, however, classical game theory provides an inadequate analytical framework for studying institutional dynamics – that is, the forces leading institutions to change and the influence of past institutions on subsequent ones. Strictly speaking, in classical game theory the present and future behavior of players is a manifestation of a predetermined strategy. All behavior is then forward-looking, although it may be conditioned on past events. Furthermore, because this behavior is an equilibrium, there are no endogenous forces causing institutions to change. Exogenous institutional changes can occur when the rules of the game change – as a result of new technology, for example – but studying endogenous change is inconsistent with the view of institutions as equilibria.

Worse yet, game theory reveals that many equilibria – self-enforcing patterns of behavior – are usually possible in a given game. Attempts to develop a game-theoretic equilibrium concept predicting a unique outcome in all games failed to do so in the repeated situations that are central to institutional analysis. Furthermore, game theory postulates no

[6] In political science, the "structure-induced equilibria" approach has enriched the institutions-as-rules approach by studying the motivation of the political actors. It studies politically determined rules as an equilibrium outcome within a game spanned by the rules of the political decision process. It considers structural features of the political decision-making process (e.g., the committee structure of the U.S. Congress) as part of the rules of the game within which political agents interact. An equilibrium analysis identifies exactly what motivates political agents to institute a particular economic rule (Shepsle 1979; Weingast and Marshall 1988; Moser 2000).

relationships between behavior in one game and a historically subsequent one.[7] Any equilibrium in a new game, even if this game is only marginally different from a previous one, is qually plausible, irrespective of what transpired in the previous game. If institutions are viewed as equilibria or beliefs in games, we cannot study the impact of past institutions on subsequent ones.

Beginning institutional analysis with a game – viewing institutions as the rules of the game – and considering the equilibrium behavior within it imply taking as given much that needs to be explained. Why, despite similar technological possibilities, are different games played in different societies? Asserting that a particular game is an equilibrium outcome in a larger – meta – game whose rules reflect only the attributes of the available technology and the physical world is useful yet unsatisfactory, because it simply pushes the question of institutional origin back one step. What is the origin of the meta-game? The theory that enables endogenous motivation to be studied is insufficient for analyzing institutional dynamics.

Finally, specifying and solving a game require strong assumptions about the shared cognitive models of the players and their rationality.[8] Initiating the analysis with a game, therefore, assumes away the possible roles institutions play in creating knowledge and cognition and directing rationality. The importance of the institutions in playing these roles, however, is highlighted in the "old institutionalism" literature. It convincingly argued that the prima facie reason for institutions is that individuals are neither fully rational nor in possession of perfect and common knowledge of the situation (see Veblen 1899; Mitchell 1925; Commons 1924; and Hayek 1937).

Incorporating the old institutionalism's assertions about limited rationality and cognition into the study of institutions and institutional dynamics is central to evolutionary institutionalism (which relies heavily on evolutionary game theory). This approach identifies institutions with attributes of the interacting individuals (behavioral traits, habits, routines,

[7] A specific game can have multiple periods, and behavior in later ones can be conditioned on behavior and events from earlier periods. This does not, however, capture the relationships between different games. It captures the relationships between different periods or stages within a given game. Game theory provides mapping from a game to a strategy combination, not a mapping between different games.

[8] Classical game theory models strategic behavior by rational agents in situations whose details are common knowledge. S is common knowledge if all players know S, all players know that all players know S, and so on ad infinitum (D. Lewis 1969).