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FOREWORD

THE economic ascendancy of the West was one of the signal, and in many respects most perplexing, events of the past millennium. Other civilizations of high attainment preceded the rise of Western civilization, but none developed the economic capability that a seemingly unfavored cluster of small north Atlantic polities did during the thousand or so years just ended. The question, of course, is why? In recent years (especially since the collapse of the Communist bloc), economists have turned greater attention to the rise of markets as the source of Western economic strength. Again, why was it that markets developed there but not elsewhere?

In his paper “State, Church and the Competition of States: On the Rise of the West” the distinguished development economist Deepak Lal offers a sweeping (and iconoclastic) rendering of the economic development of the Western economies that draws heavily on approaches to inquiry usually favored more by historians, sociologists, and anthropologists than mainstream economists. That is, he frames his answer to the questions posed above in terms of culture. Accordingly, the evolution of institutions *shaped by cultural influence* “is likely to be the central explanation of differing growth performances.”

In any number of areas Professor Lal stakes out bold new ground. His emphatically anti-Weberian account of the role of the Papacy leading up to the West’s “Great Divergence,” for example, seems bound to stir controversy. His conclusions “that at least two of the important institutional developments which influenced the Rise of the West...were the result of greed and circumstance,” were not inevitable, and are of no use for the derivation of any theory of institutional development, directly challenge prevailing views. With respect to the relationship between democracy and economic development, his discussion of The State would seem to have profound (and for many readers no doubt disturbing) implications.

Of course, Professor Lal has not been the only one to challenge the mainstream. Indeed, the notion of rational economic behavior, so widely held as axiomatic, has continued to pose something of a conundrum for many inquiries into pre-modern economies: *i.e.*, if such rationality is thought to prevail in all times and under all circumstances, why then did economies develop in some epochs and regions but not in others? In the West what accounted for the demise of feudal institutions and their replacement by markets? In his paper on “Informal Institutions and the Rise of Efficient Markets,” Professor Albrecht Ritschl of the University of Zurich reviews some of the most influential economic literature that has addressed these problems in recent years — notably the New Institutional approach and more recent work that has emphasized the role of informal institutions in fostering the development of market economies. And he offers a perhaps surprising answer to at least one of the above questions: namely, that “markets did not substitute for the institutions of feudal society, instead they co-existed for centuries. Nor were these

markets particularly inefficient....”

Of greater immediacy is the question that very recent financial market behavior would seem to pose for the efficient market hypothesis — and for some observers no doubt the very idea of human rationality. In this regard, Professor Ritschl addresses the evolution of financial markets and “bubble” phenomena in light of the new economic history. Again, he finds that recent market behavior has many antecedents: financial markets always “have encountered their main difficulties when it comes to pricing new industries whose market prospects are still highly uncertain.”

For many readers, both papers presented below may raise as many questions as they answer — including those about the effects of sometimes very discreet events on broad cultural development and the characteristics and possible limits to “rational” behavior as they relate to actual outcomes. Almost surely, what some economists view as rational risk-taking in the dim light of imperfect information others might view more conventionally as a “triumph of hope over experience.” From a broad policy perspective, perhaps one of the largest unresolved questions is: did democracy matter in the rise of the Western economies — and will it matter for the development of the rest of the world?

As in all Progress Foundation economic conferences, the views expressed by the participants are their own and do not necessarily represent the views of the sponsoring institutions. As with previous such events, however, we believe that the discussions in the pages that follow are both pertinent and provocative — and suggest further directions that students of economics might usefully pursue.

About the Participants

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Albrecht Ritschl is Professor für Wirtschaftsgeschichte und Spezialgebiete der Volkswirtschaftslehre in the Institut für empirische Wirtschaftsforschung in the University of Zürich. He is the author, among many works, of *Prices and Production: Elements of a System-Theoretic Perspective* (1989), “Did Monetary Forces Cause the Great Depression? A Bayesian VAR Analysis for the U.S. Economy,” and “Inflation and Relative Price Variability under a Gold Standard: Evidence from Germany (1850-1913).”

State, Church and the Competition of States: On the Rise of the West*

by Deepak Lal

THE millennium just ended has seen the indisputable rise of the West over its Eurasian civilizational cousins. In particular it has been the triumph of the English speaking peoples, first in the small off-shore island where they originated and then of their descendants in the New World. To put this triumph in perspective it is useful to compare the end of the previous millennium. In 1000 AD, Hindu civilization was well past its climacteric. But China was about to see extraordinary developments under the Sung. It had only one other competitor, the civilization of Islam, which stretched from the Atlantic to the Indian oceans. This dominance of Islamic civilization is well captured by the historian Felipe Fernandez-Armesto, describing the world surveyed by the Syrian geographer al-Muqaddasi at the turn of the first millennium:

“The Islam he beheld was spread like a pavilion under the tent of the sky, erected as if for some great ceremonial occasion, arrayed with great cities in the role of princes, these were attended by chamberlains, lords and foot soldiers, whose parts were played by provincial capitals, towns and villages respectively. The cities were linked not only by the obvious elements of a common culture...but also by commerce and in many cases reciprocal political obligations. The strict political unity which had once characterized Islam had been shattered in the tenth century...yet a sense of comity survived, and travelers could feel at home throughout the Dar-al-Islam — or to use an image popular with poets — in a garden of Islam, cultivated, walled against the world, yielding for its privileged occupants shades and tastes of paradise” (p. 35)

Yet Islam was to become a defeated civilization as was the Chinese which had its own climacteric in the middle of the last millennium. If anyone had suggested that a small, cold, fairly savage people on the edge of Eurasia would have pioneered the dominant civilization of the millennium they would have been laughed at. So how did it come about — this rise of the West?

This is a question which has intrigued scholars for at least a hundred years. I have provided my own answer in my recent book *Unintended*

* This is a somewhat abridged and modified version of a paper entitled “Culture and Development” presented at a panel on “The economic performance of civilisation,” at the American Association meetings, New Orleans, January 2001.

Consequences, and in this lecture I want to summarize some of my arguments and contrast them with those of others. My answer is in terms of culture. But what is culture, and can it, and if so how does it, affect economic performance? Many, including Marxists and most economists, would deny the relevance of culture, and seek to explain relative economic performance in purely materialist terms.¹ By contrast many noneconomists (particularly in East Asia), in a neat reversal of Max Weber's famous thesis, are claiming that it is unique Asian values (and the institutions they embody, e.g., statist polities, and extended families) which are responsible for the East Asian economic miracles.²

In my book (Lal (1998)) I have tried to assess these views and attempted to show how from a broad historical survey of the civilizations of Eurasia through millennia, the role of culture in development cannot be ignored, and that moreover, once these cultural factors are taken into account, many surprising features of the contemporary world can be explained.

In this lecture I will therefore begin (Section I) by outlining a simple framework which allows us to think about culture and institutions. I then show how this framework can be put to work (Section II) to show how the West diverged from its other Eurasian cousins, and the limits of materialist explanations. The third section uses the framework to examine the arguments for the transference of Western institutions — in particular democracy — to promote economic development in the Third World.

I. On Culture

(i) *Culture and Institutions*: There is growing agreement that the evolution of institutions is likely to be the central explanation of differing growth performances. Culture is the informal aspect of institutions which constrain human behavior. I have found a definition adopted by ecologists particularly useful.³ They emphasize that, unlike other animals, the human one is unique because its intelligence gives it the ability to change its environment by learning. It does not have to mutate into a new species to adapt to the changed environment. It learns new ways of surviving in the new environment and then fixes them by social custom. These social customs form the culture of the relevant group, which are transmitted to new members of the group (mainly children) who do not then have to invent these 'new' ways *de novo* for themselves.

This definition of culture fits in well with the economists notion of equilibrium. Frank Hahn⁴ describes an equilibrium state as one where self-seeking agents learn nothing new so that their behavior is routinized. It represents an adaptation by agents to the economic environment in which the economy "generates messages which do not cause agents to change the

theories which they hold or the policies which they pursue.” This routinized behavior is clearly close to the ecologist’s notion of social custom which fixes a particular human niche. On this view, the equilibrium will be disturbed if the environment changes, and so, in the subsequent process of adjustment, the human agents will have to abandon their past theories, which would now be systematically falsified. To survive, they must learn to adapt to their new environment through a process of trial and error. There will then be a new social equilibrium, which relates to a state of society and economy in which “agents have adapted themselves to their economic environment and where their expectations in the widest sense are in the proper meaning not falsified.”

This equilibrium need not be unique nor optimal, given the environmental parameters. But once a particular socio-economic order is established, and proves to be an adequate adaptation to the new environment, it is likely to be stable, as there is no reason for the human agents to alter it in any fundamental manner, unless and until the environmental parameters are altered. Nor is this social order likely to be the result of a deliberate rationalist plan. We have known since Adam Smith that an unplanned but coherent and seemingly planned social system can emerge from the independent actions of many individuals pursuing their different ends and in which the final outcomes can be very different from those intended.

It is useful to distinguish between two major sorts of beliefs relating to different aspects of the environment. These relate to what in my recent Ohlin lectures I labeled the *material* and *cosmological* beliefs of a particular culture.⁵ The former relate to ways of making a living and concern beliefs about the material world, in particular about the economy. The latter are related to understanding the world around us and mankind’s place in it which determine how people view their lives — its purpose, meaning and relationship to others. There is considerable cross-cultural evidence that material beliefs are more malleable than cosmological ones.⁶ Material beliefs can alter rapidly with changes in the material environment. There is greater hysteresis in cosmological beliefs, on how, in Plato’s words, “one should live.” Moreover, the cross-cultural evidence shows that rather than the environment it is the *language group* which influences these world-views.⁷

The primacy of one or other pole of this distinction has been fiercely contested by two warring factions we can call materialists and idealists. Marxists, with their distinction between the ‘infrastructure’ and the ‘superstructure’ believe that the latter is determined by the former. Many anthropologists and sociologists believe exactly the opposite, and contemporary deconstructionists represent the apotheosis of the idealist view. As a good

Hindu, I naturally believe that the truth lies somewhere in between!

What determines cosmological beliefs? I have argued that in part — particularly beliefs relating to political legitimacy — were determined by the material (largely ecological) circumstances of the areas in which these civilizations were initially established (see Section III below). Also, as we shall see, there was at least one important case where there was a rapid change in cosmological beliefs which led, through a historically contingent process, to a change in material beliefs (Section II below).

(ii) *On Human Nature*: So what is the human nature cosmological beliefs are supposed to constrain? Evolutionary anthropologists and psychologists maintain that human nature was set during the period of evolution ending with the Stone Age.⁸ Since then there has not been sufficient time for any further evolution. This human nature appears darker than Rousseau's and brighter than Hobbes' characterizations of it. It is closer to Hume's view that "there is some benevolence, however small...some particle of the dove kneaded into our frame, along with the elements of the wolf and serpent." For even in the hunter gatherer Stone age environment the supremely egotistical human animal would have found some form of what evolutionary biologists term "reciprocal altruism" useful. Co-operation with one's fellows in various hunter-gatherer tasks yields benefits for the selfish human which can be further increased if he can cheat and be a free rider. In the repeated interactions between the selfish humans comprising the tribe, such cheating could be mitigated by playing the game of "tit for tat." Evolutionary biologists claim that the resulting "reciprocal altruism" would be part of our basic Stone Age human nature.⁹

Archaeologists have also established that the instinct to "truck and barter," the trading instinct based on what Sir John Hicks used to call the "economic principle" — "people would act economically; when an opportunity of an advantage was presented to them they would take it"¹⁰ — is also of Stone Age vintage.¹¹ It is also part of our basic human nature.

(iii) *Agrarian Civilizations*: With the rise of settled agriculture and the civilizations that evolved around them, however, and the stratification this involved between three classes of men — those wielding the sword, the pen and the plough¹² — most of the stone age basic instincts which comprise our human nature would be dysfunctional. Thus with the multiplication of interactions between human beings in agrarian civilizations many of the transactions would have been with anonymous strangers who one might never see again. The "reciprocal altruism" of the Stone Age which depended upon a repetition of transactions would not be sufficient to curtail opportunistic behavior.

Putting it differently, the 'tit for tat' strategy for the repeated Prisoners Dilemma (PD) game amongst a band of hunter-gatherers in the Stone Age would not suffice with the increased number of one-shot PD games that will arise with settled agriculture and its widening of the market.¹³ To prevent the resulting dissipation of the mutual gains from co-operation, agrarian civilizations internalized restraints on such 'antisocial' action through moral codes which were part of their 'religion.'¹⁴ But these 'religions' were more ways of life as they did not necessarily depend upon a belief in God.

The universal moral emotions of shame and guilt are the means by which these 'moral codes' embodied in cultural traditions are internalized in the socialization process during infancy.¹⁵ Shame was the major instrument of this internalization in the great agrarian civilizations. Their resulting cosmological beliefs can be described as being 'communalist.'¹⁶

The basic human instinct to trade would also be disruptive for settled agriculture. For traders are motivated by instrumental rationality which maximizes economic advantage. This would threaten the communal bonds that all agrarian civilizations have tried to foster. Not surprisingly most of them have looked upon merchants and markets as a necessary evil, and sought to suppress them and the market which is their institutional embodiment. The material beliefs of the agrarian civilizations were thus not conducive to modern economic growth.

II. The Rise of the West

The similarities between the great Eurasian civilizations were greater than their differences — until one diverged decisively about 200 years ago, and delivered the European miracle. All these civilizations experienced periods of intensive growth of what I term the *Smithian* kind, which is due to the widening of the market and the increased specialization it brings, primarily through the establishment or extension of empires. Thus there was Smithian intensive growth in India during the Pax Buddhism of the Mauryas and the Pax Hindu of the Guptas, in the Mediterranean world during the Pax Greco/Roman of the ancient world, in the areas under Pax Islam under the Abbasids, in Japan during the Pax Tokugawa and in China during the extension of the Pax Sung to the Yangtze valley.

But in none of these civilizations with the possible exception of Sung China was there any likelihood of what I term *Promethean* intensive growth, which involves transforming a land using agrarian economy into a mineral based energy economy. This was the essence of the Industrial Revolution as Wrigley has rightly noted, and for the first time, given the relatively unbounded supply of energy available from fossil fuels, opened up the

prospect for humankind of unbounded intensive growth. This in turn opens up the possibility of alleviating that mass structural poverty which has been the bane of mankind for millennia. This was a unique event which led to the great divergence of these ancient civilizations. The reasons for this divergence are still in dispute. Technological, political and material reasons have been adduced by various authors for the Rise of the West.

(i) *Technology*: The failure of the Sung to initiate Promethean growth even though they had all the resource and technological ingredients available is one of the great puzzles of history, often labeled the Needham problem. But it does give the lie to various technologist explanations for the European miracle.¹⁷ Little (1981)¹⁸ and Scott (1989)¹⁹ have rightly argued that ‘science and technology’ are not an important dividing line between the West and the Rest.

Needham (1963) also argues that science and technology, cannot explain the rise of the West. As he writes:

“not to put too fine a point on the matter, whoever would explain the failure of Chinese society to develop modern science had better begin by explaining the failure of Chinese society to develop mercantile and then industrial capitalism. Whatever the individual prepossessions of Western historians of science, all are necessitated to admit that from the 15th century AD onwards a complex of changes occurred: the Renaissance cannot be thought of without the Reformation, the Reformation cannot be thought of without the rise of modern science, and none of them can be thought of without the rise of modern capitalism...we seem to be in the presence of a kind of organic whole, a packet of change” (p. 139)

(ii) *Polity*: An essential part of this packet, it has been claimed in different ways by both North and Thomas and Jones (1981) was the decentralization and competition among polities in the European states system which replaced the western Roman empire which was due to geography. This limited the natural predatoriness of the State by making it more contestable.²⁰ This in turn allowed intensive growth which Jones (1988) believes is just waiting to bubble forth except for the restraints imposed by the predatory state. But India like medieval Europe has also had political disunity with cultural unity (provided by the Hindu caste system in India and Christianity in Europe) but it did not obtain Promethean growth.

(iii) *The ‘New World’ Bonanza*: Recently Pomeranz (2000) has claimed that the basic cause of the great divergence was Europe’s discovery and exploitation — partly through trade — of the New World. There can be no doubt that this extended Europe’s land frontier. But how decisive was it

and why could China not do something similar?

Pomeranz himself admits that the increment to the supply of land-intensive products from the New World to Europe could not have been large, but then appeals to chaos theory to justify his thesis that they were the basis of the great divergence!

But it is the larger question — why did China not seek to exploit areas where free land was available overseas to overcome its growing land constraint — which points to the basic flaw in Pomeranz's and other purely materialist explanations for the great divergence. As Pomeranz shows, there were empty lands in Southeast Asia which “like post-contact New World, was sparsely populated and capable of supplying vast quantities of land-intensive resources that were in demand ‘back home.’ Chinese went there in significant numbers, but Southeast Asia never became for coastal China what the New World was for western Europe” (p. 200). Why? Because unlike Europe's New World empires, “the Chinese merchants...established themselves in Southeast Asia without state backing” (p. 200). This is the crucial point. To see why, it is important to note two important points not taken into account by Pomeranz.

First, under Kublai Khan the Chinese had created a powerful navy. The famous admiral Cheng Ho took his treasure ships, on expeditions to the India Ocean in the 15th century, and McNeill (*The Pursuit of Power*) notes that these expeditions eclipsed anything that the later Portuguese explorers could muster. Nor did Cheng Ho desist from coercion. He sealed Chinese suzerainty everywhere he went, if necessary by force. McNeill argues that, if the Chinese had continued to expand their overseas empire “a Chinese Columbus might well have discovered the west coast of America half a century before the real Columbus blundered into Hispaniola in his vain search for Cathay. Assuredly Chinese ships were seaworthy enough to sail across the Pacific and back. Indeed, if the like of Cheng Ho's expeditions had been renewed, Chinese navigators might well have rounded Africa and discovered Europe before Prince Henry the Navigator died (1460)” (p. 45).

But instead — the second point — after 1433 the Chinese abandoned their navy and began to restrict foreign trade and contacts. The ship-building and sea going skills thereafter degenerated, and China continued in relative isolation till the ‘new barbarians’ came knocking at its doors in the 19th century.

To understand this shift in policy and the accompanying closing of the Chinese mind — and the comparable one in Japan following its adoption of the policy *sakoku* under the Tokugawa — one has to look at the ‘cosmological beliefs’ of the various Eurasian civilizations. As these cosmologi-

cal beliefs are also related to the different polities, they also help to explain the divergences in state policy.

(iv) *The Twin Papal Revolutions*: The essential element missing in these various explanations for the rise of the West — though each forms part of Needham's 'packet' of explanation — is the role of cosmological beliefs. Uniquely for Eurasian agrarian civilizations, whose common cosmological beliefs can be broadly categorized as 'communalist,' medieval Europe departed from the pattern and became individualist (Dumont). This was due to the reinterpretation of Pauline Christianity by St. Augustine in the 5th century²¹ in his "City of God" which converted the 'otherworldly' individualism of the Christian church (a trait which it shares with Hinduism) into an in-worldly one by demanding the Church be put above the State, (Dumont) a demand that Pope Gregory VII fulfilled in the 11th century with his injunction "Let the terrestrial kingdom serve — or be the slave of the celestial," and which led to the so-called Papal legal revolution.

This change in cosmological beliefs is of course the factor which Max Weber and more recently David Landes have identified as the cause of the Great Divergence, but as both base it on the Protestant Ethic, they have got their dates wrong. For as Hicks (1969) noted an essential element in the rise of capitalism was: "the appearance of banking, as a regular activity. This began to happen long before the Reformation; in so far as the 'Protestant Ethic' had anything to do with it, it was practice that made the Ethic not the other way round" (p. 78-9).

By contrast I have argued in *Unintended Consequences* that the change in cosmological beliefs was mediated by the Catholic Church in the 6th-11th centuries,²² through its promotion of individualism, first in family affairs by Pope Gregory the Great, and later in material relationships which included the introduction of all the legal and institutional requirements of a market economy as a result of Gregory VII's Papal revolution in the 11th century.²³ These twin Papal revolutions arose because of the unintended consequences of the Church's search for bequests — a trait that goes back to its earliest days. From its inception it had grown as a temporal power through gifts and donations — particularly from rich widows. So much so that, in July 370 the Emperor Valentinian had addressed a ruling to the Pope that male clerics and unmarried ascetics should not hang around the houses of women and widows and try to worm themselves and their churches into their bequests at the expense of the women's families and blood relations.²⁴ The Church was thus from its beginnings in the race for inheritances. The early Church's extolling of virginity and preventing second marriages helped it in creating more single women who would leave be-

quests to the Church.

This process of inhibiting a family from retaining its property and promoting its alienation accelerated with the answers that Pope Gregory I (the Great) gave to some questions that the first Archbishop of Canterbury, Augustine, had sent in 597 AD concerning his new charges.²⁵ Four of these nine questions concerned sex and marriage. Gregory's answers overturned the traditional Mediterranean and Middle Eastern patterns of legal and customary practices in the domestic domain. The traditional system was concerned with the provision of an heir to inherit family property and allowed marriage to close kin, marriages to close affines or widows of close kin, the transfer of children by adoption, and finally concubinage, which is a form of secondary union. Gregory amazingly banned all four practices. Thus for instance there was no adoption of children allowed in England till the 19th century. There was no basis for these injunctions in Scripture, Roman law or the existing customs in the areas that were Christianized.

This Papal family revolution made the Church unbelievably rich. Demographers have estimated that the net effect of the prohibitions on traditional methods to deal with childlessness was to leave 40 per cent of families with no immediate male heirs. The Church became the chief beneficiary of the resulting bequests. Its accumulation was phenomenal. Thus for instance in France one third of productive land was in ecclesiastical hands by the end of the 7th century!

But this accumulation also drew predators from within and without to deprive the Church of its acquired property. It was to deal with this denudation that Pope Gregory VII instigated his Papal revolution in 1075, by putting the power of God — through the spiritual weapon of excommunication — above that of Caesar's. With the Church then coming into the world, the new Church-state also created all the administrative and legal infrastructure which we associate with a modern polity, and which provided the essential institutions for the Western dynamic that in time led to Promethean growth. Berman has shown how the whole Western legal tradition really derives from the development of both canon and secular law during the 11th-13th centuries under the aegis of the Church. The most important for the economy was the development of the 'law of the merchant' — the *lex mercatoria*.

Thus Pope Gregory VII's Papal revolution lifted the lid on the basic human instinct to 'truck and barter,' and in time to a change in the traditional Eurasian pattern of material beliefs with their suspicion of markets and merchants, while Pope Gregory the Great's promoted that individualism first in family matters and then in thought which led to the scientific

revolution. These changes in material and cosmological beliefs in time led to Promethean economic growth.

But the earlier Papal Revolution of Pope Gregory the First, which had precipitated that of Gregory VII, also led to a change in the traditional Eurasian family patterns which were based on various forms of 'joint families' and family values. In its quest to weaken the traditional Eurasian family bonds in its race for inheritances the Western Christian church came to support the independence of the young: in choosing marriage partners, in setting up their households and entering into contractual rather than affective relationships with the old. They promoted love marriages rather than the arranged marriages common in Eurasia. Friar Lawrence in "Romeo and Juliet" egging on the young lovers against their families wishes is emblematic of this trend.

It has been thought that romantic love far from being a universal emotion was a Western social construct of the age of chivalry in the Middle Ages. Recent anthropological and psychological research, however, confirms that this is erroneous — romantic love is a universal emotion.²⁶ Moreover it has a biological basis. Neuro-psychologists have shown that it is associated with increased levels of phenylethylamine, an amphetamine-related compound. Interestingly the same distinct biochemicals are also to be found in other animal species such as birds which also evince this emotion. However, it appears that this emotion is ephemeral. After a period of attachment the brain's receptor sites for the essential neuro-chemicals become desensitized or overloaded and the infatuation ends, setting up both the body and brain for separation — divorce. This period of infatuation has been shown to last for about 3 years. A cross-cultural study of divorce patterns in 62 societies between 1947-1989 found that divorces tend to occur around the fourth year of marriage!

A universal emotion with a biological basis calls for an explanation. Socio-biologists maintain that in the primordial environment it was vital for males and females to be attracted to each other to have sex and reproduce and also for the males to be attached enough to the females to look after their young until they were old enough to move into a peer group and be looked after by the hunting-gathering band. The traditional period between successive human births is four years — which is also the modal period for those marriages which end in divorce today. Darwin strikes again! The biochemistry of love it seems evolved as an 'inclusive fitness' strategy of our species.

The capacity to love may be universal but its public expression is culturally controlled. For as everyone's personal experience will confirm it is an explosive emotion. Given its relatively rapid decay, with settled agricul-

ture the evolved instinct for mates to stay together for about four years and then move on to new partners to conceive and rear new young would have been dysfunctional. Settled agriculture requires settled households. If households are in permanent flux there could not be settled households on particular parcels of lands. Not surprisingly most agrarian civilizations sought to curb the explosive primordial emotion which would have destroyed their way of making a living. They have used cultural constraints to curb this dangerous hominid tendency by relying on arranged marriages, infant betrothal and the like, restricting romantic passion to relationships outside marriage. The West stands alone in using this dangerous biological universal as the bastion of its marriages as reflected in the popular song “love and marriage go together like a horse and carriage.”

While this unleashing of Stone Age passions helped in alienating the young from their families, the Church also had to find a way to prevent the social chaos which would have ensued, if the romantic passion its greed had unleashed as the basis for marriage had been allowed to run its course in what remained a settled agrarian civilization. First it separated love and sex, and then created a fierce guilt culture based on Original Sin. Its pervasive teaching against sex and the associated guilt it engendered provided the necessary antidote to the ‘animal passions’ that would otherwise have been unleashed by the Church’s self-interested overthrowing of the traditional Eurasian system of marriage. But once the Christian God died with the Scientific and Darwinian revolutions, these restraints built on Original Sin were finally removed. The family, as most civilizations have known it, became sick in the West, as the Western humanoids reverted to the ‘family’ practices of their hunter-gatherer ancestors.

III. The State

The above account has I hope shown that, at least two of the important institutional developments which influenced the Rise of the West — the legal and commercial infrastructure of the market economy and the individualism of the Western family mode — were the result of greed and circumstance. There was nothing inevitable about them and while they have cast long shadows — a benign one concerning the market and a less benign one concerning the erosion of the ‘family’ — there is no theory of institutional development that can be derived from it. At best they represent ‘the cunning of history.’

Moreover, though in the West the change in cosmological and material beliefs was historically conjoined, there is no necessity in this conjunction. As the examples of Japan, the ‘Asian Tigers’ and increasingly China and India show, once the change in material beliefs associated with Pope Gregory VII’s legal revolution occurs, with the acceptance of the legal and

commercial infrastructure it created, there is no need to embrace the cosmological beliefs — in particular concerning the family — that arose in the West from Gregory I's family revolution. It is possible to modernize without Westernizing.²⁷

Something closer to materialist explanations can, however, I believe, be provided for the third of the triad of institutions which are relevant for economic performance — the State. Just confining our attention to historical Eurasia, there is a wide variety of types of State that have existed since the rise of agrarian civilizations in the alluvial plains of Mesopotamia, Egypt, the Indus and the Yellow river. Though the most common form has been hereditary monarchy — but with important differences in its justifications — there have been democracies in ancient Greece and in the Himalayan foothills in ancient India where ecological conditions permitted.²⁸ But, besides these exceptions, the common form of State was determined by a common problem faced by the agrarian civilizations. These were labor scarce, land abundant areas, where as Domar has shown in a sadly neglected essay that in such an economy free labor, free land and a non-working upper class cannot co-exist. These great Eurasian agrarian civilizations were created by obtaining a surplus for use in the towns (*civitas*, being the emblem of civilization). This predatory purpose in effect ruled out a democratic state, and implied that the peasants in these land abundant areas would have to be tied down to the land to provide the necessary labor for the fairly labor intensive processes of plough agriculture that were feasible in these areas and which provided enough of a surplus above subsistence to support the wielders of the pen and the sword in the cities.

The wielders of the sword were also needed for another reason. The great Eurasian civilizations were sandwiched between the two great areas of nomadic pastoralism — the grasslands of the great steppe regions to the North, and the semi-desert of the Arabian peninsula. The nomads of these regions had maintained many of the warlike organizations and violent habits of big game hunters of their hunter-gatherer ancestors. They constantly preyed on the more numerous but sedentary populations of the agrarian civilizations of Eurasia. In the subsequent collisions between farmers and pastoralists, the inherent military advantages the latter enjoyed (because of their habits) made the wielder of the sword among the farmers essential in preventing the pastoralists from conquering and exploiting them like their animals. There were thus important external exigencies for obtaining a surplus to support specialists in wielding the sword, commanded by some form of monarch.

This then meant that, to extract the surplus, labor had to be tied down to

the land. The means employed — the caste system in India, various forms of serfdom in Europe and China, slavery in many civilizations — were determined more by ecology than ideology.

But in many cases (like the Indian caste system) an ideology — or as I have called it a set of cosmological beliefs — became an essential instrument in maintaining the necessary social controls. Such cosmological beliefs are necessary because even the most savage predatory state, ultimately, has to face the question of political legitimacy. For, as is evident from the dramatic events of 1989, the role of the military or police in maintaining the institutional structures of the State is greatly exaggerated. Ultimately, like other institutions, any State also depends upon general acceptance of its right to rule. As Searle (1995) notes, one cannot usually provide some rational basis for this acknowledgment. It is largely a matter of habit. But as a result it can collapse quite suddenly when people lose confidence. These conjectures have been formalized, most notably in a recent book by Timur Kuran called *Private Truths, Public Lies*, whose title gives a succinct description of its thesis. It provides a direct link between cosmological beliefs and the polity.

In *Unintended Consequences* I provide cross-cultural evidence that these cosmological beliefs of differing Eurasian polities were determined by the ecological conditions in the areas when their ancestral States were set up. Given the hysteresis in cosmological beliefs, the peoples of these areas still find political legitimacy in terms of these ancient cosmologies. A few illustrations might help to make the point.

(i) *India*: In India as I argued in *The Hindu Equilibrium*,²⁹ Hindu civilization developed on the vast Indo-Gangetic plain. This geographical feature (together with the need to tie down the then scarce labor to land) accounts for the traditional Indian polity, which was notable for its endemic political instability amongst numerous feuding monarchies, because of the difficulties of any one establishing hegemony over the vast plain for any sustained period — given the existing means of transportation and communication. It also explains why a decentralized system, based on an internalized set of cosmological beliefs embodied in the caste system, developed as a way of tying labor down to land. This institution, moreover, by making war the trade of professionals saved the mass of the population from being inducted into the deadly disputes of its changing rulers — while the tradition of paying a certain customary share of village output as revenue to the current overlord meant that the victor had little incentive to disturb the daily business of its newly acquired subjects. The democratic practices gradually introduced by the British in the late 19th century fit these ancient habits like a glove. The ballot box has replaced the battlefield

for the hurly-burly of continuing 'aristocratic' conflict, while the populace accepts with ancient resignation that its rulers will, through various forms of 'rent-seeking,' take a certain share of output to feather their own nests. These ancient cosmological beliefs, in my view, explain why unlike so many other developing countries — democracy has thrived in such a vast, diverse and poor country, and taken deep root — as was shown by Indira Gandhi's aborted attempt to stifle it during her Emergency.

(ii) *China*: By contrast the Chinese polity, in its origins in the relatively compact Yellow river valley, constantly threatened by the nomadic barbarians from the steppes to the north, developed a tightly controlled bureaucratic authoritarianism as its distinctive polity which has continued for millennia to our day. To give some idea of the extent of this authoritarianism and its resilience over the millennia note that from the reference manuals of a petty bureaucrat of the Chin regime in about 217 B.C. (which were discovered with his body in Dec. 1975 at Shuihudi in Yunneng) it appears that the Chin regime "kept detailed, quantified central records of the state of the crops almost field by field in every county of the empire. Maintaining that sort of control would be a daunting task for a government equipped with computers and telecommunications. Doing it before the invention of paper, when all the data had to be gathered and stored on strips of wood or bamboo, would have been impossible without an enormous bureaucracy" (Jenner (1992) p. 22). Little has changed in this polity since. Thus Jenner notes the continuity between the attitudes and values of the imperial Chinese state and the contemporary Communist one.³⁰

(iii) *Western Europe*: By contrast, democracy arose in the West on the foundations of feudal societies which had grown out of the weak states which succeeded the Roman Empire, in which medieval lords had succeeded in obtaining property rights in exchange for the materiel the princes needed to maintain their highly contestable natural monopolies — their states. With the consolidation of these fragmented polities into the absolutist nation states of Renaissance Europe, "the increase in the political sway of the royal state was accompanied, not by a decrease in the economic security of noble ownership, but by a corresponding increase in the general rights of private property" (Anderson, (1979), p. 429). On this material base the Reformation provided the cosmological beliefs leading to the rise of Demos.

The Reformation in England was the logical conclusion of the problem that Gregory I's family revolution had set for Henry VIII. He took the step no other medieval king had thought of taking: "and that was to cast off the authority of Rome, to keep the Churches open on his own authority, and to accept papal excommunication as a permanent condition" (Southern (1970)

p. 21). Once that happened the church-state was dead and the nation-state was born. It also meant the end of the unity of Christendom and opened up the question of political legitimacy. Till then both rulers and ruled were bound by the common law of Christendom. But after the Reformation, who represented God's law — the Catholics or the Protestants — and whose law should you obey if you were a Catholic in a Protestant kingdom or vice versa? Equally momentous was the Protestant claim of the sinfulness of the Catholic church. If the traditional interpreters of God's will appointed by the Pope were sinful where were the true interpreters of his will to be found? "If not the Church, then only the congregations" (Minogue (1995) p. 175). These became self-governing, choosing and dismissing their pastors. But if the Church is to be governed by its members why not the State? Thus were the seeds for the rise of Demos sown in northwestern Europe.

(iv) *The Americas*: This pluralist democratic political form took immediate root in the North America of the Pilgrim fathers, where ecology further helped in creating a unique egalitarian and democratic society. We cannot go into its genesis and development on this occasion,³¹ but it provides a striking contrast to the outcome in the southern part of the hemisphere, where it was the southern Europeans of the Counter-Reformation who established their outposts. Spain after the reconquest from the Moors had developed a patrimonial state justified in terms of the neo-Thomist ideology which saw society as a hierarchical system in which every person and group "serves the purpose of a general and universal order that transcends them" (Morse, (1964) p. 146). It was a centralizing state without the manorial system with its decentralization of rights that had developed in Northern Europe. The economic correlate of this set of cosmological beliefs and the polity they supported was corporatism.

This led to very different polities in the two parts of the New World, where even when after their Independence the Iberian colonies adopted U.S. style formal constitutions, the real form was still governed by the patrimonial legacy of Philip and Isabella of Spain. The hierarchical polity justified by neothomism also permitted the accommodation of the unavoidable economic inequalities engendered by the land abundance and the demands of tropical agriculture given their climate which was only viable with some form of coerced labor.

But these inequalities — arising from its ecological and political heritage — create a dissonance between Latin America's social realities and its Christian cosmological beliefs emphasizing equality, which of course it shares with the North. There is no such Northern dissonance, as both for ecological and political reasons, a uniquely egalitarian social and political

society developed there.³²

(v) *Differences in civilizational cosmologies*: In this context it is worth noting the important difference between the cosmological beliefs of what became the Christian West and the other ancient agrarian civilizations of Eurasia. Christianity has a number of distinctive features which it shares with its Semitic cousin Islam, but not entirely with its parent Judaism, and which are not to be found in any of the other great Eurasian religions. The most important is its universality. Neither the Jews, nor the Hindu or Sinic civilizations had religions claiming to be universal. You could not choose to be a Hindu, Chinese or Jew, you were born as one. This also meant that unlike Christianity and Islam these religions did not proselytize. Third, only the Semitic religions being monotheistic have also been egalitarian. Nearly all the other Eurasian religions believed in some form of hierarchical social order, which for instance in Hindu India — with its belief in reincarnation — was rationalized as resulting from the system of just deserts for one's deeds in the past life. By contrast, alone among the Eurasian civilizations, the Semitic ones (though least so the Jewish) emphasized the equality of men's souls in the eyes of their monotheistic Deities.

Dumont has rightly characterized the resulting profound divide between the societies of *Homo Aequalis*, which believe all men are born equal (as the *philosophes*, and the American constitution proclaim) and those of *Homo Hierarchicus*, w. ch believe no such thing. This matters for the polity. With the rise of Demos, those societies infected by egalitarianism have a greater propensity for the populism which damages economic performance than the hierarchical societies. If, as in Europe, the granting of democratic rights can be phased in with the growing economic and social equality that modern growth helps to promote, then the political effects of the dissonance between an unequal social reality and egalitarian cosmological beliefs can be avoided. In the colonial and 19th century patrimonial states of Latin America this dissonance was avoided by restricting the polity — in effect to the property owning classes. But if as in this century, while still in the early stages of modern growth, the polity is expanded by incorporating the "dangerous classes" with an extension of democratic rights to the whole populace, then this dissonance can, as it has, lead to political cycles of democratic populism followed by authoritarian repression as the distributional consequences of the populist phase are found unacceptable by the Haves. By contrast hierarchical societies can more easily maintain majoritarian democracies, however corrupt and economically inefficient — as the notable example of India shows — despite continuing social and economic inequalities. Thus, as many Latin American commentators³³ have noted, the historic and continuing inequalities in

Latin America make democracy there insecure, largely I would argue, because of the social and cosmological dissonance noted above. Thus questions of income distribution, I would argue, are only of relevance in those societies and polities which have been infected by one or other Semitic religion — in particular Christianity.³⁴ Egalitarianism as so many of the other of its 'habits of the heart' being touted as universal values by so many in the West are no such thing — they are the culture specific outcomes of a particular trajectory of a particular Semitic religion!

Conclusions

I have argued that culture cannot be ignored in explaining economic performance. Of the two aspects of culture I have identified, historically, cosmological beliefs have been as important as material beliefs in determining economic outcomes. Material beliefs can change rapidly as can the institutions based on them, e.g., systems of property rights, with changing factor and commodity prices.³⁵ Cosmological beliefs influence the polity. The initial resource endowments of the ancestral states of Eurasian civilizations governed the form of their polities and engendered cosmological beliefs which provided political legitimacy. There is great hysteresis in cosmological beliefs, and ipso facto in transferring one type of polity into a region with a differing cosmology. But, paradoxically, the multiplicity of political forms as long as they do not represent an 'enterprise association' (in Oakeshott's sense) in themselves do not hinder economic growth. Thus a particular political form such as democracy is not essential for development. After all it was a corrupt hereditary monarchy not democracy which delivered the Industrial Revolution. What matters for intensive growth is that the market should be allowed to function. Here the sages of the Scottish Enlightenment were clearheaded about the link between the polity and the economy.

They recognized the importance of good governance, which for them was provided by a government which promoted opulence through promoting natural liberty by establishing laws of justice which guaranteed free exchange and peaceful competition — the improvement of morality being left to non-government institutions. But they were quite undogmatic about the particular form to promote these characteristics of the State seen as (Oakeshott calls it) a 'civil association.' On this view of the State it is not seen as the custodian of laws which seek to impose a preferred pattern of ends (including abstractions such as the general (social) welfare, or fundamental rights), but which merely facilitates individuals to pursue their own ends.

But as Oakeshott emphasizes, this classical liberal view which goes back to ancient Greece has been challenged in Western political thought

and practice by a rival conception of the State, which has its roots in Judaeo-Christian tradition, and views the State as an enterprise association. The State on this view is seen as the manager of an enterprise seeking to use the law for its own substantive purposes, and in particular for the legislation of morality. Since the truce declared in the European wars of religion, the major substantive purposes sought by States seen as enterprise associations are 'nation-building' and 'the promotion of some form of egalitarianism.' In our time, Khomeini's Iran represents the religious version of an enterprise association of another Semitic religion.

In the Third world, both nation-building and egalitarianism were the aims of the leaders who saw the State as an enterprise. As in the past, this led to dirigisme and the control of the market. The 'nation-building' aim was particularly badly served, as the dirigisme it entailed led, as in 18th century Europe — where the mercantilist system of the post Renaissance absolutist states was established for similar motives — to national disorder (see Hecksher). For dirigisme bred corruption, rent-seeking, tax evasion and illegal activities in underground economies. The most serious consequence for the State was an erosion of its fiscal base and the prospect of an unMarxian withering away of the State. In both cases economic liberalization was undertaken to restore the fiscal base, and thence government control over ungovernable economies. In some cases the changeover could only occur through revolution — most notably France.³⁶

Egalitarianism, as I have been at pains to emphasize, is a value unique to Christendom. It was incorporated into the politics of the non-Christian Eurasian civilizations by Westernized elites infected with its various variants (Fabian socialism in India and Marxist communism in China). But, with the inevitable economic failure of the dirigisme it promoted, these great Eurasian civilizations are eschewing these imported creeds and turning back to their traditional politics — which were concerned with maintaining some form of civil association and social order rather than promoting some enterprise. Though the political forms these take could diverge — for the reasons given earlier — they are more likely to be closer to the old classical notion of the State seen as a civil association than the various enterprises versions promoted by variations on the theme of St. Augustine's "City of God."

Given the uneasy tension in Western thought and action between these two rival conceptions of the State, it is those regions of the Third World (Latin America, Africa) which are outposts of Christianity, where the problems of governance *pace* Smith and Hume are likely to be most acute. The problems in Africa being compounded by the artificiality of the States created, which has pitted tribe against tribe within and without the arbi-

trary boundaries resulting from the European scramble for Africa.³⁷ Following the logic of my argument that traditional political forms have a legitimacy which imported ones do not, as they are in consonance with the people's cosmological beliefs, and that in themselves political forms do not matter for economic performance, the best outcome for Africa would be to create states which coincide with tribal homogeneity with a polity ruled as in the past by some form of tribal chief.³⁸

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Endnotes

1. Even the Chicago school which until recently ignored culture based on the Becker-Stigler (1977) manifesto “De Gustibus Non Est Disputandum” seems to be coming around to this view. Thus Becker (1996) now emphasizes the notion of social capital first developed by the sociologist James Coleman (1990). Becker notes that culture is part of social capital and is only likely to change slowly (p. 16), and that his and Stigler’s 1977 view only applied to meta-preferences, and that his later work shows “that the past casts a long shadow on the present through its influence on the formation of present preferences and choices” (p. 132). I have little quarrel with this ‘new’ Chicago viewpoint. Moreover for those who are only persuaded by cross-country regressions a recent study by Knack and Keefer (1997) provides some evidence that social capital, measured by indicators of trust and civic norms from the World Value Surveys for a 29 country sample does matter for measurable economic performance.
2. The controversy about the sources of East Asian success continues unabated. After Young (1994) (1995), had purportedly shown on the basis of careful growth accounting that this success could be largely explained by the growth of the primary factors of production (including human capital), with little contribution from productivity increases (a conclusion in consonance with the cross-country regressions based on the Summers-Heston data set by Mankiw, Romer and Weil (1992)), a recent study by Klenow and Rodriguez (1997) which has used a different human capital variable, and sought to explain differences in growth of output per worker, rather than just output, finds that productivity growth is at the center of explanations for the E. Asian miracle, as it is for the differing growth performance of the Summers-Heston set of 98 countries in the cross-section regressions which have become the norm. But like Young they find that neither for East Asia nor for the larger sample is the growth in human capital per worker important in explaining growth. This last conclusion is also in consonance with the evidence from the historical comparative studies of 25 developing countries synthesized in Lal-Myint (1996). The differences in productivity growth of course will reflect differences in institutions.
3. see Colinvaux (1983). This was the definition adopted in Lal (1988) and in Lal (1998).
4. see F. Hahn (1973).
5. see Lal (1998).
6. see Hallpike (1986), Boyd and Richardson (1985).

7. see C. R. Hallpike (1986).
8. see Lal (1998) for references. Two popular surveys of the recent developments in evolutionary biology, psychology and anthropology are Ridley (1996) Wright (1994).
9. see R. Axelrod (1984), and Hirshleifer and Martinez-Coll (1988) for a discussion on the restrictive assumptions on which the Axelrod results depend. For a lucid and accessible account of evolutionary game theory see Skyrms (1996). Also in a perceptive review of Ridley (1996), Hirshleifer (1997) points out that reciprocity cannot be sufficient to generate the virtues which are normally identified with *unreciprocated* generosity, and that social order requires more than just reciprocity. He writes reciprocity “cannot by itself explain the extent of co-operation among non-kin. A system of exchange based on property rights must rest on more than self-defense and tit for tat responses. In particular, disinterested third parties have to be willing to engage in what has been called ‘moralistic aggression’ to defend victims and punish defectors. If so, reciprocity is not the origin of virtue. Rather, true morality — pro-social propensities motivated by principle or compassion rather than by expected compensation — must be there already if a system of trade and exchange is to be viable” (p. 58). On the origins of virtue Hirshleifer states: “morality might be a human *cultural* development [or the result of]... ‘group selection,’ a concept currently scorned by most socio-biologists ...but to my mind the evidence [for its] power... seems overwhelming” (ibid). These views are very much in consonance with those expressed in this article.
10. Hicks (1979), p. 43. But as Harold Demsetz has rightly pointed out to me, of course Adam Smith said this long before Hicks!
11. see Ridley, op. cit. for references.
12. see E. Gellner (1988).
13. Also it should be noted that though there are some evolutionary biologists and anthropologists who seek to provide an account of cultural evolution (see Boyd and Richardson (1988)) the time scale over which evolutionary processes of inclusive fitness, work — about 10,000 years to produce a new species — means that the evolutionary process is unlikely to explain historical cultures. These are human creations.
14. It might also be asked why for the cheating human animal it doesn’t also pay to feign belief in moral codes? But of course it does, as the ubiquity of *Private Truths, Public Lies*, documented by Timur Kuran in his important book of that name on preference falsification attests.

However, as he shows, if there are enough believers in particular 'public lies' people will conceal their private truths, and follow the common norms. This is sufficient for the arguments that follow.

15. see Ekman and Davidson (1994). For economists who have discussed the role of emotions see Hirshleifer (1987), and Frank (1988).
16. see T. C. Triandis (1995). I have relabeled Triandis's collectivism as 'communalism' to avoid confusion with collectivism as a contemporary economic system.
17. Mokyr (1990) is the major proponent of the view that differences in technical creativity explain the different wealth of nations. But his evolutionary theory of technical creativity is not very persuasive. Furthermore, what he identifies as the West's technical creativity remains a 'black box' unless as in Lal (1998) it is identified with a unique trait which led to it, which I claim was individualism. Many of the historical puzzles Mokyr alludes to can then be more readily explained. Instead of trying to explain why something as nebulous as technological creativity was sustained in the West, the question becomes as posed in Lal (1998) the old Weberian question: "why did individualism uniquely arise in the West." My answer is that Weber got his dates wrong but the role of the Western Christian church was crucial, but in surprising ways not noted by economic historians! In this context mention should also be made of White (1978) who is also a 'technologist,' but whose linkage between the West's technological exceptionalism and the medieval Christian church has resonances with the story told in Lal (1998).
18. As Little notes, until the 18th century technological "improvements and dissemination seem to have been almost incredibly slow. The breastplate harness of horses, which tended to throttle them, reduced their efficiency, as compared with a padded collar, from 15 manpower to 4 manpower. It took 3000 years or more for a rudimentary padded collar to evolve, and another 1000 years for it to develop and become general. It similarly took thousands of years for fore and aft rigging and a swinging boom to appear. Yet such improvements did not have to wait upon new materials, or concentrated power; nor did they require, by way of "science", more than observation, wit, and ingenuity." Glancing through the 3000 odd pages of the "Oxford History of Technology", one finds dozens of statements like—"the general form of war galley had not changed very greatly 1500 years later" (*i.e.*, in AD 1800), or "thus by c. 1500 B.C. three basic glass-making techniques were in use. It was not for another 1500 years or so that a new process was developed (glass blowing)" (p. 66).

19. Scott (1989) provides a more radical departure in endogenizing the role of investment in growth by making three departures from the Solow-Swan framework. First, he argues that depreciation is essentially a transfer of income from capitalists to workers in a progressive economy. Were the 'appreciation' (in workers' income) which results not excluded, as it is in conventional national income accounting, then 'net' investment for society as a whole is (approximately) equal to gross investment as conventionally measured and not to gross investment minus depreciation. Second, he argues that there are no diminishing returns to cumulative gross investment, but there could be diminishing returns to the rate of investment. Third, he argues there is no need to invoke any independent or exogenous technical progress to explain growth. Defining investment as the cost (in terms of foregone consumption) means that all activities (including technical progress) associated with growth are covered by it. Hence in his model there is only change (growth) due to investment and population growth. He shows that the growth experience of developed countries conforms to his model, while Lal-Myint (1996) show this is also the case for the 25 developing countries in their sample.
20. see Lal (1988), and Lal-Myint (1996) for a model of the predatory state which uses the notion of contestability as a central analytical device. Recently Olson (2000) has rediscovered this predatory state model, but it is incomplete as it does not take account of the contestability of the 'natural monopoly' which is the State, and thus the equilibrium tax-take of the predator.
21. This dating gets over the Max Weber problem. Also see Kurt Samuelson's (1961) devastating critique of the Weberian thesis.
22. see Lal (1998).
23. see H. J. Berman (1983).
24. see Robin Lane-Fox (1988).
25. see Goody (1983).
26. see Jankowiak (*ed*): *Romantic Passion*; and Fisher: *Anatomy of Love*.
27. see Eisenstadt (1996), Waswo (1996), Lal (2000).
28. see Lal (1988), (1998).
29. Lal (1988).
30. As he notes: "The communist state is in many ways a reinvention of the bureaucratic monarchy...The founders of the Communist party were

products of Qing China, educated in its schools and culture and soaked its values. To them it was only natural that the state should be absolute and that a bureaucratic monarchy was the natural form it should take.... Attitude to state power remains heavily influenced by traditional values. The state's power remains absolute and sacrosanct. Though it can often be got around, it cannot be challenged. Politics at the top is played by the rules of palace struggles, which owe more to the political pundit of the third century BC Ha Fbi than to Marx" (pp. 35-6).

31. see Lal (1998b).
32. see Lal (1998), (2000a).
33. see for instance Castaneda (1995).
34. In Lal-Myint (1996) one major finding was that 'equity' defined in terms of income equality between the richer and poorer sections of the population has not been a major concern, particularly in Asia. What has been of concern are distributional problems between groups that cut across the conventional notion of income equality. Thus in Malaysia it is not income inequality per se but that between the Malays and Chinese which has been of concern, or in Sri Lanka between the Sinhalese and Tamils.
35. For examples see Demsetz, Feeny.
36. see Lal (1987), Lal-Myint (1996).
37. see Easterly and Levine (1997); M.Wrong (2000) shows the unholy brew the 'precious bane' of natural resources and the exigencies of holding a multi-tribal state together have created in the Congo.
38. It is not surprising that the one African state — Botswana — which has by and large kept its traditional polity, has both overcome the 'precious bane' of natural resource riches, and delivered an economic growth performance which outshines that of the 'Asian Tigers.' (see Samatar (1999)).

Informal Institutions and the Rise of Efficient Markets

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I. Introduction

THIS paper probably comes at a bad time. It is about the rise of market efficiency in a broad perspective on history. We commonly associate the advent of the modern age with the rise of the market system and with the fall of medieval restraints to trade. It might be a bit less common these days to associate also our own times' market efficiency, given that we have just witnessed a spectacular burst of an even more spectacular bubble in international stock markets.

This paper will take the freedom to employ the market efficiency concept with a reasonably broad brush. It will go back and ask the question of how markets, institutions, and attitudes have been related in history and how economic historians have thought about these issues. It will present results of recent research in the field that sheds new light on the historical evolution of markets, research which challenges our traditional views of economic history and which may also impact on economic theory.

Since Adam Smith and Karl Marx, scholars have been educated to think of the Middle Ages and the Early Modern Period as a dark age of non-market economies, in which inefficiency, arbitrariness, and exploitation prevailed. Economists long shared the common belief that the decisive change to this state of things came some time during the 17th century, when political turmoil in the Netherlands and England brought about a new style of government, replacing the old political elites with new ones that were apparently more business-minded. Examples of early capitalism in other periods and regions did of course not go unnoticed but were typically discarded, as they did not lead to sustained economic growth.

What exactly the driving forces were that supported sustained growth in some cases but not in others has remained the center of scholarly debate. Changes in mentality have been one hypothesis — not the earliest, but an obvious one to start with in Zurich. In the 19th century, the German historian Ranke and what came to be named the Historical School had argued for a “spirit of an epoch”, a collective frame of mind common to decision makers at a given time, which would drive the rise and decline of nations. Max Weber later applied a similar idea to the development of capitalism, stating his celebrated hypothesis that Calvinist protestantism was conducive to behavioral rules that fostered the accumulation of capital and the evolution of a market system. Whether or when this hypothesis holds is quite another matter, but it is certainly a nice one to entertain here in Zurich, where reformed Protestantism has one of its historical roots.

In fact, the idea that mentalities, mindsets, and limits to rationality impeded the transition to modern economic growth is probably still dominant, at least outside the realm of economics. Among economists, this is less certain. While Marxism deviated from the academic mainstream by its emphasis on power and exploitation, economists of all schools have usually agreed that the very basic principles of rational behavior could be gainfully employed, be it in economic history or in development economics.

This created an obvious problem for the economist's view of history. If rational economic behavior is a valid economic hypothesis also for pre-modern epochs, then why was there development in some epochs and regions and not in others? Following the tracks of Marx and many others, the question is why the way societies organized themselves, or their institutions, were sometimes conducive to economic growth and sometimes not. This is the starting point of this paper, and will determine its organization.

The next section presents the interpretation given by the New Institutionalist approach and discusses some of its classical pieces of evidence. Section III discusses recent criticism of the evidence and the implications it has for the institutionalist interpretation. Section IV turns to the discussion of informal institutions, a more recent line of reasoning that has been pursued very successfully in recent years. Section V briefly dives into the evolution of financial markets, trying to look into both bubbles and fundamental news in history. Section VI concludes.

II. The Institutionalist Paradigm

Imagine you live somewhere near the frontier of settlement, too far away from what you consider to be the civilized world and exposed both to the guerilla attacks of the native population and to a bitter climate. I refer not to the American Midwest in the 1820s or 1830s or to Minnesota in the 1860s but to Central and Northern Europe a thousand years earlier. Quite obviously, your survival will depend on your own relative firepower as well as your ability to draw on support from nearby military fortifications. There is nothing new about that: yet another thousand years back, the Romans had understood this perfectly well and covered the territory behind their borders and frontlines with a grid of military transport roads and strategically located garrisons.

Under less favorable conditions, with population density very low and no military power around to cover your back, you are on your own. You live in small groups in more or less open but highly remote villages, and can be happy if there is a local landlord with a number of horses and

warriors to protect you. Do not expect this to be a condition of free markets and fair prices. Most likely, social relationships will be paternalistic to a high degree, and markets will be regarded more as a nuisance to the social fabric than its integral part. Only to the extent that population density increases and effective transport costs go down will markets come to prevail, but once they do, the old system of paternalistic relationships will soon disappear.

This is the account of history given by North and Thomas (1973). Their approach, a grand design for economic history from the perspective of New Institutionalism, linked the rise of the market society to falling transaction cost. Their big idea was that the non-market relationships prevalent in early societies perform an economic function that markets cannot perform because of prohibitively high transaction cost. According to that view, the medieval manor system was a pretty efficient way of solving the cooperation problems of a non-market society, some kind of a second-best solution whose justification lay in the fact that markets simply could not be organized under the prevailing circumstances.

Possible criticisms of this view are obvious, but the theory does have its attractiveness: it preserves the polarity between feudalism and the market system, and it predicts that the former must go as the preconditions for the latter establish themselves. One of the most important problems of agriculture, ranging just behind protection, is the need to insure the high risks involved with farming. The manor system provided such risk sharing in a brute-force way, locking landlords and farmers into an iron straightjacket of mutual dependence — where of course the asymmetries between the fates of a farmer and of his landlord are more than visible. Thus, one should expect this to be the first thing to change when the market system advances: as property rights become more secured and capital markets develop, capital can be raised at lower and lower rates and land can be used to provide collateral for agricultural credit. Then, the paternalistic relationships between landowners and peasants should turn into market relationships. As a consequence, individual forms of ownership and land usage should replace collective farming, leading to large gains in productivity.

During some time it seemed that this doctrine was able to explain the evidence quite well: With the success of the Glorious Revolution of 1688 in England, property rights became more stable. National and royal debts were being separated from each other, and the former was put under parliamentary control. With the establishment of the Bank of England in 1694 as a private bank of the banks, financial stability was ensured to a large enough extent to even permit financing great wars on the London market without debt default, inflation, or major funding problems (Bordo/White,

1991). As a consequence, interest rates fell markedly and continued to be low throughout most of the 18th century, precisely in time to finance the beginning of industrialization.

The same goes for agriculture. The 18th century witnessed enclosures and privatizations of formerly open, collective fields on a massive scale. Most often, these enclosures had to be passed as a Parliamentary Act, which means we explicitly know how the property was redefined and who the new owners were. Agricultural historians observed that enclosed land fetched far higher prices than open land. Manors were tradable, and those where the old rules had still to be followed were far cheaper than the others, irrespective of soil quality. Hence the conclusion that there must have existed strong economic incentives to enclose and privatize land, once this had become legally possible. This appeared to prove the point: feudalism was a second-best solution that only had its legitimacy in the absence of property rights and reasonably efficient, integrated markets. As soon as these developed, the old institutions proved to be inefficient and inferior, and economic incentives were extant that soon led to their disappearance.

This story seemed coherent, and its success within the economic history community has been overwhelming. It appeared to work well also as a research program for non-European history. From an institutionalist perspective, we now would not have to worry any more why the Romans of the late republic did not industrialize or why China never invented the steam engine. Institutionalists would not look into Calvinism or Confucianism but rather into transport costs, secured property rights, and the private returns to innovation. Only if these deep parameters assumed the right values would modern institutions develop and pre-modern ones die out. The policy implication for developing countries would be obvious: just set these basic parameters right, and you will witness development very soon.

III. Were Pre-modern Markets Really Inefficient?

The problem with the institutionalist hypothesis is that it can be tested empirically. Principally, there are two avenues to pursue. One strand of research has investigated the persistence of seemingly pre-modern institutions in our times. The most famous of these examples is sharecropping, a scheme by which crops are split between the peasant and the landlord according to a fixed percentage. Both Chicago economists (Townsend, 1993) and more egalitarian development economists (Sen, 1981) have paid intense scholarly attention to these issues, trying to explain why these seemingly crude and unfair systems of risk sharing survive even in modern times, when highly developed credit and insurance markets should long

have rendered them superfluous. I remember myself having visited a farm in the Italian Alps not too many years ago, and having been bewildered by the persistence of semi-feudal structures, which I had thought had long died out in Western Europe.

If some of the most central institutions of pre-modern agriculture survive to this day in spite of seemingly abundant alternatives, the apparent conclusion must be that it is either efficient in an economic sense or, in contrast, that the possible non-economic, non-market reasons why it still exists have persisted along with it. Neither of the two interpretations fits well within the framework of the institutionalist approach to explaining the rise of modern market societies.

But there are also more direct tests available. If pre-modern institutions were a substitute for efficient markets in the presence of prohibitive transaction cost, those market activities we can observe at the time should not have been efficient. That is to say, we may observe markets for bread in some marketplace of the early modern period, but as prices were often fixed by local authorities, we would gain little information from that. As a substitute, people have looked into the market for grain. Clark (1998) studied village grain markets in Southern England for the 13th and 14th century. He found very marked, persistent differences in local grain prices. This should not come as a surprise, as people have calculated that under pre-industrial road conditions, a carriage of grain would not be possible to transport for more than 20-40 miles, as the oxen or horses would by then have consumed the caloric equivalent of the entire payload. No doubt, transport costs were often prohibitive, and we would be ready by now to accept that there were good reasons for the existence of the manor system. However, Clark's findings suggest that local grain markets did much better than we would think: running a very common market efficiency test, he found that local grain markets in medieval England were perfectly well integrated. For local markets in grain to be efficient, we would expect them to provide risk sharing across villages. For non-economists, think of risks to the crop like thunderstorms, local droughts or flooding. As long as such disasters hit only one village but not all, there is a scope for markets leveling out the shock to local grain prices, as grain is imported from neighboring villages. Risk sharing is complete if market integration is so strong that local prices will not be affected at all by local crop failures.

To provide an example, heavy rain in Switzerland during the last weeks is estimated to have reduced expected crops this year, in some places by up to one third. This is a big shock. Still, no one anticipates agricultural prices to rise steeply this year, and market integration will ensure that. Now imagine the weather shock had affected the whole of Switzerland plus the

rest of Europe in varying proportions (some claim it did). Still, market integration makes sure that our local prices will only rise by the European average.

This is precisely the nature of the market efficiency test in Clark's work on medieval English villages. Prices did of course differ from one place to the other, and varied considerably over time. But prices in individual marketplaces fluctuated, not with local trade volumes but rather with the Southern English price average, and they did so one to one. This means that in spite of the manor system, still centuries away from the modern age, we have efficient markets, no matter what we thought about transaction cost.

There is more evidence to fill in here. During the medieval expansion of settlement to Central and Eastern Europe, settlers were attracted by the promise of privileges, self-administration and personal freedom. A whole industry of developers flourished in the 15th and 16th century, founding villages and cities with settlers from all over, using standardized legal frameworks. Much of the medieval settlement in Eastern Europe was thus drastically different from the later condition of oppression by reactionary and arrogant nobility, as we have known it from more recent history. Only after the devastations of the Thirty Years War did these privileges gradually disappear. Hence, the relationship between population density and freedom seems to be the opposite of what the institutionalist approach would predict.

Van der Wee (1977) discusses in detail how credit and forward markets developed in Northwestern Europe during the Lower Middle Ages. The merchants' guilds often decreed most detailed market regulations for financial transactions. To name just one example, in the 14th century it was customary for wine merchants from other central German towns to meet in Frankfurt in spring and sign forward contracts on the expected harvest. Market regulators named a middleman who would attempt to first allocate the various qualities of wine among prospective buyers in some sort of a beauty contest until excess demand or supply reached some minimum. The remaining disequilibria — but only the remaining ones — were then auctioneered off. Unfortunately I have no information as to the type of auction they employed. To minimize the incidence of side deals, markets were restricted to only a few days per year. Lars Boerner, a student of mine, is working on this and numerous other examples of pretty involved market transactions in what we considered to be the dark middle ages, and I should not preempt him here.

In 16th century Nuremberg, local authorities tried to regulate grain markets by monopolizing grain storage within the city limits and engaging in counter-cyclical trade at times. However to little avail, as has recently

been shown (Woitek and Bauernfeind, 1996): grain prices in Nuremberg fluctuated by just as much as in neighboring places, and did so at the same frequency. Moreover, these patterns remained invariant over centuries, showing little or no reaction to changing times until the mid-19th century. That is, grain markets were regionally integrated and impossible to control for the Nuremberg city administration. Counter-cyclical policy would only have been successful had the authorities found a way to prevent grain from flowing in and out across city limits — i.e. to curb the effects of intra-regional risk sharing.

As to the effects of England's Glorious Revolution of 1688 on credit markets and on the use of land, research into land rents has shown little change during the late 17th and early 18th century. Money rents per acre exhibited a slow and steady decline. Comparison with yields on national debt suggests that the drastic decline in interest rates identified by many was confined to the public sector, where risk premia were indeed falling sharply. Thus, it was premature to draw conclusions from public-sector debt to the overall cost of investment finance in 18th century England. The same point appears to hold for the returns from enclosure. Going back to the evidence at a micro level and examining the results from probate inventories, researchers have found that the costs of enclosure in 18th century England must have been enormous. Thus, not enclosing and not privatizing a given piece of land may often simply have been rational. It was probably less of a sign of old-fashioned, paternalistic mentality, as Max Weber would have put it, nor was it necessarily an indication of missing markets. Indeed, there is now a whole body of research which argues that decision makers in Continental Europe were aware of the advances taking place in Britain but decided not to adopt them under the prevailing circumstances.

Examples like these suggest that the familiar institutionalist image of pre-modern institutions and their economic effects needs to be revised. Pre-modern institutions coexisted for centuries with markets that were reasonably efficient by the standards of modern econometrics and time series analysis. They did not necessarily precede the rise of markets, and market efficiency did not make them disappear. The rise of the Western World is probably not very tightly correlated with the rise of efficient markets.

IV. The Rise of Informal Institutions

The evidence presented so far points to a deeper historical problem. In discussing preconditions for markets to work even if they are informationally efficient, most economists would still today enumerate a list, one that is typically focused on enforceability of contracts. Only when the appropri-

ate legal structures are missing do proper economics come into play. In the late 19th century, Max Weber and his colleague Werner Sombart pioneered the historical investigation of how law and business developed alongside each other, studying the city republics of medieval Northern Italy. Their main hypothesis was that more complex organizations of business, such as the *commenda* or the *vera società*, could only come into existence as commercial law developed and embraced such hitherto unknown forms of sharing risks and delegating control.

Delegation of control was of course a problem already before those times. In a series of now celebrated papers, Avner Greif (1989) looked at the delegation problems among traders in an earlier period, the 10th and 11th centuries. Imagine you are a trader somewhere along the Mediterranean coast, in Alexandria, Egypt, say. If you want to do business across the sea, trading in, e.g., textiles or spices, you either go there and do all the transactions yourself, or you commit someone else to do this for you. In that case, there arises an obvious problem of control. How can you make sure that your agent will keep your contract and not cheat you? These principal-agent problems are well known to economists. You cannot always verify what your agent is doing and whether he is reporting the results of his transactions correctly.

Greif argued along the lines of dynamic game theory, which states that such a problem of imperfect monitoring is hard to come by unless the situation is repeated many times over. The repeated nature of the business relationship may give the agent an incentive to cooperate, even if the contract is not enforceable and the agent's behavior is only incompletely verifiable.

Greif could draw on a unique archival source, the correspondence of a small Jewish community that had been found in the Genizah of a synagogue in Cairo. This particular community, which had its own synagogues and formed rather closed groups wherever it settled, had been active in long distance trade, typically commissioning the transactions in foreign ports to members of the local community there. Organizing trade relations in this way appears to have had the effect of providing some, albeit imperfect, monitoring of the respective agents' behavior, as their actions were partly observable by other members of the community. Greif indeed found cases in which individual misdemeanor and fraud were reported back. The interesting part is that this appears to have had severe consequences for the fraudulent agents: letters were sent around to the other communities, making the fraud public and barring these people from any further transactions with that group. This is what theory would predict: an agent who commits fraud and is detected will be excluded from further cooperation. In this

particular example, it is the cohesion of the group which makes punishment more effective. The agent loses the business, not just of his principal but rather of the whole network which this community constitutes. Thus, group cohesion provides an informal contract enforcement institution. The argument can be extended to impersonal exchange among individual members of two different communities. Then, group cohesion still works, provided the two groups agree to set up a verification mechanism, i.e. local merchants' courts, and each member of one group can be held liable for the debts or frauds of another member of the same group. Greif (1999) found evidence that such semi-formal institutions indeed prevailed in medieval Europe and gave a reasonable degree of protection to merchants from one city doing business in another one — however at the cost of increasing risk of litigation for traveling business people being held liable for the debts of others.

It is commonly argued that increased codification of merchant law replaced such informal institutions with more formal ones, beginning in some cases in the High Middle Age. This may have been the case to some extent where larger territorial states developed. In the year of 1283, a statute was passed by which credits could be certified in England and repayment verified. However, this scheme soon appears to have failed because of severe verification and moral hazard problems on the part of the sheriffs involved (Greif, 1997). Legal procedures for settling disputes among merchants long remained obscure and, if anything, may have provided an incentive for either side to abstain from appealing to courts.

Throughout Europe, adherence to informal institutions and relying on reputation based contract enforcement long remained the general rule. Credit and payment transactions were refined using the IOU bill, whose force lay in the signatures it carried, i.e. the reputation of the merchants whose hands the bill had passed. Like in many other places, merchants in Southern Germany would book their transactions with their Italian partners on current account. Disputes over payment would occur only in marginal cases, as the interest in continued business relationships and maintaining reputation was paramount. Cheating and fraudulent bankruptcy continued to be punished by exclusion from the network and, therefore, loss of access to the delicate fabric of contacts and privileged treatment that membership entailed.

There seems to have been little difference in the way in which the Maghribi traders enforced their contracts and the methods of control employed by the Fugger, the Medici, and other early modern trading companies with respect to their agents. Oftentimes, the obligations of a representative were given in very detailed contracts. Still, very little if anything is

known of cases in which the company would take an agent who had violated the contract to court. Cases were typically settled by negotiations or sanctions within the firm, and if fraud occurred it has somehow not been reflected in the sources. Apparently, firms knew to set the remuneration for their agents sufficiently high (and probably knew to terminate the business relationship at random to avoid endgame effects). The early modern *lex mercatoris* or merchant law continued to evolve as a set of norms inherent to a business community, which in continental Europe was to be codified and enforced by the state in systematic manner only with the advent of Napoleonic Law.

Thus, the role of the state in providing legal structure to markets remained weak. When markets became more complex, there was a considerable amount of market organization going on, and semi-formal institutions came to exist alongside informal ones. Typically, however, these institutions rested on the self-organization of merchant communities and guilds. Abiding by merchant law was more like playing by the rules of a club, and just as your good reputation (and your money) is the driving force of the good standing of your club membership, individual reputation continued to be decisive in a merchant's transactions with the business community.

The more business-minded among you will by now have asked themselves what the difference with today really was. Business people keep telling me how much they prefer to deal with people they know and how strong the forces of a long-standing business relation can be, even in the presence of good offers from an outsider. Lawyers often point to the ineffectiveness of lawmakers' attempts to codify what has been business practice for a long time. Talk to any lawyer about the prospects of taking a dispute between two firms to court. If you are lucky, you find a judge who understands the technicalities of the problem, but what if you don't?

Still, the differences may be decisive ones. Pre-industrial markets were organized around this principle of club membership; entry was generally not free. To be effective, social control of compliance with the rules within a club depended fundamentally on the exclusiveness of a small group, whether it was a religious community, an ethnic or linguistic minority, or a guild.

Taking this reasoning a step further, a yet under-researched aspect of the transition to free enterprise emerges. Abolishing guilds, monopolies, and privileges did indeed presuppose a functioning legal system — not to provide for possible disputes among leading merchant firms, but rather in order to deal with the avalanche of new entrants into markets, whose conduct could not be controlled by anyone. Adam Smith once coined the catch phrase that any meeting of a group of businessmen was a conspiracy

against the public. Thinking that way was only possible in a highly advanced economy where guilds had already almost disappeared and the state had indeed assumed the role of guaranteeing and enforcing contracts, however imperfectly.

*Hubble bubble, all is smoke
Hubble bubble, all is broke
Farewell your Houses, Lands and Flocks
For all you have is now in Stocks.*

(1724)

V. Finance: the Rise of Inefficient Markets?

The very same Adam Smith who argued against business associations also warned against joint stock companies. These, he argued, could only be a wise arrangement for static businesses like toll roads or waterworks, where efficient administration was more important than innovative entrepreneurship. He could draw on the historical experience of three big bubbles in Western European stock markets, which in 1720 had led to the Bubble Act, restricting the activities of chartered joint stock companies. Since the experience of the 1720s, such charters were being granted very cautiously, which means that Smith was only defending current political practice of his time.

For an historian, the startling feature of financial market bubbles is their connection with new markets and innovation. Both the South Sea Bubble and the Mississippi Bubble were about chartered trading companies. The prospective aim of the South Sea Company was to repeat the success story of the East Indian Company, this time with Atlantic slave trade and access to South American ports. The French *Compagnie d'Occident* was designed as a competitor to the Britain's Hudson Bay Company (chartered in 1670), engaging in beaver trade in French Louisiana and Canada. Both of these new companies caused big bubbles and busts, which the *Compagnie d'Occident* did not survive. It should be pointed out, though, that the originals to these copies were huge success stories and exist to this day. Shareholders in Hudson or East India indeed would see their real wealth increase at very satisfying rates over the next century, as they had in the past. In contrast, the South Sea Company and the *Compagnie d'Occident* had one common defect: they were employed in desperate attempts of the state to raise money in order to consolidate and roll over public debt. This was particularly striking in the case of France, where tax collection and mining monopolies were granted to the new company, while at the same time, an inflationary paper currency was issued. But also the core business of this company was venturing into new territory: it had been given major privileges for the exploitation of a region that undoubtedly had some eco-

conomic potential: in those days prior to the French and Indian War, French Louisiana and Canada together included the whole Mississippi valley, the Great Lakes, and the St. Lawrence river valley. I freely admit that I would have been tempted as well to put my money into such a company. After all, these regions did not do so badly later on.

The case of the South Sea Company is arguably more bizarre, and probably more controversial. Its equity rested largely on converted government debt, being linked to rather intricate conversion clauses. Again, like in the French case, the problem of identifying fundamentals is obscured by the fact that the value of the company and the value of the debt purchased by the company were intertwined. Garber (2000) has argued that the public debt aspects of this problem permit a full explanation of the South Sea Bubble from fundamentals. This is probably exaggerated, but it is obvious that the story of this bubble is not a simple one from which conclusions on the nature of financial markets could be derived easily.

What could have made the core business of this company interesting was the prospect of penetrating peacefully into Spanish trade with Latin America. Expectations of the scale of this trade were probably exaggerated, all the more so as Spain made it clear in due course that it would restrain such trade by granting rights of passage only to a very limited number of ships. Still, it was here that the more typical signs of a bubble became visible. Imitations of the South Sea Company mushroomed like dot.coms to compete for investors' funds, often only to disappear over night.

It was probably not always irrational exuberance in the sense of Shiller (2000) but simple ignorance that induced people to participate. To bring some of the brave new world of England to closer to their place, the city fathers of the city of Berne had chartered a new bank in these days, which in those days prior to industrialization was actually quite a far-sighted, laudable thing to do. To provide the bank with a proper starting activity and at the same time increase public revenue they entrusted parts of the gold reserves of Berne to the bank, asking it to invest them abroad. Unfortunately, the bank managers in their wisdom put a large part of these reserves into South Sea.coms, and soon after, both the bank and the money were gone.

New economy features were also common to the stock exchange crashes of 1837 in the U.S. and the famous 1873 crisis. I do not want to discard the evidence on monetary restriction in the U.S. — the so-called crime of 1873 — and in Germany, where parts of the reparation flows from France were sterilized. The crash of 1873 ended a rally that had been going on in international stock markets since the end of the U.S. Civil War and its

German equivalent, the Austro-Prussian War of 1866. The technology stocks at the time were heavy industry and machinery, and many of the then new names that survived were on their way to becoming international leaders in their markets. In fact, the crash came at a time when output growth in these industries approached a steady state, ending almost a decade of very high growth rates.

We have rather more detailed information on the stock market of the 1920s, an area that is probably over-researched by now. The new technology stocks of those days were radio technology, electrical household appliances, and automobiles. By comparison, old industries like railways performed far worse in the boom and resisted much better after the crash, until they were also drawn into the abyss of the Great Depression. Those who had invested in the Radio Corporation of America (RCA) and got out in time increased their wealth by orders of magnitude. General Electric, now again the firm with the largest market capitalization, was a bit less dynamic than RCA back then. Buy and hold: if your grandparents were smart enough not to unload GE in the early 1930s and you held onto it later on, your portfolio structure is now admittedly a bit on the conservative side. But GE was a good bet by all standards.

More seriously, there is also an indirect test of the efficient market hypothesis for 1929. If markets were really driven by fundamentals, some movement in fundamentals should be possible to identify which matches the movement in the stock market index. Under the efficient market hypothesis, there should be a connection between a properly deflated version of the stock market index and planned investment in productive, factory-floor equipment (Hayashi, 1982). Now this hypothesis cannot be exploited directly, as the ex-post data on realized investment activity are biased away from ex-ante data on investment projects by later cancellations of orders. Ideally, ex-ante data would come from the order books of producers of capital goods. Available data for the U.S. in the 1920s do not quite provide that information. The closest one gets to this are railway statistics on the shipments of new machinery. Plotting these against a deflated version of the S&P 500, one observes a very high correlation. All the upward movement of the stock market since 1920 is supported by equipment investment, as is the downward slump after the October crash. Also, machinery shipments declined faster than the stock market, and did so earlier.

For Germany, another bubble economy of the 1920s, we do have proper data on order books. Repeating the exercise with orders to German machinery industry and a deflated version of the Berlin stock market index, we arrive at a very similar story: orders of factory equipment and the stock

market moved together. There are a number of other features to the German stock market of the 1920s: the bubble had already burst in 1927, almost two and a half years earlier than in the U.S., and the co-movement we observe concerned only domestic orders, while international orders resisted pretty well into 1930. But that is another story.

The interpretation of these results should be a cautious one. They suggest that markets were efficient in a very weak sense, implying that what happened on the stock market also mattered for factory managers and vice versa. They clearly do not mean that anyone was predicting the future correctly. What the data do say, though, is that if there was irrational exuberance in the stock market, it was shared in the boardrooms of manufacturing companies, and vice versa. If that is correct, our scholarly attention in the past has probably been overly focused on the formal institution of the financial market itself. The informal network that transmits information — or noisy signals — from the real world to the stock market and back should probably not be underestimated. Investors in the stock market of the 1920s had been irrational, but so were investors on the factory floor. The stock market did matter for the real economy — or arguably the other way round.

VI. Conclusions

This paper has looked into the connection between informal economic institutions and the rise of efficient markets. Research by a new generation of economic historians during recent years has changed the way we think about the rise of the market system and the decline of the pre-modern order. Markets did not substitute for the institutions of the feudal society, instead they co-existed for centuries. Nor were these markets particularly inefficient: there is now a lot of very sound evidence that indicates that markets were alive and well. Economic agents engaged in credit and forward transactions, and markets also played a role in interregional risk sharing. One striking aspect of these pre-modern markets is that they created their own, often informal, institutions. These apparently played an important part in contract enforcement, providing a service that we would nowadays, probably unjustifiably, relegate to the state. However, this service came at a cost, as it worked through the effects on reputation of being member of small groups, guilds, etc. This implied limits to competition and likely to innovation. Contract enforcement in the hands of the state and transition to the rule of law therefore mainly substituted the rule-enforcing role of guilds. This is what eventually made the transition to free enterprise feasible.

The increasingly dynamic nature of entrepreneurial activity also carried over to new methods of raising equity. The first stock market bubbles we

know of had to do with chartered companies that had been given monopolies by the state, and that were deeply involved in rather suspicious ways of creating public revenue. Generally, these new markets have encountered their main difficulties when it comes to pricing new industries whose market prospects are still highly uncertain. Oftentimes, new-economy stocks that were the subject of speculation in one bubble have turned into rock solid old-economy stocks in the subsequent one.

But financial markets have not just been a playfield for housewives and for self-appointed financial gurus. The informal network connecting financial market activity and factory-floor investment appears to have been rather strong in history. Financial markets and start-up enterprises may often have failed in judging the potential of upcoming technologies correctly. But this is probably the price we have to pay for a system whose performance is no longer controlled by guilds, clubs, and cartels but gives free access to anyone willing to venture into unknown territory and try something new.

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