

Coordination and Coercion:  
The Nature of Rules, Governments, States, and Social Dynamics

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## **1. The Problem of Impersonal Rules**

Over the last three centuries, a relatively small number of societies have developed the ability to create and enforce impersonal rules on a wide scale. Impersonal rules are rules that “treat everyone the same,” where treatment includes both the nature of the rule and its enforcement. Impersonal rules lay at the heart of social outcomes and intellectual concepts like rule of law, secure property rights, most notions of contract, civil rights, and limited government. Impersonal rules also play a central role in less concrete but nonetheless important concepts like trust, legitimacy, fairness, and culture. Many discussion of rules presumes that rules are meant to be impersonal rules, even though many societies lack the ability or capacity to create and enforce impersonal rules. [expand] If we define institutions as the rules of the game and the means of enforcement and organizations as the teams who play the game (North 1990), then societies with impersonal rules have institutions that enable much more human coordination and interaction, because everyone knows what the rules of the game are. We stress in this paper that not only are the primary benefits of better rules enhanced coordination, but it is in the nature of coordination that we need to seek answers to the primary question we ask: why are some societies capable of creating and enforcing impersonal rules while most are not?

Several features of impersonal rules need to emphasized from the beginning. First, in no society are all rules universally impersonal. All societies have rules that apply differently to different individuals or groups of people, so in any society impersonal rules are only a subset of all rules. Second, impersonal rules do not fit into categories like norms, customs, or conventions, because impersonal rules must be clearly known and applied to all people (or all the

relevant people). Rules that rely on repeated interaction for their enforcement usually cannot be impersonal rules, because repeated interaction requires personal relationships. Customs and conventions may appear impersonal, but they are not because the enforcement of those rules are not impersonal but idiosyncratic. Impersonal rules must be publicly known and their enforcement must be visibly unbiased and impersonal.

Third, impersonal rules require enforcement by a public organization: a government. Rather than saying governments must enforce impersonal rules, it is more accurate to say that any organization with the capability of creating and enforcing impersonal rules will be called a government. Most societies have difficulty creating and enforcing rules in an impersonal way. Many governments enact rules that have the form of impersonal rules, but in practice they lack the “capacity” to enforce rules impersonally. To be clear, by definition impersonal rules must be enforced impersonally; without reference to the personal or social identity of the individuals involved; without reference to gender, ethnicity, religious beliefs, social associations, or peers and peer groups. Impersonal justice must be blind justice. We cannot over emphasize the role of impersonal enforcement plays in affecting how rules affect social coordination. Most of the paper is devoted to understanding the dynamics of rule enforcement, either by private parties or by governments.

The final aspect of impersonal rules is the answer to central question: a society’s ability to create and enforce impersonal rules must be based on the ability of the society’s government to enforce rules impersonally, and that ability depends on the government’s ability to coordinate, not on the government’s ability to coerce. Coercion is the threat of violence. This is our most controversial claim and the heart of our argument about the nature of societies that are capable of

creating and enforcing impersonal rules. We deny the validity of the basic premise of Hobbes's *Leviathan* and an enormous social science and legal literature, which asserts that the essential characteristic of a government capable of enforcing rules must be an overwhelming ability to coerce.

The logic is based on a simple economic calculus of rule following that suggests individual follow rules when the benefits of following the rule exceed the cost of breaking them. Agreements between individuals governed by self-enforcing rules (that is, rules that are not enforced by a third-party but only by agreement of the parties and the actions and interests of the participants) will be fulfilled because it is in the interests of all parties to follow the rules. In a simple case where we hold the benefits of rule following to all parties constant, rule breaking depends on the cost realized by rule breakers. The cost of rule breaking comes in two primary forms: either the benefits lost from foregoing the relationship with the other parties in the future is too high, or because some parties are able to impose costs through coercion on parties who defect. We will return at length to the difficulty of dealing with individuals with ample coercive power. For now, note that this simple bi-polar way of thinking about the incentives that lead to the enforcement of agreements can arise from the benefits of coordination which will be lost if rule are broken, or the threat of coercion.

Social scientist have proceeded from this point by dividing human arrangements into those that are credibly governed by incentives that do not require coercion and those that do require coercive power to be credible. Mancur Olson's (1965) idea of a voluntary organization, which has long antecedents before Olson, is an organization where all members are free to join or leave, and no coercion is involved. Olson explicitly avoids the study of organizations that use

government enforced rules to organize, because those rules always include the possibility of coercion. All the social sciences recognize a difference between agreements with and without an element of coercion, but none make a great deal of the distinction because private coercion is always a possibility in the real world.<sup>1</sup> The real dividing line throughout the social science is social arrangements that include the enforcement of rules by governments, which are always taken to possess an element of violence and coercion. The government is defined as “the organization with a monopoly on the legitimate use of violence” (Weber), “the organization with a comparative advantage in violence” (North), or “the organization with a preponderance of violence capacity” (Tilly). Hobbes’s logic requires a government “leviathan” capable of coercing all of society’s members. When the coercive power of governments exists by assumption, the questions then become how to guard the guardians? (Juvenal) or how an a government powerful enough to protect property rights be constrained from expropriating them? (Weingast, following Madison).

Defining the government as the organization with a monopoly, a comparative advantage, or a preponderance in violence capacity specifically avoids asking how violence is organized. The assumption is a convenient short cut. Unfortunately, the assumption avoids ground that we need to cover in order to understand how impersonal rules come to be created and enforced. The shortcut has a conceptual and an empirical weakness. Conceptually, it seems clear that how the government organizes violence internally will effect how the government uses coercion

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<sup>1</sup>So, for example, the economics literature uses the concepts of public and private ordered relationships to distinguish agreements that do not use government rules from those that do. But there is no reason to believe that private ordered relationships cannot include an element of coercion, even if they are completely voluntary.

externally and interacts with the society around it. The idea that government can be taken as a black box and how it organizes violence is not important for thinking about how it behaves doesn't make sense. Empirically, in most societies in the early 21<sup>st</sup> century and certainly throughout history, governments are not the only organizations that use violence on a regular basis. A conceptual approach with only one coercive leviathan capable of enforcing of rules through the threat of violence may be irrelevant to the dynamics of rule creation and enforcement in a world with many potential coercive actors. Perhaps the assumption is why the social sciences have done so poorly at promoting development over the last half century.

If we do not understand the logic underlying the organization of violence, then we will not be able to understand the trade-offs that coordination and coercion offer as methods of rule enforcement. The first insight is that violence cannot be organized by violence: the king does not rule because he threatens to coerce every subject individually. A leader rules because he can coordinate a coalition of potentially violent men. As an individual, the leader is always powerless to suppress a coalition of his violent followers should they turn on him. How the coordination of that coalition is structured is of vital importance to understanding the kind of rules the coalition can credibly enforce. The internal structure of the coalition of violent men will always include the threat of violence, but what must hold the coalition together is the benefits of coordination that will be foregone if violence breaks out. The key to understanding why rules are followed within the coalition of enforcers must be the benefits of coordination, not the threat of violence.

To be very clear: we are not arguing that coercion has no role in rule enforcement. Coercion, the threat of violence, can play a constructive role in rule enforcement and the

coordination of societies. We are arguing that the internal structure of organizations that use coercion (and all powerful coercion is organized, not individual) must have a direct effect on the ability of coercion using organizations to create and enforce rules outside of the organization as well as on what kind of rules the organizations can credibly enforce. Since in many societies “governments” are just one of many organizations that use coercion on a regular basis, whether a government organization is more or less powerful than private organizations depends on many highly variable factors. Whether a government can actually coerce any or all of the private organizations in a society can never be assumed.

What, then, is the role of the government as an organization within a society full of coercion using organizations? This is the right place to start our inquiry, rather than beginning with the assumption that the government has a comparative advantage in violence. If the government cannot coerce all of the organizations in a society then the government’s ability to create and enforce rules must depend on its ability to coordinate. Rule enforcement must result from the lost benefits of coordination, rather than costs imposed by coercion. This does not mean that the government has no power to coerce, that will almost certainly part of the government organizations abilities. It does mean that rules cannot be enforced solely by the threat of violence (the Hobbesian assumption about leviathan).

For ease of exposition we will refer to the coalition of powerful organizations which the government is part of as the “dominant coalition” and the individuals who lead those organizations as “elites.”<sup>2</sup> As will become clear, the government plays a key role in coordinating

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<sup>2</sup>Being or becoming an elite may be a function of heredity, but primarily individuals become elites because they are talented, able, hard working, able to organize groups of people and ruthless or inexorable in pursuit of their goals.

the coalition of powerful organizations because it is a “public” organization. The government’s role as a coordinator within the coalition may not be visible to all members of society, but it is visible to members of the dominant coalition.

Understanding the logic of how dominant coalitions are organized provides us with a clear insight into the organization of violence within and between organizations. Our book with Barry Weingast, *Violence and Social Orders*, (2009, NWW hereafter) articulated what we call the logic of the natural state by which a dominant coalition could both organize and limit violence. The logic of those arrangements results in the internal relationships between powerful organizations that cannot support impersonal rules in most societies. That is, neither the government nor the powerful organizations find it in their interest to create and enforce rules that treat all members and organizations of the coalition the same. Since the dominant coalition of government and other organizations cannot enforce impersonal rules within the coalition, they cannot enforce impersonal rules in the larger society. If the rules that govern elite relationships treat different elites differently, then it is not credible for the government to create impersonal rules for non-elites either. The logic is straightforward, but explicating the argument takes some time and depends on a deeper understanding both of the nature of rules, organizations, and the logic of the natural state. The inability to create and enforce impersonal rules is not due to a lack of capacity on the part of the coalition or of the government, it is due to the internal dynamics of the coalition.

Only when powerful organizations and individuals find it in their interest to adopt impersonal rules for structuring the coalition that treats all elite organizations the same, that elites will be willing to allow the government to create and enforce impersonal rules. For

reasons we explain, the willingness of elite organizations to abide by impersonal rules must lie in the ability of the government to coordinate the dominant coalition. Explicitly, elites are only willing to agree to concede the government the coercive power to enforce rules over them, if allowing the government to do so raises the benefits to elites of social coordination. Most of those benefits will be “private ordered” benefits, that is, benefits that arise not from relationships between elites and the government, but from relationships between elites and elite organizations.

The bottom line is that elites are not willing to concede a monopoly on coercive power to the government because the government has an absolute, comparative, or preponderant advantage in the use of violence. Elites are willing to concede to their government an advantage in the use of coercion only when doing so enables elites to reap higher gains from private ordered relationships that are made more valuable in the presence of government enforced impersonal rules. This, then, is our answer to the question posed in the opening paragraph: how do some societies acquire the ability to create and enforce impersonal rules? They do so when powerful organizations and individuals find it in their interest to voluntarily concede the use of coercion to the government in order to enforce impersonal rules. We are, as Margaret Levi put it in call for a new theory of the state in her presidential address to the American Political Science Association, advancing a hypothesis that explains why “Governments are more able to carry out their policies when they achieve quasi-voluntary compliance – that is, compliance motivated by a willingness to cooperate but backed by coercion.” Where we differ from existing approaches is by explaining how the government’s ability to coerce is the result of its ability to coordinate, rather than assuming that its ability to coordinate is based in its ability to coerce.

After a brief digression on the nature of elites, the paper is divided into two parts. The

first part unpacks the definition of institutions as “the rules of the game and the means of enforcement, and organizations as the teams that play the game” by looking more deeply into the nature of rules, the nature of enforcement, and the nature of organizations. We show how the short cut assumption that the government possesses an advantage in coercion affects how we think about rules and enforcement by assuming that the government’s role in rule enforcement lies primarily in the enforcement of rules that threaten explicit punishments for violations. Rather, we argue, that an important role of government is in the enforcement of default rules that do not constrain individuals and are only invoked by parties to an agreement when their relationship is failing. The “shadow” of default rules casts a long, and potentially productive umbrella over private ordering of relationships. Critically, default rules are much more effective at inducing and sustaining private coordination when they are enforced impersonally. This leads to a discussion of the nature of third party enforcement more generally and, finally, to a discussion of organizations. This discussion requires a roundabout discussion of rules in order to highlight the kind of rules that elites find themselves wanting to enforce in an impersonal way. Emphasis on the type of rules also generates the possibility of testing the hypothesis that we lay out, although we do not do that in this paper.

The second part of the paper uses these more refined notions about rules to construct a conceptual approach to the emergence of impersonal rules. We characterize what individuals and organizations are buying when they concede to impersonal rules. For reasons we hope are compelling, we believe that it is the organizational interests of elites that ultimately lead them to voluntarily agree to government enforcement of impersonal rules. The government’s monopoly on legitimate violence emerges out of that intra-elite agreement. It is the benefits of government

coordination that lead to the governments control of coercion, not the other way around.

### **1a. A note on Elites**

Throughout the long history of thinking about the nature of governments, states, and societies in western political thought, governments have been intertwined with the importance of coercion as a tool of governance. The ability to threaten violence – to coerce -- to enforce rules gives the coercer the positive ability to enable greater social coordination and so enable a higher degree of specialization and division of labor. Conversely, those who possess access to coercive power are able to resist the coercive enforcement of rules by others. As a result “elites,” whether they are part of the government or not, are able to command special privileges. These privileges come both in the form of rules that treat them differently and in the expectation that the enforcement of rules will not apply to them in the same way as everyone else. The negative consequences of elites for social welfare result less from distortions caused by their special treatment, than the disabling effect that special privileges have on the ability of rules to coordinate human interaction and the specialization and division of labor that result from coordination.

Over the last three centuries the organization of some societies have changed in ways that affect both coercion and elites. Some societies have come to possess governments with a Weberian “monopoly on the legitimate use of violence.” Elites, voluntarily or under duress, have conceded their privileged status to rules and enforcement and accepted a set of “impersonal rules” that apply equally to all citizens. Both the form of the rules and the methods of enforcement are impersonal. The rise of modern societies is intimately tied up with the creation and enforcement of impersonal rules that apply to citizens and governments. Impersonal rules,

therefore, serve as the basis for limits on a government with a monopoly of coercive force. We seek to understand how and why societies are able to create and enforce impersonal rules.

The role of elites in this process is critical. Those who enjoy special rules or exceptions must somehow be coopted or overwhelmed if impersonal rules are to be sustained. The process must be dynamic, as new elite rules and exemptions must be prevented from reappearing. Impersonal rules can only be created and enforced by a public organization because both the rules and the means of enforcement must be visible and verifiable. The historical appearance of impersonal rules, then, must be associated with a change in the relationship between elites and governments: governments must become capable of disciplining elites and their organizations.

All theories and histories of the transition to modern politically and economically developed societies face the challenge of explaining the changed relationship between governments and elites. Acemoglu and Robinson theorize about how elites, faced with a short run situation where the masses can overrun them, evade destruction by using democracy to credibly commit to honor their promises to the masses.<sup>3</sup> The government becomes the agency through which the elite commitments to the masses are made credible. A host of theories of revolutions involve the ability of the masses to organize and overthrow, or reform, the elites. These frameworks implicitly or explicitly assume that elites yield control of violence to the

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<sup>3</sup>Greif (2008, p. 17) starts with the following: “Theories of constitutionalism focus on constitutional rules and commonly view them as a coordination device that fosters the security of property rights. The origin of constitutionalism is the gain to property owners from coordinating on an equilibrium in which powerful rulers and the elites respect property rights. Constitutionalism is a means of constraining the powerful. History, however, suggests that constitutionalism (constitutional rules and also the rule of law and political representation) emerged to facilitate cooperation among the powerful.”

government.<sup>4</sup> Elites do not concede their power to the masses, but to the government.

How is it that governments change from being part of the elite coalition to an organization capable of disciplining elites? How and why do elites concede the use of violence to a government? It cannot be that simply that a government organization attains a monopoly of violence sufficient to constrain elites. History is full of societies with very powerful military/government organizations that do not approach anything like the ability to create and enforce impersonal rules.

In her presidential address to the American Political Science Association, Margaret Levi argues that we need “a new theory of government.” (2006) We agree with Levi’s call for a new theory of government capable of explaining social dynamics and the transition to impersonal rules. We attempt to provide the outlines of such a theory here. What turns out to be surprising, however, is that a theory of government alone is not enough to explain how and why societies become capable of impersonal rules. In order to understand why elites are willing to concede control of violence to the government, we also need a theory of elites. More generally, we need a theory about the configuration of power in a society, where power comes from coercion as well as control of economic, political, religious, and social resources and organizations.

The main conclusion of this paper is quite simple. The ability of a society to create and enforce impersonal rules depends on the dynamics of the society’s dominant coalition. Coercion plays a role in rule enforcement. But impersonal rules are only possible when powerful organizations, public and private, want to use the government to coordinate some dimensions of their coalition relationships through impersonal rules. Until then, impersonal rules are not

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<sup>4</sup> Charles Tilly (1993) calls this process “disarming the population.”

credible, because powerful organizations will evade or ignore them. Governments that attempt to enforce rules through coercion only will degrade the possibility of coordination within the dominant coalition. The key feature of governments is not their ability to coerce, but to coordinate. Until societies reach the point where governments can credibly coordinate powerful organizations and those organizations voluntarily comply with impersonal rules, it is impossible for the government to acquire a monopoly on the legitimate use of violence. It is the coordinating power of government that leads to coercive power, not the other way around.

## **Part I: Institutions, Rules, Enforcement, and Organizations**

### **2. The Nature of Institutions**

The term institutions is so widely used and variously defined that a short review of how we define institutions may help make clear how we think about the problem of impersonal rules. As defined by North (1990): institutions are the rules of the game and the means of enforcement and organizations are the teams that play the game. The definition has three elements – rules, enforcement and organizations – all of which play key roles in what follow.

Rules vary across a wide spectrum of behavior. All humans interact and coordinate their actions. At one end of the spectrum, personal rules cover the pattern of repeated interaction we have within our families and close friends (e.g. rules in families). From there rules merge into norms or social rules, which are shared patterns of behavior between people who may or may not know one another. Formal rules are explicit rules, which may or may not be written down. Formal rules differ from norms, in that norms are often not explicit and very often hard to figure out. The formality of rules has to do with being explicit rather than being enforced in a particular

way, as we will consider shortly. Legal rules are publicly known rules enforced by a public organization, a government. The boundary between personal rules, norms (social rules), formal rules, and legal rules is porous and of infinite gradation. Rules also appear in a variety of forms that we discuss in section 3.

Enforcement of rules comes in various types that, again, grade seamlessly into one another. Some rules are enforced by actions within the group where the rule applies. Actions range from laughter, criticism, exclusion, shunning, teasing, pushing, hitting, and seriously injuring right up to causing death. Sometimes enforcement depends on the actions of those who the rule violating behavior affects. Sometimes the responsibility of enforcement is explicitly delegated to a member of the organization or community the individual belongs to. Sometimes the responsibility is explicitly assumed by and delegated to a public organization, a government, that enforces legal rules within a given geographic area or over a specific group of citizens.

Organizations are a key element of institutions because they provide both the venue in which many rules are articulated and enforced, and because organizations are the primary actors who change rules. Because we are concerned with the dynamics of institutional change, as well as the nature of institutions, we want to understand the forces at work in society to accept rules, to ignore them (cheat), or to change them. The role of organizations will be explored in greater detail in section 4.

Rules, enforcement, and organizations are the three dynamic elements of institutions and institutional change. Institutions result in repeated patterns of behavior. Because humans form beliefs and values about the world around them from their genetic predispositions as well as their experiences, institutions have a major impact on beliefs and values. Culture, the shared beliefs

and values passed through time from individuals to individuals, interact with institutions to produce the values and beliefs any individual holds at a particular point in time. But beliefs, values, and culture are not institutions. Institutions are the rules of the game, the means of enforcement, and the teams that play the game. Institutions may, or may not, constrain human behavior. While all human social interaction is played out in the shadow of institutions, institutions allow ample freedom for individual choice. Social dynamics results from the interaction of institutions and behavior. The shadow of rules looms large in any discussion of social dynamics, but what are rules?

### **3. The Nature of Rules**

Although we are all familiar with rules, indeed human experience is “bathed in rules,” our ideas about institutions and institutional change will be sharper if we are clear about three dimensions over which rules vary: coercive and coordinating rules; rules as constraints and rules as defaults; and personal, anonymous, and impersonal rules.

#### **3A. The Individual Perspective**

Jean Piaget wrote that “From its earliest months the child therefore is bathed in an atmosphere of rules, so that the task of discerning what comes from itself in the rites that it respects and what results from the pressure of things or the constraint of the social environment is one of extreme difficulty.” (1997, p. 52) Piaget studied the developing sense of rules and morality in children, and frames his results in two ways that individuals perceive rules. Some rules are perceived as heteronomous, that is, rules that are given by authority (parents, God, the

society) that the individual cannot influence.<sup>5</sup> Other rules are perceived as coordinating, that is, they are rules that arise out of the interaction of individuals and result from an agreement on or shared belief about what and how behavior should be structured. How an individual responds to and interprets rules depends on whether the rules are imposed on us or emerge out of our interaction with other people. For the very young child, all rules are perceived as heteronomous, including rules about the physical world such as the law of gravity, the rules that govern language, and the myriad of (sometimes contradictory) rules that the authority of parents prescribe.

To be clear, rules in this context are defined as consequences of actions: do x and y occurs. We can distinguish between “laws,” in which x always causes y to occur, like the law of gravity, and “rules” where there is a probabilistic chance the consequence will occur. Children are constrained by the “pressure of things,” the laws and rules of the physical world, as well as the effect of their actions on the behavior of other people, the “constraint of the social environment.” Piaget uses the concept of rules in its most general sense, encompassing personal rules, norms, formal rules, and legal rules. Although, as we discuss shortly, even Piaget does not encompass the universe of rules as commonly defined.

Piaget’s study of games of marbles among young Swiss children reveals several important regularities. The first is that young children, even when they do not completely understand the rules or play by them, interpret rules as sacred, as given by some higher authority. The charming interview with Fal aged 5, p. 55, illustrates this (interviewer in plain type, *Fal in*

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<sup>5</sup>Heteronomy is subordination or subjection to the law of another; the opposite of autonomy.

*italics*): “Did people always play marbles the way you showed me? – Yes. – Always that way? – Yes. – How did you get to know the rules? – *When I was quite little my brother showed me. My Daddy showed my brother.* – And how did your Daddy know? – *My Daddy just knew, no one told him.* – How did he know? – *No one showed him!*” “Tell me who was born first, your daddy or your granddad? – *My Daddy was born before my granddad.* – Who invented the game of marbles? – *My Daddy did.* – Who is the oldest person in Nuechatel? – *I dunno.* – Who do you think? – *God.* – ... Where is God? – *In the sky.* – Is he older than your Daddy? – *Not so old.*” Piaget interprets the interview to show that Fal “regards them [the rules] as endowed with divine right. Fal’s curious ideas about his father’s age are worth noting in this connection; his daddy was born before his grand-dad and is older than God! These remarks ... would seem to indicate that in attributing the rules to his father, Fal makes them more or less contemporaneous with what is for him the beginning of the world.” (p. 56)

Heteronomous rules come from outside the individual and they are, fundamentally, coercive. Rules are rules because if you break them, you pay a cost. Young children tend to evaluate the importance of the rule by the punishment it carries, not the benefits it produces: “These children, in short, look upon lying as naughty because it is punished, and if it were not punished no guilt would attach to it... The child does not mean that it is enough to escape censure to be innocent. What these subjects think is simply that the punishment is criterion for the gravity of the lie. Lies are forbidden, through one does not quite know why. The proof is that you get punished for it.” (pp. 168-9) It is remarkable how close the perspective of the young child comes to that of the economist, who values the seriousness of the crime by the punishment.

As children grow, however, their attitude towards the rules and the game change. By the

age of 10, most children feel that the rules exist to increase the value of the game to the participants, to enable them to coordinate their play. Devising rules so one individual can win the game is less important (to most children) than devising rules that maximize the value of the game by ensuring its integrity and rewarding skill. Older children do not lose their respect for the rules, but transform their respect from a unilateral respect for the rule maker, to a mutual respect towards the group. Rules become more fluid, “nor do boys of 7 to 10 ever succeed in agreeing amongst themselves for longer than the duration of one and the same game;” (p. 46) but retain durability through time. Children come to appreciate the possibilities of different rules. Most important, they come to value playing by the rules because their ability to participate depends on following the rules. The threat of exclusion from the game becomes the incentive to abide by the rules. [Need a quote from Piaget here] Rules cease to be heteronomous and become autonomous, which is the opposite of heteronomous, or more intuitively, coordinating. Children come to feel invested in the rules as a result of their own autonomous choice. When considering, as above, why lying is wrong older children, “who have really grasped the anti-social character of lying no longer say that we musn’t lie ‘because we get punished,’ but because to do so is contrary to reciprocity and mutual respect,” (p. 171). Not lying is necessary to continue to play the game.

Any bright undergraduate after his first game theory class could see the parallels between Piaget’s older children’s approach to games and rules, the logic of folk theorem, and the power of repeated interaction. We needn’t go farther than the folk theorem now, but want to note two aspects of Piaget’s observations. First, young children innately accept the sacred authority of rules, it is an evolutionary design rather than a cultural artifact. There are strong evolutionary

reasons why children should accept the authority of their parents rules when they are very young. Second, the changing interpretation coordinating rules as coordinating devices also seems to be innate.<sup>6</sup> Piaget stresses that coordinating rules make greater demands on the intelligence, awareness, and rationality of older children, but coordinating rules arise at a certain stage of development that is as innate as the acceptance of authority in earlier children. Again, there are good evolutionary reasons why older children should become more flexible and rational about social rules. Just as innate genetic capacities for language ultimately adapt to the specific language surrounding the child, so the child's perception of rules adapts to the reality of social interaction. This is an aspect of evolutionary development. Genes are a blueprint for organisms, but how the blueprint develops depends on the conditions of construction at particular points of time in the history of the organism. Respect for the authority of rules does not disappear at age 12, but the individual's orientation towards the rules is shaped by their family, social networks, and culture as they grow. "But from henceforward a rule is considered as the free pronouncement of actual individual minds themselves. It is no longer external and coercive: it can be modified and adapted to the needs of the group. It constitutes no revealed truth whose sacred character derives from its divine origin and historical permanence; it is something that is built up progressively and autonomously." (p. 70).

Piaget's concern is with parenting, education, and how the perspective of the child towards rules affect the moral development of individuals. His categories of coercive (heteronomous) and coordinating (autonomous) rules do not translate readily into empirical

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<sup>6</sup>It seems that one of the modifications of Piaget's hypothesis that emerged as others tried to duplicate his results is that children are capable of understanding rules as both heteronomous and cooperative from an early age. Killen???

divisions of actual rules. But they do serve us as conceptual categories that help to distinguish approaches to rules and institutions.

### **3B. Rules as constraints and rules as defaults**

The notion of rules as statements of consequences, if you do x then y will happen, is a natural way to think about rules and parallels the economist's notion that rules are constraints. Forcing all rules into the consequential formulation has its costs, however, since many rules do not operate actively as constraints but passively as defaults. For example, marriage law does not specify how wives and husbands must treat each other within their marriage. Marriage law is largely a set of default rules that come into play only when the partners contemplate or have decided to terminate their relationship. Because people are forward looking, all marriages play out in the shadow of the marriage rules. Rather than constraining actual choices, however, default rules shape the parties perceptions of the value of outside options.<sup>7</sup>

Advances in game theory show the power of outside options to shape and support human interaction. The value of outside options typically determines at least two of the payoffs in a two person game, because both individuals have the option of breaking off their relationship (often characterized as “defecting”). The deep theoretical insight is that the possibility of sustaining any relationships may depend on outside options, and moreover that the range of relationships that can be sustained may be increased if default rules are appropriately specified. Most social scientists appreciate this logic, but it often fades when considering specific forms of human

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<sup>7</sup>Important papers in the legal literature on default rules include Mnookin and Kornhauser (1979) and Ayers and Gertner (1989). The specific definition of default rules in our paper is more general than the detailed definitions in Ayers and Gertner, but the spirit of the concept is the same.

interaction. Default rules, like marriage rules, do not specify anything about the actual conduct of the relationship, they specify what will happen if the relationship ends. Default rules, therefore, do not have a direct corollary in how people actually behave. The operation of the rule will not be observable in the conduct of a marriage, but in the conduct of a divorce. We may be able to see indirect evidence of the rule in a statistical sense, that marriages on average result in different outcomes under different default rules, but we will not see the default rule in action within any particular marriage.<sup>8</sup> When our concern is specific behavior, be it exchanges, marriages, or other social interactions, we tend to focus on rules that constrain behavior rather than default rules. Piaget, for example, was clearly more concerned with rules as constraints than rules as defaults.

Many institutional rules are default rules. For example, the organizational chart of a business firm is essentially a set of default rules that specify who has the formal “right” to make particular decisions. As we discuss in the section on organizations that follow, the actual behavior in an organization often does not resemble the formal default rules. That does not make the default rules less binding, it simply means that actual decisions are made in the shadow of the default rules. For example, a manager has the responsibility for making a specific decision, say where to locate a new store, but he usually allows a subordinate to actually make the decision. The fact that the manager allows the subordinate to make the decision neither relieves the manager of the responsibility for the decision, nor does it imply that if push comes to shove and the manager and the subordinate disagree that upper management will side with the subordinate. The default rule is that the manager decides. The reality is that the decision can be made by

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<sup>8</sup>See Freidberg (200?), Evans 1996, Wohlers and Stephenson (2008).

either the manager or the subordinate, in the shadow of the default rule.

Two other aspects of default rules play a major role in understanding how governments create and enforce rules. Many default rules appear to be heteronomous and coercive in principle, because they must stand outside the relationships within the game. Despite their appearance, however, default rules may actually be coordinating rules. The parties to the relationship have the option of invoking the default, they are not coerced into doing so. For example, when a married couple reaches a decision to get a divorce, they are usually able to work out their own arrangements for child custody, property distributions, and future payments. If they cannot reach an agreement the court will apply the default rules for child care, property distribution, and alimony.<sup>9</sup> The fact that the default rules specify outcomes that the couple can avoid by reaching their own agreement, does not mean that parties to a divorce do not feel coerced by the marriage law. Nor does it mean that a court that has to carry out a decision by seizing the property of one party is not using coercion. But coercion is not the essence of the marriage rules, coordination is.

We also need to be aware that many default rules are themselves default rules for default rules. The economic approach to contract theory over the last several decades builds on “incomplete contracts;” the idea that not all contingencies can be anticipated or that the cost of writing an *ex ante* contract covering all contingencies is prohibitively costly. An incomplete contract freely entered into by two parties is itself a default rule, since the contract explicitly does not constrain or order the behavior of the contracting parties on all dimensions of their

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<sup>9</sup>Mnookin and Kornhauser report that 90 percent of divorcing couple reach their on agreement.

relationship. The contract may only come into play when the relationship is failing, the contract specifies what happens when the relationship is no longer sustainable. Legal rules about contracts, that is rules about what terms of contracts courts will enforce *ex post*, are really default rules for default rules. The uniform commercial code, for example, specifies the default rules that courts will use to interpret contractual arrangements by firms.

### **3C. Personal, Anonymous, and Impersonal Rules**

A third distinction within the population of rules needs to be made. It has already been illustrated by Piaget that many rules are not formal, but work within relationships. All families have rules that govern the relationships within the family. These relationships are “personal” because they apply directly to specific individuals.

At the other end of the spectrum are “impersonal” rules, rules that apply more generally to people, not to specific individuals. The nature of impersonal rules is the subject of the entire paper, and will be developed in greater detail later. For now it is important to note that the categories of personal and impersonal rules do not exhaust or span the complete universe of rules. Rules within families are personal. Rules about families are clearly not personal, and in that limited sense are impersonal. But rules about families may not apply equally to all families. They may distinguish some types of families from other types, or more typically apply to families in particular ethnic, religious, or social groups rather than applying to all families in a society in the same way.

Many rules that are not personal, nonetheless do not apply to everyone in the same way. Since we have already defined impersonal rules as rules that apply equally to everyone (or to a

class of people like citizens) we must identify the intermediate type of rule that applies to some groups and organizations and not others. The term we will use for these rules is “anonymous rules.” The application of an anonymous rules apply to a specific individuals depends on the group or organization that individual belongs to. Anonymous rules recognize the social identity of individuals and treat them differently according to that identity. Anonymous rules apply differently to members of different organizations.

Discussions of taxonomy and lexicography and are often only of interest to their authors. Just because things have been classified, named, and defined does not mean that they are understood. Our classification of rules has not yet talked at all about how rules are enforced except in the most general terms. Before we can operationalize the different types of rules and look more closely at the nature of rule enforcement, particularly of third party enforcement, we need to look more carefully at the nature of organizations.

#### **4. The Nature of Organizations**

Organizations coordinate human activity. Organizations are bundles of relationships that create incentives for coordinated and sustained interaction between individuals over time and space. Individuals have an incentive to participate in an organization because they are better off if they do so. In the language of classical economics, people belong to organizations because they get rents from doing so. Organizations create rents in two basic ways. The first is characteristic of all relationships that persist through time. When two individuals come to know each other and expect to interact in the future, they have a relationship. Relationships create rents when the alternative to which the relationship is compared is the prospect of dealing with

strangers whom one expects never to meet again.<sup>10</sup> These rents come both from our increased knowledge of the other person and from our expectation that our interaction will continue. These elements enable us credibly to coordinate our behavior through the logic of the folk theorem.

Coordination is the second source of the rents that organizations create. For many activities, people who work in teams are more productive than people who work individually. If the organization is a firm that produces goods, the gains can be measured in terms of physical output. But the gains from coordination are not limited to standard economic activities. Churches are organizations that coordinate behavior in ways that enhance the value of the community and the religious experience. Individual church goers receive rents from their participation in the church's activities, and it is those rents and the personal knowledge that results from participation that enable church goers to coordinate.<sup>11</sup>

Organizations, then, provide a framework for relationships that are more valuable to individuals than one-shot interactions with strangers. The value of relationships makes it possible for people to coordinate their actions, and that coordination in turn generates rents in the form of higher output or benefits than could be obtained by a comparable group of uncoordinated (unorganized) individuals.

Understanding how organizations work has been a mainstay of the new institutional

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<sup>10</sup>When we get to know a person we may learn that we do not want to interact with him or her, but even that negative information produces a rent in comparison to dealing with a person whom we do not know.

<sup>11</sup>Organizations are not the only way that people can coordinate. The gains from specialization and division of labor can be obtained in markets, in which the price mechanism coordinates individual decisions.

economics, beginning with Ronald Coase's (1937) insights about the firm and continuing on through Oliver Williamson (1975 and 1985), Sanford Grossman and Oliver Hart (1985), and a host of others. Robert Gibbons has argued that organizations should be thought of as interlaced bundles of relationships and contracts (1998, 1999, 2003). Relationships between individuals are sustained by repeated interaction and the existence of rents to both parties. Contracts are agreements between individuals that are enforced by third parties, that is, a person outside of the relationship. While some organizations can be described as self-enforcing sets of relationships, most organizations rely on some form of contractual enforcement using third-parties. A robust theory of organizations should encompass both relationships and contracts, rather than relying on one or other as the “organizing” principle.

One starting point for a theory of organizations is the folk theorem intuition that two individuals can maintain a relationship over time if both individuals receive a rent from the relationship. The players in the folk theorem receive rents from their specific relationship, so their individual identity and the identity of their partnership matters. The existence of rents makes their relationship incentive compatible. The folk theorem partnership is what we call an *adherent* organization, an organization where both or all members have an interest in cooperating at every point in time. Adherent organizations are inherently self-sustaining or self-enforcing; they do not require the intervention of anyone outside of the organization. Mancur Olson's famous “Logic of Collective Action” (1965) relies on the existence of rents enjoyed by members of the organized group, which he calls selective incentives, to explain voluntary associations. Members only cooperate if the rents are positive and, critically, if the rents are only attainable within the organization.

Rents are also a critical element of making individual behavior more predictable. The higher the rents an individual receives from an activity, the more predictably will she engage in that activity. Partners in an organization can sustain a higher degree of cooperation when members of the relationship expect to receive higher rents on an ongoing basis. Members who are pushed to the margin are not reliable partners: if a member receives total benefits that are just equal to the total costs of membership, then rents are zero and that member is indifferent to cooperating. The behavior of indifferent partners is unpredictable. Any small change in circumstances may lead them to defect. Organizations want to ensure that all members earn some positive rents so that their behavior is predictable.

If the members of an adherent organization look forward and anticipate that rents may not be sufficient to ensure the cooperation of every member at every point in time in the future, then defection is anticipated and cooperation may unravel. There are, however, ways for the members to protect against defection, like giving hostages, which provide insurance against the possibility that rents will become zero or negative at some point. The threat of killing the hostage imposes large penalties on defection, making possible incentive compatible and time consistent arrangements for the organization. The various folk theorems lay out how such punishments for deviators (non-cooperators) might be credibly imposed (Benoit and Krishna 1985, Fudenberg and Maskin 1986).

The folk-theorem logic is enough to explain the existence of adherent organizations. But organizations that depend only on the coordinated interests of their members without recourse to external enforcement of arrangements are likely to remain small. Ensuring cooperation is expensive, particularly when cooperation is attained through the continual *ex ante* transfer of real

economic assets or costly threats to destroy economic assets *ex post*. Third-parties are one way to reduce the costs of enforcing rules when it is necessary to do so. Rather than tying up valuable resources in the form of hostages or other insurance arrangements within the organization, rules and contracts enforced by third-parties offer a more efficient possible way of ensuring that rents stay positive. An organization's members accept terms and penalties for defections that the third-party enforces. The resources of the third-party need only be engaged when necessary, offering gains from resource use and specialization and division of labor. The incentives facing third-parties are an endogenous part of this relationship.

Organizations that rely on some form of external enforcement of agreements are *contractual* organizations. Anything that an adherent organization can do a contractual organization can do, but many things that contractual organizations can do are impossible to accomplish with purely adherent organizations. A dimension on which enforcement costs can be minimized is the enforcement of default rules by external third parties. For example, Aghion and Tirole (1997) distinguish between formal and real authority in a firm. We have already discussed the example of the manager and subordinate who need to make a decision regarding the location of a new store. As Aghion and Tirole show, “Real authority is determined by the structure of information, which in turn depends on the allocation of formal authority.” (p. 1) The default rule is that the manager makes the decision, but whether the manager decides to make the decision depends on the value of the information he and the subordinate possess. The nature of the default shapes who makes the decision, and in that sense the decision is made in the shadow of the rule, but the actual decision is not described by the formal rule.

As Granovetter noted, “The distinction between the ‘formal’ and ‘informal’ organization

of the firm is one of the oldest in the literature, and it hardly needs repeating that observers who assume firms to be structured in fact by the organizational chart are sociological babes in the woods.” (1985, p. 502)<sup>12</sup> What is important to appreciate in our context is that many of the formal rules that shape organizations and are capable of being enforced by an external authority are, in fact, default rules. As we noted in the previous section, the key to the operation of default rules is not coercion but coordination. As we will see in later sections, default rules are often enforced by coordinated action. What the default rule does is provide the common information necessary to implement the coordination.

In modern large organizations, what is external and what is internal to the organization is a complicated problem. Large business corporations often embody external third party enforcement of organizational rules, internally within the organization. For example, the home office serves as the third-party enforcer for individual plants.

It is difficult to overstate the importance of contractual organizations. Those of us who live in societies with open access to organizational tools may have trouble appreciating just how many of the organizations we consider “voluntary” are contractual, not adherent, organizations. The fact that we do not feel constrained by many of the contractual rules that we can access to structure our organizations is, in large part, because the rules we operate in the shadow of are defaults, not constraints. The default rules often only come into play when relationships erode or break down and individuals opt for the default. One default is always to end the relationship, but

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<sup>12</sup>“It is impossible to understand the nature of a formal organization without investigating the networks of informal relations and the unofficial norms as the formal hierarchy of authority and the official body of rules, since the formally instituted and the informal emerging patterns are inextricably intertwined.” Blau and Scott (1962, p. 6).

others, like killing the hostage, can be much more complex.

As Granovetter observes, the actual behavior of an organization is not described by its rules, but by the nature of relationships within the organization. This is an aspect of rules that goes all the way down to social norms and personal rules. Behavior often doesn't conform to the rule, but that is usually not a problem. Rules are often default arrangements, and when rules are credible, relationships operate in the shadow of the rules.

We swim in a sea of organizational tools so pervasive that we often do not even notice their existence. Which brings us to the central problem of where third-parties come from and how people can believe that credible third-parties will be credible?

## **Part II: The Dynamics of Rule Creation and Enforcement**

The preceding sections laid out the elements that make up institutions: rules, their enforcement, and organizations. The following sections in the paper lay out a way of thinking about societies that explains why some societies are only capable of creating and enforcing anonymous rules, the conditions under which a transition to impersonal rules becomes possible, and a theoretical consideration of why individuals and organizations might find it in their interests to concede to a government the ability to enforce impersonal rules. We think of these as problems of institutional dynamics, because we are trying to explain how institutions change in response to changing circumstances in the world around them.

### **5. The Logic of the Natural State, the Organization of Violence, and the Origins of Third-Party Enforcement**

If we accept the notion that violence cannot be organized through coercion, then we face a deep chicken and egg problem. If violence requires non-coercive incentives to be

organized, and the creation of those incentives depends on agreements or rules that can somehow be enforced, and enforcement of agreements requires an organized third-party that can enforce rules through coercion, then where do we break into this circle of reasoning? Weber sidestepped the problem by endowing the leader with the ability to coerce and to dominate within his organization (and within the limits of legitimacy.) Many theories of organizations assume that the institutional capacity to enforce rules and agreements already exist in the larger society.<sup>13</sup> Such an assumption will not work if our interest is in the emergence of organizations capable of enforcing rules. The institutional capacity to enforce rules and contracts in the larger society has to be created in a manner that is logically consistent with the potential for individuals to be violent. Ultimately, this brings us to the difficult questions of where third parties come from, how people can believe that third-party enforcement will be credible, and the government's potential role as a credible third-party.

In her study of *Primitive Governments* in East Africa, Lucy Mair wrote that: “It has been a principle of this book that a man who wants to secure a following must be able to offer his followers some material advantage.” (1962, p. 136) Mair’s quote begins with the desire of one man for a following. Social scientists have a predilection to think about governments in a similar way: by beginning with a single actor, a powerful individual who has a comparative advantage in violence. They proceed by identifying the interests of this single individual (actor)

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<sup>13</sup>For example, Bolton and Dewatripont begin their *Contract Theory* with the explicit assumption that “the benchmark contracting situation … is one between two parties who operate in market economy with a well functioning legal system. Under such a system, any contract the parties decide to write will be perfectly enforced by a court, provided, of course, that it does not contravene any existing laws” (2005, p. 3).

and then theorize about the conditions under which the enforcer/guardian will honor his or her commitments to provide third-party enforcement to his clients (including protection). Starting with a single actor with a comparative advantage in violence, however, avoids the important questions we must ask about the organization of violence. The puzzle within the puzzle is that violence cannot be organized simply by violence or coercion. A violence specialist cannot organize other violence specialists simply by threatening to beat them up or kill them, because a coalition of any two or more violence specialists can always defeat a single violence specialist, no matter how strong the individual specialist is. Since most male humans are more or less endowed with similar physical capacities for violence, an adherent organization cannot evolve in which one person uses the threat of violence to organize the rest of the group. Organizations that use violence must be organized by something other than coercion.

In NWW, we developed an insight about the organization of institutions to explain how societies come to organize and limit violence. Think of two individuals, each members of a different group. Each of the groups, to begin with, are egalitarian in the sense that no individual is capable of coercing the group and economic outcomes are relatively equal.<sup>14</sup> Suppose that if the two individuals can cooperate and form a coalition, they can overawe either of the groups they belong to.<sup>15</sup> They agree to come to each other's aid in the case of a conflict and by doing so

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<sup>14</sup>The evidence that small foraging bands are quite often aggressively egalitarian seems well established. Whether the small bands that make up the basic unit of most foraging societies are inherently egalitarian or whether they are egalitarian only because of their organizational response to environmental and social conditions, however, is a fascinating question. See Boehm (2001, pp and Kelly (1995, pp. ) for two different views.

<sup>15</sup>The idea that a coalition of just two members will be able to overawe either of the two groups is unrealistic. But beginning with a coalition of just two members is easier to describe and visualize. An actual coalition would need to include enough members to coerce each of the member's groups.

agree to recognize each other's rights to the land, labor, and capital in their respective groups.<sup>16</sup> Because of their coalition, the members are able to coerce their own group and gain control over resources. The land, labor, and capital they control is more productive under conditions of peace than conditions of violence. If violence breaks out, the rents each coalition member gets from his own group go down. Both coalition members can see that there is a range of circumstances in which each member can credibly believe the other will not fight. As a result, the rents from their group serve as a mechanism for limiting violence by coordinating the two coalition members. This is what NWW call the "logic of the natural state."

We do not assume that the coalition members possessed any special physical characteristics. We assume that if coalition members can cooperate, then they can overawe the members of their respective group: their strength comes from their organization. The ability of the coalition members to form a credible coalition is what makes the members of the coalition "violence specialists." They are violence specialists in the sense that only coalition members are capable of calling on the organized presence and violence potential of other members of the coalition.<sup>17</sup> The coalition is an adherent organization, the relationship between the coalition members creates rents from non-violence that provide incentives for the specialists to continue to cooperate. NWW called this organization the "dominant coalition." We continue to do so here.

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<sup>16</sup>The example is unrealistic, in the sense that only two individuals cannot possess enough coercion to overawe either of the respective groups. Two is also too small a number to solve the problem of guarding each other while the other sleeps, a major force for egalitarian outcomes in small groups (Boehm, 2001). So the number of people who reach the agreement to enforce each others claims to property is certainly larger, but two is a much easier number to visualize and represent in the figure that follows.

<sup>17</sup>The comparative advantage in violence that the coalition enjoys vis a via the unorganized general population is a function of the organization of the coalition, not of the violence capacities of the coalition members.

The nub of the agreement within the dominant coalition is about violence and rents. The ability of each coalition member to see that the other members will lose rents if they are violent enables each of them to credibly believe that there is a range of circumstances in which violence will not be used. The organization of each coalition member is more productive if there is no violence. The difference between the productivity of the member organizations under violence and under non-violence are the rents to non-violence. The rents from non-violence make the organization of the coalition members credible and sustainable. Note that the coalition members do not “share” anything except the responsibility of coming to each other’s mutual aid: they each keep the gains from their own organization and there is no sharing rule or *ex post* bargaining.

Figure 1 represents a simple version of these types of arrangements graphically. A and B are members of different groups, represented by the vertical ellipses. The horizontal ellipse represents the arrangement between A and B that creates their adherent organization: the dominant coalition. The vertical ellipses represent the arrangements the coalition have with the labor, land, capital, and resources they control: their “clients,” the a’s and b’s. The horizontal arrangement between the specialists is made credible by the vertical arrangements. The rents the members receive from controlling their client organizations enable them to credibly commit to one another, since those rents are reduced if cooperation fails and the members fight. There is a reciprocal effect. The existence of the agreement between the specialists enables each of them to better structure their client organizations, because they can call on each other for external support.

In Figure 1, the horizontal relationship between the coalition members create an adherent organization. A and B become violence specialists because of their ability to call on each other,

and their ability to coordinate with each other is made credible by the rents each receives from their respective organization. If the relationship between the coalition members is credible, then vertical relationships between the coalition members and their clients can become contractual organizations because the vertical organizations rely on the external third-party presence of the other dominant coalition members. The vertical client organizations might be organized as kin groups, ethnic groups, patron-client networks, organized crime families, guilds, or firms. The combination of multiple organizations, the “organization of organizations,” mitigates the problem of violence between the really dangerous people, the violence specialists in the dominant coalition, creates credible commitments between the coalition members by structuring their interests, and creates a modicum of belief that the coalition members and their clients share a common interests because the coalition members have a claim on the output of their clients.

The society depicted in the figure has a very simple institutional structure. The two rules that can be credibly enforced are both defaults. When there is a disagreement between A and any of the little a's, B uses the default rule that A is right. Likewise, A enforces the default rule that B is always right. The rule has the same structure as the formal vs real rule in Aghion and Tirole. There is nothing in the figure that prevents A from reaching more complicated agreements with the little a's, indeed we expect that A's ability to credibly threaten (coerce) the little a's with B's backing will enable them to reach agreements that they could no reach if their social arrangements had to be essentially egalitarian. How the gains from coordination are shared between A and the little a's is problematic.

The logic underlying Figure 1 provides an intuitive solution to two problems: the organization of violence and the existence of elites. Coordination between A and B depends on

their perception that the other receives rents from limiting violence and coordination, so there will be significant incentives for A and B to keep most of the rents.<sup>18</sup> Elites are, by definition, individuals with significant resources and the power to influence other people. Most theories of elites are very simple, they assume that individuals become elites because of their success at garnering wealth and power for themselves (using any number of means to acquire power). The social dynamics of a society with elites and masses is then driven by the desire of elites to acquire more wealth and the rare possibility that the masses can organize against the elites (think of Marx for one, and Acemoglu and Robinson for another). The logic of the natural state, however, runs on a different track and explains why some individuals emerge as elites with a particular twist. Societies in which elites do not emerge will not be able to use rents to limit violence. If unequal distribution of rents within groups strengthens the ability of the dominant coalition to both limit violence and provide credible third-party enforcement, there will be strong evolutionary incentives (in Alchian's terms) for institutional arrangements with unequal rents to persist. Violence is organized within the coalition of elites through interlocking sets of rents. Because elites are willing and able to credibly serve as third-party enforcers for each other, elites can build more powerful organizations.

The organization of violence serves as a constraint on elite coalitions and elite behavior that is not present in either Marx or Acemoglu and Robinson. While individual elites may pursue their individual wealth, simply maximizing elite wealth will almost certainly bring about conditions in which elites cannot credibly commit to each other, and civil war will result. The

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<sup>18</sup>Historically, or at least anthropologically, there are many possible arrangements for sharing the rents. It does appear, however, that the emergence of larger societies is always associated with the creation of hierarchical elites. That is consistent with A and B realizing most of the rents from organizing violence and coordination. Johnson and Earle (2000).

logic of the natural state suggests that to limit violence societies must also organize violence. The organization of violence occurs through the formation of adherent and contractual organizations, which create powerful elite individuals at the same time that those individuals are constrained by the dynamic relationships within the dominant coalition that provides elites privileged access to third party enforcement for their organizations. The organization of violence and the provision of third party enforcement are endogenous results of elite formation and elite dynamics.

While the figure is a very simple representation, it captures key elements we need to consider. In a functioning society there are many more groups. Members of the dominant coalition include economic, political, religious, and educational specialists (elites) whose privileged positions create rents that ensure their cooperation with the dominant coalition and create the organizations through which the goods and services produced by the population can be mobilized and redistributed.<sup>1</sup> But the simple picture provides enough to see how credible third-parties can emerge out of the social arrangements that limit violence. In the adherent horizontal organization of the dominant coalition, no member or organization has a monopoly on violence. What deters the use of violence is the potential rents that coalition members might lose if they choose to fight. Those rents do not come from within the dominant coalition, but from the vertical contractual client organizations. The members of the dominant coalition are able to call on each other to serve as third-parties. Initially, those services probably include the simple default rule of recognizing each other's boundaries and clients, a working agreement to live and

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<sup>1</sup>North, Wallis, and Weingast, 2009, chapter 2. Earle, 1997 and 2003, and Johnson and Earle 2000, provide a series of anthropological examples of how chiefs come to power and the scale of society increases by the systematic manipulation of economic interests.

let live, and a willingness to intervene in dispute on each other's behalf. But the roots of more sophisticated arrangements lie in the credible commitments that coalition members can make to one another.

The society depicted in Figure 1 has no government. The dominant coalition is the configuration of power in the society. We could call the dominant coalition a “state” if we wanted to, but it is not clear how much would be gained from doing so. There is a structure of power, based in organizations that are mutually supporting through an interlocking set of interests. But there is no public organization, just the members of the coalition and the organizations they head.

The dominant coalition in Figure 1 is an adherent organization. It does not rely on third-party enforcement to ensure that its internal arrangements are credible. But the dominant coalition is neither a Hobbesian nor a Weberian state. Neither A nor B is “the” leader, neither of them is able to give orders to the other, their relationship is based on coordination, not domination. A and B may not like each other, but they coordinate because it is in their best interest to do so. Weber understands that political organizations always live in a complicated environment. At several places in *Economy and Society* he talks about the “power constellation” (p. 1022) or “political constellations” or “political power relations” (p. 986). These constellations of power lay outside the organization of the government, but influence it nonetheless. Our concept of the dominant coalition corresponds to Weber’s configuration of power.

The dominant coalition in figure 1 is not a template for a Weberian state, but it has several very attractive features. Among them is the way that the adherent relationships within

the coalition enable the creation of contractual organizations. The ability of coalition members to call on each other as third-parties for their organizations enables coalition members to convert their adherent organizations to contractual organizations. Undoubtedly, when larger societies began to emerge 10,000 years ago, the nature of third-party enforcement was very limited. But the possibility that the coalition could help enforce agreements within the organization of coalition members, and perhaps more importantly, that the coalition members together could help enforce agreements between their organizations, created new rents from coordination. Following NWW's logic of the natural state, these coordination rents also served to strengthen relationships within the dominant coalition. The rents from coordination worked for social stability in the same way that rents associated with non-violence work for social stability. To the extent that the dominant coalition serves as a third-party enforcer for members' organizations, those organizations are more productive. The rents produced by coordination within the coalition and from the higher productivity of members' organizations strengthen the incentives holding the coalition together.

Note that the coalition's ability to provide third-party enforcement does not depend on interests that members of the coalition share, but on the distinct interests that each coalition member has in their own organizations. The dominant coalition does not act cooperatively to produce a joint product and then figure out how to divide up the gains (the standard contracting problem). Instead, the coalition decides on a series of strategies that make each member of the coalition better off and are thus sustainable, the idea of "rationalizable coalition."<sup>2</sup> These

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<sup>2</sup>Coalition members are not producing a joint product which they must then divide between each other. They are producing individual products, which are more valuable if they coordinate in their use of violence and willingness to enforce each other's rights. Each coalition member can see the incentives for rational behavior facing other members of the coalition. Thus

individually rational interests provide the organizational incentives that make up the relationship among organizations in the “organizations of organizations.” It is the multiplicity of organizations that makes third-party enforcement possible. If there is only one organization, there is no possibility of credible third-party enforcement. There must be at least two organizations. The dominant coalition is an organization of organizations.

A dominant coalition without a government is a better place to start thinking about the emergence of a government. Within the dominant coalition all elite organizations draw on each other for support, even though that “support” should not be thought of as cooperative or altruistic. The organizations are linked through rent creation, at the same time that the primary competitors and threats to elite organizations are other organizations within the coalition. The question about the emergence of an explicit government depends on the willingness of other elite organization to recognize, and support through their recognition, the government organization(s). Governments cannot exist independently of the coalition. This will be a key element in understanding how governments and coalitions interact, which we consider in two sections. In the following section we turn to the critical distinction between anonymous and impersonal rules, and the ability of dominant coalitions to create and enforce them.

## **6. Anonymous and Impersonal: Relationships, Exchange, and Rules**

An important implication of the logic of the natural state as depicted in Figure 1, is the importance of anonymous rules to the coherence of the dominant coalition. As we discussed earlier, anonymous rules depend for their form and enforcement on the social identity of the people involved. The adherent organization that A and B establish creates a personal

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a coalition emerges between non-cooperative actors, in which coordination is achieved, see Ambrus (2005).

relationship between A and B, but it also sets up the possibility of creating and sustaining rules based on the identity of individuals as members of A or B's organization. The essential element that binds the interests of A and B is the unique privileges they enjoy from their organizations and the enforcement of those privileges that the elites provide to one another. A and B cannot be treated impersonally, if the rules that apply to A and B are impersonal, the rents that hold the dominant coalition disappear.

Likewise, A and B are unlikely to want impersonal rules and enforcement to apply to their client organizations. The rules that A forms for his client organization that B can be called on to enforce will likely differ from the rules that B calls on A to enforce for his client organization. Because the circumstances, personalities, histories, and conditions of A's group are unlikely to be identical to B's group, we would expect different rules to coordinate relationships within the group. Even if A and B decided to adopt the same rules for their client organizations, however, it is unlikely that A and B could credibly enforce the rules in an impersonal manner. Remember, the rents that enable A and B to credibly commit to each other come from their client organization and clients. If an 'a' is charged with violating a rule, and B sits in judgement on the violation, then A is in a position to extract rents from 'a' if he (A) intercedes with B on behalf of 'a'. The ability of A and B to alter the way in which rules are enforced for the clients, is an important source of rents. For example, Alston and Ferrie attribute the persistence of 'patronage' in the American South into the middle of the 20<sup>th</sup> century in large part because of the rents that wealthy white patrons could extract from their poor white and poor black clients by interceding on the client's behalf in the legal and social systems.

While patronage systems have a bad name in development economics, we should not

rush to condemn anonymous rules as some kind of second best method of rule enforcement. As we discussed earlier, rules and their enforcement can never be divorced from the social environment. In a society where the constellation of power is in a natural state configuration, impersonal rules cannot credibly be enforced, and anonymous rules can generate better social outcomes. All organizations, public and private, have the capacity to create and enforce anonymous rules. When we suggest that societies that cannot create and enforce impersonal rules lack “capacity” we typically do not ask the extent to which those societies have the capacity to enforce anonymous rules, nor have we developed a sense of when anonymous rules are better or worse for social outcomes.

Both economic history and institutional economics have stressed the importance of impersonal relationships as a foundation for modern economic development and growth. We have, however, been vague about how impersonal relationships are defined. In one definition, impersonal relationships occur when two individuals interact in a way that does not depend on their personal or social identity. The essence of this form of impersonality is “treating everyone the same.” While the definition is not controversial, it is not the one most often used in the social science of institutions. As just described, the problem of impersonal relationships is usually motivated by considering how two individuals who do not know each other personally and have no expectation of a continuing relationship in the future can come to agree on a social relationship. This definition of impersonal is simply “not personal.” Defining an impersonal relationship as dealings between individuals who do not know each other personally, however, differs considerably from the impersonality defined as treating everyone the same.<sup>3</sup>

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<sup>3</sup>Impersonality is not a key concept for Weber, but when he uses the term it tends to reflect the “not personal” definition of impersonality. “Among the prebureaucratic types of

Institutional economics has come a long way towards understanding how anonymous rules embedded in a network of organizations can be used to support anonymous exchange.

Here is how Avner Grief defines “impersonal” exchange:

What were the institutions, if any, that supported interjurisdictional exchange characterized by separation between the *quid* and the *quo* over space and time? Specifically, were there institutions that enabled such exchange that was also impersonal, in the sense that transacting did not depend on expectations of future gains from interactions among the current exchange partners, or on knowledge of past conduct, or on the ability to report misconduct to future trading partners?

The theoretical and historical analysis presented here substantiates that in premodern Europe impersonal exchange characterized by separation between the *quid* and the *quo* across jurisdictional boundaries was facilitated by a self-enforcing institution: the community responsibility system.(Greif, 2006, p. 309)

Greif motivates impersonal exchange as a relationship between two individuals who did not know each other, but could nonetheless reach agreements that spread across space and time.

What Greif describes is anonymous exchange embedded in larger social organizations that enable individuals to credibly deal with one another because expectations about the other's behavior are grounded in the social constraints on the other person.

Grief is not wrong to define impersonal exchange this way, North defined it similarly in 1990 (pp. 34-35). But defining “impersonal” as “not personal” obscures the difference between

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domination the most important by far is patriarchal domination. Essentially it is based not on the official's commitment to an impersonal purpose and not on the obedience to abstract norms, but on a strictly personal loyalty... Such personal authority has in common with *impersonal* oriented bureaucratic domination stability and an “everyday character.” (Weber, 1978, p. 1006) Or in terms of the bureaucratic administrative mechanism: “The objective indispensability of the once-existing apparatus, in connection with its peculiarly “impersonal” character, means that the mechanism – in contrast to the feudal order based upon personal loyalty – is easily made to work for anybody who knows how to gain control over it.” Weber associates impersonality with rationality, as the quotation continues: “A rationally ordered officialdom continues to function smoothly after the enemy has occupied the territory; he merely needs to change the top officials.” (1978, pp. 988-9) Weber equates impersonality with the identification of a person, like a bureaucrat or official, with an organization. Weber's impersonality is anonymity.

anonymous and impersonal relationships. Neither Grief's nor North's definitions of impersonality differentiate between treating everyone the same – impersonality – and dealing with people you do not know personally because you know what organization they belong to – anonymity.

For our purposes it is important to understand that organizations form the social background for anonymous relationships to flourish. As Greif shows, the ability of organizations to create and sustain rents within the organization enables organizations to credibly interact in ways that enhance those rents. Organizational rents are the fundamental engine that make Grief's examples of the Maghribi traders or the community responsible systems work. A trader from Genoa could trade confidently in Hamburg, because he was identified as a merchant from Genoa. If he was cheated in Hamburg, the merchant guild in Genoa would expropriate all of the Hamburg merchants currently in Genoa. Because both Hamburg and Genoese merchants earned rents from trading, and those rents were at risk if the two communities were willing to carry out punishments, as long as merchants could be easily identified as members of the Hamburg or Genoese merchant guilds the community responsibility system could sustain anonymous relationships. Rents generated within organizations enable individuals to deal with one another credibly across organizations. These anonymous relationships are embedded in organizations rather than personal relationships.<sup>4</sup>

The community responsibility system reflects the logic of the natural state. It is possible to have private ordered contractual relationships (without government), because there are two or

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<sup>4</sup> Granovetter's (1985) notion of the embeddedness of economic actions in social structure is precisely what we are identifying in the notion of anonymous relationships. As Greif explains, the community responsibility system began breaking down when it became difficult to identify specific merchants with city guilds.

more organizations with interlocking interests. Identity matters, and it is the identity of the organization an individual belongs to that enables coordination on a larger social scale. The community responsibility system can both formulate and enforce laws, indeed it can be thought of as capable of “rule of law” in the sense that the rules are understandable, predictable, and enforced in an unbiased way. But it is a set of anonymous rules that apply differently to different people.<sup>5</sup>

The rules that the community responsibility system is capable of enforcing may have the form of modern commercial law, but their enforcement depends on social dynamics embedded in organizations in a way that makes them anonymous rather than impersonal rules. This is a tricky distinction, because the visible form of an explicit rule (a formal rule) may not correspond to its enforcement. Simply saying that the rules apply equally to everyone does not make them do so.

Societies based on anonymous relationships have trouble enforcing impersonal rules because the very logic of what holds the organizations together is that everyone is not treated the same, that every organization possess unique and valuable privileges.<sup>6</sup>

## 7. Governments, Coercion, Rules, (and States)

So far we have deliberately avoided the term “state” and focused on the concept of government as a public organization. We don’t see much to gain in grappling with all of the potential definitions of a state, but in this section we comment on states in passing while examining more closely the role of violence and coercion in most societies, as well two

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<sup>5</sup>Whether “rule of law” requires that all people be treated the same is a definitional matter, and there are many definitions of rule of law. Perhaps we shouldn’t get into rule of law here.

<sup>6</sup>The conflict between organizations and rules is explored in more detail in Wallis (2011).

examples of the origin of rules and legal systems.

The logic of natural states enables us to see how the presence of two or more organizations can create an environment in which third-party enforcement of anonymous rules is possible. Are those rules enforced by coercion? If B enforces rules that apply in A's organization, the little a's are likely to view both A and B as coercive, and legitimately feel that some of the rules that govern their relationship with A are coercive. The relationship between A and B makes third-party rules credible. While both A and B possess coercive ability, their threats to use violence against each other are options that are only part of what makes their relationship credible. The source of the coercive third-party rules is, in fact, the benefits that arise when A and B are able to coordinate. The benefits of coordination within the organization of the dominant coalition sustain third-party rules, not coercive authority.

This raises a paradox in how we both think about and obtain evidence on how societies are organized. Coercion is the threat of violence. In a natural state, everyone feels coerced because everyone is threatened by violence, even A and B are coerced by each other. The threat of violence is an inherent part of the credible commitments that make social arrangements sustainable and, yet, what limits violence is not the threat of massive retaliation, but the perceived loss of the benefits of coordination that follow if violence is used. This is a manifestation at a more aggregate level of the point we raised earlier: violence cannot be organized by violence. In a society in which everyone, even the powerful, feel threatened by violence, it is the benefits from coordination that limit violence, not the threat (or promise) of more coercion that limits violence.

This conclusion is distinctly different from the Hobbesian conclusion. Hobbes argues

that all people feel threatened by the possibility of violence (they are coerced) and sometimes a rational response to the threat is to strike first. The solution to the presence of coercion is to consolidate an overwhelming amount of violence potential in one person or group (and Hobbes is very clear that the leviathan can be a group) and use the threat of overwhelming violence to obtain compliance with the rules. Hobbes assumes that individuals will be willing to concede to this arrangements because of the enormous benefits of peace and stability.<sup>7</sup> Perhaps you needn't be reminded that Hobbes lived in a natural state, surrounded by natural states, in a century under the dramatic and persistent threat of civil war. The solution to endemic violence was a powerful ruler, and then by Hobbes's logic other good things would follow, like rules, that would be in the interests of the ruler and the ruled to follow. In Hobbes, it is coercion that creates the possibility for better coordination.

Fear of violence is not a collective illusion. People believe they are threatened by violence because they really are. The natural inference that the source of social order derives from the threat that violence will be used when rules are violated, is the source of support for rules ala Hobbes. Such an inference has enormous intellectual appeal. Hobbes's solution is to vest overwhelming violence potential in a single actor or organization, nonetheless the notion of a balance of power produced by the countervailing threats of violence provides an intuitive conceptual framework for social order. Powerful individuals and organizations are constrained

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<sup>7</sup> For the overriding benefits of peace and stability see Skinner (2002) and Wallace (1963) on the engagement controversy during the English Civil War. After the execution of the King in 1649, the Commonwealth government required individuals to swear an oath of "engagement" to the new government. A debate then ensued in different segments of English society about whether it was appropriate to recognize the *de facto* government as legitimate solely on the basis of its hold on power, rather than a *de jure* legitimacy. The benefits of peace and stability were the primary reason for recognition of a *de facto* government as legitimate.

from using violence by the threat of violent retribution from other powerful individuals and organizations. We do not deny the logic of such arguments, or the likelihood that violence is often been deterred by the threat of violence in many societies.

Yet we seriously doubt societies have gotten better at coordinating diverse individuals through impersonal rules by inventing more intricately balanced arrangements for threatening violence. The idea that individuals are willing to obey rules because the costs of the lost benefits of social coordination, rather than the fear of coercive penalties, generates a more satisfactory framework for understanding how societies move to more complicated and sustainable social arrangements. At the risk of repeating our qualification too often: we are not arguing that coercion cannot be used as a method of rule enforcement underlying social coordination. We are arguing that rule enforcement based solely or primarily on coercion will not generate social dynamics that lead societies towards better social arrangements. In contrast, rule enforcement based on the foregone benefits of coordination does offer the possibility, but not the certainty, of changing social dynamics towards better social outcomes sustained by coordination. This distinction is messy and difficult to make in a natural state where the rules that are being enforced are anonymous rules, and part of what makes the anonymous rules credible is the threat of coercion. What we hope to show is that the distinction becomes crystal clear when we consider the transition from natural states to open access orders, which must be accompanied by the emergence of impersonal rules on a large scale (NWW, ch. 5).

In the development context, that is within natural states, the tricky part is understanding how better coordinated social arrangements develop while simultaneously providing the right incentives not to use violence. We are not going to go into that problem here, but you can see

why a better understanding of anonymous rules is a prerequisite for understanding how better legal and political institutions “develop” in a natural state.

Much of the interest in rules that structure relations between “unrelated” individuals who neither have no past or future relationship nor whose relationship is embedded in organizations is directed at understanding how such rules can expand the extensive margin of relationships.

Their role in modern economic growth is largely attributed to increasing the number of sustainable relationships. The tendency has been to emphasize the government’s role in expanding the range and number of individuals who can interact with one another and from which the primary benefits are gains from trade and specialization, ala Smith’s “tolerable administration of justice.”<sup>8</sup> What such an emphasis misses, however, is the role of government enforced impersonal rules at enhancing the efficacy of rules at the intensive margin. In effect, we want to emphasize not the effect of rules on the number of relationships, but on the quality and value of those relationships. Impersonal rules, particularly impersonal default rules can make existing personal and anonymous relationships between individuals and organizations with long standing relationships more productive and valuable. We tend to think of impersonal rules as substitutes for personal and anonymous rules, when in fact they are definitely complements. The relatively neglected impact of impersonal rules on personal relationships turns out to be a critical element in understanding the dynamics that lead to impersonal rules.

One mistake we made in the framework of our book with Barry Weingast (NWW) was the implication that governments emerged when foraging orders made the transition to natural

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<sup>8</sup>For explicit consideration government’s role in extending the scale of social coordination through the provision of credible impersonal rules see North (1990, throughout the book but particularly pp. 34-5.)

states. Although we were careful not to use the word government or state when we talked about the formation of dominant coalitions, we nonetheless left the distinct impression that the dominant coalition in a natural state was something like a government.<sup>9</sup> We now realize that governments emerge, historically and in the conceptual framework, from within dominant coalitions. The role of governments is to facilitate coordination within the dominant coalition: governments are not coordinating people who would otherwise not coordinate, governments are enhancing the value of individuals who are already embedded in relationships through personal and anonymous arrangements. As an organization within the dominant coalition, government organizations may do many other things, but the essence of their role as a government is to enhance coordination within the coalition. As we argued in section 5 on the logic of the natural state, because no single organization is capable of coercing the entire dominant coalition a key implication is that governments provide coordination through coordinating rules, rather than coercive rules. Until modern societies appear with their government monopolies on violence, government organizations rarely possesses the ability to enforce rules through coercive power alone.

It is necessary, therefore, to delineate the difference between governments and dominant coalitions. Explicitly, we need to distinguish between a formal public organization, the government, and the network of organizations that represent the configuration of power in a society. Weber defined the modern state as the organization with a monopoly on the legitimate

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<sup>9</sup>We muddied the waters even further when we introduced the notions of fragile, basic, and mature natural states and defined them by how organizations related to the “state” without being clear about whether the state was a formal government or the dominant coalition. This is where the case studies applying the NWW framework in contemporary developing countries presented in North, Wallis, Webb, and Weingast (2013) were so important in leading us to reconsider the role of government in the provision of impersonal rules.

use of violence, an accurate description of how modern developed societies deal with violence. The Hobbesian state, in contrast, required an overwhelming coercive power at the disposal of the leviathan, even though he did not require a monopoly on violence. We must guard against the tendency to assume that a monopoly or preponderance of violence is an essential characteristic of “state-ness” or, more accurately for our approach, “government-ness.” There is no historical teleology that moves societies toward an ideal form of governments with a monopoly on legitimate violence. We definitely do not want a conceptual framework that embeds such a teleology.

To be clear, we want to place the origins of or rationale for government as a public organization in the midst of the dominant coalition, where the rational for its existence as a distinctively public organization is the role it plays in coordinating elite organizations and individuals within the coalition (and inevitably the larger society as we will see). The dominant coalition pictured in Figure 1 does not have government, but a government can enhance the value of relationships within the coalition. We want to stress the effect of government coordination on relationship between elite organizations, not the relationship between elite organizations and the government organization. It is critical to understand the role that government provides in enhancing private ordered relationships within elite organizations and between elite organizations in the dominant coalition.

Two historical episodes from the anthropology and legal history literature illustrate the point. These were cases where the existence of a government actor or organization provided pure coordination services that were not backed up by coercive power. The first example comes from Lucy Mair’s work on the Nuer tribe in late 19<sup>th</sup> and early 20<sup>th</sup> century Sudan. The second

from Berman's history of the earliest post-Roman legal codes in Europe, that develop around the 7<sup>th</sup> and 8<sup>th</sup> centuries. In neither case do governments coordinate through their coerce, but in both cases governments limit violence in the dominant coalition and the larger society through enhancing the value of private ordered coordination. Both examples involve the institution of the "feud," but in very different historical circumstances.

For most of human history in most societies, many groups and organizations possessed the means of violence and used violence regularly. The evidence that hunting and gathering societies were more violent than the agrarian based societies that followed them historically is growing, and the evidence that the overall rate of violence in human societies has fallen appears indisputable.<sup>10</sup> Falling levels of violence imply higher levels in the past. In societies with high levels of violence we expect that private provision of protection will be prevalent, and that those societies will develop social institutions to minimize the adverse effects of endemic violence if possible. Among the most interesting arrangements that arise to protect against violence is the institution of the feud. Feuds are a systematic way for individuals to organize retribution for harms in a world where limited third-parties exist to enforce rules. Feuds are often called self-help institutions. Feuds usually originate in personal interactions, but grow into disputes between families, kin groups, and larger social organizations. Feuds are based in a social agreement about what legitimate actions a person, their families, and their friends can take to redress an injury, including murder. Social arrangements about the legitimate causes for and conduct of feuds come into being in societies where the use of violence is widespread and, by definition, is not monopolized by one group. Feuds are always about the invocation of

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<sup>10</sup>For evidence on the falling level of violence see Pinker (2011). Steckel and Wallis (2007) provide evidence on the level of violence in hunter-gatherer societies.

anonymous rules that define individuals and their relationships by their social identity as members of particular groups.

Using the feud as an example to think about governments and states has several advantages. First, the feud ties directly into a dominant stream in the theories about violence and states that have been proposed by scholars like Robert Bates (2001, 2008, and Bates, Grief, and Singh 2002). Bates uses the feud as an example of the private provision of protection, and then builds a theoretical explanation for how the systematic provision of protection, and ultimately the state, evolves out of private protection. Bates is Hobbesian, in the sense that it is the ability to wield violence that enables the protector to provide protection and, eventually, justice.<sup>11</sup> The feud is also intimately related to the anthropological and historical evidence we have on the organization of governments in relatively simple societies. Bates's idea are grounded in the anthropology of African states, for example, Mair, Gluckman, and Evans-Pritchard to which we now turn.<sup>12</sup>

The feud is a central institution in the society of the Nuer tribe. The Nuer tribe was composed of about 80,000 people who shared a common language and folk ways, lived in small groups or bands of 30 to 50 people, and were connected by a set of kin and marriage networks, what anthropologists call segmented lineage societies. Because women (men) leave their band to marry, but maintain contact with their families, all individuals have two interrelated sets of relatives. One set is the set that the individual married into, the other the set that the individual is

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<sup>11</sup>This aspect of Bates's argument parallels Barzel's (2001) notion that individuals with a comparative advantage in violence also have a comparative advantage in the provision of justice, provided that the protectors can be adequately incentivized.

<sup>12</sup>See Bates (1983) and Mair (1962). Gluckman starts off his 1953 lectures with a discussion of "Peace within the Feud."

descended from. There are no central administrative officers or functions in the Neur, who are fiercely independent.

Violence is deterred in Neur society through the institution of the feud. Individuals who are harmed, or feel they are harmed, by the action of another, undertake to obtain justice or redress through a set of actions that can include violence. Violence can expand to include other members of a group, or larger lineage units. Opportunities for confusion abound, since individuals are linked through multiple lines, some of which may come into direct conflict in a feud. Since feuds involve more than reciprocal violence, for example individuals from feuding groups do not share food, knowing when and what feuds are ongoing is important for the Neur. Likewise, knowing when feuds have ended is important.

The position of the “leopard skin chief” is Mair’s example of the first form of government in the Neur society. A leopard skin chief has the ability to confirm that a feud has ended by performing a public ritual. The ceremony signals to the relevant groups that relationships can go back to normal. The chief, however, has no power to coerce either party to the feud. If the feud reignites after the ceremony, the chief does not discipline either group. The function of the chief is to provide public knowledge that the feud has ended. The chief is a third-party participant, but not a third-party enforcer. The chief’s role is critical in enabling coordination within Neur society, because of his ability to create common knowledge through ritual, including common knowledge about specific individuals and groups.<sup>13</sup> The leopard skin chief performs a vital public government function, yet a function that does not involve coercion.

The leopard skin chief is a very simple form of government and the Nuer are a unique

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<sup>13</sup>On the role of ritual as a means of creating public, common knowledge see Chwe (2003).

and specific society, yet the example demonstrates the important ability of governments as public organizations to leverage up the coordination capacity of private actors. In the leopard skin chief case, the publicness of the government conveys information to everyone. The aspect of publicness is critical for identifying which organizations are actually governments and therefore is an essential element of all governments. Publicness is a complicated attribute. Most government organizations do many things, and many of the things that governments do have little to do with their being governments.<sup>14</sup> Publicness is not a zero/one condition, it is a continuum along which government and private actions are apparent to people within the society.<sup>15</sup> A key aspect of government enforced default rules is their potential for being public rules that are widely known.

The feud provides us with another historical example. Berman's sweeping history of law in Western Europe in the second millennia begins with a review of the earliest surviving western law codes, first the *Lex Salica* issued by the Merovingian King Clovis in 496:

"It starts by listing monetary sanctions to be paid by a defendant to a plaintiff for failure to respond to appear in the local court. It also lists monetary sanctions to be paid by wrongdoers to injured parties for various kinds of offenses, including homicides, assaults, thefts. These are typical of primitive law; one of their principle purposes was to induce parties to a dispute to submit to a decision of the local assembly (the hundred court) instead of resolving their dispute by vendetta, or else to provide the basis of negotiation between the household of the victim and that of the offender. Sometimes, however, they

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<sup>14</sup>As Weber said (1948, pp. 77-78): "But what is a 'political association' from the sociological point of view? What is a state? Sociologically the state cannot be defined in terms of its ends. There is scarcely any task that some political association has not taken in hand, and there is no task that one could say has always been exclusive and peculiar to those associations which are designated as political ones."

<sup>15</sup>Acemoglu and Jackson (2011), develop a model in which the only attribute of leadership that matters in a game of social coordination is that the leader's action is publicly known to all decision makers who follow in the game (which is a sequential game of agents who live for two periods), while the actions of non-leaders is not public.

did not even have that effect. The injured party, in the words of one of the Anglo-Saxon laws, might either “buy off the spear or bear it.” The prevalence of private warfare was connected with the great difficulty of bringing a person accused of wrongdoing to trial or getting witnesses to testify or enforcing a judgement.” (1983, pp. 53-4)

Although the end of the quotation stresses the prevalence of private warfare (feuds) was due to the lack of an effective judicial system, Berman’s central point is that these legal codes form the basis for the development of a substantive legal system. The codes have detailed penalties for different damages, and importantly the penalties not only reflect the damages but the status of the person who was damaged.<sup>16</sup> Murder carries larger penalties than maiming, but killing a noble carries a much higher penalty than killing a slave.

Two features of these legal codes are important for our purposes. First, they were default rules that listed detailed default penalties for specific injuries to specific individuals. They were not only anonymous rules (they did not apply equally to everyone, yet they did not apply differently to everyone either, they applied to well specified groups of people), they were clearly defaults. Individuals could decide to resort to violence to redress their grievances, or they could go to court. If they went to court, the potential damages were publicly known before they went

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<sup>16</sup>“Ethelbert’s laws are remarkable for the extraordinary detailed schedules of tariffs established for various injuries: so much for the loss of a leg, so much for an eye, so much if the victim was a slave, so much if he was a freeman, so much if he was a priest. The four front teeth were worth six shillings each, the teeth next to them four, the other teeth one; thumbs, thumbnails, forefingers, middle fingers, ring fingers, little fingers, and their respective fingernails were all distinguished, and a separate price, called a *bot*, was set for each one. Similar distinctions were made among ears whose hearing was destroyed, ears cut off, ears pierced, and ears lacerated; among bones laid bare, bones damaged, bones broken, skulls broken, shoulder disabled, chins broken, collar bones broken, arms broken, thighs broken, and ribs broken; and among bruises outside the clothing, bruises under the clothing, and bruises which did not show black.

If the act of the defendant caused death, the price to be paid to the kin of the deceased was called *wer* (or *wergeld*). Much of written Germanic (including Frankish and Anglo-Saxon) law was concerned with setting different measures of wergeld for different classes of people.” (1983, p. 54)

to court.

Second, although Berman notes the important role that these heavy penalties could have played as deterrents and the role that they played in allowing a peaceful settlement of the feud, he concludes that “In functional terms, the institution of monetary sanctions for crime, payable by the kindred of the wrongdoer to the kindred of the victim, is to be judged, not primarily by the extent to which it served to deter or to punish or to compensate for a crime, but primarily by the extent to which it served to forestall family vendettas and, more particularly, by the extent to which it facilitated negotiation and mediation between hostile families.” The key to these default rules is their ability to facilitate coordination between members of the dominant coalition. The penalties served as a very public signal that compensation for the damages had been paid and normal relationships between the parties could resume.

Indeed, the courts had no powers of enforcement themselves. The enforcement mechanism was very Piagetian, powerful individuals who wished to continue to enjoy the benefits of inclusion within the dominant coalition abided by the decisions of the court, or they were excluded from the game. There was no coercive power of government to enforce these decisions, only the self-interest and self-enforcing arrangements within the dominant coalition. Private parties could decide to “buy off the sword or bear it.” But the decisions were government decisions, provided by a public organization without the means of coercion but endowed with the means of publicly creating common knowledge.<sup>17</sup> Individuals who did not abide by the court

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<sup>17</sup>Kuran and Lustig (2011) examine the administration of justice in Ottoman Courts in the 17<sup>th</sup> century. The note that most cases the courts simply issued decisions which were enforced by the community, rather than by the government. A difference between the Ottoman courts and the Christian and Jewish courts of the time, however, was the possibility that the Sultan could be called on to enforce a decision. Again, coercion was important, but the key element in enforcing decisions was coordination. Milgrom, North and Weingast (199 ) and Greif, Milgrom, and

decisions would not be coerced, but they could bear significant costs from the loss of relationships within their communities.

Even legal systems that eventually grew to include coercive powers often began in courts whose effectiveness was based completely on public coordination. The process of initiating a case in Roman or English law was also highly ritualized. Plaintiffs and defendants had to perform exactly the right actions and speak the right words in order for their cases to move through the process. Courts made decisions, often according to default rules, and then left enforcement up to the aggrieved party. The social sanction that ensured enforcement of decisions was not the power of the aggrieved party but the benefits of social coordination that the defendant would lose if he did not abide by the decision.<sup>18</sup> Over time in Rome, in Europe, and in England the government came to play a more active role in enforcing the decisions of the courts, but the origins of the courts lie in coordination, not in coercion. The courts utilize the coordinating dynamics within the dominant coalition for enforcement.

## **8. The Shadow of the Law and the logic of government enforcement through coordination**

We are close to understanding the conditions under which elites would be willing to concede to the government the ability to enforce impersonal rules. As we have seen, governments can never have a monopoly on the enforcement of anonymous rules, because organizations can always create inter-organization arrangements to order their relationships.

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Weingast provide examples of how trade relationships were made credible by the threat that relationships would not extend into the future, rather than the threat of coercion.

<sup>18</sup>“There was no direct state enforcement of the appearance of the parties or of the execution of the judgement, and there were no professional judges.” This was changed after the Edict of Julian in the fourth century AD (I think), Nicolas, pp. 27, see also page 22. For the forms in English law see Maitland (1909). In English law there was a growing use of coercive power to enforce court decisions.

Governments can play an important role in enhancing the value of private ordering, as shown in the last section, and do not necessarily need to use coercion to do so. Elites may be willing to voluntarily agree to submit to government enforcement of some anonymous rules, under the expectation that the rules will still continue to apply differently to different elites (status and privilege as it were). The extent to which dominant coalitions can make credible arrangements that sustain coordination within the coalition and society will play an important role in social outcomes. Societies that are better organized will typically have better outcomes, *ceteris paribus*. What remains to be shown is the extent to which government enforcement of default rules does not necessarily bind elites, but opens up wider possibilities for productive elite arrangements. This gets us in to a subtle discussion about enforcement.

In his classic book on the development of American law in the 19<sup>th</sup> century, James Willard Hurst noted the paradox that while Americans thought that they were developing a laissez-faire society, in fact they were doing so by involving government more closely in the details of their daily lives.<sup>19</sup> At one point, in a quote we have been unable to locate for this draft, Hurst points out that while freedom of contracting is often interpreted as laissez-faire, in fact it is inserting the government more directly and coercively, into private arrangements. The following

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<sup>19</sup>Guy Callender began up his 1902 article with exactly the same argument: "It is a commonplace observation that the last century witnessed everywhere a great extension of the activities of the State into the field of industry. Americans are not accustomed to think of their own country as taking a very prominent part in this movement, much less as having ever occupied a leading position in it. To them, as to the rest of the world, America is the land of private enterprise par excellence; the place where "State interference" has played the smallest part, and individual enterprise has been given the largest scope, in industrial affairs; and it is commonly assumed that this was always so... Nevertheless, it is a fact that this country was one of the first to exhibit this modern tendency to extend the activity of the State into industry. And it advanced so rapidly and so far along this line that it became for a time almost as prominent an example of it as the Australian colonies are in our own time." (1902, p. 111)

long quote gives Hurst's clear sense that what the United States did was to lend the coercive power of the government to private parties:

Let us turn back to this central institution of private property. It consisted in very important degree of legal limitations on the power of government and so far seems to exalt laissez faire as the keystone policy. But the law of private property – the law of the autonomy of private decision makers – included also positive provision of legal procedures and tools and legal compulsions to create a framework of reasonable expectations within which rational decisions could be taken for the future. Of course, businessmen's invention – and, even more, their initiative – joined that of lawyers to fashion instruments of dealing; and of course, men abide by the agreements for other reasons than fear of lawsuits. But it does not exaggerate the role of law to see that its procedures and compulsions were inextricably involved in the growth of our market economy. By providing authoritative forms of dealing and by enforcing valid agreements, we loaned the organized force of the community to private planners.

Throughout the enthusiastic nineteenth-century expansion of contract, two sobering strains of doctrine attested that the courts never wholly lost sight of the fact that their enforcement of promises involved delegating the public force in aid of private decision making. (Hurst, 1956, pp. 10-11)

Hurst conceives of the law as requiring coercive power, indeed that the fundamental problem of law in early 19<sup>th</sup> century America was to find a way to lend the coercive power of the government (the community) to private individuals to secure their ability to contract in such a way as to “release” their economic energy. The government as a third-party enforcer of contracts is, in fact, a party to the contract. The parties call on the government to lend the contractual provisions the force of the government's coercive power. The central problem, then, is to somehow limit the government's ability to use its coercive power. We are challenging this paradigmatic view of government.

The discussion of default rules in section 3 highlighted the feature of default rules not as constraints, but as defaults. A government that enforces a default rule does not enforce the contract the two parties write. The government enforces a publicly known rule that exists outside of the arrangement of the two parties. The parties bargain in the shadow of that rule.

The detailed arrangements the parties reach between each other, their “contract,” may not be enforceable in the courts and indeed the parties may have no intention or expectation that disagreements over some terms of their contract can ever be resolved by a third-party. In both the economics and law literatures these aspects of agreements fall under the rubric of incomplete contracts. Whether the actual agreement between the parties is incomplete or not is not really the issue. Incompleteness stems from the inability to use third-party enforcement for all the dimensions of a contractual agreement.

The key element to see is not the inability of the government to enforce all and every aspect of a contractual agreement, it is that by enforcing some elements of agreements in a pre-determined way the government enables contracting parties to reach a wider and more productive set of contractual agreements. This wider set of contractual arrangements will include details that the government will not enforce. The pre-determined features of relationships are default rules, not constraining rules. Governments do not impose the default rules on private parties, nor is the government promising to enforce whatever agreement the private parties reach. Hurst’s vision of the government as inextricably involved in the private contract by lending its coercive force to the private actors, but a government enforcing a default rule is not involved in the actual agreement the private parties reach nor does it lend its coercive power to the parties. The government is defining an outside option for the parties. If they chose to activate the outside option they may, but they may chose not to and they are certainly not coerced into activating the option.

In this important sense the default rule stands in relation to the agreements of the private parties just as the formal rules stand in relation to the informal arrangements within an

organization that we discussed in section 4. Aghion and Tirole's (1997) distinction between formal and real authority reflects the same idea, the default rule is not the real rule that governs relationships between private parties. Granovetter's dictum that "The distinction between the 'formal' and 'informal' organization of the firm is one of the oldest in the literature, and it hardly needs repeating that observers who assume firms to be structured in fact by the organizational chart are sociological babes in the woods" (1985, p. 502) mirrors the reality in the larger society: most formal rules are not constraints that shape behavior and are therefore visible in behavior, they are defaults that support arrangements between individuals and between organizations.

How the world actually works will not follow the default rules in detail. Truly impersonal default rules can unleash a tremendous amount of private ordered contracting that is freely entered into by private parties and is not constrained by the government rules but, instead, lives a vigorous life in the shadow off the default rules.

Lawyers and legal theorists both recognize and struggle with the notion of default rules. They are often concerned primarily with how the law works in the courts when disputes have to be resolved. As Hadfield and Weingast (2010) discuss, the attributes actively displays are not the only attributes of a legal system. "We do not identify voluntary compliance with law as the absence of law; it may instead reflect a highly functioning legal order, where decentralized enforcement works more efficiently than solely a state-sponsored coercive system. Most disputes never reach courts, in part because of bargaining in the shadow of the law (Mnookin and Kornhauser 1979), but also because of decentralized enforcement." (p. 4) Much of legal and social science theorizing about law focuses on a subset of behavior that is visible in the legislatures and courts, and not the effect of law on the behavior which is neither immediately

visible nor seems to correspond to legal forms.

How does this help us understand the behavior of elites, and particularly their willingness to voluntarily concede to government the ability to enforce impersonal rules? There are four elements to our argument. One is tautological: elites must benefit significantly from the move to impersonal rules or they will block the move. The second is that the move must benefit all elites, rather than a subset of elites. Anonymous rules and natural state arrangements offer a way for the dominant coalition to manage internal division over the allocation of rents and privileges. Although the balance created by the allocations can seem more stable at some times than others, there is always a significant fear that arrangements will unexpectedly begin to break down and violence will increase. To the extent all natural state societies live in the shadow of violence, any move towards impersonal rules that imposes significant costs on a major elite group is unlikely to be sustained, as the affected group will threaten violence. A preponderance of elites must (in Levi's term) "quasi-voluntarily" agree to abide by the rule and that will require that the benefits of the rule be widely spread throughout the elite.

Third, and more difficult to grasp, is that the move will be more likely to succeed if the change is perceived by as an increase in their freedom to operate rather than an imposition of a government's coercive power. Hurst's observations into the "myth of laissez-faire" in early nineteenth century America offer some important insights here, although not the ones that Hurst drew from his history. Hurst highlighted the inconsistency of liberal and libertarian beliefs in early nineteenth century America that private actors were operating with fewer constraints imposed by government, even as they called on government to lend its coercive power to private agreements. The result was an expansion of the power of government that coincided with an

increase in the market economy. Hurst explicitly identifies the role government as a coercive third-party enforcer, and thus the contradiction he notes.

What Hurst appreciates is that Americans felt less constrained by the government, but he fails to connect how the form of legal rules that were spreading in the early nineteenth-century were not constraining rules but default rules affects the perception of government coercive power. The spread of default rules enabled a much wider range of private contracts to be reached, even if the details of the arrangements in those contracts could not or would not be enforced by the courts. Later in the book (and I don't have the page numbers to hand at the moment, JW) Hurst shows convincingly how American state governments began moving to default rules with respect to commercial, property, and corporate law. These default rules were not "obeyed." People were free to ignore the default rules in their contracting, with the knowledge that if the contract was not self-enforcing the parties could fall back on the default arrangements. The defaults provided an increasing sophisticated and wider spreading shadow of the law within which Americans could freely contract without the direct intervention of the government in their arrangements. Americans were free to adopt contractual agreements that the government would not enforce, yet a wider range of agreements and arrangements could credibly be entered into and enforced because of the availability of a wider and deeper set of default rules. Elite concession of the enforcement of impersonal default rules to the government was not perceived or conceptualized as a reduction in the coercive power of elites, but an increase in their freedom of contract, association, and organization.

The final element also seems obvious to us, but has not been well understood. The value of default rules to a society is much greater when the default rules are impersonal rules.

Impersonal default rules leverage up the value of private ordered coordination. The ability of a default rule to coordinate behavior is limited by the number of people to whom the rule predictably applies. In an anonymous rule regime, it is always difficult to know how a rule will be enforced because enforcement depends on the social identity of the parties. A simple example will suffice. Suppose the courts enforce the laws with respect to joint stock share ownership differently with respect to the king, the nobility, the gentry, and commoners. For essential reasons, the law of joint stock companies is explicit that shares can be traded. What is the value of a share to a specific individual? Clearly, everyone who owns shares has to be uncertain about how the courts will treat the company should a disagreement arise among or between the stockholders, because how the courts will decide will depend on whose hands the shares are held. There will be a strong incentive in the market for ownership of the shares to end up in the hands of the king or the high nobility, and the extent to which gentry and commoners are willing to hold shares will depend on their relationship with powerful patrons that can protect their interests should a dispute arise. This is the logic of the natural state and Figure 1.

One can imagine situations where all parties, elite and non-elite would benefit from the impersonal and unbiased enforcement of a rule that all shares of stock are treated the same, regardless of the identity of their owner. In order to realize those benefits the impersonal rule both as to be created (written) and, the more intractable problem, it has to be impersonally enforced. In modern developing countries the problem appears to be much less getting elites to agree on writing down an impersonal rule, than getting the impersonal rule enforced impersonally.<sup>20</sup> To understand why developing countries are unable to move to unbiased

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<sup>20</sup>Robert Bates's work is particularly accessible and persuasive on this point (1983, 1989, 2001, and 2008).

enforcement we draw on the arguments we have already developed.

Elite creation and enforcement of anonymous rules does not require a government or a public organization, it only requires the presence of mutually recognizing organizations with some likelihood of existing into the future. The logic of the natural state shows how elite organizations can sustain and support each other even when they are in competition with one another. The power of any organization, public or private, to impose its will on other organizations is partly a function of its own internal resources, but much more importantly the dynamic environment in which it finds itself. Truly powerful organized interests are typically coalitions of organized interests: organizations of organizations. When any individual organization or coalition of organizations, private or public or a mix, attempts to exert more influence over other organizations through coercion or other means, the other organizations push back. If one sub-coalition or organization obtains a predominance of violence capacity, the other organizations may defer for a short while to the stronger organization, but the long run dynamics inevitably lead other organizations to increase their coercive power as well or new configurations to appear in the coalition.<sup>21</sup> In this sense, actively using violence within the dominant coalition is likely to produce the long run result of a more weakly organized coalition and greater likelihood of violence and civil war.

Default rules may emerge within these coalitions, but they are likely to be anonymous defaults that apply only to certain groups (like the community responsibility system). Default rules in these environments can only be considered defaults with some probability, since if circumstances lead to the enforcement of a default rule for or against the interests of a powerful

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<sup>21</sup>The logic of cycling within coalitions was described by Arrow.

group within the coalition, the rule may suddenly cease to be a default rule and become an issue of contention.

NWW propose that most natural states are not in a position to move away from anonymous rules (although that is not the language that we used in the book, as we did not appreciate the distinction between anonymous and impersonal) until the doorstep conditions are met: rule of law for elites, the ability to create perpetually lived public and private organizations, and consolidated control of the military. We argued that these conditions were necessary, but not sufficient, to allow elites to form impersonal rules for elites (chapters 5 and 6). Two papers at this conference, Dan Bogart and Robert Oandasan's paper on early 18<sup>th</sup> century Britain and Qian Lu's paper on early 19<sup>th</sup> century Massachusetts, both document how natural state societies on the doorstep were unable to provide elites with impersonal access to the rules governing organizations. In Britain it was river improvement companies and in Massachusetts it was banks. The legal form of certain types of organizations was well understood, indeed the forms were soon to become default rules, but neither society could make access to those rules impersonal.

What happened in both Britain and the United States was that elites moved their government to create default rules for the formation of organizations. The next section will provide a narrow theoretical argument for why both elite individuals and organizations might support such a move to impersonal rules. The point we want to make to close this section is that in order to actually credibly provide the organizational rule to all elites, the rule had to be an impersonal default rule. There are two reasons.

The first was simply that if the organizational rules that the government would enforce

were different for every organization, then the government would have to recognize (in this case through granting a charter) what rules it would enforce for each organization. These rules would obviously not be impersonal rules, since they would vary from organization to organization.

Elite access to those rules would depend on the dynamics of the dominant coalition, by the early 19<sup>th</sup> century those dynamics were embedded in Parliament and the state legislatures. This is the logic emphasized in NWW (chapter 6) and in Wallis (2005, 2006, 2011, and in progress).

Probably the more powerful, and much less well understood reason, is that not all elites wanted the same form of organization. That they wanted different forms was evidenced by the wide diversity of organizations created under the regimes of special incorporation (for businesses, cities, churches, schools, and other organizations) in both Britain and the US. What is abundantly clear from the historical record is that the actual form that organizations took was not what the law prescribed, in many cases not even close to what the law prescribed. When impersonal default rules for the formation of organizations were adopted in the 19<sup>th</sup> century United States that were available to elites and eventually all citizens, even though the rules prescribed relative narrow forms of organizational rules, the actual internal relations within their organizations and between their organizations in a wide variety of arrangements. Only some of those arrangements actually conformed to the default rule.<sup>22</sup>

If members of the organization fell into disagreement over the structure or behavior of the group, or if the external relationship of two or more organizations went south and the organizations went to court, the courts would apply the default rules for what an organization was. The challenge brought formally against an organization was *quo warranto*, by what

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<sup>22</sup>See Hilt, 2013, for a nice expression and documentation of how corporate organizations were structured in early 19 century America, with particular emphasis on New York.

authority.<sup>23</sup> Some default rules became effective guides to outcomes. The legal history of organizational forms is rich and complicated. But it often focuses on what forms of organization the courts would recognize as defaults, and ignores the rich variety of actual organizations that existed despite the fact that the organizations did not conform to the rule. Members of the organization, however, could easily agree to the form of their organization, even if the form was alegal (rather than illegal),<sup>24</sup> because as long as they agreed with one another, the organization could exist and if they disagreed, they knew the court would apply the default rule. Organizations that broke up usually did so without the intervention of the courts, because the default rules were well understood.

Both Britain and the United States were moving quickly to impersonal default rules for land, property, contracts, commercial activity, and organizations in the early 19<sup>th</sup> century it seems clear that elites could reap enormous benefits from the provisions of these default rules. Elites were the people with the already existing relationships that would be enhanced by the new defaults. As we suggested, it is important to look at the intensive effect of default rules on existing relationships, which would be disproportionately elite relationships. In contrast, the extensive effect of the new rules, drawing larger numbers of elites and non-elites into relationships is usually the focus of the histories. Acemoglu and Robinson (2012) capture this spirit in their idea of “inclusive” institutions become and NWW in the idea of open access.

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<sup>23</sup>For a nice example of the use of *quo warranto* see Liu, Tian, and Wallis (2013) where American cities were able to avoid repaying debts incurred to finance railroads at the end of the 19<sup>th</sup> century because they were not given the authority to borrow the money by the state in their charters in the first place.

<sup>24</sup>By alegal we mean arrangements that were not against the law, but were not enforceable at law either.

Undoubtedly the implications for social outcomes of the extensive margin were greater over the long run. But our interest here is explaining why elites were willing to support the new impersonal default rules. In order for the default rules to yield their greatest value, however, they had to be impersonal rules.

Only in a society where elites had shaped a dominant coalition of considerably complexity and sophistication would such a transition be possible. Elites had to develop the capacity to credibly create and enforce anonymous rules through a government organization before the capacity to create and enforce impersonal was feasible. Long lived elite organizations had to develop capable of generating the kind of rents that would make investment in impersonal rules beneficial and credible. And finally, the threat of civil war had to recede.

The logic of the natural state demonstrates how a set of interlocking relationships between elite organizations lead to mutual dependence and recognition, and can result in more organized and better coordinated societies through the provision of anonymous rules. Governments in most societies are part of the dominant coalition, and how much power they have depends on the private organizations just as much as the private organizations depend on the government. This section has tried to show why the creation impersonal default rules, which could only be enforced by the government, could under certain conditions be in the interests of elites.

Why did this work? Elites were asked to approve a set of default rules which did not necessarily bind them, or more accurately only bound them in cases where their relationships were breaking up. This enabled them to dramatically increase the value of social coordination, which they were in a unique position to capitalize on. The government needed to be able to

enforce the defaults impersonally, and for that they required the quasi-voluntary consent of elites. For the most part, enforcement of default rules did not involve the use of government coercion.

The actual arrangements that elites made could be significantly expanded and did not require the active or coercive involvement of the government. Unlike Hurst's interpretation, where the government was deeply involved in the enforcement of every contract and agreement, in our view enforcement of impersonal rules for elites produced a situation where private parties were much freer to contract in the shadow of law. The actual form their contracts took was, to a much greater extent, up to the parties themselves. Rather than submitting to more government coercion, elites perceived the change as an increase in their contractual freedom and opportunities. Hurst's history of early 19<sup>th</sup> century America is very clear on this. The elites supported impersonally enforced default rules had a strong interest in bargaining in the shadow of those rules.

In turn, the government's monopoly on coercion was not a license to use force, but an agreement that elites would abide by the enforcement of the default rules. In return for which the government accepted clear lines delimiting how it used violence and coercion.

The default rules covered major elements of the economy, and therefore of elite interests. They spread much more slowly to other parts of society, and indeed are still spreading in developed countries to things like civil rights for racial, ethnic, gender and religious groups.

The next section places these ideas in more narrow conceptual terms.

## **9. Rents, Kobe Bryant's choices, and the continuation problem**

The key to stability in a natural state is that only members of the dominant coalition have

access to the organizational tools offered by the coalition. Every organization draws on the third-party enforcement of anonymous rules. The identity of coalition members and the rules the coalition will enforce are not independent of one another, they are intimately related. In natural state individuals have strong incentives to support the organizations they belong to. Wallis (2011) framed a question about the emergence of impersonal rules by asking when individuals and organizations would act in the interest of supporting the rules rather than acting in the interest of the organizations they belonged to? The answer to that question provides us with a more narrow economic theory of why elite individuals and organizations could find it in their interest to support impersonal rules.

NWW emphasize that the doorstep conditions are important because they create the possibility for *impersonal* elite relationships. A society meeting the doorstep conditions faced an opportunity to transform anonymous elite relationships into impersonal relationships. The impersonal rules at issue are the rules for forming organizations that the larger society, including the government, will support. The focus on organizations is important. NWW argue that allowing impersonal rules for the formation of organization leads to open access, and changes the dynamic interaction of political and economic interests. We will not go into that here. We simply note that allowing all elites access to the same social tools to support their organizations through impersonal rules for forming and operating organizations involved two elements. The first applies both to elites and non-elites and has to do with the nature of rents. The second applies only to elites and has to do with protecting their interests within the coalition.

Most economic rents are “socially constructed” in the sense that all rents depend on the relevant alternative: the value of the best alternative foregone. A key element of institutions is

structuring the range of choices available to individuals. Institutions often frame choices in such a way that there are more than relevant alternative to be foregone. For example, in the 2008-2009 basketball season, the Los Angeles Lakers paid Kobe Bryant a reported salary of \$21,262,500.<sup>25</sup> He was the fourth highest paid player in the league. Almost certainly, Bryant would have been willing to play basketball for an amount far lower than \$21 million a year, say \$1 million a year. So his rent from playing basketball was roughly \$20 million a year. The rent he receives from playing for the Lakers, however, was far less. Many other teams would be willing to pay Bryant somewhere in the neighborhood of \$20 million a year, so his rents from playing *for the Lakers* were somewhere in the neighborhood of \$1 million a year.

Not all the rents that Bryant receives from playing basketball are available to secure his relationship with the Lakers. Those organization-specific rents are only \$1 million a year, and if the Lakers offer Bryant a salary lower by \$1 million he leaves for another team. Bryant's individual-specific rents, the \$20 million rent he gets from playing basketball, are related in part to Bryant's unique personal characteristics and, in part, on the existence of the National Basketball Association (NBA). The NBA is an organization responsible for setting and enforcing formal impersonal rules and informal norms. Bryant's individual-specific rents are directly related to the success of the NBA as an organization, and to the extent that the NBA's success is related to the public perception that the rules are enforced in a fair and unbiased way, Bryant has an incentive to support the rules. By most accounts, Bryant is an extremely competitive and motivated individual, and whether his interests in winning (perhaps by bending or breaking the rules or intimidating the referees) dominate his interests in supporting the rules is

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<sup>25</sup><http://www.insidehoops.com/nbasalaries.shtml>

an interesting problem. What the example makes clear is that the rents Bryant puts at risk if he cheats are not the rents he receives from the Laker's, but from the larger NBA, i.e. in this case the impersonal rules.

The Bryant example illuminates the individual element in the rise of impersonal rules. If the balance between organization-specific and individual-specific rents shifts away from organization rents, more individuals may find it in their interests to act in support of the rules, rather than in support of their organization. If the value of their alternatives outside the organization they belong to increase, then individuals may find it in their interest to support rules that sustain a larger number of alternative organizations. Allowing more organizations to form will change the value of outside options for all individuals.

This factor by itself is not capable of providing a general explanation for the rise of impersonal rules, however. The interests of individuals are too likely to be compromised by free rider problems and fluctuations in the relative returns to supporting the rules and breaking them. Nonetheless, the emergence of impersonal rules and organizations that enforce them will systematically change individual interests.

The interests of elite organizations under certain circumstances is capable of explaining the rise of impersonal rules. In the simplest terms, elites may find that the best way to protect their individual interests from intra-coalition competition is to open access to organizations. Elite members of the dominant coalition have more to fear from each other than from the rest of the population. As military power is consolidated under the government, economic organizations become a more important influence in the polity, and coalition members seek to prevent the accession of a sub-coalition, an elite "faction," that uses the manipulation of

economic privileges to control the political system and depose part of the existing coalition. When control of the means of violence is dispersed throughout the dominant coalition, all coalition organizations live under the shadow of violence and could, potentially, become violent.

Limited access poses a serious threat to all elite organizations and individuals. They are constantly faced with the possibility of elimination from the coalition. In many societies elimination means more than a loss of rents, it often means death.<sup>26</sup> We model the value to elites of a rule allowing elites to form organizations as a continuation problem. When will elites, in general as a group, be willing to adopt a rule that enables all elites to form an organization that will be recognized by the dominant coalition?

The binding condition for most societies will be the credibility of the rule. In a natural state where the dynamic relationships within the coalition result in the frequent use of violence (either legitimate violence condoned by the coalition, like attainder for treason in England, or outright civil war), the idea that the coalition will continue to allow all existing elites to form organizations will simply not be credible. Until natural states meet the first two doorstep conditions, rule of law for elites and the ability to support perpetually lived public and private organizations, allowing all existing elites to form recognized organizations at will cannot be credible. So elites will not be willing to consider an impersonal elite rule for forming organizations until the doorstep conditions are in place.

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<sup>26</sup>Hilary Mantel's (2009, 2012) best selling novels about the elite coalition ruling England during the reign of Henry VIII, and the rise and fall of Thomas Cromwell, contains many fictionalized details, but the deaths are all historical. The main dynamic in Cromwell's rise to power under Henry was Cromwell's ability to create the conditions for judicial murder of members of the dominant coalition who need to be eliminated. For a more systematic and historical treatment of judicial murder of coalition members in English history see Bellamy (1970).

Having the doorstep conditions in place, however, does not guarantee a move to an impersonal rule. We can draw on the political science analysis of coalitions within legislatures to model a piece of the dynamics within the dominant coalition. Like legislatures, dominant coalitions are larger than the “minimum winning coalition.”<sup>27</sup> Organizations within the dominant coalition exercise more or less power depending on their relationship with other elite organizations, and so the gains from coalition membership vary across organizations. The threat of elimination from the coalition is always significant and a part of the dynamics that hold the coalition together.

Suppose the coalition members conceived of a rule that allowed all existing members of the coalition to form organizations at will. These organizations would not enjoy any special privileges and would have a continuation value of  $C$ . That is, any elite could form an organization in the future that yielded a benefit of  $C$  (per year or unit of time, but we are abstracting from that). The probability that the dominant coalition will actually honor its promise to allow such organizations to form and provide the promised support is  $pc$ .

Suppose further that the benefits from being in the ruling part of the dominant coalition are  $WCB$ , the probability of any individual elite organization being in the ruling part of the coalition in any given year as  $pw$ , and the benefits from being in the weaker part of the coalition are normalized to zero. At the beginning of any period, the expected ex ante expected benefits from being in the coalition are:

$$(1) WCB*pw = WCB*pw - 0*(1-pw)$$

In most natural states, the dynamics of the coalition lead expectations that promises made to

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<sup>27</sup>The model that follows draws on Weingast (1979) and Baron and Ferejohn (1989).

specific groups, much less all elites, pc, will in fact be honored quite low. As a result, the expected value of being in the coalition is higher than the value of a fixed organizational rule, C\*pc:

$$(2) WCBi * pw > Ci * pc \quad (\text{For all coalition members, } 1 \dots i)$$

Most dominant coalitions do not have formal decision rules. But many societies as they move toward the doorstep conditions may form an institution like a Parliament to formally represent some elites in a visible way. Nonetheless, if the probability that a promise can be honored rises then perhaps:

$$(3) WCBi * pw < Ci * pc \quad (\text{For all coalition members, } 1 \dots i)$$

Under the conditions in (3), there is the possibility that the coalition will be willing to adopt a rule that will give all elites the “right” to form an organization. Such a rule can be credible, since all elites can see that they benefit in expected terms.<sup>28</sup> A key element will be expectations about the enforcement of the rule, pc, which is why the doorstep conditions play a fundamental role in setting the stage for the adoption of impersonal rules.

There is a large historical literature on the emergence of general laws for the formation of organizations in Britain, France, and the United States, summarized in NWW chapter 6, that demonstrates how the logic of the simple model plays out in much more complicated historical circumstances. The logic of why Massachusetts moved to open access banking after 1812, as described in Qian Lu’s paper, follows this logic.

Open access to organizations transformed the nature of political and economic

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<sup>28</sup>Weingast (1979) and Baron and Ferejohn (1989) show how the universal policy, in which each element in the coalition, or legislators in their case, gets a fixed benefit is a stable equilibrium rule.

competition. Short of putting the genie back in the bottle by reversing course and limiting access to organizations, elites now found it in their interests to maintain open entry. The best response to Schumpeterian creative economic destruction was innovation, which required new organizations (Schumpeterian entrepreneurs being consummate organizers). Open access did not signal the end of interest group politics, groups still had an incentive to press for special privileges, but impersonal rules about the formation of organizations meant that many of the rents that could be created by privileges would ultimately be competed away. The expanding number of elite organizations increased the returns to default rules for other aspects of life, like commerce. Initially, elites were the primary beneficiaries of such rules.

Two conditions had to be maintained for the transformation to persist. First, elites had to continue to find it in their interest to support impersonal rules for organizations. Once open access was in place, however, going back became quite difficult. Any attempt to limit access would undoubtedly create winners and losers within elites, so how was a change in policy to be brokered? Such a negotiation would be complicated by the changing nature of elites. Open access itself would begin to erode the distinction between elites and non-elites, and some newly rich and newly powerful non-elites would now be able to demand a voice in the governance process. Elites who were currently on the inside of the governance organization, but feared that they might soon become outsiders, had a strong incentive to maintain the open access rules. That is, the continuation value of forming an organization,  $C$ , increased, and with time so did the perception of the probability that the impersonal rule would be enforced,  $pc$ . Open access to organizational tools would enable them to reorganize and continue to compete.

The second condition concerns the organization of the government and the services it

delivers. The advent of impersonal rules for organizations requires a shift in the structure of the government, as several of the organizations within the government must now deliver impersonal third party enforcement of specific rules. Namely, the administrative organization(s) that grant recognition to organizations and the judicial organizations that enforce the internal and external rules regarding the actions of organizations. Here is where Greif's insight about anonymous exchange leading toward the "path to the modern economy" is accurate: societies that cannot support extensive anonymous exchange do not possess the institutional resources to implement impersonal rules. Doorstep condition number one, rule of (anonymous) law for elites, is a prerequisite for the emergence of impersonal rules for elites. Until institutions that can support sophisticated anonymous rules are in place, it is extremely unlikely that conditions leading to impersonal relationships to be adopted by elites will arise.

This is why NWW place so much emphasis on the doorstep conditions. A mature limited access society already knows how to structure sophisticated organizations, like corporations, but those organizational structures are embedded in a framework of personal, rent creating relationships. Moving to impersonal rules for organizations does not involve changing specific rules, since the formal rules for the internal and external relationships of the organizations can stay the same, what changes is the institutional dynamics that now allow anyone to create an organization that can call on the support of the government.

Impersonal rules require an unbiased bureaucracy: a nameless, faceless, rule bound organization that does not recognize personality or identity, but only relies on whether the rules are being correctly applied. Elites must be willing to support the formation and operation of such a bureaucracy. Impersonal bureaucratic administration of certain government policies is

essential for the operation of impersonal default rules. The benefits of these rules lies in coordination made credible by the benefits of coordination, not in coordination made credible by coercion. In an open access society the government must provide a wide range of services on an impersonal basis. The enforcement of impersonal rules cannot be based on personal relationships, and so the parts of the government organization that administer impersonal rules must be governed by rules of law, not by rules of men and the logic of the natural state.

Since politics is inherently based on personal relationships and coalitions of interest, impersonal rules will not be sustainable without an institutional dynamic sustained by open access. If a society possess the social tools capable of supporting complex organizations (and many do not) and extends those tools to everyone (citizens), then the dynamics politics are fundamentally altered. Personal relationships, rents, relational contracting, and hierarchy all still exist. None of the fundamental features of the natural state societies that emerged five or ten thousand years ago wither away: large social organizations are still held together by relationships and rents. But anonymous relationships between people who do not know one another personally, but nonetheless must be able to place each other within an existing social framework, can give way to truly impersonal relationships.

## **10. Conclusions**

We set out to understand how societies could acquire the ability to create and enforce impersonal rules on a wide scale. We realize that in no society are all rules impersonal, nor is enforcement perfectly unbiased and impersonal, but we are not seeking for perfection. In most societies in history and in the contemporary world it is difficult to find any rules that are impersonal and impersonally enforced, as elites in most places seem to have the ability to wiggle

out of the rules.

The idea that coercion is an integral feature of governments and their ability to enforce rules did not originate in Hobbes's *Leviathan*, but Hobbes crystallized the idea that the government must possess overwhelming capacity for violence in order to credibly enforce rules. Powerful elite individuals and organizations will not comply with the rules unless they are coerced. The problem for civil societies then become finding a way to limit the operations of an overwhelmingly powerful government whose ability to enforce rules depends on its ability to coerce.

In contrast, our argument builds on the commonsense notion that many rules are enforced because the value of continued interaction between the parties in a relationship is at risk if rules are not obeyed. These rules are self-enforcing or private ordered. Coercion may play a role in private arrangements, but it need not and in a wide variety of human relationships violence and coercion, the threat of violence, play little or not role.

One of our contribution to the centuries long debate over the provision and constitution of social order through the enforcement of rules through a public organization is to draw our attention to the fact that societies are not governed by leviathans. They are governed, well or poorly, by coalitions of individuals and organizations. Understanding the internal dynamics of these coalitions is critical to understanding how societies behave, both in theoretical terms and in practice. The logic that ties the dominant coalition together in most society produces social dynamics that do not enable the creation and enforcement of impersonal rules. Most societies are capable, however, of moving beyond purely personal rules to the creation and enforcement of anonymous rules that depend on the social identity of individuals and the groups they belong to.

The rents associated with the existence of privilege organizations, ala the logic of Greif's community responsibility system, are an essential element in the credible enforcement of rules, which is why the rules that are credibly enforced are anonymous rules that treat people from different organizations and groups differently.

We emphasize that governments are just one of many organizations in dominant coalitions. What distinguishes a government organization from a purely private one is its public nature. Governments arise in natural states because governments provide coordination within the dominant coalition. Government coordination may involve coercion, but the primary role of the government within the dominant coalition is a coordinator not a coercer. Within dominant coalitions violence begets violence, and powerful groups who attempt to coerce other organizations within the coalition are likely to worsen social outcomes rather than provide more stable rule enforcement.

Our second contribution is to draw together different ideas about the nature of rules into a coherent framework. Cooperative rules and constraining rules; personal, anonymous, and impersonal rules; and default rules rather than constraints are important elements of rules that need to be separately appreciated. The idea that in some circumstances rules between individuals, rules within and between organizations, and rules within and between societies can be enforced because of the continuing value of the relationships that the rules help order is not original. But the basic idea that the value of private ordered rules can be enhanced by well crafted and publicly enforced rules has received much less attention than it deserves. The social sciences that actively consider how rules work fixate on the operation of rules in courts (of many types) backed by the coercive power of government or the community, paying much less

attention to the effect of the public rules on value of private ordering.

Our third contribution is to recast our old conceptual view of the government as the organization in society with a monopoly, a comparative advantage, or a preponderance of violence capacity into the government as a public coordinating organization. It is a fact that in many societies the organization, or coalition of organizations, with the most violence capacity is called the government. There is also little doubt that many government organizations that appear to be highly integrated organizations with violence capacity on closer inspection, or in the right circumstances, turn out to be fragile, problematic coalitions of many groups and organizations all of whom are potentially violent.<sup>29</sup> We continually forget that the power of the government as an organization depends on the configuration of power in the larger society, not just on the internal capacity of the government organization.

Clinging to the idea that governments enforce rules primarily through the threat of violence has led us into a conceptual dead end. Nowhere is this more clear than the way we think about elites. In order for modern societies to emerge, somehow elites must give up their coercive power to the government. Why would they ever do that you might ask? And we are asked the question all the time. The problem with the question is not that it is a bad one, but that it assumes that somehow elites are being asked to voluntarily give up valuable privileges in return for a better society in which they are no longer “elites.” That way of asking the question has enormous appeal if you believe that the government is defined by its coercive power, and

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<sup>29</sup>The experience of the Mubarak regime in the Arab spring is a graphic and dramatic illustration of the fact that even very strong governments can in a few short weeks become very weak, because the configuration of power in the dominant coalition shifts. The experience of the Assad regime in Syria is a dramatic illustration of the dark side of the shadow of violence, in which case the shadow of the law offers little or no protection or coordination.

what the elites are giving up is the “right” to use coercion. Then we are in the world of trying to guard the guardians, or limit a government with unlimited coercive power.

Perhaps we have not brought out enough in the paper that elites in natural state are privileged, but they are not free. They are coerced: they are threatened with the possibility of violence on a regular basis. They enjoy a far higher material standard of living than non-elites. They enjoy a privileged existence in which they possess unique and valuable privileges, but they are not free.

Our most important contribution is to show how, by recasting how we think about the government’s role in all societies, but particularly about governments role in the transition from limited to open access societies in the terms of NWW, or from traditional to modern societies, from status to contract, from feudalism to democracy, we draw out how it is the ability of government’s to coordinate that enable elites to find it in their interests to accede to government enforcement of impersonal rules. The special insight is seeing how impersonally defined and enforced default rules can significantly enhance the value of existing relationships and agreements. When we step back and realize that elites in a natural state are already involved in relationships of significant value to them, relationships which are made possible by the creation and enforcement of anonymous rules, we realize that elites stand to gain the most from the creation and enforcement of impersonal rules. Then we have an answer that to the question we posed at the beginning: how are some societies able to create and enforce impersonal rules?

It is less that elites give up their power to coerce to their governments, although all of the paranoia in American and western European elites about the tyrannical power of government that surged through the 18<sup>th</sup> and 19<sup>th</sup> century gives credence to the idea that elites traded

the ability to coerce for something. It is more that elites seized an opportunity to double-down and increase the value of their privileges at the same time that they increased their “freedom” to act, to contract, to own property, to associate with others by entering into private ordered relationships and exchange that lies within the growing shadow of impersonal rules. We need to stop viewing the shadow of the law as a shadow of coercion, and realize that, under the right conditions, government and the law can cast a shadow of coordination.

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Figure 1

