

## INSTITUTIONS RULE

**How have 800 years of political and economic developments in western society resulted in modern-day efficient markets? Cheyne Cudby, in a 2010 essay for ECON330, explored the institutional foundations underlying market behaviour and how these have evolved over time to facilitate efficient coordinated activity. This article is an abridged version of her essay.<sup>1</sup>**

Early economic theory held that institutions had no particular relevance to the dynamics of economic development. Efficient economic activity was presumed to occur because, in a world of no transaction costs, bargaining between parties led to the optimal outcome – regardless of the initial allocation of property rights. In reality, however, transactions nearly always have costs because of asymmetrically held information and the need for at least one party to acquire the information they lack.

Institutions – which are the rules, beliefs and norms of society that prompt individuals to follow specific behaviour – play a fundamental role in regulating interactions where there are high transaction costs. They provide the foundations of markets by allocating and protecting property rights, promoting efficient contracts and encouraging specialisation and trade (thereby reducing the transaction costs that arise from information asymmetries).

### **The trader's dilemma**

Institutional evolution is illustrated in the medieval 'solution' to the difficulties of long-distance trade. Despite the fact that self-interested individuals can (at times) cause defection from the optimal outcome, the market can still achieve coordinated activity – provided economic and political institutions effectively promote this outcome.

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<sup>1</sup> It draws in material from:

K W Dam (2006) 'Institutions, History and Economic Development' Olin Working Paper No 271. University of Chicago.

V Dutraive (2009) 'Economic Development and Institutions' (available at <http://regulation.revues.org>).

A Greif (2006) *Institutions and the Path to the Modern Economy: lessons from Medieval Trade*. Cambridge University Press. p3.

A N Licht (2008) 'Social Norms and the Law: Why Peoples Obey the Law' *Review of Law & Economics* 4.

R H McAdams (2008) 'Beyond the Prisoners' Dilemma: Coordination, Game Theory and Law' Olin Working Paper No 437. University of Chicago.

D North (1994) 'Economic Performance through Time' (available at <http://nobelprize.org>).

D North (1992) 'The New Institutional Economics and Development' (available at [www2.econ.iastate.edu/tesfatsi/NewInstE.North.pdf](http://www2.econ.iastate.edu/tesfatsi/NewInstE.North.pdf)).

Trade between different cities and nations did occur in medieval times. But in the absence of a common legal system to enforce contracts between trading parties in different civic jurisdictions, opportunistic purchasers had an incentive to renege on their contracts with vendors from other cities. Many otherwise-beneficial trades were foregone – which offers evidence for the contention that coordinated activity requires more than just formal institutions and suggests that, in absence of norms such as the rule of law, legal institutions may still fail to work effectively.

To solve problems associated with long-distance medieval trade in Europe, a ‘community responsibility system’ was established: this made whole trading communities liable when one member failed to uphold a contract. The nation of the party who suffered could impound all goods from the other party’s nation in order to motivate the debtor to make payment. Because of their huge dependence on trade, communities were motivated to pay their debts, protect their reputations, and avoid trade boycotts.

While this system seemed effective, it became economically inefficient as communities expanded and trade extended beyond domestic borders. It was gradually revoked in several nations and replaced by alternative enforcement institutions.

### **The drive to optimise markets**

One of these alternative institutions was the reputation-based private-order contract enforcement exercised by communities such as the Maghribi traders, a group of Mediterranean Jewish merchants who engaged in principal-agent relationships with foreign agents. The Maghribi reduced the costs and risk associated with trade by establishing a repeat-transaction relationship with foreign agents and selling their goods in overseas markets through these agents.

This worked effectively because the agent’s ongoing reliance on his reputation in the merchant’s community encouraged him to convince the merchant prior to trade that he would not act opportunistically. If the agent were to defect from his agreement with one merchant, his reputation would be tarnished within the entire Maghribi community and thus his future business would suffer.

## **We've got here – but where are we going?**

Since then, there's been a dramatic shift from private enforcement institutions to centralised (political and legal) institutions. A governing state that's capable of enforcing property rights beyond domestic boundaries while conforming to underlying societal norms is essential for ensuring formal rules are respected. Furthermore, no modern day society is complete without an impartial court system capable of providing mechanisms to solve transactional issues where the quid and the quo are separated.

Modern institutions such as the World Trade Organization and the international courts have evolved to address the challenges of modern international trade, but their efficacy is likewise constrained by self-interested individuals. Formal and informal institutions are essential to efficient coordinated activity – and they will continue to evolve as they address the specific challenges posed by the costs and risks of transacting.

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