Leviathan Denied:
Governments, Rules, and Social Dynamics

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This paper lays out the core conceptual ideas of a book we are in the process of writing, with the same title as the paper. This version is intended for presentations in seminars in the spring of 2014 and neither represents our finished ideas about the emergence of impersonal rules and the nature of governments, nor is it ready to stand on it own without explanation, as it were. We have asked the places which post it for seminar purposes to take it down after the seminar. Please do not quote, cite, or post to another web site without the authors's permission. We hope to have a finished version of the working paper in the NBER working paper series sometime early in the spring of 2014.

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Part I: Leviathan Denied

Section 1. The Emergence 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 form of the rules and their enforcement. The idea that governments should create a set of rules that apply equally to everyone is a deep and complicated problem that goes the very heart of what a“modern” society is. “Indeed so deeply embedded in modern man is the principle that prima facie human beings are entitled to be treated alike that almost universally where the laws do discriminate by reference to such matters as color and race, lip-service is still widely paid to this principle.” (Hart, 2012, p. 162) But, as Hart pointed out, alas, most legal systems pay more lip service than real service to the principle. The inability of most societies in the contemporary world to actually create rules that treat people the same lies at or near the heart of the problem of economic and political development. It is a key to understanding the economic history of the developed western world. It is a problem that we do not have a very good handle on.

This paper asks how did it come about that a few societies have been able to create and credibly enforce impersonal rules on a wide scale, and why so few? The answer inevitably involves ideas about governments. Since credible impersonal rules must be publicly known and visibly enforced in an unbiased way, impersonal rules are always created and enforced by governments. Or, equally true, any organization capable of creating and enforcing impersonal rules we call a government. While getting every day courts and judges to render decisions about legal rules in a fair and unbiased manner is a complicated problem, it is not the primary focus of our inquiry. In most societies in the world today, impersonal rules are not credible because they

cannot be enforced against powerful individuals who are able to resist the enforcement of the rules through their wealth, influence, position, or all three. These people are, in a word, elites. One need only open the newspaper to see example of rules that treat some elites differently or, more frequently, to see that rules meant to apply equally to everyone apply differently to elites. There are elites in every society. Elites are both powerful because they make and enforce the rules and they make and enforce the rules because they are powerful. We need to disentangle this endogenous social dynamic between governments, elites, and rules if we are to understand how, in some societies, elites come to create and credibly enforce rules that treat everyone the same. We embrace the complicated endogeniety of elites, governments, and rules and find our answers in the interaction of interests, rather than in a neat identification scheme that singles out a causal mechanism.

There is a long intellectual tradition stretching back to at least Thomas Hobbes that identifies the essential element of a government as its ability to coerce: to threaten violence. "Hereby it is manifest that during the time men live without a common power to keep them all in awe, they are in that condition which is war, and such a war as is every man against every man." (Hobbes, 1994, Chapter XIII, section 8, p. 76). In very simple terms, governments cannot enforce impersonal rules until the government can coerce the powerful elites "and keep all of them in awe." Since governments do not acquire that kind of coercive power until the rise of national state in the 18th century, it is not surprising perhaps that wide spread government enforced impersonal rules do not appear until the 19th century. As Max Weber argued "The development of the modern state is set in motion everywhere by a decision of the prince to dispossess the independent, 'private,' bearers of administrative power who exist alongside him," (Weber, 1994, p. 315.) Those who exist along side him are the powerful elites who are

dispossessed by the prince or, as Charles Tilly (1990) describes it, the powerful elites who are disarmed by the state. Weber, through Tilly and others, continues to exert a strong influence in the conceptual framework that we use to understand how governments, rules, and elites interact, as seen in Besley and Persson (2011), Dinceccco (2011), Bates (2001, 2008), Bates, Greif, and Singh, Greif (2002), Ertman (1997), Spruyt (1994). Five years ago we struggled to understand the emergence of impersonal rules within the framework of a government defined by its coercive power. North (1981) defined the state as the organization with a comparative advantage in violence, North and Weingast (1989) was concerned with creating credible commitments for the coercive monopolist, and in our 2009 book with Barry Weingast, *Violence and Social Orders*, we predicated the emergence of impersonal rules in an open access social order on the doorstep condition that a society had obtained political control of a consolidated military. We now think the idea that coercion defines the essential nature of government is wrong.

An aphorism attributed to Einstein goes something like "all good theories are as simple as they can be, but not simpler" applies to our assumptions about governments, coercion, and rules. If we define institutions as the rules of the game, the means of enforcement, and the organizations that play the game, then the emergence of impersonal rules is an institutional change that needs to be explained in terms of rules, enforcement, and organizations. The ideas that social scientists have used to think about governments and rules have been too simple, and we try to complicate them just enough to get an understanding of the emergence of impersonal rules.

Part II, sections 3 and 4, look carefully at the nature of rules and organizations. Rules are part of our relationships with spouses, children, family, kin, neighbors, colleagues, business

associates, religious associates, and ethnic groups. These rules are often personal and idiosyncratic. They are an integral part of how we structure our interactions with the people around us, both people we know personally and people we do not know.[1] One can say that the primary function of rules is to enhance coordination between individuals. Rules underlay social norms and social conventions, even though by definition those are not enforced by a government. Rules play a particularly central role in organizations. Formal and explicit rules, either spoken or written, are usually part of an organizational structure. Finally, there are legal rules stipulated and enforced by some collective organization backed by coercive force, which we usually call a government. Legal rules are just part of a society's ecology of rules. How rules affect behavior depends on the interaction of all the rules, all across the spectrum of rules from the personal to the formal and legal.

We are particularly concerned with how rules are enforced, and make several distinctions. The first is between rules that are self-enforcing with a particular relationship and those that require third-parties. The second is between rules whose form and enforcement is based on the social identity of the parties involved, what we call "identity rules," and impersonal rules that treat everyone the same regardless of their social identity. The institutional literature has been slow to recognize this critical distinction. The third is between rules that act as constraints and rules that are defaults. Constraining rules are familiar to all of us. They take a consequential form, do action X and consequence Y ensues. Default rules are fundamentally

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[1]The ability to use rules is deeply embedded in human genetics and behavior. As the child development psychologist Alison Gopnik concludes: "Rules are a particularly powerful way to extend our immediate emotional moral reactions. Our moral intuitions may tell us that hitting someone is wrong, and helping them is right – even very young babies seem to appreciate that.... The human ability to coordinate actions for the good of the larger group is one of our greatest evolutionary advantages. This ability depends on the distinctively human tendency to make and follow rules." Gopnik, 2009, p. 212.

different. Default rules are rules that can be invoked when relationships break down, we use the example of divorce throughout the paper, but the disputing parties can avoid the application of the default rule by reaching their own agreement.[2] The final distinction is between the "legal" forms of relationships and agreements that are formally recognized and enforced by the government, the "illegal" forms of relationships and agreements that are prohibited by the government and may or may not be actively suppressed, and "alegal" forms of relationships and agreements that are neither prohibited by the government nor are they enforced by the government. The emergence of impersonal rules is closely associated with an expansion of default rules and the range of activities that are alegal. We use the notion of an ecology of rules to show, in the end, that elites are willing to move to impersonal rules because of the effect of impersonal default rules and alegal relationships on the value of all elite relationships, but that is getting ahead of ourselves. The typical notion that rules are constraints, and that governments have a comparative advantage in rule enforcement because of their coercive powers are two "too simple" ideas.

Part III takes the conceptual ideas about rules from part II and looks more closely at how rules are enforced, both by private individuals, by organizations, and ultimately by governments. The critical problem is understanding how credible third party enforcement of agreements and rules arises. The assumption of a government with coercive power short circuits our understanding of credible third-parties in two ways. By assuming that governments are the organizations with a comparative advantage in violence, we fail to examine the critical problem of how violence is organized. By taking governments as organizations, or idealized individuals

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[2]This is similar, with a slightly different twist, to the notion of a default rule in the law and economics literature, for example, Ayers and Gertner, 1989 and 1992.

like the king or commander-in-chief who are endowed by the theoretical approach with violence capacity, a too simple idea, we miss the connections between how violence is organized and the kind of rules that violence using individuals and organizations can credibly enforced. Institutional arrangements within elite networks establish elite identities, largely through elite organizations. It is those identities that enable the creation and enforcement of identity rules. As you might expect, how violence is organized has a direct impact on the kind of rules a violence wielding third-party can credibly enforce.

The coercive rule enforcement assumption also leads us to ignore the fact that because any two or more elite organizations can create and enforce identity rules, the government organization, coercive or not, can never have a monopoly on the creation and enforcement of rules. Elites, if you will, always have alternative rule enforcement arrangements available. When will elites coordinate through government organizations, or more accurately, when will elites decide to create a government organization or designate one of their number to become the government? Rather than defining government by its coercive power, we define governments as organizations that "publicly signify agreements." The conceptual shift from governments as coercive organizations to coordinating organizations enables us to see how elites might find the value of government enforced impersonal rules to be valuable enough to concede to the government the ability to enforce those rules. Elite concede their right to resist, and the government's coercive monopoly emerges because of its ability to coordinate.

The emergence of impersonal rules comes out of elite dynamics and the ability of societies to create arrangements between powerful organizations such that the government's ability to coordinate is enhanced. Tautologically, elites concede, indeed demand, public enforcement of impersonal rules by governments only when it is in the interests of most elites to

do so. The paper attempts to lay out the logic of how that happens, in a way that we hope moves us past tautology.

Section 2 Elites, Governments, and Coercion: the seductive attraction of the single actor

This section recognizes several of the too simple ideas that are commonly used and, in some cases, dominate discourse about governments, rules, and social coordination. Virtually everyone defines elites as powerful individuals, who can by virtue of their personal characteristics, their social, economic, or political position, or their coercive power influence the behavior of others and some part of the larger society. All societies have elites. The United States today has elites as surely as does Mexico, Argentina, or China. Elites are always embedded in networks of other elites.[3] They become powerful as individuals because of their relationship with other powerful individuals; although it is more accurate in most societies, to define elites by their close association with organizations and elite power as the result of the relationship between elite organizations. Elite relationships are simultaneously cooperative and competitive. Just as elites are only powerful because of their relationships with other powerful elites, the greatest danger to elites come from other elites.

Talented, innovative, driven, and often ruthless individuals rise into the elites in all societies. As a result, there are no societies with a closed set of elites, despite the many generalizations and descriptions to that effect. Elite status is not an absolute condition: some elites are more elite than others and status among those with status can be infinitely graded. Status relationships among elites change constantly, and even small shifts gradations of status

[3]For a study of elites and "How chiefs come to power" that emphasizes the importance of networks of elites see Earle 19xx and Johnson and Earle 2000.

can be important sources of instability.

The dynamics of change in any society are usually driven by elite conflict and competition. Political history is largely the history of elite competition, accomplishment, or failure. Even a successful people's revolution ends up producing elites, and very often and ironically in the case of communist revolutions, the new elites are just as elite as the old elites they replaced. We will term intra-elite competition as the normal ongoing competition that occurs within elites, and inter-elite competition as what occurs when factions and coalitions of elite groups compete, what often results in civil war.

Although some may quibble with the form of the definition, we do not regard any of the foregoing as anything more than common sense. It may come as a surprise then that some of the most prominent theories in the social sciences treat elites as homogenous groups of actors, with identical interests and facing identical constraints. Karl Marx is master of the assertion. In his framework, economic forces dictate the interests of the dominant elites and a historical dynamic of change revolves around competition between large blocks of homogenous elites: classes. Acemoglu and Robinson (2006) is the most recent and influential work that divides the world into elites and masses, and explains the emergence of modern democracy in terms of homogenous elite interest. Tilly (1990) is only slightly more nuanced. In his framework there are two groups of homogenous elites, military elites and commercial elites. The dynamic relationship between coercion and capital explains the emergence of national states. In these models elites share identical interests and essentially act as a single actor or entity.

Treating elites as homogenous group that can be modeled as a single actor or governments as single actors is done to simplify a very complicated problem. Tilly clearly

knows that governments are made up of coalitions of organizations and, for most of the period he studies, no governments had a monopoly on violence, legitimate or otherwise. With characteristic charm and candor, Tilly apologizes early in his book for using the language and logic of single-actors in his conceptual framework and his history:

> "In the interests of compact presentation, I will likewise resort to metonymy and reification on page after page. Metonymy, in that I will repeatedly speak of "rulers," "kings," and "sovereigns" as if they represented a state's decision-making apparatus, thus reducing to a single point a complex, contingent set of social relations. Metonymy, in that cities actually stand for regional networks of production and trade in which the large settlements are focal points. Reification, in that I will time and again impute a unitary interest, rationale, capacity, and action to a state, a ruling class, or the people subject to their joint control. Without a simplifying model employing metonymy and reification, we have no hope of identifying the main connections in the process of state formation." (Tilly, 1992, p 34).

Note that Tilly begins with "the interest of compact presentation," a purely rhetorical point, but ends with "without a simplifying model" which is the gist of the "too simple" problem.

While for Tilly there are two types of elites, the government is dominated by the military elites. For Tilly, the state is a single actor whose defining characteristic is coercive power: the government as the organization in an area with a clear priority of violence capacity. (1991, p. 1) Most of the influential approaches to the development of modern societies typically treat the government as a single actor, not an organization of elite individuals with competing interests. Mancur Olson's (1993) "stationary or roving" bandit is a single-actor government. Robert Bates's (2001, 2008) nice intuitive model of government protector and enforcer begins with a single individual as rule enforcer, as does the much more complicated model developed in Bates, Greif, and Singh (2002). North (1981) begins with a revenue maximizing monarch with a comparative advantage in violence.

Not only do these approaches model governments as a single actor with a well defined

objective function, the defining feature of what makes the actor a government is the ability to control through coercion: the threat of violence. Coercion has been central to theories of government since at least Hobbes. Weber famously defined a modern government as the organization with a monopoly on the legitimate use of violence. North defines the state as "...an organization with a comparative advantage in violence, extending over a geographic area whose boundaries are determined by its power to tax constituents.." (1981, p. 21). James Madison asked in the Federalist papers:

"But what is government itself, but the greatest of all reflections on human nature? If men were angels, no government would be necessary. If angels were to govern men, neither external nor internal controls on government would be necessary. In framing a government which is to be administered by men over men, the great difficulty lies in this: you must first enable the government to control the governed; and in the next place oblige it to control itself." James Madison, writing as Publius in *The Independent Journal,* Wednesday February 6, 1788; Federalist #51.

Coercion is an essential element of government in all of these approaches because without out the ability to coerce, how could a government insure that people will follow the rules? As Hirschleifer puts it "Even more than regulating the scope and methods of conflict, the law generally stands ready to enforce agreed settlements. But note the word "enforce": *regulation* of conflict can be achieved only if the regulator has the power to inflict even heavier damages." Hirschleifer (2001, p. 13). Impersonal rules pose an even greater need for government coercion, because they must apply equally to everyone, even elites, and therefore the government must have the power to coerce elites before it can enforce impersonal rules. Thus Weber's modern state monopoly on legitimate violence. Poggi (1990, p. 5) provides a lucid summary and survey of recent political theory and concludes that "Yet there are good grounds for relating conceptually the whole phenomenon of political power to the unpleasant realities

evoked by the figure of the warrior. Ultimately, it would be difficult to think of any significant embodiment of that power ... which does not owe its political identity to the fact of relating however indirectly, to violence and coercion."

Governments do use coercion, and Madison is certainly right that figuring out ways to control a government organization with a comparative advantage or preponderance of violence capacity is a major problem in most societies. To be very clear: we are not questioning whether governments use coercion, or whether associating governments with coercion is an appropriate approximate description of governments in history. We are, however, questioning whether such an approach to government helps us understand why impersonal rules emerge as stable social outcomes in some societies and not others.

The existing paradigm has not produced a clear understanding of how impersonal rules emerge because framing the question about government as essentially about coercion allows two implicit assumptions about rules and coercion to go largely unexamined. One assumption is about why people follow rules. Part II consider rules in depth, both what they are and why people follow them. In most theorizing about government, careful consideration of rule following is often assumed away because obedience is presumed to rely ultimately on a coercive threat. The second assumption results from the single actor assumption, very little attention is paid to how violence is organized in the first place. The organization of government violence is assumed away because governments or leaders (ala Weber) are endowed with violence capacity as an essential part of their nature as governments. Part III considers how a society made up of elites with divergent and competitive interests could possibly organize them in a way that limits the use violence by elites. Out of that analysis comes a better understanding of what

governments are and why identity rules are so prominent in many societies. Part IV shows how a different understanding of rules and governments, we can how coordination is the key to emergence of impersonal rules.

Part II: Rules and Organizations

Section 3. The Nature of Rules

The variety of humanly devised rules that coordinate our social interactions is as wide as the human experience itself. What follows is far from a complete or exhaustive categorization of rules and we make no attempt to survey the multitude of theories about and taxonomies of rules from legal theory and the social sciences. But we have to start somewhere if we want to have a comprehensible discussion of rules and their enforcement.

In the most general terms, rules are connected to relationships. They range at one extreme from purely personal relationships between two people, like a husband and wife, whose enforcement is made credible by the ongoing value of the relationship to each of them; to the other extreme of legal rules formally created by governments and enforced through a network of organizations empowered to use coercion; and everything in between. Table 1 sketches the range of rules form personal rules, social norms, social conventions, formal explicit rules, and legal rules can be enforced and thumbnail ideas about how they are enforced.[4]

The list is ordered roughly from the personal to the legal, but it is important to acknowledge from the beginning that the list is a spectrum, not a hierarchy. We are all aware that the many rules that govern our lives are not all consistent with one another, and what rules

[4]We are not wedded to any of the specific terms in the table or to any specific ordering in the table. We are willing to admit a catholic and inclusive set of human relationships, and are not concerned to rank them in any hierarchy.

we chose to follow and which relationships and agreements we choose to honor depend on circumstances and situations rather than a strict hierarchy of rules. Indeed, the feature of the list in the table that matters most for our argument is that how one rule affects how people behave depends on the

Table 1

Rules, Relationships, and Enforcement

Rules, like relationships, range from	Enforcement
Purely personal	Repeated interaction, secured by the value of the relationship
Social norms	Repeated collective interaction and reaction
Social conventions	Collective reaction and costs of non-coordination
Formal rules (explicit rules)	Usually enforced within or between the context of specific organizations.
Formal legal rules	Enforced by a government.

existence and enforcement of other rules. The rules that govern our personal relationships are affected by social norms and formal rules, just as formal rules and legal rules are affected by social norms and personal relationships. Any one with an ounce of sense who set out to explain why a society adopted a particular social norm would have to take into account the legal rules, the formal rules, and the personal patterns of behavior as mutual determinants of why a particular social norm works. This goes deeper than endogeniety in the causal sense and reflects the fact that our lives are bathed in an enormously complex ecology of rules and relationships. The interactive effects of rules on each other will, in the end, be the key to our explanation of how impersonal rules emerge. Elites actively press for and adopt impersonal rules when they find that the effect of impersonal rules on other rules and relationships create benefits for elites than exceed the costs to elites from their loss of privileges they enjoy under identity rules.

Our ideas about institutions and institutional change, about rules, organizations, and enforcement, 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, identity, and impersonal rules. These dimensions potentially exist in all of the rules listed in Table 1.

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 framed his results in the 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. Other rules are autonomous rules. Autonomous rules are perceived as coordinating 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.[5] 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. In Piaget's framework, the very young child perceives all rules externally imposed, 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.[6]

To be clear, rules in Piaget's context are defined as consequences of actions: do x and y occurs. 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 of Table 1. 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 italics)*: "Did people always play

[5]Heteronomy is subordination or subjection to the law of another; the opposite of autonomy.

[6]Modern research has gone well beyond Piaget's stage framework, and have overturned some of Piaget's insights. A moral sense appears to be present in children from the very beginning, rather than emerging in stages. See Gopnik 2009 and Bloom 2013 for accessible reviews and Killen and Smetana 2014 for a more detailed summary of the field or moral development in children. We are using Piaget's insights for their heuristic value, rather than an absolute statement of how children develop.

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 come to 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. "Why are there rules in the game of marbles? – *So as not to be always quarrelling you must have rules, and then play properly* – How did the rules begin? – *Some boys came to an agreement amongst themselves and made them."* (p. 66) Rules intuitively become coordinating. Children come to feel invested in the rules as a result of their own choice. When considering 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 playing the game.

The parallels between Piaget's older children's approach to games and rules and the logic of folk theorem based on the power of repeated interaction are readily apparent. We needn't go farther than the folk theorem now. "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 understanding of a child's moral judgement results from an interaction of the child's experience with the way the world around her works interacting with what they are taught, told, and learn about what the explicit rules are. We are completely comfortable with the idea that individuals and societies develop morals, beliefs, values, and culture based on both individual and shared experiences. But heading in that direction will take us away from our goal of understanding how impersonal rules emerge. We are not denying that morals, beliefs, and culture matter for impersonal rules, but we do not believe that beliefs about impersonal rules played a key role in the emergence of impersonal rules. When the time comes, we address this directly.

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. It parallels the economist's formal and mathematical notion that rules are constraints, where constraints map out boundaries of what outcomes are possible and which are unobtainable. Forcing all rules into the consequential formulation of constraints has its costs, however. We accept the notion that rules both emerge out of relationships and serve as a way to frame relationships. Yet, even when rules provide a structure for relationships, many rules do not operate actively as constraints but passively as defaults. Default rules do not map out the boundaries of what is attainable and unattainable in a relationship, as constraints do, they map out the implications of what may happen if the relationship breaks down and the default rule

is invoked. For example, modern American marriage law does not specify how wives and husbands must treat each other within their marriage. Marriage law is largely a set of rules that comes 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, which are also divorce rules. Rather than constraining the actual choices spouses make within their marriage, these rules shape the parties perceptions of the value of outside options.[7] The behavior of partners within a marriage will be shaped by what each of the partners believes will happen if the marriage is terminated and the relationship broken (or altered). These beliefs are not constrained by the default rule since what will happen if the marriage ends is not necessarily determined by the default rule. The default rule will only apply if the two individuals fail to come to an agreement. What the partners believe will happen the case of divorce is affected by the default rule, but not constrained. That is one sense in which the marriage rules are default rules rather than constraints.

The other and potentially more important reason that rules like the marriage rule are default rules rather than constraints concerns their enforcement. As Mnookin and Kornhauser (1979) document, less than ten percent of divorces actually involve a decision by a judge which settles disputes between the divorcing spouses. While there are sometimes "hard" cases to decide that press the boundaries of the marriage laws, in most cases if required the judges apply a well understood pre-existing rule, such as rules for child support payments, alimony, division

[7]Important papers in the legal literature on default rules include Mnookin and Kornhauser (1979) and Ayers and Gertner (1989, 1992). 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.

of property, etc. Divorcing spouses only go to the judge when they cannot agree on a divorce settlement. Since the "default" rules that the judge will apply if the spouses cannot agree are clear, most divorce agreements are reached by the spouses (and their lawyers) and then rubber stamped by the court to be made official. The divorce agreements are reached in the shadow of the law, but the divorce agreements are not constrained by the law.[8]

As Mnookin and Kornhauser emphasize, the existence of the marriage default rules enhances the ability of divorcing spouses to use "private ordering" to determine how their marriage will terminate.[9] When the spouses cannot agree on a divorce settlement, when private ordering breaks down, then the court applies the default rules. The ability of the legal rules to enhance the value of personal arrangements lies not in the ability of the courts to coercively enforce divorce settlements. Getting deadbeat dads to pay child support is not the primary contribution of divorce courts to the marriage system. It is the ability of the legal rules to define outside options for the spouses. If one spouse fails to agree, then the default rules apply: the default rules define outside options.[10]

Advances in game theory show the power of outside options to shape and support human

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[8]Even in the United States, certain divorce arrangements with respect to children, are not allowed. But on many important dimensions like property and income allocation, spouses have a very wide freedom to chose.

[9]As Mnookin and Korhauser explain, and we should note, that divorce law in the United States before the no fault revolution was not structured as default rules in this way. In most societies, marriage law is not structured this way either.

[10]The default rules vary from state to state. Some states have unilateral divorce and other states require both spouses to agree to the divorce. There are many societies in which marriage laws are not default rules. In those societies couples may be married by arrangements and have no say over ending their relationship.

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 (defecting). The deep theoretical insight is that the possibility of sustaining any relationships depends in part on outside options, and moreover that the range of relationships that can be sustained may be increased if outside options are appropriately specified through default rules. Most social scientists appreciate the logic, but it often fades when considering specific forms of human 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 necessarily 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.[11] Default rules matter, but they do not constrain individual behavior.

We cannot emphasize enough the basic point that default rules do not structure the relationships to which they apply and they are not in any active way "enforced." Marriage law does not govern the conduct of spousal relationships within marriages nor is the law coercively enforced in a divorce. Most of the rules in the Uniform Commercial Code are default rules. Firms operating under the code are not required to actually follow the code and no government agents actively enforce the commercial code rules. Individuals and firms who use the code are

[11]For the effect of different marriage default rules on behavior in marriage across states and time in the United States see Freidberg (1998), Stevenson and Wohlers (2006).

free to enter into contracts with lots of provisions, many of which may not conform to the code. But when their contractual relationship breaks down and they go to a court to resolve their conflict, the court will apply the default rules about contracts specified in the code. Contracting parties are free to structure private ordered arrangements, and as long as the private ordered relationship is sustained, the courts have nothing to do with enforcing the private contract.[12] Private parties are able to write contracts that structure their relationship in the shadow of their contract, which exists within the shadow of the law. If their relationship breaks down and if they go to court, the court will not enforce all of the private arrangements the parties actually reached. The court will only enforce the terms the parties agreed to that fall within the rules the court has already announced it will enforce. The critical point to keep in mind is that the court does not automatically enforce the agreement the parties reached. We return to this later.

Both default rules and constraining rules provide a framework for personal interaction. People often believe that they know what the formal legal rules are even when they do not. People who get divorced are often surprised to find that the courts don't care whose fault caused the breakup of the marriage. People actually do know what the rules they operate under are, but most of the rules that govern peoples lives are not the formal legal rules in Table 1. They are the rules that fall under the rubric of personal relationships, social norms, social conventions, and the formal rules that govern the specific organizations they work in and associate with. A culture, a

[12]This is an important point. Much of the legal literature, Hart for example, assume that the law provides a model for private relationships. We explicitly suggest that many private relationships deviate in significant and in trivial ways from the relationships specified in laws. This is both because the law is incomplete, so private relationships, like contracts, contain provisions of which the law is unaware or mute. But also because individuals may agree to agree or contract around the law. The fact that these deviations cannot be enforced in a law court does not mean that they cannot be enforced in the context of the parties' relationship.

belief system, or a value system reflects the rules that people commonly share and work with, but which are not backed by coercive force of a government. This does not mean, however, that the personal, social, and cultural rules that exist at any point in time in a society are independent of the rules the government will enforce. All of the rules in a society effect how all the other rules work, and therefore effect how societies actually work.

Two subtler aspects of default rules play a role in understanding how governments create and enforce rules. First, despite the fact that the marriage law specify default outcomes that the couple can avoid by reaching their own agreement, this 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. Second, 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 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, Identity, 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. 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 broad class of people like citizens) we must clarify the intermediate type of rule that applies to some groups and organizations and not others. As already discussed we use the term "identity rules" to describe these rules and identity enforcement to describe rules who enforcement varies across individuals with different social identities. The application of an identity rule to a specific individual depends on the group or organization to which that individual belongs to. Identity rules recognize the social identity of individuals and treat them differently according to that identity. Identity rules apply differently to members of different organizations.[13] We will return to identity rules and discuss them in much greater detail.

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[13]Wallis 2011, calls these rules "anonymous rules." There is no difference between identity rules in this paper and anonymous rules in the 2011 paper, it is a matter of exposition and clarity.

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. Identity rules are always tied up with organizations, whether those organizations are formally recognized, like corporations and families, or social groups like ethnic and kin networks.

3D. Shadow of the Law and "Alegal" relationships

Two loose ends need to be tied up before we move on to the dynamics of rule enforcement. One is the shadow of the law. As legal scholars have long recognized, if a rule is clear and a court's decision is predictable, then people will carry out their relationships in the shadow of the law (as emphasized by Mnookin and Kornhauser with respect to divorce). The influence of the law extends far beyond the cases that come to court. The shadow of the law is a powerful concept.

The shadow of the law can extends far beyond what is in the laws as well. When governments enforce laws they support and enforce forms of explicit or implicit agreements. The explicit forms of relationships and agreements governments will enforce we can call "legal" forms. A legal relationship is not only allowed, but under the right conditions the government will enforce the terms of the relationship. Both constraining rule and default rules formally specify legal forms of relationships, and both types of rules cast a shadow of the law. Governments also prohibit "illegal" forms of relationships. When the government becomes aware that two parties are engaged in an illegal relationship, they break up the relationship and impose punishments on the offenders. Governments may or may not actively enforce

prohibitions against illegal relationships (seek out violators), but when they are brought to the government's attention it moves against them. Illegal forms of relationships also cast a legal shadow. As with personal and impersonal relationships, however, there is a third category between legal and illegal, which we will call "*alegal*" forms of relationship. An agreement based on an alegal form of relationship is not enforceable in court. But an alegal relationship is not illegal. Even when the government is aware of an alegal relationship it will do nothing to stop it, but it will not enforce it.[14]

Under the right conditions, the shadow of the law can also extend far into the realm of alegal relationships. We need to keep this in mind as we consider why elites might be willing to support the enforcement of impersonal rules. In an identity rule regime, it can be difficult, *ex ante* to know what is legal and what is illegal, because the application of the rule depends on the identities of the individuals involved. As a result, it is almost impossible in an identity rule regime, to engage in an *ex ante alegal* relationships or arrangements. *Ex post* many relationships and arrangements turn out to be *alegal* because the government decides to ignore them. But should a person, elite or not, come to the attention of the government, it is not clear that allowed behavior is anything other than explicitly legal behavior. Arbitrary government -- government that does not predictably enforce existing rules and bends rules to cover behavior in unexpected ways -- shrinks the *alegal* relationship space. Identity rules always contain an element of arbitrariness, at least from the *ex ante* viewpoint of parties who cannot know how the rule will be applied until they know the identities of the other parties who will actually appear in court. As

[14]There is a tendency to think of acts as legal or illegal, and in that strict division alegal acts are "legal."

we will see, one of the primary motivation for elite pressure to impose impersonal rules was the desire of elites to constrain arbitrary government. Elites wanted to expand the social space available for *alegal* relationships and arrangements.

Section 4. The Nature of Organizations

All of the social sciences study organizations. Groups of people who coordinate or cooperate to pursue some agreed upon end are the essence of "social" in the social sciences. Sociology, anthropology, political science, and economics all have well developed theoretical and empirical understandings of what organizations are and how they operate, although none of the theories has carried the day as a general theory of organizations. Our argument about the emergence of impersonal rules depends critically on the role of organizations in societies, but not on a complicated or sophisticated model or concept of what a human organization is. We present a simple, but we hope not too simple, and not controversial concept of an organization. Even a simple model of organizations, however, has several very important implications.

First, in all almost societies elites are elites by virtue of their position within an organization.[15] While all people, elite and non-elite, are individuals, elite individuals are powerful or influential because they are able to command, direct, influence, or affect the behavior of other individuals and their land, labor, and capital through an organization. This is true whether the organization is a tightly defined legal entity, like a modern corporation, or a loosely organized group with no legal identity, like a religious sect or a book group. Leadership is a capability that individuals exercise largely within the framework of organizations. The

[15]It is only in the recent past in some developed societies that a person can be defined as an elite simply because they have lots of money.

"interests" of elites are dominated by the interests of the organizations in which they operate and act. The more powerful the elite individual, the more important are organizations to his or her interests. While social scientists, particularly economists, may wish to abstract interests from organizations and only focus on the interests of individuals, they are inexorably drawn back to the fact that patterns of social organization determine what interests are, and in the case of powerful elites those forces are vital and powerful organizational interests. Elites cannot be separated from their organizations.

Second, a great deal of human experience with rules occurs within the framework of organizations. Many, although by no means all, organizations create explicit formal rules (written and unwritten) that are enforced by a variety of means. Individual families are organizations. Some families are tightly structured and others are not, and families very widely in the nature and enforcement of their own internal rules. We are bathed in rules from the very origin of our conscious lives, and those rules originate in the organizations we belong to.

Many organizational rules, even explicit formal rules that organizations write down, are default rules that are actually not followed explicitly or only followed under specific conditions. Any one who thinks they understand how an organization actually works by looking just at the formal rules is bound to misunderstand the organization. As Granovetter wrote "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)[16] Any theory of

[16]"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

organizations worth thinking about should come to grips with the fact that many organizations (like families) create rules that are often not followed. It is here that the concept of default rules is particularly useful.

Finally, organizations provide the social identities that underlay identity rules. Few of us when asked who we are, would respond like God to Moses from the burning bush: "I am that I am." We answer the question by placing ourselves in relationship to other individuals with whom we have a organizational affinity. Just as with single actor theories of government, we need to remain constantly aware that organizational identities can only exist if there is more than one organization. Although we will talk about rules within a single organization, our main focus is on rules that are created and enforced because of the interaction of two or more organizations. Greif (2006) has laid out formal model of how organizational identity can sustain credible rule enforcement in his "community responsibility system." NWW provided another model in our "logic of the natural state." If individuals identify with organizations from which they receive rents, then the two organizations can enter into agreements with each other that enable their members to credibly interact according to rules agreed to by the organizations.

The first two points are obvious, not profound, and the third is not an insight of this paper but earlier work. Nonetheless, they can be combined with a very simple model of organizations to generate some unanticipated implications. The implications are generated because focusing on organizations enables us to identify in a very general way some interests of elites, understand why default rules play such a large role in individual and social behavior, and finally open a door into the nature of enforcement through identity rules. What follows starts out with the theory of

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are inextricably intertwined." Blau and Scott (1962, p. 6).

what an organization is, but ends with the realization that the role of rules in organizations cannot be understood unless we have a theory of multiple interacting organizations. This is hardly an onerous requirement, since human societies have always been made up of multiple interacting organizations. The implications about enforcement are explored in more detail in the section that follows.

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.[17] 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. Two interacting individuals who know each other creates more value for each of them than interaction with a stranger. A relationships create rents when the value created in the known relationship is greater the value of dealing with strangers whom one expects never to meet again. There is no requirement that the rents be symmetric, only that they are positive for both parties. The 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. The smallest size organization is simply a pair of friends.

Coordination is the second source of the rents that organizations create. For many

[17]We only discuss rents in the classical sense. A choice produces a rent if the benefits of that choice exceed the value of the best alternative choice foregone: the opportunity cost. We never utilize the directly unprofitable rents definition.

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.[18]

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 economics, beginning with Coase's (1937) insights about the firm and continuing on through Williamson (1975 and 1985), Grossman and Hart (1985), and a host of others. Gibbons has argued that organizations should be thought of as interlaced bundles of relationships and contracts (1998, 1999, 2003).[19] Relationships or agreements between individuals can sustained by repeated interaction and the existence of rents to both parties.

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[18]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.

[19]Gibbons and Roberts (2012) is a thorough introduction to the economics literature on organizations.

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 partners matters. The existence of rents makes their relationship incentive compatible. The pure folk theorem relationship 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.[20]

Rents are 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. Members in an organization can sustain a higher degree of cooperation when members of the relationship expect to receive higher rents on an ongoing basis. An individual member who receives total benefits that are just equal to the total costs of membership receives zero rents from belonging to the organization. That member is indifferent to coordinating through the organization and her behavior is unpredictable, since any small change in circumstances may

[20]Voluntary organizations in Olsen's terms are not quite the same as adherent organizations in our terms, as Olson explicitly excludes the possibility that the organization uses coercion on its members. By an adherent organization we mean, explicitly, that no external parties are involved in the enforcement of rules and relationships within the organization, but we do allow the use of coercion within an organization, as discussed in the next section.

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 Maskin1986).

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 coordination and cooperation is expensive, particularly when coordination must be made credible through the continual *ex ante* transfer of real economic assets or costly threats to destroy economic assets *ex post*.

Contracts are agreements between individuals that can be enforced by third parties, that is, a person outside of the relationship. 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 rules and penalties for actions 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. By its very nature, third-party enforcement involves at least two organizations, the organization of the enforcer and the organization of the parties. As discussed earlier, the idea that a rule enforcer could be a single individual capable of coercing multiple individuals is simply unrealistic. The third-party is almost always an organization, and third-parties that use coercion are always organizations.

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. Contractual organizations have several advantages over adherent organizations. The employment of third parties may reduce the cost of internal rule enforcement and coordination within the organization. The employment of third parties may make some arrangements between an organizations credible when no internal arrangement can create credible commitments. Third parties who enforce the same set of rules over multiple organizations may significantly reduce the costs of coordination to all of the organizations. On the other hand, the multitude of adherent organizations suggests that these advantages are not always decisive.

A very simple set of governance rules for an organization illustrates how contractual organizations utilize third parties, borrowing from the ideas in Aghion and Tirole (1997) about formal and real authority within organizations. The simple specification of the formal rules lay

out who gets to make decisions about the allocation of certain resources within the organization.[21] You can think of these rules as an organizational chart. The rules allocate decision making power and are characteristic of a general class of rules that allocate the power to decide among individuals. 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. Actual decision making within the firm (real authority) often does not resemble the formal default rules. Aghion and Tirole use the example of a manager who has the formal responsibility for making a specific decision about where to locate a new store. In practice, the manager 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. Whether the manager or the subordinate decides does not make the default rule less than binding, it simply means that actual decisions are made in the shadow of the default rules.

What Aghion and Tirole show in their formal model is that "Real authority is determined by the structure of information, which in turn depends on the allocation of formal authority." (p. 1) The structure of the formal rules creates incentives that govern the relationships between individuals within the firm. The formal rules are "good" if they increase the value of the relationship (the information) between the manager and his subordinates, even if the actual decision maker is not the formal decision maker.

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[21]So, for example, the charter of a corporation typically specifies a decision structure in which the right to make certain decisions are ultimately lodged with different groups, shareholders, managers, etc.

When relationships within the firm break down, the third-party agrees to enforce the decision rule when called on. That is, no matter who decides where the new store will be located in the normal operation of the firm, if there is a dispute within the firm over where the new store should go, the third-party will allocate the decision to the manager. Note that this particular example of a third-party enforced rule operates as if it were a default rule, no matter how it is enforced. As long as the members of the firm are capable of agreeing among themselves how to make the decision over the location of the new store, the third-party is not invoked.

As we emphasized earlier, the role of the third-party is not to insure that the manager actually picks the location for the store. We cannot place too much emphasis on this point. The point of the rule allocating the decision to the manager is not to have the rule enforced, it is to coordinate the individuals within the firm as they make their decision. The formal role of the third-party is to resolve disputes within the firm by enforcing the formal rule when necessary. The real function of the third-party in enhancing the value of the firm, is to clearly define the outside options for the manager and his subordinates in such a way as to make value enhancing decisions more likely. Any rule arrangement with third-party enforcement must be specified ahead of time, even if the rule is very simple, as in the manager always gets to make the decision. As we will see in the next section, it must be in the interest of the third-party to enforce the rule. In order to be effective, third-party enforcement must be credible.

Aghion and Tirole distinguish between real and formal authority, which is perfectly appropriate for their purposes, but for our purposes a more general point emerges. All of us live in multiple organizations governed by explicit rules, yet in many situations the rules are not

actively "enforced."[22] Even when explicit rules are actively enforced our behavior does not conform to the rule. In the manager example, the firm may require and actively enforce that the manager sign a form designating the location for the new store. Despite the apparent active enforcement of the rule, the manager may still allow his subordinate to make the choice. This does not mean that his actual behavior "breaks the rule," however. In many dimensions of our lives, what matter are the relationships, arrangements, and agreements made between people. As long as those agreements are amendable to all parties, the rule is not invoked. We are following the purpose of the rule even if we are not following the letter of the rule.

This is because the if the full specification of the rule was written out it would be apparent that the rule is really a default rule. A full specification of the rule that the manager decides, if written out fully might read: "the manager is responsible for making the decisions, but he can use the advice of or allow any one else in the firm to make the decision. If there is a disagreement within the firm over what decision will be made, the third-party will ensure that the manager makes the decision." This is a default rule. The threat that one of the participants in the firm will invoke the third-party to enforce the default rule defines an outside option for each participant. As long as the actual arrangements work better than the rule based arrangements, the rule is not invoked. In other words, the existence of the default rule provides incentives for the participants in the firm to find arrangements that work better that the default for everyone, in which case the default rule is never invoked.[23] This is the same logic that we identified with the

[22]Active enforcement requires monitoring and principles or agents who carry out consequences for rule violations.

[23]Invoking rules and reducing the value of relationships is a tactic utilized by unions and other employees when they "work to the rule."

role of default rules in marriage law.

Whether formal rules are followed in practice or not depends on the continuing value of the actual relationships sustained by the participants in the relevant organization or parts of an organization. This is the logic of coordinating rules laid out by Piaget: we are willing to follow rules, even if the rules are evanescent and only affect our immediate group, as long as the rules enable us to play the game at a higher level of value. As we noted earlier, the key to the operation of default rules is not coercion but coordination. The cost of breaking a default rule is not a coercive punishment, but the loss of the continuing relationship. As we will see in the next sections, default rules are often enforced by coordinated action, rather than coercive punishments. A default rule provides the common information necessary to implement a coordinated pattern of behavior among diverse individuals.

Part III: Dynamics: Organizing Violence, Enforcement, Networks, and the Emergence of Impersonal Rules

Part II laid out two of the three elements that make up institutions: rules and organizations. This part deals with the third element: enforcement of rules. Enforcement is inherently a dynamic problem. Even in the two person folk theorem understanding of rules it is the participants' expectation of future behavior, and the value of the relationship into the future, that enforces the rules the parties agree upon. When we move to relationships in which there is a third party rule "enforcer," the dynamic problem becomes more complicated, as expectations of the behavior of the parties as well as the enforcer must be credible in order for rules to coordinate behavior. Credible rule enforcement requires that under a variety of expected conditions, but not under all possible conditions, enforcement will be robust to small changes in

circumstances. Rule enforcement is never certain, it is always probabilistic. As a result, there is almost always some trade-off between the effects that a rule has on the people to which it applies if it applies with certainty, and the probability that a rule will actually be applied.

Section five develops the logic of the natural state, and shows how identity rules can increase the probability that rules will be enforced by embedding rules in a network of organizational relationships. The rents associated with the existence of organizations serve to make the behavior of organizations and their leaders more predictable. Identity rules, however, can never be impersonal. Avner Greif's community responsibility system clearly draws out this logic both formally and intuitively. In the process, we also provide a way to see how violence is organized in natural states and how identity rules and the organization of violence are connected.

Identity rule enforcement within a network of elite organizations does not require a government, but it does produce what NWW called the "dominant coalition." One of the implicit mistakes we made in our book was to equate the dominant coalition with the government. Here we begin by looking at a coalition, but eventually identify a "dominant network" of organizations. The rules for forming organizations, the rules that support the "entityness" of an organization, are crucial elements in the institutional structure of the dominant network. Since credible third party enforcement of organizational arrangements can be sustained by private ordering using identity rules, the formation of elite organizations does not require a government either.

The willingness and ability of organizations to sustain coordination, including their willingness to coordinate on the public decision made by one of the members who can be called a "government," depends strictly on the dynamic relationships between the organizations. The

interactive dynamics of elite organizations sometime leads to situation where it is important to make public the agreements within and between elites. We define governments formally in section six as organizations that signify public agreements. For reasons that will be clear, it doesn't make sense to think of these dynamics as rooted primarily in the coercive power of the government organization.

The seventh section lays out the logic by which individual elites and elite organizations may find it in their interest to begin to move toward impersonal rules on some dimensions. Elites must find it in their interest as individuals and as organizations. It will also be easier if elites conceive of the move as increasing their options and welfare, rather than as a sacrifice of their special privileges to the government. Finally, we emphasize the benefits of moving to impersonal default rules, which we suggest accrue primarily to elites, but only under certain conditions. We touch briefly on the American example and the work of James Willard Hurst, to show not only that the conditions applied in early 19th century America, but that elites conceived of what they were doing in the ways we expect.

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

Many theories of organizations assume that the institutional capacity to enforce rules and agreements already exist in the larger society.[24] Such an assumption will not work if our interest

[24]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).

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.

A fundamental 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. 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.) Starting with a single actor, however, avoids the important questions we must ask about the organization of violence.

In NWW, we developed an insight about the institutional relationships between organizations 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.[25] Suppose that if the two individuals can cooperate and form a coalition, they can overawe either of the groups they belong to.[26] They agree to come to each other's aid in the case of a conflict and by doing so agree to recognize each other's rights to the land, labor, and capital in their respective groups. Because of their coalition, the members are able to coerce their own group and gain control over its 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 be 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

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[25]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.

[26]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. Burkett, Steckel, and Wallis are working towards a formal model of coalitions and violence.

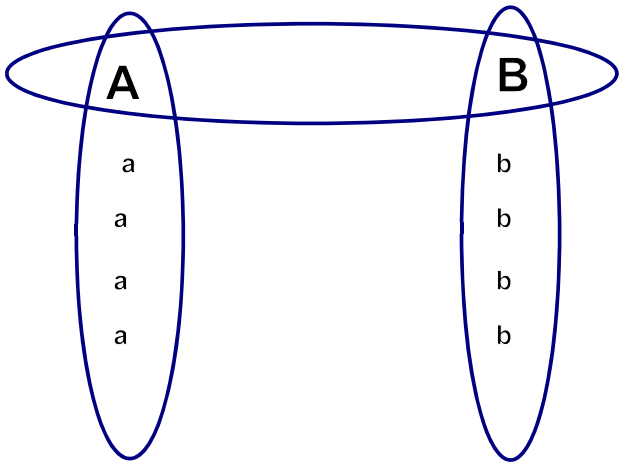
the coalition members to form a credible coalition is what makes the members of the coalition "violence specialists." They are violence specialists in the sense that only coalition members are capable of calling on the organized presence and violence potential of other members of the coalition.[27] The 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," a term we will reconsider shortly.

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

[27]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.

Figure 1



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 rents generated in 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 vertical arrangements also depend on the horizontal arrangements. Agreement between the specialists enables each of them to change and better structure their client organizations, because they can call on each other for external support.

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. Those rents also make the commitment to use violence credible. 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.

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) The logic of the natural state articulates how a material advantage can be created for A and B by entering into the credible arrangement depicted in Figure 1. The logic of the natural state transforms Mair's statement from a single actor theory, "that a man who wants to secure a following ..." to a multi-actor model, "that the men who wish to secure and lead a following ..." Neither A nor B holds a monopoly on violence. Their agreement, however, gives each a credible belief both the other will not fight.

The logic provides an institutional relationship between A and B that enables them to act in a coordinated way to use violence. A, B, the a's, and b's together constitute an institutional arrangement with rules, means of enforcement, and organizations that play the game. Critically,

the organization of violence that A and B are able to use depends on the nature of their agreement with each other and on the dynamic relationships between their adherent organization and their contractual organizations. Their relationship becomes an institutional arrangements through the creation of identity rules. The logic specifies the rules of the game, the means of enforcement of those rules, and the organizations that play the game. The rules identify A and B, who each enjoy privileges that are individually specific to them. The rules identify two organizations whose members, the a's and b's, have social identities that differ from A and B, but also from one another. In come circumstances it matters whether you are an "a" or a "b," a situation we consider with a more nuanced example in a moment.

The society depicted in the figure has a very simple institutional structure. In a minimal sense, we can think about two simple identity rules that can be credibly enforced, and both are default rules. The first rule is that A and B recognize each other's territory and assets. The second rule is that within the client organizations, when there is a disagreement between A and any of the little a's, B uses the default rule that A is right. In a dispute with his clients, A can always call on the support of B, and if B's presence is invoked, he rules in favor of A. 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 not reach if their social arrangements had to be essentially egalitarian. The logic of how violence can be credibly used to create gains from organized activity is laid out in Bates, Greif, and Singh (2002), we have put their single actor model into a multi-actor framework where

violence capacity is endogenous.

The logic underlying Figure 1 provides an intuitive solution the existence of elites and the dynamics of elite interaction. 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.[28] Elites are, by definition, individuals with significant resources and the power to influence other people. Unlike most theories of elites who are driven by the desire to acquire more wealth and the rare possibility that the masses can organize against the elites (Marx for one, and Acemoglu and Robinson (2012) for another), the logic of the natural state 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. These societies will remain small, or be characterized by small groups that cannot organize into larger groups under normal circumstances.[29] The rents that A and B lose if the fight, makes the no fighting rule between A and B credible under the right conditions. Enforcement of the rule is adherent, based on the interests of A and B and their ongoing relationship. If unequal distribution of rents within the society, and within each of the client groups, strengthens the ability of the dominant coalition to both limit violence and provide credible third-party enforcement, there will

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[28]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 association 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).

[29]Mary Douglass (1986, pp. 22-25) has a very nice observation on Mancur Olson's (1965) assertion that small groups are able to use repeated personal interaction to organize and solve collective action problems. Douglass points out that small groups cannot solve the collective action problem or they would be able to grow larger!

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 an interlocking sets of rents, and continued existence of the rents depends on enforcement of the identity rules. 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 simply not present in either Marx or Acemoglu and Robinson. Individual elites pursue their individual wealth, but simply maximizing elite wealth in total will almost certainly bring about conditions in which elites cannot credible commit to each other, and civil war will result. Historically, it probably is the case that elites who seek simply to maximize their individual rents create instability. The 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. Critically, the rules that elites enforce are identity rules that depend on the identity of the elites and the organizations they create. If we begin with the assumption of homogenous elites and single actor governments, then we are precluded from understanding these endogenous and dynamic elite relationships. The enforcement of rules involves coercion: rules are agreements ultimately backed by the threat of violence. But the viability of the rules as an institution depend on their ability to coordinate. It is the ability of

elites to coordinate, of A and B to work out a credible arrangement between them to limit the use of violence, that creates their ability to organize coercion. Coercion is rooted in coordination, not the other way around.

While the figure is a very simple representation, it captures the key elements we need to consider. In a functioning natural state the are many more organization. Member organizations of the dominant network include economic, political, religious, and educational specialists (elites) whose privileged positions create rents that ensure their cooperation with the dominant and create the organizations through which the goods and services produced by the population can be mobilized and redistributed. But the simple picture provides enough to see how credible third-parties can emerge out of the social arrangements that limit violence.

Institutional economics has come a long way towards understanding how rules embedded in a network of organizations can be used to support exchange over time and space between individuals who do not know each other personally. This definition of "impersonal" covers both what we define as impersonal and identity rules. We need to carefully separate them without losing the valuable insights already developed. Avner Grief defines impersonal exchange as occurring "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?" (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 identity based 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 identity and impersonal relationships. It is a too simple distinction.

Organizations form the social background for identity relationships to flourish. As Greif shows in his example of the community responsibility system, the ability of organizations to create and sustain rents within the organization enables organizations to credibly interact in ways that enhance those rents. A trader from Genoa could trade confidently in Hamburg, because he was identified as a merchant from Genoa. If he was cheated by a merchant in Hamburg he would goo to the Hamburg merchant guild. If the Hamburg guild court did not provide him with justice, then the Genoese trader returned home and sought justice in the guild court in Genoa. If the merchant guild in Genoa found his claims to be supported, the Genoese merchant guild would expropriate all of the Hamburg merchants currently in Genoa. Both Hamburg and Genoese merchants earned rents from their guilds and from trading. Those rents were available to secure the enforcement of trading rules if the two organized communities were willing to carry out punishments against members of their own guild and in favor of outsiders. This was only possible if outside merchants could be easily identified as members of the Hamburg or Genoese merchant guilds. The community responsibility system could sustain an identity based relationships over time and space because the rents generated within the merchant organizations enabled individuals to deal with one another credibly across organizations. These identity

relationships were embedded in organizational relationships rather than personal relationships.[30] In effect, the two guilds enable the guild leadership, the big A and B, to credibly enforce rules that the members, the little a's and b's, could utilize. The rules in Hamburg were not, however, impersonal in the sense of treating everyone the same. If you were not a merchant from Genoa or member of a merchant guild with which Hamburg had an ongoing relationship, you could and would be cheated by Hamburg merchants and in the Hamburg courts. Different rules and enforcement applied depending on your identity.

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 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 the rules they create and enforce are identity rules that apply differently to different people.[31]

The society depicted in Figure 1 has no government. A larger scaled up version of Figure 1, with many more elites organized into a network of coalitions, need not have a government either. The dominant network is the configuration of power in the society. We could

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[30] Granovetter's (1985) notion of the embeddedness of economic actions in social structure is the notion of identity relationships. As Greif explains, the community responsibility system began breaking down when it became difficult to identify specific merchants with city guilds.

[31]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.

call the dominant network 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 integrative public organization, or even any public organizations, that rule enforcement is lodged in. There are just the members of the network, the organizations they head, and the organization of the network. As depicted, the dominant network 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. Violence is limited by the creation and enforcement of identity rules, within a network of elites with interlocking rents. But the network does create the possibility of a government, to which we now turn.

Section 6. Defining Governments

If two or more organizations can always enforce identity rules, what is the role of government with respect to rules? We can not define government in terms of rule enforcement generally, since private organizations can create and enforce identity rules. Since few societies can enforce impersonal rules, but nonetheless most all have governments, we cannot define governments in terms of the capacity to enforce impersonal rules either. Our central question is how we should think conceptually about historically contingent transition have occurred from societies that support identity rules to societies with governments that can create and enforce impersonal rules. It is not about first principles that apply to all societies. Nonetheless, we do require a first principle definition of what governments are, one that is unchanging through time and across societies. After providing our definition we illustrate it with an example taken from marriage law. Then we compare our definition to Weber's famous definition of the modern state

and show that his definition is a special case of our definition. Then, definition in hand, we consider the relationship between governments and networks of elite organizations that make up the dominant network.

Credible impersonal rules require government creation and enforcement of impersonal rules that are publicly known. One key aspect of governments, therefore, is their publicness. Many organizations are public, however. Our definition of governments are organizations that "publicly signify agreements." Signify in the sense of to denote or to make known. Agreements are more complicated and we return to them in a moment. To illustrate, go back to the example of marriage law in the United States.

In many marriage ceremonies, the person conducting the ceremony concludes the formal part by saying "By the power vested in me by the state of (say) Maryland, I now declare you husband and wife." By those words, the "state" is publicly signifying that an agreement exists between these two specific people; that their agreement exists within the larger agreement of the political society that stipulates marriages enjoy certain rights and privileges and bear certain duties and obligations; and that the rules of the agreement apply both to the couple and to the society at large. The agreement has two explicit dimensions, one between the partners and the other between the partners and the government. A host of other dimensions may be explicit (tax implications) or implicit (social acceptance of cohabitation). The public ritual of a marriage ceremony signifies that a particular agreement has been reached, and is itself subject to a larger agreement that we all understand, at least in principle. The ritual invokes rules that provide a

framework for many relationships, even if none of those rules are coercively enforced.[32]

To relate our definition of governments as organizations that publicly signify agreements to Weber's definition it is useful to consider his classic definition in its full context:

> "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: today the state, or historically, those associations which have been the predecessors of the modern state. Ultimately, one can define the modern state sociologically only in terms of the specific *means* peculiar to it, as to every political association, namely, the use of physical force.
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> 'Every state is founded on force,' said Trotsky at Brest-Litovsk. That is indeed right. If no social institution existed which knew the use of violence, then the concept of 'state' would be eliminated, and a condition would emerge that could be designated as 'anarchy,'in the specific sense of this word. Of course, force is certainly not the normal or the only means of the state – nobody says that – but force is a means specific to the state. Today the relationship between the state and violence is an especially intimate one. In the past, the most varied institutions – beginning with the sib – have known the use of physical force as quite normal. Today, however, we have to say that a state is a human community that (successfully) claims the *monopoly of the legitimate use of physical force* within a given territory. Note that 'territory' is one of the characteristics of the state. Specifically, at the present time, the right to use physical force is ascribed to other institutions or to individuals only to the extent that the state permits it. The state is considered the sole source of the 'right' to use violence. Hence, politics for us means striving to share power or striving to influence the distribution of power, either among states or among groups within a state. Max Weber, from "Politics as a Vocation"[33]

Weber wisely begins his definition by articulating his definition in terms of the means peculiar to states rather than particular functions, tasks, or ends that political association perform

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[32]On the role of ritual as a means of creating public, common knowledge see Chwe (2003).

[33]The quotation is from Weber, 1948, pp. 77-78. A slightly different translation is availble at Weber, 1994, p. 315. There are several other places where Weber provides similar definitions of the state, some more succinct and others expanded. One is in *Economy and Society,* 1968, pp. 56, which is usefully located since it follows Weber's definition of organizations and other sociological terms on pages 50-56.

or pursue, since there is scarcely an end which some government has not pursued. He then defines the modern state as the organization that claims and exercises a monopoly on the legitimate use of violence. Note that the formal government is not the only organization that uses violence, but that no organization or individual can use violence without the state's permission: "the state is considered the sole source of the 'right' to use violence."

To rephrase Weber slightly, a modern state or society comes into being when the government obtains the ability to publicly signify agreements that completely determine the "right" to use violence. The agreement itself allocates to specific organizations and individuals like police and military organizations, the ability to use violence under specific conditions and circumstances. The arrangements are recognized by the larger society "within the given territory." Part of the agreement is that the government organization itself, or its delegates, can use violence under specific conditions. Part of the agreement is that private individuals and organizations can use violence under certain conditions, and that the use of violence carries with it obligations, duties, and penalties under certain conditions as well.[34] The agreement is not just about what the government can and cannot do, it is also about what private actors can and cannot do.

Although we put our words in Weber's mouth, Weber argues that modern societies appear when governments are able to publicly signify agreements between and among violence using organizations and the larger society in such a way that the use of violence is codified and agreed upon (difficult or hard cases about applying the rules of agreement not withstanding).

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[34]Weber should be read as assuming that we are talking about credible agreements about the use of violence, although he does not make that explicit caveat.

Because people generally agree that the agreement is in force, the agreement is "legitimate." Use of violence outside of the agreed forms is *per se* illegal and can result in sanctions or punishments. This simplification of Weber's argument it is not an unwarranted simplification of much of the theoretical social science, law, and philosophy approaches to this key element in modern societies that assume, as we showed in section 2, that the government possesses monopoly on the legitimate use of violence.

Weber's definition of the modern state is a specific instance of our general definition of government as the organization that publicly signifies agreements. We diverge from Weber in two ways. We don't think that Weber would disagree that publicly signifying agreements is one of the functions that many governments perform. He would disagree that signifying agreements is an essential function of all governments. He would insist that the agreement about the allocation of the "right" to use violence is the essential agreement that makes for a modern state.

Many have interpreted Weber as saying that when the government obtains a monopoly on the legitimate use of violence, then modern societies and states appear. We disagree with that interpretation. Careful reading of the quote reveals that Weber, in effect, was saying something different. Modern states appear when not when the government has a monopoly on the use of violence, but when the government has a monopoly on the rules governing the use of violence. More explicitly, the institutions that govern the use of violence -- the rules, the means of enforcement, and the organizations that use violence -- are all under the force of an agreement publicly signified by the government. Part of the agreement is that the government can punish rule breakers. Part of the agreement is the conditions under which private actors can legitimately use force. The agreement must be credible, of course, but that is a central question that we have

been wrestling with throughout the paper.

Like us, Weber was understanding how societies worked and were organized, but for him the answers were to be found in understanding the nature of leading and following: how leaders led and why followers followed. For us, social identity and identity rules are an outcome of social dynamics. For Weber, the sociologist, social identities were fundamental primitives of social life. Weber takes leadership as an everywhere present element of societies, we take leadership as the outcome of a particular set of social relations. Weber opened his lecture on "the profession and vocation of politics," from which the previous quotation is taken, by asking "What do we understand by politics (*Politik*)? The term is an extraordinarily broad one, embracing every kind of independent leadership (*leitende*) activity... Today we shall use the term only to mean the leadership, or the exercise of influence on the leadership, *of a political association* (*Verband*), which today means a *state*."[35]

Weber understands that the ability to lead, particularly to lead organized violence, while it may be based on the *charisma* of an individual leader, requires organization:

> All organized rule which demands continuous administration requires on the one hand that human action should rest on a disposition to obey those rulers (*Herren*) who claim to be the bearers of legitimate force, and on the other hand that, thanks to this obedience, the latter should have at their command the material resources necessary to exercise physical force if circumstances should demand it. In other words, it requires an administrative staff and the material means of administration. p. 313

He then describes how in most societies, ownership of the means of administration is widely dispersed in *estates* (very feudal and European). What occurred in the emergence of modern states was the consolidation and conquest of the means of administration by the central

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[35]The quotation is taken from Weber, 1984, p. 309, which is the Ronald Spiers translation of "*Politik als Beruf,"* which is translated as "Politics as a Vocation" in other versions.

government, or the *prince*:

> The development of the modern state is set in motion everywhere by a decision of the prince to dispossess the independent, 'private,' bearers of administrative power who exist alongside him, that is all those in personal possession of the means of administration and the conduct of war, the organization of finance and politically deployable goods of all kinds. The whole process is a complete parallel to the capitalist enterprise (*Betrieb*) through the gradual expropriation of independent producers. In the end we see that in the modern state the power to command the entire means of political organisation is in fact concentrated in a single pinnacle of power, so that there is no longer even a single official left who personally owns the money he expends on buildings, supplies, tools, or machines of war over which he has control. Thus in today's 'state' (and this is fundamental to the concept), the 'separation' of the material means of administration from the administrative staff, the officials and the employees of the administration, has been rigorously implemented. At this point the most modern development of all begins, for we are now witnessing the attempt to bring about the expropriation of the expropriator of the means of politics, and hence of political power itself. Weber, 1994, p. 315.

The quote sounds familiar, and it is. It expresses clearly the logic that underlies the consolidation and creation of nation states in Tilly, if not the details of the history. It rings true to Acemoglu and Robinson's emphasis that modern development can only occur in a society where the state has "centralized" (2012, pp. 79-83, 91-95). It is the image of a state builder, in the person of the prince and his extended body – the administrative mechanism – that builds a powerful center out of chaos, that underlies the notion of state capacity (Besley and Persson, 2011) the appearance of the sovereign state and its competitors (Spryut, 1994), or the subtitle of Ertman's (1997) *Birth of the Leviathan: Building States and Regimes in Medieval and Early Modern Europe.* It is the central image in Hobbes.

For Weber, modern states appear when ownership of the means of government, which include the organizations that use violence, are concentrated in a single person. The sociology of the administrative structure necessary to run the government must organize "rationally." We

have to be careful about words here. We substantially disagree with Weber when we argue that "modern" societies emerge with the appearance of credible impersonal rules. The rules that govern the use of violence are only a subset of those impersonal rules. Moreover, the social dynamics that make the rules about the use of violence credible are embedded in more that the costs and benefits of violence, but involve all of the rules based relationships is in a society. Contemporary China and Russia are modern in Weber's definition, but they are not modern in our definition.

A government becomes modern in Weber's definition when it acquires a monopoly on rules governing the use of violence. At that point, the dynamics of government and government administration are fundamentally altered, and altered in sociological terms.[36] The government's control of violence also alters the government's relationship with other powerful organizations in the society, the previously private 'bearers" of government coercive power that have been expropriated by the prince. In our framework, the government's ability to create and enforce impersonal rules is not fundamentally grounded in its monopoly on coercive power, but on the nature of those changing dynamics within elite organizations that make up the dominant network. The government's monopoly on coercive power is the result of its ability to leverage up the value of coordination in the entire society. Coercive power flows from the government's ability to coordinate through rules, not the other way around. The government does not seize coercive power and expropriate the existing powerful organizations. We have a very different conceptual view of the social dynamics that surround the emergence of societies with centralized

[36]For a very similar view, see Schumpeter's understanding of why professional administration will eventually subvert capitalism in *Capitalism, Socialism, and Democracy*.

governments. Our view enables us to explain why the United States and Russia, while both modern states by Weber's definition, differ in their ability to create and enforce impersonal rules. It is not the social dynamics that flow from the coercive power wielded by Obama and Putin. I fit were, both societies would have impersonal rules.

Where do governments come from? Think of a society made of many clumps of elite organizations capable of creating and enforcing identity rules. Like Figure 1, only the clumps have multiple elites (A, B, C, D, etc.) and the groups or coalitions of elites and their organizations are tied into the network of other elite coalitions. Identity rules exist in these larger networks as well. In some societies there is a king or big cheese, whose identity is paramount, even if his or her power may not be. In other societies there are powerful actors who head organizations with a well recognized social identities, but there is no paramount identity. Elites possess social power, in the sense we talked about earlier. Elite organizations specialize in many different things, some more coercive than others. But all organizations are organized, in the sense that the network collectively recognizes the existence of all elite organizations. The majority of the population, the masses if you will, are located within elite organizations. They are the little a's and b's. In reality an infinite gradation of stature exists between and among elites, and within elite organizations between and among members, from the King to the lowliest peasant or slave. All societies make distinctions and create identities. Undifferentiated masses of people only exist for people who are viewing the society from far away and not paying attention to details. These identities are a critical element of the existence and enforcement of identity rules between and within organizations. The identities extend from the very highest to the very lowest levels fo socceity. Third party enforcement is available within and between

organizations in the context of the identities generated by the pattern of organizations.

Coalitions of elite organizations are always able to generate rules and third party enforcement (subject to their ability to coexist). The extent to which they can access third party enforcement from a larger network of elite coalitions depends on the nature of coordinating rules at higher and more aggregate levels of social interaction. In NWW we used the term "dominant coalition" to describe elite interaction. Here we use the broader term "dominant network" to signify the potential existence of multiple elite coalitions, all of which have the capacity to create and enforce some identity rules for themselves. Governments emerge out of the interaction of elite organizations in the dominant network, like clumps of butter forming in churning buttermilk.

In such a society there will be many governments as we define them. Elites and elite organizations will often find it in their interest to enhance coordination by publicly signifying what they have agreed upon. The benefits to the coalition come from the gains created by focal points, common knowledge, and/or equilibrium selection. Some of these agreements will concern coercion and the use of force, but many elements of the agreements will concern other aspects of relationships. Whether the agreements are credible, of course, depends on the effect of the agreement on the value of the relationships enjoyed by those to whom the agreement applies.

The mistake we made in NWW was to implicitly identify governments with the whole dominant coalition. Although we were careful not to present a theory of the state and to avoid making an explicit connection, as soon as we began to apply the conceptual framework to historical cases (see North, Wallis, Webb, and Weingast 2013), we found that we had no way to

sort out what dominant coalitions were from what governments were. To be clear, when we define governments here as organizations that publicly signify agreements, then many organizations of the dominant network in a society are not governments: because they do not signify public agreements. To be clear, in most societies there are many government organizations and those organizations need not be powerful in the coercive sense. Most societies are not systematically organized in the way that social scientists would like to imagine. We tend to impose order on disorder, if only as a way to organize our knowledge.

Societies appear to be hierarchies of authority, that is orders of ascending coercive power, but in reality they are hierarchies of coordination. The most powerful individual head organizations which are able to coordinate the resources of other powerful organizations into a powerful elite coalition. The willingness of elites to coordinate through publicly signified agreements determines what government organizations exist and how much coercive power those organizations possess. It is the ability to coordinate between elite organizations that creates power, coercive or otherwise. Coordination depends on the ability to construct a system of rents that produce predictable behavior. The rents are created and sustained by agreements and relationships embedded in rules that produce social identities and are intrinsically identity rules. Social identities are created by social dynamics within the dominant network and in the larger society. Identities are a result of those dynamics, not their determinant.

This is where the problem of too simple ideas reappear. Weber is among the greatest of sociologists and his way of thinking about societies depends on the existence of identities as

social primitives, the ideal types of his theory.[37] Most modern scholarship on governments and rules is Weberian in this sense, not because we read or consciously follow Weber, but because we start from the same simplifying theoretical position. Governments are not, however, social primitives but highly constructed social, economic, indeed political organizations that depend critically on the nature of the society in which they exist. Their fundamental, ideal type feature is NOT their ability to impose order on the larger society through coercion, the threat of using violence. Their fundamental feature is their ability to leverage up the value of elite relationships through the creation of a public agreement that signifies how elites and, eventually in modern societies, everyone have agreed to order their relationships. Governments appear when elites find a public organization useful for coordinating their arrangements. Governments may, or may not, possess coercive power as part of the publicly signified arrangement.

In societies without governments, where units of social organization are small and violence is prevalent, individuals often resort to the institution of the "feud" to protect themselves. The feud is a self-help institution. The institution of the feud deters violence by raising the cost of using violence, in the form of retaliation. Feuds usually originate in personal interactions, but grow into disputes between families, kin groups, and larger social organizations. Feuds are embedded in a social norms about what legitimate actions a person, their families, and their friends can take to redress an injury, including murder. Social norms about the legitimate causes for and conduct of feuds come into being in societies where the use of violence is widespread and, by definition, not monopolized by one group. Feuds are always about the

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[37]Weber brilliantly uses these tools and ideas. See the *Protestant Ethic and the Spirit of Capitalism* (2001) for what is surely one of the most subtle and powerful use of social identity, that of a Dutch Calvinist, to explain the emergence of the modern world.

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

The feud was a central institution in the society of the Neur tribe of what is today South Sudan. In the late 19th century, under British colonization, the Neur 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 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 leopard skin chief publicly signifies the agreement that

the feuding parties have reached. 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. The leopard skin chief performs a vital and conceptually pure government function, a function that does not involve coercion.

The leopard skin chief is a very simple form of government and the Neur are a unique 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 public signification of a private agreement conveys information to everyone. The aspect of publicness is critical for identifying which organizations are actually governments and therefore is the essential element of our definition of government.

Theories tell us which ideas can be used as building blocks to construct models of the world. As Einstein warned, be careful of building blocks that are too simple: the assumption that what goes on inside the blocks is not relevant to how the blocks interact with other blocks. Weber's notion of ideal types is a perfect description of theoretical ideal blocks. Weber never believed that the internal structure of government didn't matter, he knew it did. But he and we have assumed that the essential nature of the interaction between government and other powerful organizations in society occurs along the dimensions of the government's capacity for violence. With that assumption, the dynamic interaction of government's and elites along the coercion

dimension becomes the key determinant of the societies ability to create and enforce rules on the elites.

In the last two sections we have laid out a set of ideas that describe how the creation and enforcement of rules is inherently connected to the organization of violence. We cannot separate how rules are created from how rules are enforced, and therefore we cannot assume that the government's capacity for violence can be treated as a theoretical block independent of the kind of rules that determine the interaction of governments and other powerful organizations. We have all been making that assumption. Not because we were unaware that it is an assumption, but for lack of a better alternative. We have provided an alternative definition of government, now the question is whether is helps us understand the emergence of societies capable of creating and enforcing impersonal rules.

Section 7. The Shadow of the Law and the logic of government enforcement through coordination

It is time to put up or shut up about the emergence of impersonal rules. How can we understand the behavior of elites and particularly their willingness to voluntarily concede to government the ability to enforce impersonal rules? If we take the theoretical context of rules and governments developed so far in the paper as given, then there are four elements to our argument. The first is that elites must benefit significantly from the move to impersonal rules or they will block the move. The move must benefit essentially all elites, rather than just a subset of elites. Any move that imposes significant costs on a major elite group or coalition faction is unlikely to be sustained, as the affected groups will respond by threatening violence. The second is that the move must have positive benefits for elite organizations as organizations, as well as

elite individuals. Identity rules and natural state arrangements offer a way for the organizations in the dominant network to manage internal division over the allocation of rents and privileges. Although the balance among elite interests created by the rent allocations seems 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 that extent, all natural state societies live in the shadow of violence and any move towards impersonal rules that threatens elite organizations threatens the very foundations of the social order. Any move towards impersonal rules that makes elite organizations less valuable in general will be opposed. A preponderance of elites must (in Levi's term) "quasi-voluntarily" agree to abide by the new impersonal rules and that requires the benefits of the rule be widely spread throughout the elite.

Third, and more subtle, the move towards impersonal rules will be more likely to succeed if the change is perceived by as an increase in elite freedom to operate rather than an imposition of a government's coercive power over elites. Our insistence on the role of governments as a coordinator rather than coercer creates a pivots around on this critical point. Elites are, in a word, paranoid. They a justifiable paranoid about the ability of other elites to usurp or destroy their privileges. If elites in general, are forced to concede privileges to the elite faction that controls the government, elites will resist. We must not only show why the move toward impersonal rules makes elites better off, but we must show how elites conceive of the move as strengthening rather than weakening their collective position relative to the elite faction(s) in control of the government, and thus the faction in control of the formally enforced legal rules.[38]

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[38]On this point we all need to guard very carefully against anachronism. The contemporary world, us, almost universally reads Madison's quote that men are not angels to reflect his belief that a government made up of diverse power would be able to check any

The final element now seems obvious to us, but has not been well understood or, as far as we know, integrated at all into explanations of the move towards impersonal rules. The value of default rules to a society, organizations, and individuals is much greater when the default rules are impersonal rules. As we have discussed, default rules leverage up the value of private ordered coordination. Publicly enforced impersonal default rules have a significantly larger leveraging effect than identity based default rules. The ability of a default rule to coordinate behavior is limited by the number of people to whom the rule predictably applies. In an identity rule regime, it is always difficult to know how a rule will be enforced because enforcement depends on the social identity of the parties. The benefits that flow to elites from the impersonal enforcement of default rules lubricate the entire process, and provide the rational that satisfies the first three conditions.

Why can default rules be more powerful coordinating mechanisms if they are impersonal? A simple example illustrates. Suppose the courts use identity enforcement of the laws with respect to share ownership in a joint stock company. Rules apply differently with respect to the king, the nobility, the gentry, and commoners. For essential reasons, the law of joint stock companies explicitly allows shares to be traded. What is the value of a share to a specific individual? In most cases, when a company is liquidated, for example, the existing share holders agree to a settlement. A court will be asked to adjudicate the liquidation only if there is a disagreement among the shareholders. Clearly, everyone who owns shares is uncertain

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faction, and thus the pluralism of modern society is an inherent part, or inherent implication of Madison's ideas. That is not what Madison was thinking. The American founders wanted to construct a "good" natural state in which the ability of an elite faction or coalition to take over and dispossess other elite factions was limited.

about how the courts will value shares should a disagreement arise among or between the stockholders that leads to a liquidation of the company, because how the courts will allocate assets and liabilities will depend on in whose hands the shares are held. Because shares are tradeable, the allocation of shares among groups is *ex ante* unpredictable. If the king turns out to be a shareholder, he will get a better deal from the courts that a commoner, because enforcement is based on identity. The expected benefits of share ownership to a commoner will be lower if he or she cannot know who else will own shares. Likewise, despite the fact that the king gets a higher value of shares in a bankruptcy, the price the king's share command on the open market will be lower if the king get privileged enforcement. There will be a strong market incentives 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.[39] This is the logic of the natural state and Figure 1.

The king might be better off in the sense of realizing a higher market value for his shares, if he could credibly commit not to take a privileged position in the event of a disputed bankruptcy. The key, as always, is the credibility of the rule, not the king's promise. One can imagine situations where all elite parties, as well as non-elites, would benefit from the impersonal and unbiased enforcement of a rule that all shares of stock are treated the same,

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[39]Drelechman and Voth (2011a, 2011b, and 2010) have a very nice example of how the the debts of the Spanish Hapsburgs under Phillip II, who defaulted four times in the late 16th century, were were held by a coalition of powerful political insiders and Genoese bankers, who were able to credibly constrain Phillip's defaults by renegotiating the terms of loans and regulating access to additional loans. It was his relationship with them that made repayment credible. Impersonal bearer bonds would not have been credible.

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. The key, as always, is enforcement. If elites resist the enforcement of impersonal default rules, then the rules are not credible.

To gather up the main ideas: all human societies are composed of relationships and those relationships are coordinated by rules. Rules range from the highly personal and idiosyncratic rules that order a marriage, family, or friendships; to casual social norms and folkways that order small communities, neighborhoods, and groups; to social norms and conventions that affect larger groups; to formal and explicit rules within organizations; to formal legal rules, publicly signified agreements using the accepted public choice mechanism to articulate what agreements are accepted and how they will be enforced. As Aghion and Tirole emphasize, in many organizations (or organized human activity) the actual behavior of people is framed, but not determined, by the rules. The form of their rules are default rules. The default rules are not constraints. The default rules only come into play when relationships and decision making within the firm break down. The default rules define outside options that, hopefully, increase the value of the decisions that individuals within the firm make.

Expand the Aghion and Tirole analogy to the entire society. Elites are willing to create and abide by impersonal rules, when the credible enforcement of those impersonal rules create outside options that increase the value of the full range of all other elite relationships sufficiently that elites are made better off despite the loss of the advantages they get from enforcement of identity rules biased in their favor. The value of the impersonal default rules to the elites is not apparent in the enforcement of those rules, for the rules are applied only when relationships

break down. The value of the impersonal default rules is the increase in the value of other elite relationships that are sustained and increased in value. The effect of the rules is evidenced in the value of relationships that exist in the shadow of the law, not in the value of relationships that end up in court rooms.[40]

We explicitly attribute intentionality to elites in our explanation, which raises the question what intentions they had and what they thought they were doing. In the Tilly coercion/capital story, and even more explicitly in Acemoglu and Robinson, elites are explicitly disarmed or threatened with expropriation. In line with the Hobbesian idea that the state ensures rule compliance through the threat of violence, these stories depend not on the willing compliance of elites but on the coercive power of government. Despite Acemoglu and Robinson's argument that Britain moved to democracy because of popular unrest in the 1830s, neither the history of the United States nor of Great Britain suggests that the government threatened elites with coercive power (remember the capacity for government coercion of elites is implicit, yet critical, in the Acemoglu and Robinson history). The French did kill their king, queen, and a number of notables in their revolution. But again, there is no evidence beyond *post hoc ergo propter hoc* that regicide was a step on the path towards impersonal rules.

We need to be careful about making the too simple assumption that all elite share a common interest. In any system of identity rules, the biases in rule enforcement cannot always run in favor of all elites simultaneously. The enforcement of rules that depend on social identity

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[40] For a clear exposition of the shadow of law and the value of relationships see Hadfield and Weingast, 2014. Although we do not pursue the implications here, the idea that impersonal default rules will change the range and type of relationships that can be sustained should be readily testable by looking at the societies when they adopt impersonal rules, like the United States and Great Britain in the first half of the 19th century.

cannot always protect elites from other elites. In a conflict between elite groups, the group with more power or better connected interests within the dominant network will work against the interest of less powerful elite groups when it comes to rule enforcement. When Henry VIII desired to have Anne Boleyn removed as Queen, he had his officers bring a case against her accusing her of incest. She, her brother, and four others were convicted and executed. The bias in identity rules can go both ways, and members of the dominant network who find themselves in a weak position will be vulnerable. There is no doubt that fears of intra-elite, intra-network competition were high on the anxiety list of European elites in the 17th and 18th century, including elites in their colonial offshoots. Madison's Federalist paper #10 is a clear and familiar statement of elite fear of inter-elite factional conflict. The idea that a political faction/coalition could manipulate economic privileges to secure the support of other elite factions, and then use their coalition of economic interests to dominate the political system goes far back in European political thinking.[41] These are not fears that elites have about non-elites, they are fears elites have about each other.

We want an explanation of why elites decided to push for impersonal rules that identifies the benefits that elites generally received, where it is clear that no significant elite group was seriously disadvantaged, and, if possible, the argument came in a rhetorical package that suggested the power of the government organization was being reduced rather than being

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[41]Pocock, 1975 and 1987; Skinner,1978a, 1978b, 1988; Wallis, 2005, 2006, 2011; and North, Wallis, and Weingast 2009. These ideas are also identified with the "republican synthesis" in American history; Bailyn, 1967 and 1970; Wood 1969; and Shalhope, 1972 and 1982. The paranoia about factions and coalitions is currently the consensus view about why America revolted from Britain. While there are many debates about what caused the Revolution, there is no doubt that these ideas figured prominently in elite thinking in the 18th and early 19th century. It may be paranoia, but sometimes there are realities to be afraid of.

strengthened. The explanation will be historical contingent, rooted in the particular society from which we draw our example, and perhaps not generalizable.

Somewhat surprisingly, the historical events and historical ideas that fits the bill are still with us very much today in the politics of modern, open access societies. They are still associated with the interests of the elites, although how that interest is drawn and the elites are defined evolves through time. The ideas and debates are the staple of classic 19th century liberalism: freedom of contract.

We definitely are not saying that the idea of contractual freedom, somehow by itself, resulted in the emergence of impersonal rules and the transformation of societies. We are saying that if we look carefully at what elites said and did in the 18th and early 19th century, we can see in the vigorous debates a widespread and growing elite consensus that governments should allow more contractual freedom. That freedom was defined in specific way that map directly into our earlier concepts about rules, particularly about default rules. The argument for contractual freedom identified a clear and underlying logic that doesn't work in reality. Nonetheless, without understanding quite what they were doing, those ideas enabled early 19th century elites to move quickly towards truly impersonal rules.

These were not unique to the United States, but we both started out as American economic historians and the historical case is so well understood that we use to highlight what a fuller history could reveal. Before we do that we need to expand on aspects of default rules that we introduced earlier. As we said, default rules do not constrain the kind of agreements individuals can reach, nor are default rules actively enforced. There is nothing "illegal" about ignoring a default rule, or forming an agreement explicitly inconsistent with the default rule.

Default rules set outside options, invoked only when the relationship ends.

When governments enforce rules they are supporting forms of explicit or implicit agreements. The explicit forms of relationships and agreements governments will enforce we can call "legal" forms of relationships. A legal relationship is not only allowed, under the right conditions the government will enforce the terms of the relationship. Both constraining rule and default rules formally specify legal forms of relationships, and both types of rules cast a shadow of the law. Governments also prohibit "illegal" forms of relationships. When the government becomes aware that two parties are engaged in an illegal relationship, they break up the relationship and impose punishments on the offenders. Governments may or may not actively enforce prohibitions against illegal relationships (seek out violators), but when they are brought to the government's attention it moves against them. As with personal and impersonal relationships, however, there is a third category between legal and illegal, which we will call "*alegal*" forms of relationship. An agreement based on an alegal form of relationship is not enforceable in court. But an alegal relationship is not illegal. Even when the government is aware of an alegal relationship it does nothing to stop it, but it will not enforce it.[42] (This is our last modification of existing idea that is too simple.)

As Anne Boleyn discovered, under an identity rule regime what is legal, alegal, and illegal is not entirely clear *ex ante*. There seems little doubt among historians that Anne did not commit incest, but her relationship to that rule depended critically on her position within the dominant network and, in her case, her personal relationship with the king. In an identity rule

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[42]There is a tendency to think of acts as legal or illegal, and in that strict division alegal acts are "legal."

regime, what behavior is legal, alegal, or illegal depends not only on who an individual is, it can depend on the identity of people the individual is associated with, whether that association is deliberate or not, or even whether the individual is aware of the association. Even if the personal identity of the associated people are known, it is impossible to predict *ex ante* what the dynamic situation within the dominant network will be at any point in time in the future, and thus it is impossible to predict with much confidence how identity rules will actually apply in the future as the fortunes of individuals and organizations waxes and wanes. Default rules based on identity, or identity default rules, are problematic because the operation of the rule cannot be determined without knowing the social identity of the parties involved. Identity default rules do not cast a very long or deep shadow into society as a result.

Proponents of freedom of contract often complained about arbitrary government. These complaints had many dimensions, but a central one was establishing rules that would be applied in a predictable way, and therefore rules that could not be based on social identity. Legal realists have formalized the idea that predicting what the courts will do is the central feature of law. Elites who urged the adoption of more certain rules, tended to do so using the language of impersonality: treating like alike, with the critical implication that most laws apply equally to all citizens. The shift to impersonal rules made clearer what forms of relationships are legal and illegal. The theoretical effect of specifying more definitively what is legal and illegal does to the range of alegal relationships is unclear, but in practice the effect of making rules impersonal was to better define what is legal, illegal, and alegal.

If the government was to apply rules in a predictable manner, then the government must become more constrained to abide by rules that apply equally to everyone, and then the

government has to follow its own rules.[43] Constraining government is a central tenet of laissez faire, and an central element in the arguments for freedom of contract. Conflation of many of these elements from the 19th century right up to the present can make it difficult to sort out whether the provision of credible impersonal rules is conservative, liberal, progressive, reactionary, racist, or civil libertarian at any moment in our recent history. While the debate within the legal community over legal positivism continues to rage on, the point the legal positivists make about the importance of predictable rules as constraints on the government continues to be one of the dramatic consequences of impersonal rules.

James Willard Hurst was a pioneer of law and economics and major contributor as well to the economic history of law. In his book *Law and the Conditions of Freedom*, Hurst attempted to sort out some of the confusion that existed in mid-20th century United States over the perception of early 19th century America as they heyday of limited government: when America was a Republic where "one might believe that law played a minimum positive role in shaping our nineteenth-century society. It has been common to label nineteenth-century legal policy as simple laissez faire." (Hurst, 1956, p. 7) What Hurst argued instead was

> "The record is different. Not the jealous limitation of the power of the state, but the release of individual creative energy was the dominant value. Where legal regulation of compulsion might promote the greater release of individual or group energies we had no hesitation in making affirmative use of the power of law... (p. 7)"

And that the central institution of private property,

> "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 ... 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

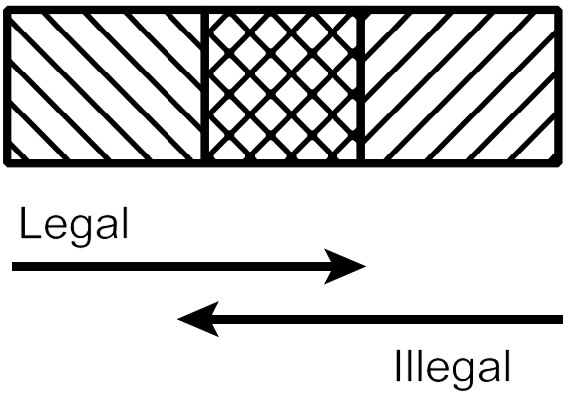
[43]Llewellyan, 2011, p. 46 has a very nice exposition of the logic.

> taken for the future.... 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*." (pp. 10-11, emphasis added)

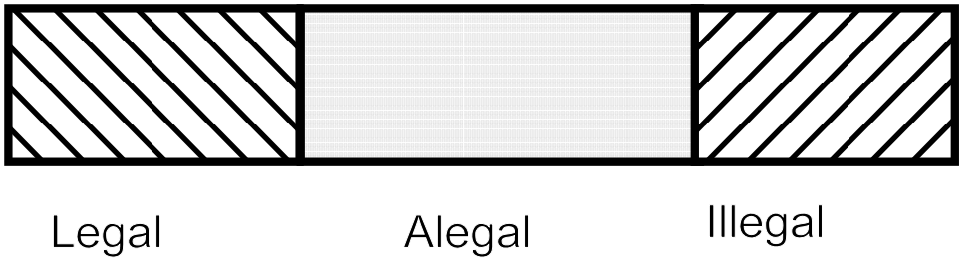
Hurst castigated the early 19th century liberals who thought they were achieving limits on arbitrary government and an increased autonomy of action. He documents the widespread belief that freedom of contract had expanded in the early 19th century, and pointed out that their new found contractual liberties depended on delegating the public force in aid of private decision making. For our purposes, Hurst identified what early 19th century elites were thinking, although we want to turn his interpretation on its head.

Historical proponents of freedom of contract argued in a straightforward way that the government should simply not be involved in the regulation of many types of relationships: that those relationships should be alegal. In our view, most of the relationships listed in table 1, virtually all of the personal relationships and social norms, already fall into the alegal category. The provision of clear impersonal default rules can significantly increase the number of

Figure 2



Identity Rule Regime



Impersonal Rule Regime

sustainable relationships by more clearly defining outside options for members of relationships. To the extent that the logic was at work with the appearance of impersonal rules, then the range of alegal relationships that could be credibly sustained increased with the appearance of credible impersonal rules. Simply moving from rules that were enforced using social identity to default rules that are impersonally enforced should have increased the range of alegal relationships.

Figure 2 depicts a stylized way of the transformation. In the upper panel, under the logic of the natural state relationships are legal or illegal, and the two categories overlap. That is, certain behavior may be legal under some circumstances and illegal under others, where legal and illegal refer to agreements that the government will enforce or prosecute. Given the fundamental uncertainty about what the government will do, lots of relationships may end up being alegal *ex post*, but it will be risky to assume that they are alegal *ex ante.* In the lower panel, a society with impersonal rules, the distinction between legal, alegal, and illegal becomes distinct. The range of relationships that can be supported both by the law and by the shadow of the law expands.

We want to second the emphasis that legal theorists have placed on the predictability of the legal and illegal rules. But we want to draw attention to the effect of impersonal rules and particularly of impersonal default rules as a different way of conceptualizing "limited government." Rather than limits on the use of coercive force, we want to stress the limits on the reach of governments into the realm of individual arrangements. In a regime of identity rules, it is difficult for the government to credibly commit to limit its rules and rule enforcement *ex ante*, because the identity of the individuals who bring a dispute to the government, or with whom the

government itself has a dispute, will influence the enforcement of the rule. Limits on government are represented in the relative size of the legal and illegal boxes in comparison to the alegal box. The 19th century western European world witnessed a dramatic expansion of the alegal, which was simultaneously a clearer definition of the legal and illegal.

Hurst's criticized the laissez-faire interpretation of freedom of contract for overlooking the fact that the government was "delegating the public force in aid of private decision making" for all of the legal and alegal relationships and agreements. Hurst explicitly thought that public force was in effect everywhere the shadow of the law extended. We disagree. The range of sustainable agreements dramatically expanded beyond the agreements that the government would actually enforce. The default rules created a framework for contracting, even if some of the supported forms of contracting were not enforceable in court.

The benefits to an individual of the society moving to impersonal rules in this setting depends on the number of existing relationships that the individual is engaged in whose value will increase in the presence of an impersonal rule. Elites engage in a much wider and deeper range of relationships than most people. The more powerful the elite the wider and deeper, and so the benefits of moving towards impersonal rules will be greater for elites than non-elites and greater still for more powerful elites. So to, however, will the costs of surrendering identity rules which is why the movement toward impersonal rules is problematic for most societies.

NWW identified three doorstep conditions as necessary, but not sufficient, for the transition to open access. The first two are rule of law for elites and the existence of perpetually lived elite public and private organizations. The importance of both of those doorstep conditions is heightened by the logic we are describe here. Elites who do not experience credible

enforcement of some identity rules (and this is where government capacity is important) will never believe that enforcement of impersonal default rules is credible. Until elites experience credible enforcement of the laws they have, they will never be willing to concede to their governments the ability to enforce impersonal rules and realize the benefits reflected in the lower panel of Figure 2. Elites will be particularly sensitive to the nature of rules for forming organizations as well. In the next section considers explicitly the interaction between rules for forming and structuring organizations and the interests of elites. We will take that up in the next section.

We opened this section with four requirements for an explanation of how elites could find it in their interests to move to government creation and enforcement of some impersonal rules. Unlike the existing explanations of the rise of the national state or the transition from dictatorship to democracy, our framework does not require elites to stomach a significant reduction in their well being through the loss of privileges. Instead, we show how elites in particular could benefit from an expansion of impersonal rules if they believed that such rules could be credibly enforced. We also showed how the expansion of impersonal rules could be interpreted as a reduction or limit on the power of government, rather than a unilateral curtailing of elite privileges. Elites obtained the right to engage in relationships that the government would ignore, while still maintaining a clear set of boundaries for relationships and actions that the government would police. Expanding the range of relationships that were supported by the shadow of the law motivates the expanding notions of freedom of contract.

Now what about elite organizations?

The rules for the formation of elite organizations is a tricky subject, one that is dominated

by our experience with organizations in the modern world. Elites are always associated with organizations. While natural states always limit access to organizations, it is a bit of a misnomer to say that elites have limited access to organizations, or more accurately in terms of the logic of the natural state, that elites have limit access to third party enforcement for their organizations, because what makes an elite and elite is possessing the access. While we do not want to lose the powerful idea that limiting access creates rents, when we look inside the dominant network all the elites have access to some organizational tools. We do not want to confuse "access" with impersonality, particularly not in the context of elite organizations.

What happened historically, beginning on a wide scale in the 1840s in the United States and Great Britain, was a change in government policy toward the formation of organizations, particularly corporations. In the United States these were called general incorporation acts and in Britain registration acts, that allowed any citizen who met certain criteria to form a corporation through an administrative act. In the United States in particular, given the historical debate over the rises of democracy, the general incorporation acts are seen as a critical step in opening access to organizational forms. NWW devote chapters 5 and 6 to the logic and dynamics by which Britain, France, and the United States made the transition from natural states to open access orders largely in terms of the rules for forming organizations.

Seen from inside the dominant network, however, the movement to impersonal rules for forming organizations is not about opening access to organizations, since the elites already have organizations, it is about making the rules for the formation of organizations more uniform across elites. As we stressed in the logic of the natural state, all elite organizations are different. A and B in Figure 1 enjoy unique and personal privileges, privileges that are tied to their

organizations. The movement to a general incorporation law did not necessarily homogenize the rules regulating corporations, but it did create an organizational form that was available to all elites. Although the history of general incorporation acts and registration has largely been written from the perspective of opening access to organizations for non-elites, we want to explore what happens if we think of general incorporation acts as adopting an impersonal rule for the formation of organizations within the dominant network of elites?[44]

Elites are always paranoid about other elites, as we have stressed. Having the doorstep conditions in place does not guarantee a movement to impersonal rules, but it does mean that elites can experience of modicum of experience with rules that are credibly enforced by a government and its courts. Like legislatures, dominant networks are larger than the "minimum winning coalition."[45] Organizations within the dominant network exercise more or less power depending on their relationship with other elite organizations, and so the gains from network membership vary across organizations. Like parties in a legislature, the coalition structure within the dominant network determines the power and influence of specific elite organizations. We can draw on the political science analysis of coalitions within legislatures to model a piece of the dynamics within the dominant network. The threat of elimination from the network is always significant and a part of the dynamics that hold the network together.

Suppose the network members conceive of a rule that allowed all existing members of the coalition to form a new organization at will. The new organizations would not enjoy any

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[44]NWW look at general incorporation as a way of creating impersonal rules for elites, but Wallis (2005 and 2006) looks at general incorporation as a way of opening access to organizations for all citizens. Historically both views are sustainable, and both might be correct simultaneously, but that is not a question we address here.

[45]The model that follows draws on Weingast (1979) and Baron and Ferejohn (1989).

special elite privileges, that is the organization would enjoy a specific organizational form (or choice of forms). For simplicity, assume that the new organization has a continuation value of C for all elites. 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 abstract from time). One source of uncertainty facing the elites is the probability that the dominant network will actually honor its promise to allow such organizations to form. The governing part of the dominant network is a government that publicly signifies agreements. In this case, the agreement is that any elite has the ability to form an organization that the government will signify as a legitimate organization. The probability that the government will actually honor its promise is pC.

Suppose further that the benefits from being in the governing part of the dominant network are WCB (Winning Coalition Benefits), the probability of any individual elite organization being in the governing part of the network in any given year as pW, and the benefits from being in the non-governing part of the coalition are normalized to zero. At the beginning of any period, the expected ex ante expected benefits from being in the governing part of the network are:

(1) WCB*pW = WCB*pW - 0*(1-pW)

In most natural states, the dynamics of the network lead to expectations that promises made to specific groups, much less all elites, pC, will in fact be honored are quite low. As a result, the expected value of being in the governing (winning) coalition is higher than the value of a fixed organizational rule, C*pC:

(2) WCBi*pW > Ci*pC (For all coalition members, 1...i)

Most dominant networks 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 is a visible way. Regardless of how the agreement is arrived at, if the probability that a promise can be honored and the government organization makes a public signification that every elite has the right to form an organizations at will, then if the probability of the rule being enforced is high enough, perhaps:

(3) WCBi*pW < Ci*pC (For all network members, 1...i)

Under condition (3), the dominant network might 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.[46] A key element will be expectations about the enforcement of the rule, pC, which is which why the doorstep conditions play a fundamental role is setting the stage for the adoption of impersonal rules.[47]

Weingast (1979) and Baron and Ferejohn (1989), from whom the logic is taken, show how such a policy of "universalism" – giving every legislator some minimum benefits even if every legislator is not on the majority coalition – is a stable equilibrium. Weingast explains how the Congressional norm of not excluding any district from the benefits of Congressional legislation is supported.

It is easy to see how fragile a dominant network's commitment to the impersonal access

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[46]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.

[47]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.

rule for elite organization will be. The first rules to be adopted will probably be narrowly constructed, governing perhaps the formation of churches or manufacturing enterprises.[48] But even if narrowly prescribed, it will be difficult to maintain the substance of the rule. If churches are allowed to freely organize, and then some churches may become focal points for political organization against the governing faction, the rules are unlikely to be sustained.[49] When the rule is broken even once, pC decreases, and the likelihood that elite organizations will support the rule evaporates. Most dominant networks will not be able to credibly support a rule providing all elites support for forming an organizations, since such a rule means that the network cannot move against one of its members. That is, of course, why impersonal rules constrain the government as much as they governed, and why they are so hard to adopt and sustain.

Part IV

The final part of the book will draw implications of this approach to government for history, empirical work, and policy. For now a few of those are discussed in the conclusion.

Section 8: Implications and Conclusions

We have explained the historical emergence of impersonal rules by developing an

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[48]General incorporation laws for churches were the first adopted in the United States, in 1783 in New York for churches followed by other states. Manufacturing was next, 1810 again in New York, although these were not large enterprises.

[49]For example, in 17th century England their was formally "freedom on conscience" with respect to religious affiliation, but in practice and in law, rules were not impersonal with respect to religious identity. Religion was one of the important poles around which coalitions were organized at several points in the century, leading to a civil war and the deposition of a sitting king.

alternative way of thinking about how governments, rules, and social dynamics interact. Our most important conceptual contribution is to recast the definition of the government's role from coercer to coordinator. We have also expanded our conceptual and terminology for talking about rules. We illuminate how the ability of governments to coordinate may enable elites to achieve better outcomes even in societies with identity rule regimes, what we call natural states. Coordination within the dominant network is never completely stable and predictable, and identity rule regimes tend to go backwards as much as they go forwards (NWW, ch. 1). This has important implications for our understanding of the development process within natural states which we have not expanded on in this paper.

Viewing governments as coordinating organizations enables us to understand how and why elites may find it in their interests to accede to government enforcement of impersonal rules. This is true whether we frame the emergence of impersonal rules as the transition as from limited to open access societies in the terms of NWW, or from traditional to modern societies, from status to contract, or from feudalism to democracy. The key 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 identity rules, we realize that, under the right circumstances, 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?

Thinking of the essential element of governments as coordination rather than coercion

has several important implications that we can only mention here. One implication is to cast in doubt the importance that social science has placed on government capacity. In most societies governments are embedded in a network of elite organizations. Government "capacity" does not exist independent of dominant network dynamics. What appears to be a government with overwhelming capacity today can quickly become powerless tomorrow, as the case of Mubarak in Egypt in the Arab Spring so dramatically illustrates. Shifts in dominant network dynamics can destroy or create governments, and government capacity, quite quickly. Attempts to build government capacity by development agencies is likely to be problematic, as are models of development that center on government capacity, as in Besley and Persson (2011) or in Dincecco (2011). We come to this conclusion reluctantly, as it forces us to rethink the central role we have placed on fiscal capacity and fiscal interests in our own work (North, 1981; North and Weingast, 1989; NWW, 2011; Wallis, 2005 and 2006; and Wallis, Sylla, and Legler, 1994). We are not suggesting that fiscal interests and government capacity do not matter, but that we may have to rethink their role in network dynamics.

One certain implication of this paper is that attempts to impose order and enforce rules by strengthening the coercive power of one organization or group of organizations within a society will be counter productive. In the dynamic logic of natural state, making one group of elite organizations more powerful in coercive terms does not result in the other elite organizations submitting to their dominance, at least not in the long run, and it certainly does not create governments capable of better creating and enforcing rules. The American experiments in Iraq and Afghanistan are only the most recent examples of such a policy misconception.

To be clear, we are aware that Hobbes, Weber, Tilly, and our contemporaries like

Acemogly and Robinson, Bates, Greif, or Besley and Persson understand that elites are masses are not homogenous and that governments are not single actors. The question is whether in our conceptual frameworks, when we make simplifications that enable us to keep in our minds all of the complicated interactions, certain critical relationships and dynamics are collapsed and "too simple" theories result. We have come to realize that the assumption that the essential aspect of government that we need to understand for a society's ability to create and enforce any rules is the government's coercive power is one of those too simple ideas.

Elites were not forced to give up their power to coerce to their governments in a few 19th century societies. Impersonal rules did not appear because governments acquired the capacity to overpower their elites and citizens. Hobbes was wrong conceptually when he said "during the time men live without a common power to keep them all in awe, they are in that condition which is war." The paranoia in American and western European elites about fear of faction and the tyrannical power of government that surged through the 18th and 19th century was, at root, a fear of intra-elite dynamics. It was a fear of what happens if one elite faction gets control of the government organization. In the 19th century, 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 government enforced impersonal rules. As Hurst pointed out, the shadow of the law was growing. We need to stop viewing the shadow of the law as a shadow of coercion, and realize that, under the right conditions, government and impersonal rules cast a much wider, deeper, and more powerful shadow of coordination.

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