Comment on Clifford Zinnes and Omar Azfar's

"Preparatory Fieldwork for Designing Institutions for SME-friendly Trade Liberalization"

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This comment argues that Zinnes's and Azfar's proposals (henceforth ZA) can be strengthened by recognizing that institutional analysis is inherently context-specific and institutional development is inherently a historical process. Institutional analysis is context-specific in the sense that it requires identifying the details of the relevant transactions and the (often unobservable) institutions that influence behavior in these transactions. And institutional analysis is inherently historical in the sense that the effectiveness of a particular institutional change depends on institutions inherited from the past. Furthermore, the effectiveness of a new institution in generating particular outcomes can endogenously change over time due to its implications. More generally, an economy institutional needs change over the course of a development process. Hence, an analysis aimed at evaluating and designing institutional changes has to be context-specific and has to take into account that intervention is a process and not a one time event.[1]

I will elaborate on these points while drawing mainly on the history of a particular institution that contributed to trade expansion during the Late Medieval Commercial Revolution. In this developmental epoch, stretching from the eleventh to the fourteenth centuries, Mediterranean and European long-distance trade reemerged after an extended period of decline.

During this period, in many trade centers, merchants from various parts of Europe, who seemed to have few personal and repeated relationships, entered into exchange characterized by separation between the quid and the quo over time and space, such as credit, contracts for future delivery, negotiable securities, and maritime insurance.

The ability to conduct impersonal exchange enhances efficiency. But what were the institutions that enabled such exchange in the late medieval period? How could a creditor from one corner of Europe, for example, trust a debtor from another corner about whom he knew little and who could avoid interacting with him in

[1] For an elaboration on these points, see Greif, Forthcoming.

the future to pay his debts? Understanding the institutions that enabled such impersonal exchange characterized by separation between the quid and the quo over time and space during the late medieval period requires understanding how someone could have committed to fulfill his contractual obligations in such an exchange despite the inherited contractual problems and the institutional environment that lacked an impartial legal system with authority over the interacting individuals.

Combining historical evidence and insights from an overlapping generation, repeated game with imperfect monitoring highlights the institution that facilitated impersonal exchange characterized by separation between the quid and the quo over time and space. (Henceforth, I will refer to such exchange simply as impersonal exchange.) This institution - the Community Responsibility System (CRS) - functioned throughout Europe and enabled large-scale impersonal exchange without requiring that a merchant verify his current partner's past actions and also in the absence of an impartial legal system with authority over the interacting individuals.

At the center of the CRS were communities that were on-going organizations of overlapping merchants' cohorts and had intra-community contract enforcement institutions. Central to the operation of the CRS was joint-liability. If a member of community A, for example, had cheated a member of community B, each and every member of community A was held legally responsible by community B for the damage. Hence, community A had the choice of either ceasing to trade with community B or compensating for the damage and seeking retribution from the individual who cheated. This joint-liability system implied that members of each community were endogenously motivated to utilize their community enforcement institutions to discipline a merchant member who cheated in inter-community exchange.

These community enforcement institutions included courts or tribunals with coercive powers that acted, on the equilibrium path, as dispensers of impartial justice. Unlike courts-of-law, however, their behavior neither reflected adherence to principles of justice nor incentives provided by a third party. Instead it was a reflection of the incentives generated by the operation of an inter-community reputation mechanism, which was possible because of, rather than despite, the partiality of these community tribunals. The concerns of these tribunals with the ability of their merchant members to trade in the future induced them to dispense impartial justice. Finally, the CRS altered the information required to sustain impersonal exchange. On the equilibrium path, one did not have to know the past conduct of his current partner in order to exchange, only his partner's communal affiliation. The way in which inter-community trade was organized was aimed at facilitating the transfer of this information.

This short discussion of the CRS suggests the benefits of a context-specific analysis whose point of departure is the identification of the particular transactions and behavior that takes place within them that is crucial to the desired outcome - trade expansion. In general, in evaluating and designing different institutions it is beneficial to pay close attention to the details of the relevant transaction, the sequence of relevant transactions in which particular behavior has to be induced to achieve a particular outcome, and the institutions that currently influence behavior in these transactions. The importance of this starting point for evaluating the impact of various institutional designs is that the implications of a given institution depend on the nature of the relevant transactions and existing institutions. Without considering such transactional and institutional distinctions among various places or industries, for example, comparative analysis based on survey results or quantitative analysis can be misleading.

The functioning of the CRS, for example, crucially depended on the possible ex-post verifiability of past conduct by a third party. In the absence of such verifiability, any elder member of community B (in the above example) would have found it optimal to claim to have been cheated by a member of community A. This, however, would have made any exchange impossible on the equilibrium path. Indeed, historically, the CRS did not govern agency relationships in which past conduct could not be verified. The results of an econometric analysis of the effectiveness of the CRS that would have lumped together these two types of transactions would have been misleading.

Similarly, the efficiency contribution of the CRS reflects the broader institutional context and how it complemented the CRS. It shows the absence of other, alternative institutions, such as an impartial European legal system covering all countries and the existence of other institutions, such as intra-community contract enforcement institutions and institutions implying a high cost for living in one's community. An attempt to evaluate the efficiency contribution of the CRS without controlling for these institutional aspects of the situation would be misleading. Evaluating the effectiveness of various institutions requires recognition of the particular attributes of the transactions under consideration and their inter-dependence on other institutions.

More generally, the welfare contribution of introducing various rules and organizations, such as joint-liability or information-sharing organizations, crucially depends on the context. For example, in the community of the Maghribi traders who operated in the Muslim Mediterranean during the late medieval period, information was shared and any overseas agent who cheated a merchant was ostracized by all the other merchants. (Greif 1993.) In contrast, when organizations for information sharing were introduced among manufacturers in various contemporary Sub-Saharan countries, individuals provided false information by failing to report those who cheated them.

Arguably, this distinction reflects contextual differences. The details of the situation were not the same in both cases. The Maghribi traders operated in competitive markets and in relatively large commercial centers where many other agents operated. Hence, these traders were not competing with each other - one trader's gain was not the other's loss - and ceasing to operate through a particular agent was barely costly, if at all. This was not the case among the African manufacturers who competed with each other in local markets. Assisting your rival by helping him avoid a supplier who cheated you in the past was thus costly.

Similarly, the optimality of particular rules for punishing a cheater, even if it is sustained as a Nash equilibrium outcome, critically depends on the context. Among the Maghribi traders, for example, all merchants ceased trading with an agent who cheated one of them. Among the American merchants who operated in Mexican California, this was not the case. (Clay 1997.) Merchants reduced, but not to zero, the amount of their trade with an agent who had cheated once. They ceased trading with an agent only after a second incident of cheating. This distinct punishment strategy reflects the distinct contexts. Among the Maghribis, agents were perfect substitutes for each other and hence ceasing to trade with some agent was not particularly costly. Agents for the American merchants, however, settled in a particular Mexican community and had a local monopoly in that location. Different agents were not substitutes for each other there and initial punishment, therefore, did not entail cutting trade relationships with that agent.

The evaluation and design of new institutions can also benefit from paying more attention to the fact that institutional dynamics is a historical process in which past institutions influence the rate and direction of instructional change. Consider the CRS. While its origins are not reflected in the historical records, it was built on a foundation of existing institutions to which new elements were added to create a new institution. The CRS was developed from the existence of communities, intra-community contract responsibility, and the legal principle of incorporation. The ability to implement a new institution and its impact on a particular economy depends on the institutions inherited from the past.

The decline of the CRS reflects other manifestations of the nature of institutional dynamics as a historical process. During the thirteenth century, the CRS was on decline and was gradually replaced by other institutions. Why did the CRS decline? Its decline illustrates that institutional design should take into account that over time the institution itself may lead to changes that can undermine its economic benefits and political viability.

The CRS worsened the moral hazard problem associated with credit financing. The joint-liability reduced lenders' incentives to check the creditworthiness of their borrowers. The assurance that one's community would bail him out when necessary reduced the motivation to check the creditworthiness of a particular borrower. This, most likely, encouraged loans for commercial ventures that should not have been undertaken. Such loans reduced the economic efficiency of the CRS. Imperfect monitoring by communities - that is, genuine disagreements over whether or not cheating had occurred - implied a periodic breakdown of trade. The more loans that were not repaid, the more it was likely that such disagreements would occur and trade would cease.

Apart from reducing the economic efficiency of the CRS, the implications of this system also undermined its intra-community political support. Rich merchants, for example, found themselves benefiting less from the system than those who were poorer. Richer merchants could have traded based on their own reputations but they were the ones who bore most of the system's costs. When a poor merchant was unable or unwilling to fulfill his contractual obligations, the rich merchants suffered more from the resulting trade disturbance or they had to pay compensation. Endogenous differentiation in the initially homogenous communities reduced political support for the system.

Ironically, it was the same welfare enhancing processes that the CRS fostered - processes through which trade expanded and merchants' communities grew in size, number, and economic and social heterogeneity - that reduced its economic efficiency and intra-community political viability. Yet, the ability of various communities to replace the CRS with an alternative institution depended on their political environment. In England and France the political systems contributed to a transition to a system based on Individual Legal Responsibility and contract enforcement provided by the state. But this was not the case in politically fragmented Italy and Germany. In Germany, for example, the CRS was replaced by a system based on hiring mercenaries, following a disputed default accusation, to force the borrower's community to compensate for the damage. This system seems to have been much less efficient than the ones that prevailed in England or France.

This process of decline highlights another major consideration in designing institutions to advance development. The nature of the institutions required to enhance welfare change as development - brought about by past institutions - proceeds. Once again, the appropriate institutional design should be made while taking the context - stage of development - into account. Furthermore, this implies the need for forecasting and preparation for the institutional requirement once the current institutions are no longer sufficient.

In sum: evaluating the influence of particular institutional change and designing new institutions requires context-specific analysis and recognition of the historicity of institutions.

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