



# An Economic Theory of the Evolution of Governance and the Emergence of the State

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**Abstract.** Individual's desires to expand wealth in the face of scarcity underlie the evolution of rules and institutions of governance, as individuals attempt to reduce the transactions costs that impede coordination and motivation in an uncertain world. Some wealth-seeking individuals have or develop comparative advantages in violence, however, and behavioral rules and governing institutions may evolve to coordinate joint production of extortion too. The process by which such institutions evolve into a state is discussed. To illustrate the plausibility of this theory, various historical and modern state and non-state governance institutions are shown to be consistent with it.

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## 1. Introduction

Mises explains, in his discussion of “The Imaginary Construction of a Socialist Society” (1949:689–697), that when the foundations of praxeology and economics were being laid during the eighteenth century, it was an almost universally accepted assumption that “the state” represented the interests of the entire society. Since then, the state has, in the minds of many, become almost god-like, as they presume that it can solve all of the problems that arise from market imperfections (Mises 1949:689). Mises (1949:692) explains that in essence, such views “ascribe to the *state* not only the best intentions but also omniscience”, and he goes on to point out that neither assumption is valid. Austrian scholars have tended to focus on the knowledge problem in their challenges to the socialist doctrine, of course, although many obviously also recognize the interest problem. In contrast, constitutional-economics and public-choice scholars have tended to focus on the interest problem in their analysis of government failure, although some also obviously recognize the knowledge problem. Leading contributors to both schools see major flaws with the state but many still generally follow Hobbes (1651) and conclude that the concentration of power in the hands of a central authority is necessary for the maintenance of internal order (e.g., defining and enforcing property rights, enforcing contracts), so they develop Lockian type “social contract” or “constitutional” theories of the state and propose various constitutional constraints that

\*I wish to thank the Editor and two anonymous referees for their encouraging and helpful comments. This paper is part of a larger project on “The Evolution of Law” which has been supported by the Earhart Foundation, the Institute for Humane studies the Carthage Foundation, and the Independent Institute. It is a companion to Benson (1999a), drawing from and expanding upon that paper, and as a consequence, there is considerable overlap in the two papers. The focus is different, however, as this one stresses the evolution of institutions under different conditions regarding the distribution of power, while Benson (1999a) predicts the different types of norms that evolve in these alternative institutions.

are intended to alleviate the knowledge and/or interest problems while granting the state various law making and law enforcing functions [e.g., Hayek (1973, 1976, 1979), Buchanan (1975, 1993)]. By relaxing both the benevolence and omniscience assumptions, however, an alternative theory of governance and of the state emerges that appears to be much more consistent with historical evidence. This theory rejects the Hobbesian justification for the state, although it also suggests that the state may be inevitable.

The primary purpose of the following presentation is to provide a positive analysis of the evolution of governance and the emergence of the state based on the fundamental assumptions that provide the basis for most microeconomic theory—(1) scarcity, (2) methodological individualism, and (3) rationality—while relying on the fundamental principles of comparative advantage and opportunity costs.<sup>1</sup> These assumptions are brought to bear in the context of an uncertain world with transactions costs impeding coordination and motivation of behavior, and both primary rules of behavior and secondary institutions of governance evolve, at least in part, to reduce such costs. While the same assumptions underlie other explorations of governance, including many which have developed social-contract theories of the state, this presentation stresses that some individuals have or develop comparative advantages in violence. In this context, behavioral rules and governing institutions may coordinate joint production of plunder and extortion too.<sup>2</sup>

Section 2 contends that the desire to expand wealth in the face of scarcity underlies the evolution of many if not all rules and institutions of governance. Depending on comparative advantage, however, an individual may expand wealth either through “production” or “plunder,” to use Bastiat’s (1850) terms. The rules and supporting institutions of governance that evolve in a system dominated by cooperation to expand wealth production are explored in Section 3. Section 4 focuses on the rules and institutions that emerge in a system dominated by coercive wealth transfer (plunder and extortion). It is contended that the “state” evolves from these institutions, so the process by which such institutions evolve into a state is discussed. In order to illustrate that this theory of the evolution of governance and the emergence of the state is plausible, various historical and modern state institutions are also shown to be consistent with it. The same is true of many non-state governance institutions, so as an illustration, various underground and above-ground (“legal”) market institutions are briefly discussed in the concluding Section.

## **2. Scarcity, wealth seeking, and the evolution of rules**

Rules are behavioral patterns that individuals expect each other to follow. The rules one individual is expected to follow influence the choices made by other individuals: like prices, rules coordinate and motivate interdependent behavior. A subset of rules, “moral norms,” generally do not require explicit codification or backing by coercive threats to induce recognition, because they are widely “shared values” (Voigt and Kiwit 1998) adopted by individuals in their interactions with an identifiable (but perhaps changing) group of other individuals for reasons explained below. As such interactions evolve and change, norms also spontaneously evolve (Benson 1999a). There are obviously many other rules beyond norms that people are expected to follow, however. Some rules are not shared values, for instance, but instead, they discriminate in favor of targeted individuals and are imposed on others with coercive threats. Furthermore, many rules and accompanying governance

institutions are established through deliberate design rather than evolving spontaneously. The historical importance of deliberately designed rules as actual determinants of behavior is probably much less than is popularly perceived, however, since people rely on norms (including customs, conventions, etc.) to govern much of their behavior even when some formal rule of law may appear to apply (Ellickson 1991; Benson 1989, 1999a; Bernstein 1992). There are too many uncontrolled margins and unanticipated responses for a rule designer to consider. Nonetheless, such designed rules do *influence* behavior. In particular, deliberate efforts to impose rules create incentives to find and exploit uncontrolled margins in order to avoid the full consequences of those rules [e.g., see Cheung's (1974) and Barzel's (1989) discussions of the consequences of price controls], and in this context, the search for ways to avoid the rules also can significantly alter the path of the spontaneous evolution of behavioral norms. This occurs because the primary motivation for developing rules and institutions, whether spontaneously or deliberately, is that rational individuals are attempting to find ways to expand personal well-being or "wealth" in the face of scarcity (Hume 1751; Commons 1924:138; Benson 1994b). After all, rules are generally not necessary if there are no conflicts to resolve, and as David Hume (1751) emphasized almost two and a half centuries ago, the primary source of conflict between individuals is scarcity. Note in this regard that wealth does not just mean monetary wealth or even physical possessions, of course; it can include many other sources of satisfaction, such as health, security, loyalty, friendship, family, prestige, and power. Indeed, the relative values that individuals place on material and non-material aspects of wealth are at least partially endogenous [an important tenet of Austrian economics is that preferences are continually changing as people undergo the experiences of life (Vaughn 1994:80)]. In a very hostile environment, for instance, individuals may willingly sacrifice a good deal of potential material wealth in order to obtain more safety or security. Importantly, however, there are two ways that an individual can expand personal wealth regardless of what is valued.

Wealth can expand through cooperative interaction, including team production (e.g., of goods, protection, mutual insurance, child care), as well as the division of labor and voluntary exchange (of goods, but also of support, friendship, loyalty, etc.). Such voluntary cooperation requires trust, of course, so ethical behavior must be anticipated in order to participate in such a positive-sum game. The second method of wealth enhancement for an individual involves taking wealth produced by others through the use of force and/or guile. This does not just involve money and goods. For instance, slavery also can destroy wealth arising from family, friendship, and so on, in order to enhance the master's well being. And importantly, rules to facilitate extortion of involuntary transfers can be institutionalized, leading to what Oppenheimer (1908) labels as the "political" means of personal wealth enhancement (he contrasts it with the "economic" means of wealth production through cooperation). Naturally, incentives to avoid extortion are strong, so a political environment will influence the behavioral norms of both extortionists and the targets of their extortion. A positive analysis of the evolution of governance must account for the influence of the rules and institutions which facilitate cooperation and wealth expansion as well as those that are part of the political process of wealth transfer.

*The state of nature.* Let us begin with the thought experiment so common in political philosophy (Hobbes 1651, Locke 1690, Rawls 1971, Nozick 1974) and constitutional economics (Buchanan 1975, 1993). Imagine the Hobbesian "state of nature" wherein no

cooperative interaction occurs. Further assume that while there is considerable uncertainty, and therefore high transactions costs, decisions are *not* made behind the Rawlsian “veil of ignorance.” Thus, this analysis focuses on the rules and institutions that emerge assuming that rational individuals recognize at least some of their alternatives and anticipate some potential but uncertain outcomes [see Rubin (1998) for a criticism of the “state-of-nature” approach, but note that many of those criticisms probably do not apply here, in part because of this assumption].

Because of scarcity, competition over the use of property is inevitable (Hume 1751:14–34; Benson 1994b). Unilateral efforts to capture exclusive benefits of an asset (turn a property claim into actual ownership) requires that an individual back a claim with a sufficiently strong threat of violence to induce others to abandon their conflicting claims [violence is defined as the allocation of resources (e.g., capital to build a fort, labor time in guarding and fighting) to exclude other individuals from using claimed property]. Since several individuals are likely to have similar incentives with regard to any particular scarce resource, competition through violence could consume vast amounts of resources as each invests in an effort to exclude others. Is such a “war of all against all” (Hobbes 1651) an inevitable characterization of the state of nature? No. The competition for scarce resources is multi-sided, and any subset of individuals might be able to reduce the costs of conflict by voluntarily recognizing some subset of each others’ claims (Vanberg and Buchanan 1990:18). Importantly, however, given the option of employing violence as a means of securing property claims, each individual will enter such an arrangement only if he expects to gain as much wealth as he expects to have through the use violence (Umbeck 1981:40). Force determines the initial distribution of wealth rather than fairness (i.e., rather than some underlying social contract arrived at from behind the veil and based on distributional justice, some “natural law,” or some preordained morality), *even* when that distribution is voluntarily agreed upon (Umbeck 1981:45).

Where no one has a comparative advantage in violence [e.g., perhaps because the marginal product of investing in conflict is very low for all parties, as in Skaperdas (1992) and Rider (1993), or in a repeated-game setting where the parties learn that their capacities for violence are equal despite initial expectations of high marginal products], individuals can contract to recognize an equal initial distribution of private property rights to scarce resources. The incentives to cooperate in this case are largely positive: individuals enter the contract because they expect to increase personal wealth by focusing resources in productive activities as a result of reciprocity-based credible commitments to respect each other’s property rights claims, rather than through investments in violence which only produce mutual deterrence. In a dynamic, uncertain world, the resulting property rights arrangement still will require the support of some institutions (e.g., honest disputes may arise that can best be resolved by third parties), but they will not rely exclusively on coercion because, under these circumstances institutionalized sources of credibility other than violence also will evolve, as explained below.

If the agreement stems from an initial situation involving highly asymmetric capacities for violence, the dominant power can demand a relatively large share of property rights and wealth (e.g., property rights to some of the wealth created by other individuals). Indeed, an individual with an absolute advantage in violence will be in a position to induce another individual to accept slavery (Rider 1993), thus concentrating all property rights (including the ownership of other persons) and wealth in the hands of one individual. But,

the slave's incentives to accept the "contract" are "negative"—subjugation is expected to be better than the alternative very high probability of losing everything through violent confrontation. Accepting slavery leaves open at least some possibility of escape in the future, after all, while death does not. Therefore, the master also has to maintain his position of dominance in order to assure credibility on the part of the slave. The institutions that evolve to support credible commitments to "respect" the rules dictating a highly concentrated distribution of property rights and wealth like slavery will obviously be those of coercion and command.

Between the extremes of violence-free cooperation and coercively-imposed slavery, many other possibilities exist. Some involve dispersed private property rights and high levels of cooperation, with modest payments of protection money (tribute, taxes). Indeed, it may well be that those choosing to pay the tribute could effectively produce a sufficient counter-force to over-throw the "subjugator," but if the tribute demanded is not too great, and/or if the subjugator offers something in return (e.g., protection from outside threats) thereby reducing the net cost of such extortion, the opportunity cost for highly productive individuals to invest in creating a counter-force may be too high to make it worthwhile. Thus, the subjugator is constrained in how much he can extract. In this light, a continuum of "tributes" is theoretically possible, ranging from "slavery" (Rider 1993) when one person has an absolute advantage in violence, through situations involving a large degree of extortion and concentration of property rights, to modest taxes for individuals who could also produce effective violence if pressed (perhaps accompanied by some real protection services), to an initially equal distribution of private property rights and no coercive authority. All such systems can "naturally" evolve under different circumstances.

Since there is no unique prediction regarding the institutional arrangements that should move individuals out of the Hobbesian jungle, it becomes an empirical question, and the empirical evidence is pretty overwhelming. Essentially, all of the anthropological evidence points to the emergence of cooperation to facilitate order *within* groups rather than the emergence of coercion (Ellickson 1993; Ridley 1996; Rubin 1998; Benson 1999a). Hobbes' (1651) "war of all-against-all" at the individual level is rejected, even in the most primitive states of human (and pre-human) existence (Rubin 1998). This is not surprising since significant comparative advantages in violence probably did not exist until wealth began to accumulate. However, through hard work, luck, uneven distributions of productive resources, and so on, some individuals and groups develop comparative advantages in production and expand wealth more rapidly than others. Those with a comparative disadvantage in production (i.e., a comparative advantage in violence) have incentives to engage in plunder and to develop or adapt technologies that could facilitate the taking of the wealth others are producing (Oppenheimer 1908). The evidence is pretty overwhelming on this as well: while cooperation dominates within primitive groups (and extensive cooperation also definitely arises between some of these groups, as explained below), inter-group conflict appears to be a ubiquitous characteristic of human history (Ridley 1996:152–169, 189–193; Rubin 1998; Benson 1999a). Therefore, even though the rules and institutions of a spontaneously evolving cooperative order are considered below before turning to institutionalization of extortion and the evolution of political institutions, it must be emphasized that these developments are not necessarily sequential. They can occur simultaneously and each can influence the evolution of the other.

### 3. Cooperation, property rights, and the evolution of governance

Vanberg and Buchanan (1990:18) define “trust rules” to be rules of behavior toward others which individuals have positive incentives to *voluntarily* recognize, and explain that:

By his compliance or non-compliance with trust rules, a person selectively affects specific other persons. Because compliance and non-compliance with trust rules are thus “targeted,” the possibility exists of forming cooperative clusters.... Even in an otherwise totally dishonest world, any two individuals who start to deal with each other—by keeping promises, respecting property, and so on—would fare better than their fellows because of the gains from cooperation that they would be able to realize.

First consider the nature of the trust rules that should evolve and some of their implications for behavior, and then conditions that tend to facilitate their development and evolution will be discussed.

*Property Rights.* The primary source of conflict is scarcity, so trust rules will focus on property allocation issues. Wealth can be enhanced for everyone involved in such trust relationships if property rights are made relatively more secure and relatively more private. As Hayek (1973:107) explains, “The understanding that good fences make good neighbors’, that is, that man can use their own knowledge in the pursuit of their own ends without colliding with each other only if clear boundaries can be drawn between their respective domains of free action, is the basis on which all known civilization has grown. Property, in the wide sense in which it is used to include not only material things ... is the only solution men have yet discovered to the problem of reconciling individual freedom with the absence of conflict.” Indeed, the absence of conflict may be the primary objective of such agreements, as suggested above, given the relatively low probability of winning in violent confrontations, as even in many animal societies property claims in the form of hunting ranges are delineated and recognized, thereby reducing conflict (Hayek 1973:75). In other words, the primary goal of such agreements may be to obtain non-material wealth in the form of “peace” or security, but of course, the production of more material wealth is also likely to be enhanced for everyone involved in such trust relationships. If property rights are made relatively more secure and relatively more private, after all, time horizons lengthen and incentives to use the property for production increase. At any rate, whatever the objective, all organizations function to a substantial degree by delineating various rights that individuals are expected to respect (Barzel 1989:7).

The earliest forms of cooperation may not have involved completely individualized private property, of course. Ridley (1996:105–117) explains that hunter-gatherer groups probably shared food from successful large game hunts, for instance. Such rights are private in a *relative* sense, however, as compared to what existed in the Hobbesian jungle (and under a system of rules supported by coercion rather than cooperation, as explained below). Before being killed, the game was unowned (part of a common pool), but joint production in the hunt probably substantially increased the chances of success. Since an individual was unlikely to kill large game or defend it once killed, there were incentives to form “partnerships” for joint production of hunting and exclusion (an individual hunter would

have a great deal of trouble securing his claim to the carcass even if successful, after all, as other animals and men would have incentives to steal, so joint production of exclusion also substantially increased the likelihood of successful consumption). The result is not individualized private property, of course, but it is private property in the same sense that partners jointly own a business and share profits.

Through joint production and sharing, output rises dramatically. The risk of individual injury and/or starvation is also reduced (Ridley 1996:102). Significant reciprocities also existed, after all, as different hunters might be the ultimate killer on different hunts, so by sharing, individuals were reducing their risks and increasing their joint productivity. Such “insurance” also gives rise to moral hazard, of course, so there are also incentives to free ride, as Ridley (1996) explains. Therefore, cooperation might not materialize without rules to undermine free-rider incentives. Such rules clearly arose, including strong norms regarding sharing, as well as taboos against free riding and other activities (e.g., hording) that might create incentives for hunters in the group to shirk. Thus, an understanding of cooperation requires more than a recognition of potential benefits. The development of commonly accepted norms, *and* of governance institutions that instill incentives to recognize them must also be considered. Without a wedding between rights and obligations, the concept of rights has no real meaning, after all, as the fruits of one person’s alleged freedom can be taken or destroyed by another person.

Not all property rights in primitive communities were vested at the group level, however. In fact, as the benefits of individualizing property rights arose, such rights were recognized. Hunters tended to own hunting tools, for example, and with domestication of animals for hunting (dogs, horses), individual private property rights were recognized for them as well (Benson 1991a). A group might also claim a territory for hunting and/or herding, but with advances in agricultural technology, private property rights to land evolved (Ellickson 1993:1366; Bailey 1992): “There is abundant evidence that a ... group need not make a conscious decision to establish private property rights in land [and other resources].... Contrary to Hobbes and Locke, a property system can get going without an initial conclave.” No one really knows how cooperation and property rights actually emerged since the emergence of both predates recorded history and clearly predates the musings of philosophers, anthropologists, historians, and certainly economists. Let us focus on one possible theoretical scenario, however, in order to illustrate some of the types of governing institutions that can arise as private property rights are established.

Initially, productive resources may be abundant relative to potential claimants. Since individuals who do not have a comparative advantage in violence are likely to prefer to avoid conflict, they will tend to claim resources that are not yet claimed, as long as alternative productive resources exist (note that they do not have to be equally productive since the expected benefits of a less productive but undisputed asset may be greater than the expected benefits of more productive but disputed property, given the probability of losing in a violent confrontation). Thus, each party tacitly recognizes previously existing claims and chooses to claim previously unclaimed resources (indeed, it is likely that an already-cooperative nomadic hunter-gatherer community will claim adjoining landed properties and explicitly recognize such claims). This suggests that neighbors are not hostile towards one another from the outset, so various social and economic relationships may also develop relatively

easily. A multilateral web of such relationships may evolve and a “community” may form before scarcity of productive resources becomes a problem and conflicting claims arise. As more people make claims, resources ultimately become scarce and new entrants may attempt to institute conflicting claims (i.e., take property already claimed). Existing claimants now have a strong common interest in maintaining first-possession claims, however, and some experience with at least tacit cooperation in recognizing them. At a minimum, they have already tacitly agreed not to attack one another, and by building upon that cooperative relationship they may join together in a protection association in order to exclude outsiders from taking any of their possessions. While we can only speculate about prehistoric events of this kind, this is in fact what happened in many areas of the American West, for instance, where contractual associations in the form of mining camps, land clubs, and cattlemen’s associations formed to support existing claims and exclude outsiders (Anderson and Hill 1979; Umbeck 1981; Benson 1991b; Morriss 1997). Similar arrangements arose in medieval Iceland (Friedman 1979; Solvason 1992, 1993).

Social contract theorists in the Hobbesian tradition do not see behavioral rules and property rights evolving in this fashion, of course. Note that the veil-of-ignorance assumption turns the decision into a one-shot game, however, wherein individuals agree to a cooperative solution only if they expect others to be forced to behave cooperatively (i.e., only if some coercive institution is created). One-shot games do not really provide a compelling framework for thinking about the emergence of behavioral norms and property rights though, since this emergence has long-term implications for repeated and multi-party interactions (Ellickson 1991; Benson 1994b; Ridley 1996:57–84; Rutten 1997), and game theory demonstrates that cooperation can arise through repeated interactions, for instance (Axelrod 1984).<sup>3</sup> Perhaps, at some point, different individuals (e.g., members of different nomadic bands), decide to claim adjoining areas. Facing the likelihood of repeated interaction, they form relatively tentative bilateral relationships based on reciprocity incentives, promising to recognize each others’ territorial claims. Because the long-term reciprocal response is uncertain, a repeated-game situation does not guarantee unconditional cooperation even with the tit-for-tat threats to reinforce the positive incentives associated with remaining on good terms with the other party (e.g., relatively secure property rights, the potential to focus resources to produce wealth rather than violence). The dominant strategy still depends on expected payoffs, frequency of interaction, time horizons, and other considerations (Tullock 1985:1073; Ridley 1996:74–75; Rutten 1997).<sup>4</sup> Additional incentives for cooperation arise, however.

As more bilateral relationships are formed in recognition of the benefits from cooperation, a loose knit group with intermeshing reciprocal relationships begins to develop. In fact, even in a very primitive setting (i.e., not far from a state of nature), individuals are generally involved in at least one “community” as described by Taylor (1982:26–30), wherein “the relations between members are *direct* and ... *many-sided*” [also see Ellickson (1993)]. An exit threat becomes credible when each individual is involved in several different games with different players, in part because the same benefits of cooperation may be available from alternative (competitive) sources (Vanberg and Congleton 1992:426). When competitive alternatives make the exit option viable, Vanberg and Congleton (1992:421) suggest that one strategy that can be adopted is unconditional cooperation until or unless uncooperative behavior is confronted, and then imposition of some form of explicit punishment of the



non-cooperative player as exit occurs. They label such a strategy as “retributive morality,” and the “blood- feuds” of primitive and medieval societies provide examples of such behavior. This practice of retributive morality strengthens the threat to non-cooperative behavior by adding violence back into the repeated game (i.e., replacing tit-for-tat). However, the fact is that retributive morality or the blood feud played a much less significant role in primitive and medieval societies than is popularly perceived (Benson 1991a, 1992). After all, such violence is risky, and there is an even better alternative. If information spreads about the non-cooperation that leads the other party to exit, all of the beneficial relationships that the non-cooperative individual enjoys within the community can be put in jeopardy. All members of the community have an exit option, and therefore they may cut off all relationships with someone who has proven to be untrustworthy in dealings with anyone else in the group. This means that there is a low cost option to retributive morality: unconditional cooperation whenever an individual chooses to enter into some form of interaction, along with a refusal to interact with any individual who is known to have adopted non-cooperative behavior with anyone in the group and the spread of information about such untrustworthy people. Vanberg and Congleton (1992) refer to this response as “prudent morality,” and given that reputation information spreads quickly within a group, the consequences of retributive and prudent morality become quite similar.<sup>5</sup> If everyone spontaneously responds to information the result is social ostracism, a very significant punishment, even though it is not explicitly imposed by a single retributive individual. Essentially, each individual’s reputation is “held hostage” by every other individual in the evolving group, a la Williamson (1983) and reputation is an ideal hostage. It is highly valued by the individual who has invested in building it, so a credible threat of destroying it can be a significant deterrent, and the threat is also credible because the hostage has no value to the hostage holder and the cost of destroying (spreading truthful information) it is low.

*Solidarity rules: conformity to moral sentiments.* The spontaneous development of social ostracism illustrates that as a group evolves based upon bilateral trust rules, group-wide norms also evolve. Note that it is not the existence of “close-knit” communities that generates group-wide norms, as implied by Ellickson (1991:267). Instead, norms and communities evolve simultaneously as each affects the other: the evolution of norms of cooperation lead to the development of a web of interrelationships that become a “close-knit” community, and the development and extension of such a community in turn facilitates the evolution of more effective norms. Thus, as Vanberg and Congleton (1992:429) conclude, perceptions “of what is moral vary with relevant differences in exit costs. At the high-cost end of the spectrum, moral justification for tit-for-tat and retributive behavior seems to be fairly common, whereas Prudent Morality gains in importance as we move to the low-cost end.”

Many group-wide norms are simply commonly adopted trust rules that apply for all interactions. Others, called “solidarity rules” by Vanberg and Buchanan (1990:185–186), are expected to be followed by all members of the predefined group (although the boundaries of the group can certainly change as it attracts new members, etc.) because individual sacrifices associated with obeying solidarity rules produces positive externalities within the group. Solidarity rules are things like “do not behave recklessly and put others at risk.” However, they can also involve rules about individuals’ obligations in cooperative production of

rule-enforcement functions. Rules like “inform your neighbors about individuals who violate trust rules,” and “do not cooperate with individuals who behave in a non-cooperative fashion with someone else,” are solidarity rules in the sense that production of information and ostracism create benefits for everyone in the group by deterring non-cooperative behavior. This discussion may appear to imply that some sort of group selection process is at work, violating the assumption of methodological individualism. As suggested above, however, such rules are not explicitly established as contractual obligations in a cooperative cluster: they evolve spontaneously, just as trust rules do, out of individual self-interest. As such behavior becomes widely practiced everyone is expected to conform with it, creating expectations of *automatic* expulsion for a breach of a trust rule. When everyone is expected to follow this solidarity rule, failure to conform to it can also result in automatic ostracism.

“Conformist” behavior within groups is a widely observed phenomenon (Ridley 1996: 181–193). Such conformism and the consequent automatic application of rules by everyone in a group may also appear to be in conflict with methodological individualism, but again it is not. In particular, the internalization of norms (adoption of them as “beliefs,” so that they are simply followed in an uncalculating manner) allows individuals to avoid the high cost of calculating expected outcomes in every situation.<sup>6</sup> Significant limits on abilities to reason and to absorb knowledge means that individuals are not able to use conscious reason to evaluate *every* particular option in the array of alternatives that are available (O’Driscoll and Rizzo 1985:119–122; Hayek 1937, 1973), so rational individuals will often find it beneficial to voluntarily conform to rules in an almost unthinking way. And in this context, as Ridley (1996:132) notes, “Moral sentiments ... are problem-solving devices [that evolve] ... to make highly social creatures effective at using social relations [by] ... settling the conflict between short-term expediency and long-term prudence in favor of the latter.”

People conform to all sorts of faddish and ritualistic behaviors, of course, and even though they may appear to have nothing to do with evolving moral sentiments, they actually may have similar functions: facilitating cooperation. After all, while individuals want to identify and exclude non-cooperative players, they also have strong incentives to identify themselves as cooperative (Ridley 1996:139). Outward conformity to a group’s fads and rituals can serve as a signal of willingness to cooperate in order to be in a position to reap the rewards from participation in joint production and other forms of interaction within the evolving group. As Ridley (1996:188) explains, “We are designed not to sacrifice ourselves for the group but to exploit the group for ourselves.” Indeed, other acts that appear to involve more significant sacrifice for the group can be seen in a similar vein.

*Self-interested altruism.* Consider the position of the *tonowi* among the Kapauku Papuans of West New Guinea (Pospisil 1971:67): “an individual who has a great amount of cowrie-shell money, extensive credit, several wives, approximately twenty pigs, a reasonably large house, and many cultivated fields.” The wealth accumulated by an individual in Kapauku society almost always depended on that individual’s work effort and skill, and his ability to cooperate with others, since wealth is most effectively expanded through joint production or division of labor and voluntary exchange. Therefore, anyone who had acquired sufficient property to reach the status of *tonowi* was likely to be a mature, skilled individual with considerable physical ability and intellectual experience, and perhaps more important, someone

who had a history of cooperative behavior. He was deserving of respect, and in fact, those who gain wealth in cooperative societies are generally held in very high regard (Benson 1991a, Pospisil 1971). However, not all *tonowi* (wealthy men) achieved respect that would attract substantial numbers of others outside his own family to regularly rely upon him as “leader”—essentially, an individual who acts as a nexus of the voluntary exchange relationships that dominated Kapauku life (Pospisil 1971:67). Among the Kapauku, for instance, “The way in which capital is acquired and how it is used make a great difference; the natives favor rich candidates who are generous and honest. These two attributes are greatly valued by the culture.” The honor of being recognized as a *maagodo tonowi* (a “really rich man”) was “purchased” through public displays of generosity demonstrated at occasions such as marriages and in connection with disputes, as a *tonowi* provided “gifts” on behalf of his relatives and neighbors in order to secure good marriages or buy peace among disputants. By achieving (purchasing) prestige, such leaders expect to benefit in the future by entering into more joint projects and trades. As Ridley (1996:138) puts it, such acts “scream out ‘I am an altruist; trust me.’” Not surprisingly, “gift exchanges” and “potlatching” are common practices in such societies all over the world (Ridley 1996:114–124).

Entrepreneurial individuals in cooperative groups actually use a number of similar tactics in order to gain prestige and persuade others to associate with them in joint production and/or exchange. After all, these leaders typically do not have any coercive power. As anthropologists point out, the distribution of weapons make the use of force risky so that leadership by persuasion is more attractive than leadership by coercion (Ridley 1996:164). Individuals within such groups generally choose among alternative entrepreneurs competing for “leadership” in various activities (often different entrepreneurial individuals specialize in areas of comparative advantage, including organization of joint production activities such as hunting or warfare, or in other areas of social interaction such as religious activity). In order to persuade potential followers that they are worthy of contractual allegiance, they voluntarily provide various special services that demonstrate their knowledge, leadership capacity, willingness to cooperate, and so on. They frequently arbitrate disputes and provide advice free of charge, for instance (Pospisil 1971; Benson 1991a), as explained below, but before discussing this, note that there is another “self-interested” reason for generosity and the practice of gift giving in evolving cooperative groups, even for those who are not trying to compete for leadership positions.

Some individuals inevitably fall on hard times, whether through ineptitude or bad luck, and these individuals may feel compelled to take wealth from others in order to survive. The potential for such occurrences make property rights relatively insecure, so a cooperative group may establish mutual insurance arrangements to encourage people to continue to recognize the cooperatively-produced property rights system even when circumstances change for the worse. That is, apparent altruistic behavior in the form of voluntary wealth transfers can be made by rational self-interested individuals in order to induce others who find themselves in distress to continue to behave in predictable ways over the long term (Johnsen 1986). If the flow of payments is always in the same direction this would be analogous to a tax induced by the threat of violence, of course, but such transfers can arise due to expected reciprocities. One individual or family may have a poor harvest in one year, and therefore receive a transfer, but the next year another person could have the poor

harvest so the transfer goes in the opposite direction. Thus, voluntary mutual insurance is a more appropriate description.

Other “altruistic” sounding solidarity rules like “watch out for your neighbor” and “inform everyone when a rights violation occurs” also tend to evolve. After all, transaction costs of possessing property include the devotion of resources to theft prevention, and high transactions costs for an individual imply that protection will not be completely effective even with mutual insurance arrangements. Individual costs of protection can fall when groups are formed because individuals can create obligations to cooperate in “policing” by watching out for one another’s interests, thereby creating another form of mutual insurance of property rights. The empirical fact is that one joint product of cooperative clusters often involves the policing functions of watching to prevent theft, and cooperation in pursuit and prosecution when a theft occurs (Benson 1991a, 1992). Incomplete knowledge, scarcity, and transactions costs mean that policing is imperfect, so someone alleged to have practiced non-cooperative behavior may not be guilty and “disputes” over guilt or innocence arise. Disputes can be resolved by violent “prosecution” and exclusion of the loser, but in a close-knit group such violence can have significant negative spill overs, particularly if the opinions of individuals in the group are mixed with regard to guilt (Benson 1991a, 1992). The cost of dispute resolution can be reduced by developing non-violent means of solving disputes. For instance, a mutually acceptable mediator or arbitrator might be chosen from among the most reputable members of the community (and entrepreneurs seeking prestige for reasons suggested above will voluntarily provide such services). Since this third party must be acceptable to both disputants, “fairness” is embodied in the dispute-resolution process. Furthermore, by choosing an arbitrator/mediator attempting to build a reputation of trustworthiness, strong incentives are created for the judge to avoid the appearance of bias. The chosen arbitrator/mediator must convince individuals in the group that a judgement should be accepted, after all, since he has no coercive power to enforce it. More importantly, an appearance of bias will damage the individual’s reputation. In essence, public displays of wisdom and fairness are like public displays of wealth: generous gift and advice giving (dispute resolution) both serve as signals that the individual is successful, cooperative and trustworthy, and therefore an attractive partner for joint ventures. The ruling can therefore be backed by an ostracism threat, although in general, dispute resolutions are likely to be accepted because individuals recognize the benefits of behaving in accordance with members’ expectations, not because they fear ostracism (Benson 1989).

Since solidarity rules such as those which underlie cooperative policing and acceptance of non-violent dispute resolution produce benefits for everyone in the group, free-rider incentives arise, just as with any other jointly produced products. However, free riding is successful only to the extent that a free rider cannot be excluded from consuming benefits. Thus, as solidarity rules develop, the scope of the ostracism solidarity rule itself is likely to expand to include “do not interact with anyone who does not obey other solidarity rules.” Therefore, solidarity rules are not public goods, as non-free riders are the only members of a group who are likely to retain membership in a cooperative cluster.

*Customary law.* Trust and solidarity rules may continue to evolve as unrecorded behavioral norms, but as they become more and more complex, and/or as a group expands so interactions with less familiar individuals arise and relationships become increasingly

intricate, some formalization may occur. Perhaps some of the rules will even be written down as “law” codes or precedents. It is not the recording of rules that makes them laws, of course. Indeed, following Hart’s (1961) definition of law, such a norm-based cooperative arrangement has a “legal system” (in contrast to Hart) since it has primary rules of obligation (e.g., recognized norms, whether recorded or not) backed by secondary rules or institutions of recognition (e.g., reciprocities, mechanisms to spread information about reputations, ostracism, mutual insurance, cooperative policing), adjudication (e.g., negotiation, arbitration, mediation), and change [e.g., innovations in behavior followed by observation, emulation and conformity; such innovations can also arise through contracting or dispute resolution (Benson 1988, 1998a)]. No central “authority” with coercive powers is necessary to produce the “customary law” that characterizes such a cooperative social order, however. Ethical behavior, respect for others, cooperation, and benevolence or altruism all tend to evolve spontaneously, and any codification of the associated rules simply serves to lower transactions costs. Negative threats (e.g., pursuit, prosecution, ostracism) generally are important only at the margin. Obligations are largely self-enforcing because it pays for each party to live up to them as they expand individual wealth in the long run through mutually beneficial interaction, including reciprocal reductions in personal investments in violence.<sup>7</sup>

*Inter-group relationships.* No community evolves in complete isolation. Anthropological and historical evidence suggests that intra-group conflict has been an almost ubiquitous characteristic of human history, of course, but before turning to this issue, it must be emphasized that cooperative arrangements can and often do evolve between members of different groups (Benson 1995b). Even in primitive societies, entrepreneurs establish extensive trade networks that cross community boundaries, for instance (Benson 1991a; Ridley 1996:195–211), but as such arrangements evolve they also have to be accompanied by various institutionalized rules to function effectively (Benson 1991a, 1989). Groups need not formally “merge” and accept an entirely common set of rules governing all types of interaction, however. Individuals only have to expect each other to recognize a common set of rules pertaining to the types inter-group interactions (e.g., trade) that evolve. Indeed, a “jurisdictional hierarchy” often arises wherein each group has its own norms for intra-group relationships, with a separate and possibly different set of rules applying for inter-group relations (Pospisil 1971; Benson 1991a, 1992). Prudent morality might dominate within groups, for instance, while at least initially, tit-for-tat applies between groups where reputation effects are weaker. Furthermore, to facilitate inter-group interactions, entrepreneurs who expect to benefit often promote the use of internal sanctions to bring community members to justice when they attempt to take advantage of (e.g., attack) members of the other group (Benson 1991a). These entrepreneurial leaders also may serve as arbitrators of disputes arising between members of the different groups (Pospisil 1971; Benson 1995b), in order to enhance their reputations as fair and cooperative (trustworthy) individuals, but in doing so the security of property rights is increased for both groups. Many intra-group norms will be commonly held, of course, and emulation also will occur where differences initially exist but individuals observe and perceive superior arrangements among other groups (Benson 1988, 1989), so the evolution of common norms recognized and applied in a very extensive web of communities is clearly possible (e.g., Benson 1989; Putnam

1993). The transactions costs of such inter-group cooperation are obviously relatively high, however, so inter-group conflict can also be expected.

Since a key function of cooperative clusters is to establish and secure private property rights, and such rights are insecure if outsiders are able to “invade” and take the property, one joint product of a cooperative group is likely to be mutual defense. In fact, an external enemy can strengthen group cohesion (Ridley 1996:174). It is clear that all humans distinguish between group members and outsiders (Brown 1991:136). Humans quickly classify others as members or non-members of their own group, and all non-members tend to be viewed as being alike. They are perceived as enemies, and norms that support the production of mutual defense against enemies evolve, so an important part of an individual’s belief system will be a “communitarian” one (e.g., tribalism and “a concept of them and us” where individuals are expected to aid in the defense of the “community”). In this light, another source of prestige for entrepreneurial leaders seeking to enhance their ability to enter joint production and trade agreements within a group is skill and bravery in battles against external enemies (Benson 1991a; Ridley 1996:166). This skill and bravery can be exhibited in community defense or in aggression against enemies, however.

#### **4. Coercion and redistribution: The beginnings of the state**

As wealth accumulates and some individuals prove to be less productive than others, these individuals may perceive that they have significant comparative advantage in violence. One group may rely on hunting, for instance, and while the improvements in technologies for hunting resulting from specialization can enhance wealth in the short run, the long-run effect can be quite different. Many migratory animals were hunted into extinction by primitive groups (Ridley 1996:227–247) because ownership could not be established until an animal was killed. As a result of such common pool problems, the group’s members might accumulate relatively less wealth compared to members of another group claiming relatively fertile land and settling into agricultural production. However, because the members of the group relying more on hunting than on agriculture also develop new weapons and other inputs to hunting (e.g., horses, ships), and became skilled in the use of those inputs, they develop a comparative advantage in violence. Therefore, an entrepreneurial leader skilled in combat and especially in organizing joint production of warfare efforts, may expect that an attractive way to gain property rights and wealth is through organized aggression against another community. He may persuade members of his community to act as a “firm” for the joint production of plunder. After all, given the group norms and perceptions that some other group is made up of enemies, such aggression can easily be rationalized—“the best defense is a good offense”—particularly when the expected gains in wealth exceed the expected costs. Not surprisingly, many historical examples of organized plunder involve cooperative communities with established internal trust relationships such as those described above (e.g., tribes that attacked Rome during its decline, Vikings).<sup>8</sup>

*Extortion.* Plunder may produce relatively small returns compared to the wealth that might be extorted over time if productive people are allowed to continue their productive efforts in exchange for payment of “protection money.” Therefore, rather than simply raiding, an entrepreneurial war chief who believes that his forces are strong enough to capture

and control another group (or perhaps a sub-group within a community), may advocate invasion and occupation of the territory of the other community, intending to tax (or enslave, given a sufficient comparative advantage) those who are conquered. The most successful examples of protection rackets by modern organized crime typically involve kinship or ethnic “communities” that have strong internal trust relationships supported by recognized norms of behavior [e.g., see Gambetta (1993)], for instance. Similarly, Oppenheimer (1908) contends that the origins of the earliest states trace to precisely this situation, as nomadic hunting and/or herding communities from the relatively unfertile mountains, deserts, or sea coasts, invaded and subjugated those who had settled in fertile valleys, setting up a “protection racket.”<sup>9</sup> Carneiro (1970) agrees with this historical description of early state formation but adds that successful creation of relatively permanent states of this type occurred where exit by those being subjugated was very difficult due to the surrounding hostile environment (e.g., deserts, mountains, other hostile communities). Indeed, a vital institutional objective of an entrepreneurial extortionist must be to erect barriers to exit from the extortionist game (i.e., establish a “monopoly in violence” over the subjugated territory). After all, if a potential target for extortion can turn to another “firm” specialized in the sale of true protection, or to an alliance of cooperative groups that jointly produces defense, then the extortionist’s ability to extract tribute is significantly limited.

When a group that uses cooperative procedures to maintain internal order also acts as an organized protection racket, there will be “honor among thieves” (see the discussion of evolving behavior below, however), but the same rules clearly do not apply to interactions between the conquerors and their subjects. Indeed, the rules that apply in such a society will have to be discriminatory, as a “class system” is created and maintained through coercion. Thus, “law” in the form of rules mandated by the extortionist at the “top” and imposed downward becomes necessary when groups are combined through violence rather than consent. The entrepreneur in extortion is no longer simply a “leader” who achieves his position through persuasion. He must become a “ruler” (rule maker and enforcer) who continues to persuade supporters to work within the extortionist organization while also coercing tribute from those who have been conquered. In this regard, as Levi (1988:46–47) explains, the academic debate between those supporting contract theories of the state and those advocating conflict theories is misdirected: “All rulers are part of a contract, yet all engage in conflict... The contract is with those who gain from the trade of revenue for protection and other services [see discussion below]; the conflict is with those who are plundered or victims of a protection racket.”

The ruler also should recognize that selectively supporting rules that originated within cooperative institutions provides low cost mechanism for facilitating cooperation in wealth creation that he can then expropriate. Thus, the ruler is likely to explicitly recognize many of the customary norms that have evolved in a community that has been conquered. In this same context, a ruler clearly faces tradeoffs (constraints) in regard to how much can be transferred at any point in time, both to himself and to powerful subgroups. After all, wealth must be produced for it to be transferred, and private property rights create the strongest possible incentives for long-term wealth creation. Therefore, large levels of extortion in the short-term, reduce productivity, wealth creation, and the potential for transfers over the long run. The actual degree of transfers in any period, therefore, depends

in part on the ruler's time horizon (Levi 1988:13, 32–33; Holcombe 1994:112). If the ruler is relatively short sighted, perhaps because there are significant competitive threats to his claim of sovereignty, property rights become very insecure as high levels of transfers can be expected. However, a long time horizon implies that the present value of potential future transfers are higher, so property rights will be relatively secure in order to stimulate wealth production. Oppenheimer's (1908) political means of wealth expansion is a parasite on the economic host so it can only survive over time if the economic means of wealth enhancement also is functioning. Thus, the extortionist must recognize and protect some private property rights, and allow some cooperative organizations to exist in order to create incentives for continually producing more wealth.

Other constraints exist as well. For instance, the greater the takings the more likely are the prospects for resistance and even revolution. In fact, the changes in redistribution rules and institutions are often slow, or marginal, because if the extortionist imposes costs on some group that are relatively high, that group may organize for resistance and threaten the extortionist's position of dominance. Even a short-sighted extortionist cannot disrupt property rights so quickly or completely that an immediate revolution results. Of course, if a ruler incorrectly predicts the response of the losing groups in the transfer process, revolution can result, and since no ruler is likely to be able to accurately predict the consequences of every change in rules or institutions, revolution need not be uncommon.

The transactions costs of coercive control mean that some interactions between victims and some of their wealth will remain outside even the most powerful extortionist organization's control. Indeed, even if a particular claimant to sovereignty gains control over some "jurisdiction" (e.g., wins a "war"), the result is not likely to be permanent. After all, a weak individual's promises to the extortionists are credible only because of the fear of violence, so the extortionists will have to be forever vigilant in policing existing claims, even as he attempts to expand his domain. Opportunistic breaches of imposed obligations may involve simple defiance of the extortionist's rules through guile (e.g., "underground" activities, tax evasion), but those with a comparative disadvantage in violence also have incentives to search for innovations that might reverse the comparative advantage. Organized revolt is also possible as numerous weak individuals form (or reform) a cooperative group to take property rights back from the powerful individual.<sup>10</sup> Thus, the internal dynamics of the transfer system appear to be relatively unstable (Levi 1988:44). Other groups outside the ruler's jurisdiction (or perhaps inside—e.g., part of the military/policing organization discussed below) may pose significant threats to the ruler, or they may see the ruler as a significant threat to them and mount a preemptory offensive against him. Thus, there are external sources of instability as well. There are ways to reduce both internal and external threats (i.e., insure against disruption of the property rights system established through violence), however, and rulers have strong incentives to exploit them (Levi 1998:11).

*Coercion and discriminatory cooperation.* By spreading information, for instance, those who employ a comparative advantage in violence can develop a reputation for being skilled in its use. Such a reputation can be quite valuable as increasingly, the threat of violence alone may be sufficient to extort transfers; actual violent acts may become unnecessary. Therefore, the extortionist ruler invests heavily in "punishment" to deter opposition (Levi 1988:70), and the punishment will generally be conducted in a highly visible way. Part



of the extortionist organization will become specialized in policing and punishment in order to perform this function, of course, and highly visible indicators of police power (e.g., uniforms, special weapons) are likely to evolve. Coercion can be a costly means of inducing compliance even with specialized bureaucracies, however, so the ruler will search for ways to reduce costs. For instance, improved transportation routes can facilitate the movement of policing and collections agents (and military, given the threat posed by external enemies on more than one front), thereby raising the threat of punishment even with a relatively small enforcement institution. Perhaps more significantly, a critical barrier to effective coercion is high monitoring and measurement costs. Therefore, rulers tend to develop institutions that lower these costs. Certainly, some of the members of the extortionist organization are likely to specialize in “spying” on subjects and in investigation of potential non-compliance, but instituting rules such as standardized weights and measures, monopolization of money to standardize the measurement of taxable value, developing land surveys and records of title, conducting population censuses, and so on, also all tend to lower measurement and monitoring costs (Levi 1988:29). All of these enforcement activities also imply that bureaucratic institutions tend to expand and multiply.

For these bureaucratic organizations to function, cooperation is necessary. Indeed, initially they are likely to be made up of members of the close-knit group that was successful in aggression and subjugation. However, if the territory and/or population under control is large enough, more employees will be recruited into the bureaucracy. Some will specialize in violence, so people who have exhibited such skills are likely candidates [e.g., see Gambetta’s (1993:66–68) discussion of recruiting by the mafia]. Others will specialize in accounting and other bureaucratic activities. New cooperative arrangements will be required. The cooperation that evolves tends to be within spontaneously-evolving “informal networks.” These are the non-market institutions of exchange through which individuals from the ruling elite, politically influential interest groups, and members of the bureaucracies cooperate in order to obtain information and benefits from each other and to circumvent various administrative rigidities that inevitably characterize bureaucratic organizations [see Breton and Wintrobe (1982:78–87, 99–106)]. Informal arrangements have to be built on trust (Tullock 1965:37), of course, so behavior towards others within a network can be quite “moral” in the senses discussed above—behavior based on honesty, generosity, cooperation, and loyalty to the group. Indeed, Tullock (1965:37) emphasizes the importance of the almost unconscious influence of “cultural environment” in these networks and suggests that “As a result of his indoctrination in a native cultural pattern, the individual simply will not realize that there may exist alternative ways of doing things. This unconscious cultural indoctrination will tend to be reinforced by rational considerations. In order to be successful, the politician must be trusted.... He must become an organization man.” The informal networks bind an individual to behavior expected by others within his network, although not to behavior demanded by people outside the network (Tullock 1965:37).

The norms binding bureaucrats in their networks are strong when conditions are stable, but they can be fragile when conditions change. For example, Tullock (1965:38–40) explains that a successful bureaucrat must be loyal to his immediate superior even if it means frustrating the desires of someone higher up in a bureaucratic hierarchy. Such loyalty is valued even by those higher up, to such degree that when they look for people to promote to

positions immediately below them (e.g., to replace someone who has been frustrating their desires) they often promote those who were strongly loyal to a direct superior (even if the person was frustrating their desires). In this case, loyalty and cooperative behavior towards other individuals tends to be turned off and on as changes in job assignments create new loyalties and end old ones, and move individuals into new networks. Norms within political/bureaucratic environments tend to be institution specific then, rather than individual specific.

The specialists in policing and collections are acting as agents of the ruler, but principle/agent problems arise as they will be in a position to skim relatively large shares of the revenues and/or accept bribes to reduce the amount taken from some who are paying for protection (Levi 1988:14). Therefore the ruler is likely to doubt the credibility of his own organization members' commitments to cooperate. Indeed, they may have stronger loyalties to others in their networks than to the ruler. Some of the members of the extortionist organization may also feel that they are in a position to carry out a successful *coup de tat*, and gain a larger share of the wealth transfers. Thus, the ruler has incentives to limit the power of individuals and subgroups within the extortionist organization, perhaps by keeping the evolving military/policing/strong-arm institutions specialized and decentralized (although probably with some overlapping functions) while allocation decisions remain centralized. This raises the cost of collusion by these potential competitors for power, and it creates a competitive environment (Levi 1988:35) as each group competes for portions of the wealth being transferred (e.g., bureau budgets). One competitive tactic that the ruler may encourage is for each to monitor the others, reporting opportunistic behavior to the ruler (and this is likely to be relatively effective if some functions overlap so members of each institution has some knowledge of what the others are suppose to be doing and some expectation that their institution could be expanded to encompass the other's functions if they can reveal opportunistic behavior in the rival organization). The ruler also is likely to demand extensive record keeping on the part of his agents, in hopes of detecting any skimming by comparing records over time and across agents, and he may move agents relatively frequently, both geographically and functionally.

The ruler may be able to reduce the threat from external powers through negotiations. The ruler's non-aggression promises may not be credible, of course, but there are mechanisms for increasing their credibility. For instance, the ruler can offer a "hostage" (Williamson 1983) (e.g., a daughter in marriage) or give the potential rival a generous gift, essentially transferring some of the extorted wealth to potentially powerful individuals in *exchange* for an agreement to respect his sovereignty (i.e., not to oppose his extortion efforts directed at others who are less likely to be able to resist). As Ridley (1996:123) notes, for instance, lavish gift giving was widely practiced among European monarchs. Depending on the relative power of the ruler and the potential rival, such exchanges may simply produce a non-aggression alliance. Alternatively, if the ruler's military organization is relatively powerful (but perhaps not powerful enough be assured of victory), the potential rival may agree to "honor" the ruler and accept certain obligations in interacting with him (e.g., as between feudal kings and their powerful "vassals"—barons, earls, etc.) while retaining a good deal of power within his jurisdiction. This produces a hierarchical system wherein the "vassal" rules in his jurisdictions but also has some obligations to the more powerful ruler, perhaps

paying some protection money in exchange for the opportunity to pursue local extortion. Yet another alternative is the merger of jurisdictions, but with the extortionist's institutions of violence employed to grant to and even protect property rights for those who are relatively strong in exchange for pledges of loyalty and support. As a result, the "protection racket" can involve a mix of rules supporting extortion of the weak and protection of the relatively powerful. In fact, since successful extortion requires a monopoly in violence, the ruler must agree to protect those who might have sufficient power to oppose him against outside threats, and also eliminate cooperative defense arrangements that could coalesce and rebel. Therefore, in order to maintain power, the extortionist organization will have to defend the territory against outside threats. Indeed, as Holcombe (1994:8-9) explains, since the ruler obtains his income from the productive activities of his subjects, he has strong incentives to protect those subjects, because by doing so he is protecting the source of his income. Thus, as Gambetta (1993) explains, for instance, the Mafia simultaneously extorts wealth by demanding protection money, and supports wealth production by protecting its subjects (e.g., from outside threats) and by enforcing their contracts.

Negotiation with and selective granting of privileges (rights) to internal groups beyond those in the extortionists' prior support group and expanding bureaucracy can also be important. In fact, in order to maintain power, the extortionist has incentives to redistribute wealth as the relative power of subgroups within his sphere of influence changes, much as a consensual system's mutual insurance arrangements do when the incentives to cooperate change. In this case, however, the redistribution involves an effort to obtain the support of the sub-groups whose comparative advantage in violence appears to be developing, in order to protect his source of wealth. Thus, while mutual insurance arrangements in the cooperative systems described above tend to transfer wealth to the temporarily disadvantaged, extortion-based systems tend to transfer wealth to those who are becoming powerful, as they have weaker incentives to respect the extortionist's claim to sovereignty. Of course, there is a potential danger that some of the disadvantaged will organize effectively and revolt, so some transfers also may flow to some of these individuals if they are perceived as developing threats. In a relative sense, however, transfers to the powerful will actually dominate, and transfers to the threatening disadvantaged will predominantly flow from others who are also relatively disadvantaged but not expected to become powerful [the powerless are excluded from any bargaining (Levi 1988:11)]. To facilitate this ongoing redistribution process, the ruler will develop institutions intended to lower the costs of: (1) obtaining information about changes in the relative power of the sub-groups in order to discriminate among them, and (2) bargaining with those groups that have or gain power [e.g., roads and communications networks connecting the ruler's central location with the outlying locations of his potential rivals (Levi 1988:28); spies and other information gathering institutions; advisory councils, forums and representative assemblies (North 1990:49-51)]. A ruler does not simply want to create a monopoly in violence; he will also "attempt to act like a discriminating monopolist, separating each group of constituents and devising property rights for each" (North 1981:230; also see Levi 1988:10-14).

Given the incentives for a ruler to use transfers as a low cost mechanism of insuring against competition, sub-groups have incentives to compete for favorable treatment from the extortionist. Furthermore, the extortionist may encourage such "rent-seeking" competition

(Levi 1988:12), since by keeping sub-groups divided into adversarial political camps the possibility of a strong coalition forming to overthrow his rule is reduced. By focusing such competition in “advisory councils” or “representative assemblies,” the transactions cost of interacting with various powerful groups can be lowered (North 1990:49–51), and powerful groups also see their interests linked to the interests of a “sovereign” as they have a more direct say in the decision-making process. Furthermore, by focusing the competition for wealth transfers in such forums, the ruler reduces the incentives for potentially powerful groups to develop their capacities for violence. These groups can gain transfers through the extortionist apparatus, so they do not have to develop their own military potential. Thus, such political institutions are “substitutes for destructive competition for power” (Holcombe 1994:112). They may also divert at least part of the animosity towards the transfer process away from the extortionist himself, toward the assembly and those with sufficient political influence to gain transfers. Such institutional innovations are double edged, however (Levi 1988:28). By creating them, the extortionist can create potential sources of rivalry for power. Indeed, the relationship between the ruler and his “representative institutions” tend to involve both cooperation and conflict, with the status of each changing as shifts in power are perceived. Rivalry and cooperation between the parliament and the king both shaped important parts of English legal history, for instance, and kings ultimately lost to parliamentary forces: “Parliaments are both bulwarks of legitimacy and hotbeds of rebellion” (Levi 1988:64).

An effective entrepreneur in extortion might also be able to simultaneously lower the cost of ruling and legitimize his claim to sovereignty by offering to resolve disputes between competing sub-groups in “adversarial” forums (e.g., “royal courts”) with outcomes determined on the basis of the relative power of the groups involved and backed by threats of violence by the extortionist.<sup>11</sup> Such a “service” provided by the ruler also reduces the incentives of powerful factions to invest in violence themselves, as they can substitute threats of litigation backed by the extortionist’s coercive power. Furthermore, it provides another mechanism for gathering information and promoting adversarial rivalry, and like representative assemblies, it may also divert some animosity away from the extortionist to the court. And the ruler can claim that provision of dispute resolution “obviously” justifies (legitimizes) some payments to him (e.g., tribute, taxes).

*Legitimization and state creation.* The description of evolving institutions presented above could apply to “organized crime” or to evolving “kingdoms.” The precise point at which a protection racket becomes a state is not clear, but some extortionist rulers manage to retain power and gain “legitimacy” while others do not. Since the transfer process must have losers, there will always be some sources of potential opposition no matter how effective the ruler is in using developing institutions for information gathering, coercion, bargaining, and the maintenance of rent-seeking competition. The ruler also has incentives to undermine this opposition. As Levi (1988:52–70) explains, rulers attempt to instill incentives and beliefs that lead to “quasi-voluntary compliance.” For instance, rulers often have taken advantage of religious beliefs by claiming to be a god or to rule through “divine right,” and “When rulers are viewed as gods, or ordained to be legitimate by gods, it is difficult for mortals to question their legitimacy” (Holcombe 1994:160). To do so, the ruler often must bargain with religious leaders in order to obtain their explicit recognition of this claim.

Such a bargain may result in special privileges and wealth transfers for these leaders that are comparable to the treatment of those individuals who have a considerable level of military power (church leaders were often treated on a par with barons in medieval England, for instance), and/or in the use of the ruler's coercive power to support the establishment of a single religion within his jurisdiction. As with other efforts to retain control, of course, such special status creates a potential rival for power, so the relationship between the ruler and the religious organization is often similar to the relationship between a ruler and a parliament: one reflecting both rivalry and cooperation.

Another legitimization tactic for rulers is to promote the belief that only he can provide, vital "services" to everyone in the jurisdiction. While customary communities and private entrepreneurs do provide roads (Benson 1994a), the use of coercive taxes to provide roads may in fact benefit many influential people by shifting part of their costs onto others, for instance. Therefore, although their primary purpose may be as suggested above (facilitating the movement of military and police forces, and of tax collectors), it may be easy to convince many people that roads are "public goods," producible only through coercive taxation. A more obvious "public good" is defense against outside threats. If the ruler can convince the populous that other powers will treat them much more harshly than his organization does (a very real possibility, since these outsiders may not expect to be able to maintain power over a distant jurisdiction and therefore engage more in plunder than in extortion—recall the discussion of rulers' time horizons), he may be able to legitimize some transfer payments to "purchase" defense (Holcombe 1994:160). People do not have to see everything that a ruler and his organization does as legitimate, but if some activities are seen as legitimate the costs of enforcing compliance are reduced (Holcombe 1994:159). Indeed, the ruler has incentives to manufacture an outside threat even if one does not exist (Levi 1988:43). If successful, such legitimization creates widespread norms like "nationalism" and "patriotism" that tend to increase compliance, and they apparently are successful in many cases since national government revenues grow dramatically during wars and they do not shrink back to their pre-war levels after a war (Higgs 1987).

An alternative to outright warfare is to create and focus on threats that are ongoing and undefeatable, but that also are not likely to be able to defeat the ruler. This might involve a foreign threat of similar power where mutual deterrence "requires" ever-increasing taxes (e.g., the cold war's "arms race" lasted for almost 50 years without direct conflict between the superpowers involved), or a lesser power that is intentionally allowed to survive (e.g., Saddam Hussein in Iraq?), but reliance on such foreign threats may be both costly and dangerous. Internal threats, real or manufactured, can serve a similar purpose, however. It is not at all unusual for modern rulers to describe never-ending campaigns against crime, drugs, poverty, and other internal problems in the same terms that they describe external threats, for instance, in an effort to create the "moral equivalent of a war." Furthermore, the advent of politicized extortion tends to undermine the incentives that individuals have to cooperate in policing (Benson 1992, 1994a), as well as to produce wealth and the development of mutual insurance arrangements discussed above. Therefore, crime and poverty both become more likely and the provision of both policing and welfare may also be seen as "public goods." In the face of these threats, the extortionist might intentionally develop policing and welfare programs, but in fact, a more likely scenario is that as communities that had provided

such services are weakened or destroyed, so are the incentives to voluntarily produce such services. Some of the services may be desired by powerful groups within the rulers' jurisdiction, and they apply pressure in order to get the ruler, with his claimed monopoly in violence, to provide them (Benson 1992, 1994a). While such efforts disproportionately benefit the wealthy and powerful by reducing threats against their wealth, the ruler can claim that they benefit everyone (e.g., the poor who receive welfare). To the degree that he is successful, compliance may become relatively more voluntary. Other even more sinister examples of such internal "threats" can also be cited (e.g., numerous examples of religious or ethnic persecution such as Hitler's manufacturing of the threat posed by the Jews).

In order to extort wealth and to change the allocation of wealth in the face of changing political power, the ruler must claim to be the supreme "lawgiver," but this also creates an opportunity for legitimization. For instance, in part for reasons suggested above, many early codes by kings claiming to be lawgivers were largely codifications of customary law with modifications to dictate distributional issues (Benson 1992). By enforcing some customary norms as well as distributional rules, however, the ruler also may help legitimize his claim to sovereignty. Hayek (1973:126) explains that as law and its enforcement became regarded as the primary task of centralized coercive institutions, all of the rules produced and enforced by those institutions came to be described by the same term (law), as rulers attempted to confer on their rules the same dignity and respect that spontaneously evolving customary law enjoyed.

Even those who clearly are net losers have incentives to accept the extortionists legitimization claims and adopt quasi-voluntary compliance. That is, while they want to resist the takings whenever possible, they also have incentives to recognize and even explicitly promise (pledge) to honor and obey the sovereign, by recognizing the extortionist's claim to sovereignty. After all, the more secure the sovereign feels, the longer his time horizon tends to be, and this in turn implies more secure private property rights. In this light, recognizing a "dynasty" (e.g., a royal family in a kingdom, family succession in the mafia, the "right" of the boss in a "political machine" to select his successor) or strongly supporting an incumbent's repeated reappointment (or reelection), may be very rational. Thus, even though some claims by rulers may be obvious fictions upon careful inspection (e.g., divine rights), they may be "accepted as fact for convenience" because they facilitate an implied improvement in the relationship between a ruler and the ruled (Holcombe 1994:170–171). Acceptance of these fictions is not unlike conformity with norms in a cooperative group where information costs and the costs of taking calculated action in every case may be high (Holcombe 1994:171).

In this same vein, Mises (1957:291–292) explains that political actors' "endeavors to mislead posterity about what really happened and to substitute a fabrication for a faithful recording ... were often prompted by the desire to justify their own or their party's actions from the point of view of the moral code of those whose support or at least neutrality they were eager to win." Indeed, tactics of misrepresentation and falsification of information are common in political institutions (Breton and Wintrobe 1982:39), as they raise the transactions costs for those who might attempt to obtain bargaining power to oppose the ruler (or use existing bargaining power) if true information was available. As Levi (1988:67) explains, legitimization efforts are relatively successful when there is uncertainty. Uncertainty does

not necessarily require outright falsification, of course. It can be increased by making laws very complex and difficult for most people to understand, for instance, and given the payoff for individuals trying to interpret the laws, rational ignorance suggests that such a tactic may disguise the underlying transfer implications. Levi (1988) also suggests that quasi-voluntary compliance may increase if people believe that everyone is sharing the burdens imposed on them. Therefore, one legitimization tactic may be to establish complex rules that appear to apply to everyone, but then selectively enforce them. Giving enforcement agents more discretion does increase the potential principle-agent problem, of course, but the payoff in terms of increased compliance may be worth it to the ruler.

### **5. Conclusions: The state, private property rights, and the market economy**

State-made “law” simultaneously serves many functions, some of which are widely seen as legitimate, and some of which are widely despised. The law protects some private interests and destroys others, it serves to integrate “society” through force while disintegrating the groups that make up “civil society,” it fosters the production of wealth by some and the taking of wealth by others, it defines crimes and is used to commit crimes. Law (in a positive sense) and justice (in a normative sense) are clearly not synonymous. Nonetheless, there is a widespread belief that there must be one source of all “law” within a geographic jurisdiction and that coercive power vested in this legal institution is necessary for the survival of society. Many historical claimants to sovereignty clearly have been relatively successful in legitimizing their claims, since most (all?) modern nation-states clearly evolved from extortionist institutions (e.g., tribal war chiefs became kings and kingdoms became nations; these nations have combined and broken apart as relative power within their borders and across them has changed). But legitimization and justification are not synonymous.

*The state and property rights.* In one sense, the state does become a vital source of law, of course. For instance, individuals within the jurisdiction of a state often must turn to that state in an effort to secure their property rights, but it is because states are the primary threat to those rights, and because the rise of the state tends to undermine the potential for non-state governance arrangements that can define and enforce rights. When a strong coercive power exists, economic success requires that property rights be recognized and supported by that power—that is the essence of a protection racket. State recognition of property rights is required to achieve the most efficient use of resources then, but only because the state is a threat to those rights. But if states did not exist, property rights still would. After all, property rights arise in customary law communities without state backing (Ellickson 1993; Bailey 1992; Benson 1991a, 1992, 1994a). Customary property rights are never completely secure if a comparative advantage in the use of violence exist, however, because those with such a comparative advantage have incentives to take the assets and wealth to which they are attached. When a community is at a comparative disadvantage in the use of violence it may not be able to prevent subjugation by a protection racket such as a state. Once subjugated, some of those property rights will be transferred. Thus, while the state is not justified in the Hobbesian or Lockian sense as a necessary precursor to social order or to property rights, the state and its role as a definer of rights may be inevitable.

The existence of a state does not produce stable property rights either, of course. Property rights are subject to reallocation as the distribution of political power changes, and any rights claimed by those who have no political power will be extremely insecure since the state can take those rights if they become sufficiently valuable. Therefore, individuals do not have sufficient political power to induce the state to recognize their property claims have incentives to avoid detection by developing cooperative efforts “underground” in order to protect the wealth they create. There really is no case in which the power of a sovereign has become truly absolute, after all, so as Nee (1998:88) explains, “opposition norms” inevitably evolve as the incentives created by formal institutions and sanctions are weak relative to the incentives to pursue conflicting interests. An accepted “norm” of behavior for many people subject to extortion may be that “breaking the coercively—imposed rule is OK if you can get away with it” (e.g., a “moral obligation” supporting tax evasion and avoidance may be widely accepted and even respected), and communities can form to support such norms. Numerous examples of centralized coercive systems can be cited where “parallel” predominately cooperative systems of norms and institutions actually dominate many and at times even most interactions (e.g., de Soto 1989; Acheson 1988; Ellickson 1991). De Soto’s (1989) detailed analysis of the “informal” sector in Peru is particularly revealing in this regard, as he explains that the “squatter communities” are very well organized, that members respect each others’ property claims, cooperate to enforce rules of behavior, and so on. Nonetheless, the existence of a coercive ruler raises transactions costs for such groups. Because property rights are relatively insecure, for instance, time horizons are short so both repeated-deal arrangements and reputations are less valuable. Ostracism is less effective, so prudent morality may be ineffective and a victim may opt for retributive morality. Cooperative clusters may still aid in the “illegal vigilante” exaction of retribution, of course. Under such circumstances, a considerable amount of “crime” may be “undertaken to exercise social control” (Ellickson 1991:213; Acheson 1988; de Soto 1989). If members of such a group can gain political influence (e.g., by gaining wealth or by threatening political disruption) and induce a ruler to recognize their property claims they may be able to develop institutions that allow them to more effectively enforce their customary norms. However, if they are successful in gaining political influence, they are also likely to demand wealth transfers that threaten other peoples’ property rights. Many merchant communities have, throughout history, been able to avoid the state by enforcing some of their own customary rules, for instance, while simultaneously using the state to gain special advantages.

*The state and the market economy.* There is no systematic relationship between the state and internal order within communities, in contrast to the social contract theorists who adopt the Hobbesian and Lockian contentions that a monopoly in violence is necessary for such order. Similarly, there is no systematic relationship between the state and development of market institutions, in contrast to the economists who assume that the state must make and enforce the rules of the game for a market economy to function. Indeed, Ridley (1996:114, 199) explains that “For all the protestations of Karl Marx and Max Weber, the simple idea of gains from trade lies at the heart of both the modern and the ancient economy” and therefore, “the origin of the market, with all its capacity to exchange goods of different kinds, exploit the division of labour and provide a hedge against dependence on one good, may lie in the reciprocal food-sharing arrangements of a hunter-gatherer band” as well



as in subsequent gift exchanges among increasingly wealthy groups. Not surprisingly, an examination of the emergence of commerce in the medieval period (Benson 1989), as well as the relationships in modern international commerce (Benson 1998b, 1999b) and within domestic trade associations (Bernstein 1992; Benson 1995a) reveals that they are ruled by modern versions of the same kinds of institutions and customary norms (practices and usage) that develop in primitive societies. After all, resistance to wealth transfer efforts by protection rackets is likely to be most effective where the benefits generated through voluntary interaction are large (so the costs of submission are large) and/or the relevant group members' wealth is mobile so they can interact across the jurisdictions of different authorities and inter-jurisdictional competition to attract that wealth occurs. As European governments attempted to establish control over maritime trade in order to tax it, and granted franchises for numerous trading monopolies between 1500 and 1800, for instance, the "average merchant and seaman" responded with piracy and smuggling, and a substantial part of maritime commerce was carried out in violation of the laws of some nation-state (Rosenberg and Birdzell 1986:92–96). Furthermore, the middle and even the upper classes willingly wore, drank, and ate smuggled goods (Rosenberg and Birdzell 1986:93). Indeed, many smugglers were highly respected members of the merchant community, as well as their geographically localized communities (e.g., John Hancock).

Several centuries earlier the merchant community of early medieval Western Europe developed a recognizable system of customary commercial law, *lex mercatoria* or the "Law Merchant," consisting of rapidly evolving customary norms, and disputes were resolved in the merchants' own courts. Similarly, modern *lex mercatoria* evolved from this medieval legal system (with some interruptions, such as those arising under mercantilism in the late medieval period), and remains as a largely voluntarily produced and enforced system of spontaneously evolving norms for international commerce, despite many attempts by various coercive states (some supported by politically powerful merchants seeking special privileges) to subjugate it over the centuries (Benson 1989, 1998b, 1999b), as does much of intra-national commercial law (Bernstein 1992; Benson 1995a). Indeed, as Hayek (1973:81–82) explains, "The growth of the purpose-independent rules of conduct which can produce a spontaneous order will ... often have taken place in conflict with the aims of the rulers who tended to try to turn their domain into an organization proper. It is in ... the law merchant, and the practices of the ports and fairs that we must chiefly seek the steps in the evolution of law which ultimately made an open society possible."

The norms of commerce are quite similar to the norms that evolve in primitive societies under customary law. Strong incentives to cooperate through exchange, to live up to promises, to respect one another's property rights, and to support an unbiased and fair dispute resolution system arise because of positive benefits associated with repeated dealing reciprocities and reputation effects, and because of the potential for ostracism. Individuals gain respect when accumulate wealth through initiative and enterprise (rather than through force or guile), and when they generously share it, and this in turn enables them to enter into more beneficial exchanges. Thus, for instance, Wesson (1978:160) explains that in the Italian commercial cities of the 13th to the 15th centuries, "actions were judged by success and gentlemen were judged by appearance and worth, not pedigree. Men were not born noble or made noble by a sovereign but ennobled themselves by industry, intelligence,

and skill.” The wealthy Italian merchants dressed modestly but gave generously to public projects such as universities and cathedrals (Wesson 1978:162–163). Similarly, in Holland of the 17th century, “the Dutch liked to consider their material prosperity as proof of their virtue.... Honesty was one secret of their commercial success. Incidentally, no other people provided so amply for their poor as the mercantile Dutch” (Wesson 1978:173). The same was true of England of the 18th century, where commerce required dealings on the basis of “equality, according to recognized rules and by mutual consent” so the merchants were “famed for honesty”; but in “seeking security for property and person, freedom to produce and enjoy wealth,” they were also characterized as “generous, sober, and charitable” (Wesson 1978:197, 199).

The state is frequently called upon to establish and enforce rules having to do with economic activity, of course, and often by the same merchants who are able to enforce their own rules in international trade and within their trade associations. Unfortunately, members of the merchant community are also susceptible to the incentives to take wealth from others, and they also tend to have considerable bargaining power in the political arena because they can threaten to exit. Therefore, rulers have incentives to grant merchants special privileges within their domains that lead to wealth transfers to the merchants in exchange for a portion of the transferred wealth (or perhaps, simply to generate more wealth production on the part of relatively immobile resources that are inputs to or complements of the merchants’ enterprises). Thus, merchants have certainly taken advantage of rulers’ coercive powers to obtain wealth transfers within political jurisdictions. To the degree that there are different margins along which individuals and groups can adjust in an effort to capture wealth, it is reasonable to expect that they will do so. Medieval mercantilism was a system dominated by merchants dealing with kings to restrict competition in favor of domestic monopolies and guilds, and that system has a firm hold within many twentieth century economies (de Soto 1989). In fact, in every political jurisdiction, economic regulations limit competition and generate rents for businesses. The economy and the state have become tightly intertwined. Under these circumstances, merchants’ incentives to oppose the extortionist or avoid his jurisdiction are weakened by growing incentives to recognize his claim to “legitimacy” in order to gain wealth through both political and economic means. Thus, while the state is not a necessary source of the rules of the game for markets, just as it is not a necessary source of social order or property rights, the state’s role in the economy may be just as inevitable as its existence appears to be.

## Notes

1. Rationality as employed here does not imply “rational expectations.” It implies purposefulness, in the sense that individuals attempt to achieve their personal goals in the face of incentives and constraints, and that they respond to the incentives and constraints that they perceive in rational (predictable) ways.
2. The term “institution” is used in a variety of ways. As Vanberg and Kerber (1994) note, it frequently means a “configuration of interconnected rules,” for instance, so the set of rules of conduct, including the moral code is an institution. In order to distinguish between the institutions of primary rules of conduct and the institutions of secondary rules of organized governance (as in Hart 1961), however, terms like “rules” and “codes” will refer to the former while “institutions” imply the organizations or collections of institutions that supports rules of conduct (i.e., the configuration of organizational rules) as in Vanberg and Kerber (1994).

3. While many of the concepts from game theory are useful demonstrating the gains from cooperating and defecting in various contexts, and therefore, in thinking about determinants of behavior (e.g., Axelrod 1984; Ellickson 1991; Ridley 1996; Vanberg and Congleton 1992), as North (1990:15) explains, game theory “does not provide us with a theory of the underlying costs of transacting and how those costs are altered by different institutional structures.” An understanding of the evolution of behavioral rules and property rights really requires consideration of the factors that lead to a transition from one institutionalized game setting to another and another and so on, as suggested below, rather than the analysis of a particular game. Thus, game theory can only serve as a supplement to the more fundamental institutional analysis outlined here.
4. There are also conditions that can produce a cooperative solution even in a one-period game, however. Skaperdas (1992) and Rider (1993) develop two-person, one-period models of cooperation, conflict, and power and deduce three possible outcomes. (1) “Full cooperation,” which implies that neither person invests in the production of violence, occurs *if* it is very costly for either person to increase the probability of winning a violent conflict and *if* both parties recognize this. The result is a private property arrangement as each party does not attempt to claim resources or outputs of the other (Rider 1993:152). (2) “Conflict” strategies dominate when the marginal product of violence is expected to be high for both parties: each believes that increasing investments in the capacity for violence substantially enhances their probabilities of winning. (3) “Partial cooperation” occurs when one party’s opportunity cost of investing in conflict differs substantially from the other party’s. Thus, one individual invests in violence, subjugating and extracting tribute from the relatively productive individual who chooses a “cooperative” strategy (i.e., acquiesces to the threat of violence) because it produces greater personal wealth than is expected through conflict.
5. Note that the exit option combined with multi-sided, multi-dimensional reputation effects can mitigate the consequences of asymmetries in power. If one individual is very powerful he may wish to force others to grant him the preponderance of property rights and privileges, but if everyone has the ability to simultaneously exit, thereby ostracizing the powerful individual, his demands may have to be tempered considerably. Indeed, the relatively weak individuals in an evolving close knit group might well be relatively strong when backed by an ostracism threat (Ridley 1996:160).
6. An uncalculating conformation to expected behavioral norms may also be rational in part because observing how others behave in a particular situation is a source of accumulated information (Ridley 1996:184).
7. This discussion and others that have preceded it may imply that an “efficient” system of property rights evolves under a voluntary system of rule creation. Indeed, this may be a reasonable inference to draw, although it is not proven here. At one level it is a trivial issue, of course. Given a consensual system, survival of a rule implies that it is efficient because the transactions cost of changing it exceed the benefits. However, in the context of a comparative institutions analysis, the issue is not so trivial. To make such a claim, factors like the potential outcome of alternative institutional arrangements, the extent of experimentation, competition and emulation, the ease of exit and entry, the size of consensual law groups and the extent of network externalities would all have to be addressed (Benson 1994b).
8. A comparative advantage need not result in complete specialization, of course. Indeed, if there are different margins along which individuals can adjust to expand their wealth, then we should anticipate that they will do so as long as anticipated benefits exceed anticipated costs. Thus, for instance, Jones (1981:88) asks “When does a pirate become a trader? When he sells his booty to a community too strong for him to attack, or to his own folk, as the Vikings did with the proceeds of their North Sea pillaging.” Similarly, Rosenberg and Birdzell (1986:94) note that “The history of commerce in the Mediterranean, both during and after the Middle Ages, is to a considerable degree a history of trading combined with raiding and freebooting. Differences of religion between the Moslems and Christian furnished a pretext for mutual depredations.... It legitimized the pirates by renaming them privateers.” Such raiding was probably legitimized in the minds of the raiders by the “us-against-them” views that arise in the context of the morality of group loyalty discussed above. Many other examples exist as well. The internal order of the famous commercial cities of ancient Greece and of early modern Europe depended on cooperation created through trust, honesty, and generosity, as suggested in Section 5, for instance, and dealings between the merchants from these cities were similarly cooperative (Fox 1971:37–39, 65–66; Benson 1989), but one of the most important “commodities” traded in both of these periods of commercial development was slaves (Fox 1971:35–36, 62–63). Greek cities often sent their own ships out on raids to capture slaves, while the Dutch and British created markets for slaves that encouraged others to actually capture them.

9. Levi (1988:110) references other historians and political theorists who see early states as protection rackets.
10. Opportunistic breaches of promises in cooperative clusters are also possible, of course. This incentives issue is a relative one rather than an absolute one. In a cooperative group, everyone is likely to be relatively better off than they would be if the cooperation breaks down and the group returns to the state of nature. A risk averse individual, recognizing this and considering the expected outcome given the probabilities of a successful and an unsuccessful opportunistic breach, relative to the status quo, is less likely to breach. On the other hand, a slave or someone subject to heavy extortion could well be better off in a state of nature, given that the master is successfully overthrown, and the status quo is clearly relatively undesirable. Thus, the incentives to find a way to successfully breach are relatively strong.
11. Disputes in a cooperative system such as those described above will also be adversarial, of course, as the immediate decision causes one party to gain and another to lose, but this short-term adversarial issue is only part of the outcome. Another part is that solution of the dispute maintains or reestablishes long-term interactions for mutual gain. Furthermore, it can clarify property rights so that future disputes are avoided and the potential for wealth-enhancing interactions expand. Therefore, within a close-knit cooperative group non-violent dispute resolution can be seen as a cooperative alternative to some more violent option (e.g., the blood feud).

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