

# From “The Lowest State of Poverty and Barbarism” to The Opulent Commercial Society: Adam Smith’s Theory of Violence and the Political Economics of Development

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## Abstract

What accounts for the differences in the “wealth of nations”; that is, the differing levels of opulence across countries? Adam Smith’s answer to these questions is complex and has yet to be fully understood. Moreover, I argue that it is as relevant today as it was in Smith’s time. On the economic side, his answer is well-known and includes the division of labor, the role of capital, and the absence laws and regulations that encumber competition and markets. Yet Smith did not confine himself to economic issues, instead turning equally to politics. As I demonstrate, violence is central to Smith’s approach to development, and Smith scholars have systematically under-appreciated the importance of violence in his approach to economic and political development. In the face of violence, individuals have little incentives to be industrious, to save, or to invest. Development, therefore, requires solving the problem of violence. I also show that Smith’s theory of opulence depends on three mutually reinforcing elements, liberty, commerce, and security. If commerce represents the development of markets in Smith’s approach, we can think of liberty and society as providing the legal and military infrastructure to sustain markets.

## 1. Introduction

What accounts for the differing levels of opulence across countries? Why do so many countries fail to achieve opulence? In short, what accounts for the differences in the “wealth of nations”? With persistently high levels of poverty throughout the world (Collier 2007), these issues are as relevant today as they were in Smith’s time. So too, I argue, are Smith’s ideas on these topics.

Adam Smith’s answer to these questions is complex and multifaceted; and it has yet to be fully understood. On the economic side, his answer is well-known and includes the division of labor, the role of capital, and the absence laws and regulations that encumber competition and

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markets, such as mercantilism and barriers to free trade (see, for example, Aspromourgos 2009; Eltis, 1975; Hollander, 1973; Myint, 1977; O'Brien, 1975 [2004]; and Rothschild and Sen 2006).

Yet Smith did not confine himself to economic issues when addressing the problem of development, instead turning equally to politics. His discussion of the transition from feudalism to the commercial society – that is, his explanation for the development of Western Europe – hinges on politics, political exchange, and, also, violence. Skinner (1975:168), in his famous characterization of Smith's argument about development, concludes that “the motivation behind many of the most important changes was in fact political rather than simply economic.”

As I shall demonstrate, violence is central to Smith's approach to these issues. Just as modern scholars of development systematically under-appreciate problems of violence (see North, Wallis, and Weingast 2009 – hereinafter: NWW), scholars studying Adam Smith have systematically ignored or under-appreciated the importance of violence in his theories of economics and politics, particularly in his theories of economic and political development.

Smith does not provide a systematic, abstract theory about the role of violence or about the politics of development that parallels his abstract economic theories about the division of labor, price theory, and the role of capital in the *Wealth of Nations* (WN) Books I and II. Because Smith embeds his analysis of the politics and economics of development of Western Europe in a narrative, the underlying theory is easy to miss.<sup>2</sup>

Nonetheless, we can extract a theory of Smith's political economics of development from his many discussions of this topic, especially, from his analyses of European history from the fall

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<sup>2</sup> Indeed, most economists studying the history of economic thought dismiss WN book III, one of the main sources of Smith's theory of political development in the *Wealth of Nations*. See, e.g., Blaug (1978), Brue and Grant (2007), and Robbins (1998). Although Schumpeter (1954,187) observed that “**Error! Main Document Only.** This third Book did not attract the attention it seems to merit,” he devotes only two other sentences to this topic. Skinner (1975, 1996) is an obvious exception.

of Rome through the rise of the commercial society.<sup>3</sup> Smith's analysis represents what economists and political scientists call applied theory – or, in this case, an “analytic narrative” (Bates, et al. 1998) – explaining the evolution of Western Europe from the fall of Rome to Smith's present.

Violence is a principal impediment to economic growth in Smith's approach; violence can occur within a society as different groups, factions, or regions fight one another; or it can occur when the government plunders its citizenry.

Smith answer to the puzzle of the “slow progress of opulence” or the lack of economic development involves violence:

We come now ... to examine the causes of the slow progress of opulence.

When one considers the effects of the division of labour, what an immediate tendency it has to improve the arts, it appears somewhat surprizing that every nation should continue so long in a poor and indigent state as we find it does. The causes of this may be considered under these two heads, first, natural impediments, and secondly, the oppression of civil government. [*LJ(B)* 521]

Smith explains the unfortunate effects of incentives fostered by violence and “oppression of the civil government”:

In all countries where there is tolerable security, every man of common understanding will endeavour to employ whatever stock he can command in procuring either present enjoyment or future profit. If it is employed in procuring present enjoyment, it is a stock reserved for immediate consumption. If it is employed in procuring future profit, it must procure this profit either by staying with him, or by going from him. In the one case it is a fixed, in the other it is a circulating capital. A man must be perfectly crazy who, where there is tolerable security, does not employ all the stock which he commands, whether it be his own or borrowed of other people, in some one or other of those three ways.

In those unfortunate countries, indeed, where men are continually afraid of the violence of their superiors, they frequently bury and conceal a great part of their stock, in order to have it always at hand to carry with them to some place of safety, in case of their being threatened with any of those disasters to which they consider themselves as at all times exposed. [*WN II.i.30-31:284-85*]

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<sup>3</sup> Smith presents sustained historical analyses in *WN* Book III; in Book V on the medieval Church; and in both *LJ(A)* and *LJ(B)*.

The purpose of this paper is to sketch systematically Smith's answer to the questions asked at the outset about the differences in the wealth of nations. I summarize his analysis as follows. The various invasions of the Roman Empire ultimately forced it to collapse, and with it, the Roman system of property rights, division of labor, and exchange.

Smith characterizes the consequences of the invasions and the violent environment that followed, “The rapine and violence which the barbarians exercised against the antient inhabitants, interrupted the commerce between the towns and the country. The towns were deserted, and the country was left uncultivated, and the western provinces of Europe, which had enjoyed a considerable degree of opulence under the Roman empire, sunk into the lowest state of poverty and barbarism.” [WN III.II.1:381-2]

Eventually, the feudal form of governance arose. In this system, land represented the means to power. Violence, as Smith emphasizes, was a constant presence. The most powerful lords typically obtained the largest and best land, allowing them to support many retainers and large armies. The lords constantly fought each other and the king. The feudal society can be characterized by the “violence trap” (Cox, North, and Weingast 2014 – CNW).<sup>4</sup> The violence trap works like this. Economic growth requires both capital accumulation and economic integration that accompany an increasing division of labor; moreover, economic integration raises the costs of fighting. But violence threatens the value of the investments necessary for economic integration, especially integration across regions or factions that might fight each other. Smith again and again explains that, given the risk of violence, rational investors will not invest in economic integration:

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<sup>4</sup> Poverty traps are common in economics as explanations of the persistence of poverty and the lack of economic development (Azariadis and Stachurski 2005 provide a recent survey).

In the infancy of society, as has been often observed, government must be weak and feeble, and it is long before it's authority can protect the industry of individuals from the rapacity of their neighbours. When people find themselves every moment in danger of being robbed of all they possess, they have no motive to be industrious. There could be little accumulation of stock, because the indolent, which would be the greatest number, would live upon the industrious, and spend whatever they produced. Nothing can be more an obstacle to the progress of opulence. [LJ(B) 522]

Given these incentives, the violence trap is self-sustaining and hard to escape; most incremental changes are insufficient to escape the trap.

Smith clearly understood the logic of poverty traps. For example, he argued that: "This is one great cause of the slow progress of opulence in every country; till some stock be produced there can be no division of labour, and before a division of labour take place there can be very little accumulation of stock" [LJ(B) 287:522]. Set in the context of Smith's arguments about violence, Smith's logic reflects the violence trap. Hence the feudal equilibrium of violence and low-growth was stable.

How did Western Europe escape the violence trap? According to Smith, the rise of towns represented the essential step in the political economic development of Europe. In the midst of the feudal equilibrium, the king and town (small groups of traders) engaged in an important political exchange, forming a coalition against their common enemy, the local lords, and altering the constitution of the towns. The king granted the towns rights of self-governance, trading, and defense in exchange for taxes and military service. The new system represented a non-incremental change that simultaneously produced liberty, commerce, and security, allowing the town to escape the violence trap and a positive feedback system with increasing returns.<sup>5</sup>

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<sup>5</sup> "Increasing returns and economic progress" – the title of Young's (1928) well-known paper – have long been a part of the literature on Smith. See also the "virtuous circle" of MacFarlane (2000:\*\*) and Rothschild and Sen (2006: 334-37).

The towns extended their reach into the countryside, transforming self-sufficient agriculture into specialists produce food and raw materials for the towns and, ultimately, long-distance trade. A necessary component of the towns escape from the violence trap is that the towns gained local military superiority relative to the local lords. This superiority allowed them to trade, amass wealth, and grow opulent while defending themselves against the arbitrary exactions and rapacious violence of the local lords – and also the king.

This paper proceeds as follows. In the second section, I discuss the NWW and CNW approach to violence and economic development. Section 3 presents several abstract propositions summarizing Smith's arguments. Section 4 summarizes Smith's approach to the feudal equilibrium, while section 5 explains his theory of the towns' escape from that equilibrium. My conclusions follow.

## **2. Elements of the NWW/ CNW Political-Economic Approach to Development**

In this section, I summarize the NWW/ CNW framework, focusing especially on the idea of the natural state as a violence trap.

### **The Framework**

Although a long tradition exists in studying development and state-building with respect to violence from sources external to the state (Bates 2001, Tilly 1992, Jones 1972), the idea of intra-state violence has received far less attention; and here, the tendency is to associate violence with special cases of the so-called failed states, such as Somalia or the Democratic Republic of Congo rather than a systematic factor affecting all developing countries (see, e.g., Collier 2007).

The reality differs considerably. Developing countries typically face distributed sources of violence potential. As CNW demonstrate, violence – including civil wars, insurgencies, and especially coups – is surprisingly common in modern developing countries. They show that the median regime in the bottom half of the distribution of states by income experiences violent leadership turnover once every seven years. For the second richest decile by income (containing the richest developing states), the median is just twelve and a half years. In contrast, the richest decile of states experience violence only once every 60 years. In comparison to the developed world, the developing one faces regular problems of violence.

Violence is a tool used by which some groups to survive by plundering the efforts of others (Hirschleifer 1994, Dixit 2004). Absent constraints, competition for survival means that even if most people are non-violent, some individuals and groups can and will gain advantage by using violence as part of their survival strategy.

All developing states, past and present, must therefore devise a means of mitigating the problem of violence, and how they do so affects their pattern of development or the lack thereof. In particular, developed states solve this problem in a manner that differs considerably from how today's developing states and almost all states throughout history (NWW).

The evidence on the prevalence of violence throughout the developing world underscores the point that a central task in developing countries is to prevent violence. They do so by inducing individuals and groups with violence potential to cooperate rather than fight. The NWW/ CNW approach shows that the natural way to mitigate violence and induce cooperation is rent-creation: developing countries limit access to privileges, rights, state services, organizations, and competition so as to create and distribute rents to powerful constituencies, especially those with violence potential. Because violence typically lowers rents, the appropriate distribution of

rents makes those with violence potential better off than fighting. NWW calls these rent-creating societies *natural states* because this has been the dominant way of organizing states throughout history.<sup>6</sup>

CNW use a bargaining approach to model the natural state, which produces several results. Suppose two groups compete for a total surplus normalized to 1. Let  $p$  be probability the first wins;  $c_1$  is the first's costs. The expected value of fighting to group 1 is  $p \cdot 1 - c_1 = p - c_1$ . A similar logic for 2 yields that 2's expected value from fighting is  $(1-p) - c_2$

To prevent violence, natural states distribute rents and privileges according to the *proportionality principle*, the idea that benefits from cooperation among those with violence potential must be distributed in proportion to power. The following inequalities must hold:  $R_1 \geq p - c_1$  and  $R_2 \geq 1 - p - c_2$ , where  $R_i$  are the rents and privileges going to powerful group  $i$ . These inequalities simply state that constructing a bargain to support peace among 1 and 2 requires that each player is better off cooperating than fighting.<sup>7</sup> If either of these inequalities fails to hold, then one of the bargaining parties is better off using violence to gain a greater share of benefits rather than cooperating, so the natural state is not stable.

CNW introduce a dynamic element to the static bargaining framework. The world is constantly changing, even non-ergodic (North 2005), and all states experience episodic shocks. In natural states, these shocks often alter the relative power of groups with violence potential. For example, relative prices may change; sectors of the economy grow differentially; technological change occurs; changes occur in the international environment, such as the rise of

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<sup>6</sup>In contrast, developed societies solve the problem of violence through economic integration that raises the economic costs of fighting, the development of institutions that create credible commitments, open access to economic and political organizations and hence economic and political competition. Violence potential in these societies is largely centrally controlled and subject to self-enforcing rules that limit the use of violence against the population.

<sup>7</sup>We know that it is possible for both inequalities to hold because war wastes value; i.e.,  $c_1 + c_2$ , so both players can be made better off cooperating rather than fighting.

a new and dangerous neighbor, and various demographic trends emerge. These changes often affect those with violence potential differentially.

Consider a natural state that has reached a bargaining equilibrium producing cooperation and peace among those holding violence potential. Sufficiently large shocks in the natural state's environment hold the potential to alter the distribution of relative power so that the proportionality principle no longer holds in the post-shock environment. For example, differential economic growth may make one of the parties far stronger than before. In the face of such shocks, the parties must bargain to reallocate benefits or risk violence.

The dynamic setting has two implications. First, suppose a shock is large enough so that one group's rents no longer satisfy the inequality about – say that the probability that group 1 wins a conflict,  $p$ , has risen to  $p'$  so that  $R_1 < p' - c_1$ . That is, the proportionality principle fails in the new environment for player 1. Further suppose that the effects of the shock on power are common knowledge. Then the two parties can reach a new bargaining solution to prevent violence by transferring some rents and privileges from player 2 to player 1 so that the no-fight inequality holds again, i.e., that  $R'_1 \geq p' - c_1$ .

A problem arises, however, when the common knowledge assumption about the effects of the shock fails. In this case, three major problems impede the renegotiations, low economic costs of violence, commitment problems, and asymmetric information. These problems frequently impede the success of bargaining so that the parties fail to arrive at a peaceful a solution (this result is standard in the literature – see Fearon 1995; but also Powell 1999 and Moothu 1999).

Consider the problem of asymmetric information that results in differences in perceptions. Suppose group 1 believes that the shock has made it much stronger while group 2

thinks that the shock has made group 1 only modestly stronger. When these differences in perception are sufficiently large, the highest offer 2 is willing to make to 1 may be *lower* than the lowest offer that 1 will accept. Not bargain for peace is possible under these circumstances, so violence results.

This model explains why violence is so common in natural states and especially why violent regime change occurs frequently. Shocks continually affect the bargaining parties and their power; violence arises because of problems of asymmetric information, commitment problems, and the relatively low costs of violence.

An important part of the NWW understanding of the natural state involves the concept of *perpetuity*. A perpetual organization is one that lives beyond the individuals who create it. A business partnership, for example, is not perpetual because it ceases upon the death of one of the partners. In contrast, a corporation is perpetual because its life is independent of the lives of its shareholders.

This concept applies not only to all organizations but to states. In particular, some states are perpetual, although most are not. Perpetuity in a state means that the institutions of the state are self-enforcing in the sense that no actor with the power to disrupt the state has an incentive to do so. In a perpetual state, citizen rights and political and economic institutions are independent of the identity of those in power. In these states, new leaders have no authority or incentive to alter the political rules of the game. Perpetuity also requires that turnover in political leadership is peaceful.

In contrast, violent leadership turnover is frequently associated with change in political institutions, rights, privileges, and policies. States subject to regular, if episodic, violence cannot be perpetual because the identity of today's vs. tomorrow's leader matters. Most developing

countries fail on this dimension, as the CNW evidence on the frequency of violent regime change demonstrates.

NWW (ch5) argue that the first step in development – the transition from a natural state to an open access order – is the *doorstep conditions*; namely, rule of law for the elite; perpetuity; and neutral control of the violence potential by the state. The three characteristics defining political development either include or imply the three doorstep conditions.

### **Implications of the Framework for Political-Economic Development**

What prevents most natural states from developing? The NWW framework, as refined by CNW, answers that a violence trap prevents almost all natural states from developing; the need to solve the problem of distributed violence leads natural states to policies that prevent development.

The bargaining framework implies a violence trap; that is, a positive feedback loop in development with multiple equilibria. Low economic costs of violence, asymmetric information, and the absence of credible commitments all plague attempts by developing countries to initiate and sustain the path of development. These states typically remain in the bad, less developed equilibrium. Greater economic integration raises the costs of violence; but in the face of violence potential these investments in greater economic integration do not occur. Problems of violence – for example, in the wake of bargaining failure in the face of new circumstances – plague attempts by developing countries to foster investments in economic specialization and exchange, especially economic integration across groups that might fight. These attempts frequently make at least one of the bargaining parties vulnerable to opportunism in the face of violence.

A feature of the developing country-qua natural state-environment is that the economic costs of violence are (relatively) too low (CNW). Extensive economic integration across factions who might fight if violence breaks out raises the costs of violence. Sufficiently high levels of economic integration raise the economic costs high enough that they prohibit violence. But herein lies the violence trap. Economic integration is necessary to raise the costs of violence; but people will not make these investments because the threat of violence makes the investments too risky.

This model affords two equilibria. The first we have just described as the violence trap. Because the threat of violence, investment and development fails to take place; but without investment and development, the costs of violence remain (relatively) low so that violence has a positive expected value.

A second equilibrium also exists. In this setting, the costs of violence are high and so violence is not a credible threat within this society; due to high economic investments and economic integration, even powerful groups face a negative expected value of fighting. Raising the costs of violence requires high economic integration so that the outbreak of violence disrupts a complex and productive economy, making all worse off.

The great difficulty for development in this approach is moving from the violence trap equilibrium to the development equilibrium. Put simply, how is this achieved? The absence of deep theories of development involving violence means we have too little theory to help us understand. NWW trace many of the steps necessary for this development, notably the idea of a state on the doorstep conditions and their characterization of the open access order's equilibrium. But they do not explain the forces leading a given state to make the changes necessary for the

transformation out of a natural state into a state on the doorstep or one that becomes an open access order.

The CNW perspective adds some hints. First, as with most poverty traps in development (see Azariadis and Stachurski 2005), there exists a positive feedback loop so that a state that begins to escape the violence trap often moves quickly toward a state on the doorstep conditions. The positive feedback loop also implies that incremental attempts to establish the doorstep conditions typically make the country worse off; incremental changes therefore fail. Providing significant levels of market-enhancing public goods, for example, forces a reallocation in the distribution of policy benefits away from those with violence potential toward ordinary citizens. Such incremental changes conflict with the proportionality principle. Because these changes make those with violence potential worse off, they are likely to threaten violence, in turn threatening the provision of public goods.

Perpetuity is also hard to engineer in the natural state environment. As we have seen, sufficiently large shocks require large redistributions of rents and privileges, forcing the existing regime to redefine privileges and revise institutions regardless of what the constitution might say. Perpetuity in this environment restricts the regime's ability to adjust to shocks, making violence more likely.

All told, then, the violence trap represents a major impediment preventing natural state from sustaining reform and development. This trap also demonstrates that the problem of development is at once political and economic. Without political development, economic development cannot proceed. And yet, the un-developed features of the natural state economy – especially its distribution of rents and privileges to maintain the property – preclude political development.

### 3. Smith's Theory of the Political Economics of Development

In Book III of the *Wealth of Nations*, Adam Smith provides a theory of the political economics of development of Western Europe. The theory is easy to miss because Smith embeds his approach in a historical narrative. Indeed, many scholars dismiss Book III.<sup>8</sup>

Nonetheless, an important group of Smith scholars examine Book III carefully, helping to extract Smith's theoretical argument from the narrative; notably, Skinner (1975), Winch (1978:ch 4), Moss (1979), Haakonssen (1983:165-71), and Asproumorgos (2009,ch 5). In this section, I draw on these works to explore several general theoretical propositions about the political economics of development proposed by Smith in his historical jurisprudence focusing on Western Europe. I illustrate and defend these claims in sections 4 and 5.

**(1) Violence.** Adam Smith understood violence to be a first order problem for development; any solution to the development problem, therefore, had to involve limiting violence. Smith studies several types of violence, including predation by the government, plunder by neighbors, and invasions by distant foes. Each of these sources of violence reduces the incentives for industry, saving, investment, and specialization. To develop, a society must therefore solve the problem of violence. Put simply:

*Violence is a major impediment to economic development.*

**(2) The Feudal Equilibrium.** Smith shows why the violence of the feudal era created a stable political-economic equilibrium of very low growth. Because of the risk of plunder, men rationally avoided hard work, initiative, and investment. In Smith's words, “[T]he occupiers of

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<sup>8</sup> Most economists studying the history of economic thought dismiss *WN* Book III. See, e.g., Blaug (1978), Brue and Grant (2007), and Robbins (1998). Although Schumpeter (1954,187) observed that “**Error! Main Document Only.** This third Book did not attract the attention it seems to merit,” he devotes only two other sentences to it.

land in the country were exposed to every sort of violence. But men in this defenceless state naturally content themselves with their necessary subsistence; because to acquire more might only tempt the injustice of their oppressors.” [WN III.iii.12:405]. Further, a “person who can acquire no property, can have no other interest but to eat as much, and to labour as little as possible.” [WN III.ii.9:387-88ea]

In proposition form, we have:

*The feudal system was an equilibrium of very low growth, in part due to the prevalence of violence; what we today term a “violence trap” (CNW).*

**(3) Political exchange and the escape from the violence trap.** Although Smith never says so explicitly, his argument suggests that the escape from the violence trap was non-incremental. This claim is not a large stretch from his logic. Indeed, we can think of this political exchange as an explicit revision of the constitution governing the towns. King and town made an alliance against their common enemies, the local lords. The alliance made the king more powerful – through revenue and military service from the town; and the towns gained a non-incremental increase in control over their own destiny.

For the growth of towns following the political exchange to work, the town had to provide for its security. Given the history of plunder of the great landholders, the towns’ survival required that they had to have a local comparative advantage in fighting. Without this advantage, the towns would have disappeared. Commerce was also necessary, for it provided the gains from exchange and hence the means for financing the towns’ public goods, such as order, security, and justice, including strong property rights. Liberty – in the form of strong property rights, a system of justice, and the absence of predation – was also necessary. Constitutional change inherent in the political exchange underpinned the transition. Thus:

*A major political exchange underlies a non-marginal change, allowing the towns to escape the violence trap. Specifically, political exchange supported dramatic change in towns' circumstances with three simultaneous revolutions: liberty, commerce, and security.*

Smith indicates the new equilibrium involving the towns as they extended their reach, control, and laws into the neighboring countryside: “A regular government was established in the country as well as in the city, nobody having sufficient power to disturb its operations in the one, any more than in the other.” [WN III.iv.15,421]

#### **4. The Feudal Equilibrium, or the “Lowest State Of Poverty and Barbarism”**

In this section, I develop Smith’s argument that violence is a principal impediment to both economic growth and the escape from poverty. I draw on recent work of: Aspromougos (2009, ch5), Bell (1992), Haakonssen (1981:165-71), Henderson (2006,ch8), Hollander (1979), Hont (1988), and especially Skinner’s classic treatment (1975).

The purpose of this exercise is not to evaluate how well Smith's history holds up given what we know now; but to reveal the underlying logic he uses explain events and phenomena. Smith applies this approach to the history of the West from prehistoric times to his own (*LJ*). Along the way, he discusses progress toward greater opulence and the impediments to this progress. We begin with Smith's discussion of the consequences of the fall of the Roman Empire.

As background, we begin with Smith's observations about the consequences of the fall of Rome. For several centuries prior to the invasions that would destroy it, the Roman Empire sustained sufficient security to foster substantial division of labor, specialization and exchange, and hence opulence. The various invasions destroyed this peaceful stability, with disastrous economic effects.

Having displaced the Romans, the invaders settled down. Property became more than an economic asset. As the principal means of supporting warriors, property also represented power in this world. Those who held higher quality and larger tracts of land commanded larger armies.

Reflecting the natural state logic described in section 2, no one could keep the peace. The king and government were insufficiently powerful to enforce their authority, law, and order throughout his domain. The result was violence and disorder. The great lords “were always at war with each other and often with the king, their whole power depended on the service of their retainers and tenants.” [LJ(A) iv.126-27:249]

The king also found it absolutely necessary to grant the power of jurisdiction to these lords; for as he had no standing army there could be no other way of bringing the subjects to obey rules. A debt could not be taken up, nor an offender punished, any other way. “A king's officer would have been laughed at or massacred. [LJ(A) iv.119:246]

In those disorderly times, every great landlord was a sort of petty prince. His tenants were his subjects. He was their judge, and in some respects their legislator in peace, and their leader in war. He made war according to his own discretion, frequently against his neighbours, and sometimes against his sovereign. [WN III.ii.3:383]

Smith characterized the feudal world as violent and predatory, with little overall growth. Most people lived at subsistence, with minimal degrees of trade, division of labor, specialization and exchange. Centered around the manor, the local agrarian economy was largely self-sufficient and based on custom with little monetary exchange. The local lord captured most of the local surplus, converting it into security through local military organization (North and Thomas 1973,\*\*) and by dividing the surplus among retainers in exchange for various service obligations, especially military obligations.

Investment, in Smith's view, was generally fruitless because of violence and predation. Indeed, to invest, improve, and better one's condition was to become a target of plunder:

“[T]he occupiers of land in the country were exposed to every sort of violence. But men in this defenceless state naturally content themselves with their necessary subsistence; because to acquire more might only tempt the injustice of their oppressors.” [WN III.iii.12:405].

In the absence of positive rewards, the threat of violence was one of the few means available to motivate workers:

A person who can acquire no property, can have no other interest but to eat as much, and to labour as little as possible. Whatever work he does beyond what is sufficient to purchase his own maintenance, can be squeezed out of him by violence only, and not by any interest of his own. [WN III.ii.9:387-88]

More generally, Smith argues that to be independent individuals and groups needed to be powerful – that is, to possess their own violence potential to protect themselves from the violence of others. If they did not possess power, they were forced to ally with a powerful group for mere survival:

Those whom the law could not protect, and who were not strong enough to defend themselves, were obliged either to have recourse to the protection of some great lord, and in order to obtain it to become either his slaves or vassals; or to enter into a league of mutual defence for the common protection of one another. [WN III.iii.8:401]

**4.1. The feudal equilibrium as a violence trap.** The bargaining model introduced in section 2 applies to this setting. Regularly changing circumstances, asymmetric information and the absence of credible commitments plagued negotiating agreements to maintain peace. The feudal society represented an equilibrium in the sense that, though the fortunes of individual lords changed over time, the basic structure of the political and economic arrangements remained stable.

Military competition drove the political structure. Because of the constant threat to security, lords who failed to capture most of the surplus and use it to maintain their violence potential became vulnerable. Moreover, the militarized environment afforded few gains from

specialization and exchange. The main agricultural products, such as grain, could not be carried profitably far over land. The absence of a state that could provide order and security meant great risks to specialization and exchange as transporting items risked being stolen in the attempt.

The authority of government still continued to be, as before, too weak in the head and too strong in the inferior members, and the excessive strength of the inferior members was the cause of the weakness of the head. After the institution of feudal subordination, the king was as incapable of restraining the violence of the great lords as before. They still continued to make war according to their own discretion, almost continually upon one another, and very frequently upon the king; and the open country still continued to be a scene of violence, rapine, and disorder. [WN III.iv.9:418]

As described by Smith, the feudal equilibrium reflects the logic of the natural state.

Virtually all organizations had to be associated with the local lord, or else they were captured or destroyed with their assets expropriated.

This environment of political opportunism and predation provided poor incentives for saving and investment. Any investment or attempt to save surplus by peasants must be hidden or risk confiscation. In Smith's words, "men in this defenceless state naturally content themselves with their necessary subsistence; because to acquire more might only tempt the injustice of their oppressors." [WN III.iii.12:405]

The feudal equilibrium qua violence trap and predation meant that investment and improvement were unprofitable. As noted in the introduction, it is clear that Smith understood the logic of traps. Violence prevented the accumulation of stock, without which the economy could not grow.

Rents and privileges were distributed according to the proportionality principle and adjusted as shocks and changing circumstances required. When bargaining failed to make adjustments according to the proportionality principle, violence occurred. Agreements between lords and the king, among lords, or between lords and their retainers were constantly broken or

adjusted unilaterally. Increases in inclusion could occur only if it reflected new sources of violence potential. A lord or king who sought incremental reform to increase rule of law, credible commitments to rules, or limits on their own use of violence made themselves worse off in this environment of violence and the frequent need, in the face of changing circumstances, to adjust the distribution of privileges and rents.

In NWW's term, regular violence meant the absence of perpetuity and impersonality. Perpetual institutions stand in the way of natural state adjustments to changing circumstances, and impersonality implied violations to the proportionality principle. Given the natural state bargaining setting, the need to adjust rules and privileges to changing circumstances so as to maintain the proportionality principle, the failure of perpetuity and impersonality meant the absence of the rule of law in natural states (Weingast 2010).

Needless to say, this world was poor, violent, and undeveloped.

**4.2. Economic effects of the feudal equilibrium.** Violence and predation had clear economic effects. The violence associated with the invasions and with the post-empire world produced a downward economic spiral as exchange – the necessary basis for the division of labor and of hence of opulence – became risky and vulnerable. Trade and communication fell precipitously, although they never disappeared. Speaking of the great lords, Smith says: “Their lawless and freebooting manner of life [of the great lords] also destroyed all the commerce and industry of the former inhabitants, who were obliged to leave the cities and seek possessions and protection in the lands of the several lords.” [LJ(A) iv.124:248]

Put simply, plunder inhibited economic development:

In a rude state of society there are no great mercantile or manufacturing capitals. The individuals who hoard whatever money they can save, and who conceal their hoard, do so from a distrust of the justice of government, from a fear that if it was known that they had

a hoard, and where that hoard was to be found, they would quickly be plundered. [WN V.iii.9:911]

**4.3. Property rights in land.** Because land represented power in the feudal society, the form of property rights in the feudal system was central to its survival.<sup>9</sup> The form of rights reflected the needs of security over efficiency. In Smith's argument, the rights in land are endogenous to the setting.

Modern, developed open access orders have a complex system of legal infrastructure that facilitates exchange and efficient allocation of land based on a strong system of property rights. Some of the characteristics of this infrastructure include: (i) strong protections from expropriation and plunder by the state and by others; (ii) a system of titling, ownership rules, and a judiciary to enforce them so that it is clear at any given moment who is the property holder; (iii) a qualification to rights based on preventing potential harms to others (harms recognized as externalities in economics and nuisance in property law); (iv) the right to devise property by will among heirs; (v) rights of free alienation of land with an absence of encumbrances on selling the land and to whom the land may be sold; and (vi) a legal system that enforces contracts, including the exchange of land (see, e.g., Posner 2006; Barzel 1990, Alston et al 2013). Each of these characteristics facilitates the exchange of land from lower to higher valued users; in particular, to individuals who would improve the land.

The feudal system of property rights to land involved none of these characteristics. The problem of violence and the need to maintain security forced significant deviations from the set of characteristics just outlined. Lords regularly fought one another, and the winners often forced the losers to transfer portions of their land; condition (i) therefore failed to hold. The absence of a

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<sup>9</sup> The discussion of Smith's views of property rights in land draws on Aspromougos (2009, ch5) and Henderson (2006, ch8).

government and a judicial system imply that conditions (ii and vi) failed. External harms (iii) were often dealt with through bargaining and violence, not through law. As I report shortly, a wide range of restrictions were imposed on the right of property holders to devise property by will, particularly *primogeniture*, which prevented division of the land among several sons; and *entails*, which prevented a landowner from dividing his property and alienating some of the pieces. Taken together, these and other restrictions imply that conditions (iv) and (v) failed. The feudal system of land rights dramatically restricted the transfer of land from low valued users to higher valued users; and, also, of markets to engineer movement toward the optimal organization of parcels and, generally, more efficient production.

As Smith explains, the logic of the failure of conditions (iv) and (v) involve violence.<sup>10</sup>

According to Smith:

When land, like moveables, is considered as the means only of subsistence and enjoyment, the natural law of succession divides it, like them, among all the children of the family; of all of whom the subsistence and enjoyment may be supposed equally dear to the father. This natural law of succession accordingly took place among the Romans, who made no more distinction between elder and younger, between male and female, in the inheritance of lands, than we do in the distribution of moveables. But when land was considered as the means, not of subsistence merely, but of power and protection, it was thought better that it should descend undivided to one... The security of a landed estate, therefore, the protection which its owner could afford to those who dwelt on it, depended upon its greatness. **To divide it was to ruin it, and to expose every part of it to be oppressed and swallowed up by the incursions of its neighbours.** [WN III.ii.3:382-83, emphasis added]

The relationship between land, retainers, and power – as already mentioned – bundled rights to land with service obligations to the lord. Individuals did not own the lands in the modern sense of clear title with an absence of the ability of the government or other individuals to force the property holder to give up the land.

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<sup>10</sup> The example of the deviation of rights in land from those best suited to markets to those best suited for feudalism is an illustration of Smith's contention that Europe did not take the natural path to opulence, but deviated from that path considerably (WN III.i.8-9:380).

Many of the most inimical features of feudalism's rights in land can be explained by their role in supporting violence potential. These constraints on property improved local security even though they harmed the local economy by restricting land from moving to higher valued uses. Adam Smith argued that the emergence, role, and stability of primogeniture, entails, and wardship all improved the lord's ability to project force and maintain local security.

Primogeniture prevented lords from dividing their property among many heirs, requiring instead that all of a lord's property go to his first born son. Primogeniture would prove very costly in the developing commercial economy. In the violent feudal society, however, it was highly valuable because it enhanced security:

The law at that time ... did not provide, nor indeed could it, for the safety of the subjects. Each principality ... provided for its own defence... In this state a small property must be very insecure, as it could not defend itself and must be entirely dependent on the assistance of some of the neighbouring great men... [A]s the only security in the other case was from the strength of the possessor, small property could be in no security. [*LJ* i.130-31,55]

Smith explains the main implication: "If therefore an estate which when united could easily defend itself against all its neighbours should be divided in the same manner as moveables were, that is, equally betwixt all the brothers, it would be in no state of equality with those to whom it was before far superior." [*LJ* i.131,55]

The same logic applies to entails, a legal device that settles or limits the succession to real property, such as land. If primogeniture preserves a lord's estate at time of death; entails preserve the estate while he is alive. In the feudal system, entails helped "preserve a certain lineal succession, of which the law of primogeniture first gave the idea, and to hinder any part of the original estate from being carried out of the proposed line either by gift, or devise, or alienation; either by the folly, or by the misfortune of any of its successive owners" (*WN* III.ii.5:384).

Wardship, the practice whereby the king or lord appoints another the right to use the land while an heir remained a minor, provides an interesting variant on this logic. Though much hated by the elite, wardship represented a solution to an important problem in the feudal society. Recall that vassals of a lord held land by virtue of an exchange to supply military and other services. A problem arose in this system because a ward as heir could not meet his feudal obligations associated with his land; in particular, he could not provide the required military service to the Lord. Given the constant threat of violence, a Lord could not afford to have property in his domain that failed to contribute to his power and security. Hence, wardship evolved, allowing the Lord to assign rights to run the property to another person for the duration of the wardship in order to finance violence potential and meet the military service obligations to the lord that accompanied the ward's property.

**4.4. Summary.** The feudal world was violent, stable, and poor. In modern terms, we call this world an equilibrium variously characterized as a “violence trap” (CNW) or a “vicious circle of poverty” (Macfarlane 2000:98). This section suggests an essential tradeoff between security and growth; that is, of security for economic growth. The inability to forestall violence helps explain why this system failed to grow.

## **5. The Transition from Feudalism to the Commercial Economy**

The transition out of feudalism began with the chartering of towns, creating a significant, non-marginal constitutional change affecting a small but important subset of the feudal society. These changes had unintended consequences, helping specific parts of Western Europe – notably the towns – to escape the violence trap. Although trade fell dramatically after the fall of Rome, it never disappeared. Small time traders, often in “servile, or very nearly servile” relations to local

lords, paid the lords for the right to trade (*WN III.iii.2:397-98*).<sup>11</sup> These traders, often living together in tiny towns, worked under remarkably unfavorable conditions of violence and predation. Potentially significant gains from exchange existed in long-distance trade and local specialization, but these gains were unrealizable under the feudal system because of the threat of violence and plunder.

To take advantage of profitable opportunities in long-distance trade, the towns and traders needed non-marginal increases in security from local violence and predation. Increased security, in turn, allowed the towns to govern themselves, producing islands of perpetuity, impersonality, and order for elites. The more secure political environment fostered investment, specialization and exchange, and economic expansion. The three simultaneous revolutions of liberty, commerce, and security enhanced one another. Rothschild and Sen (2006:334-37) capture this logic: “The progress of opulence can be seen as a virtuous circle, in which legal and political improvement leads to economic improvement, and economic improvement, in turn leads to further improvement in political and legal institutions.”

We explore Smith’s argument about the logic of the towns’ escape from the violence trap in four stages; we evaluate Smith’s logic in the following section.

**5.1. Political exchange between king and town.** Following Smith, we can think of the feudal environment as having three relatively independent groups: the king, the lords, and the towns. In the beginning, as we have seen, the king and lords were constantly fighting each other; and each also plundered the towns, which were too small to defend themselves or attack the other two.

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<sup>11</sup>Smith says in *LJ(A)* [iv.142-43:255] that the burgers: “were at first slaves or villains who belonged to a certain lord or master to whom they paid a summ of money for the liberty of trading. They lived in small towns or | villages for the convenience of trading, but in but very small numbers.”

Coastal towns faced potential opportunities for long-distance trade along the water, but they were hindered by political uncertainty and the constant threat of predation from local lords. Skinner summarizes Smith as follows: “the wealth which [the traders] did manage to accumulate under such unfavorable conditions was subject to the arbitrary exactions of both the king and those lords on whose territories they might happen to be based on through which they might pass” (Skinner 1975:162, citing *WN III.iii.2:397-98*).

The political exchange between town and king created a coalition against a common enemy. Moreover, this political exchange allowed the towns to initiate the transition out of the old feudal equilibrium and to capture the benefits of specialization, exchange, and long-distance trade.

Smith makes four points about this political exchange. First, he describes the initial conditions involved a natural state logic based on violence potential:

In order to understand [the kings’ grant of independence to the towns], it must be remembered, that in those days the sovereign of perhaps no country in Europe, was able to protect, through the whole extent of his dominions, the weaker part of his subjects from the oppression of the great lords. Those whom the law could not protect, and who were not strong enough to defend themselves, were obliged either to have recourse to the protection of some great lord, and in order to obtain it to become either his slaves or vassals; or to enter into a league of mutual defence for the common protection of one another.

Second, Smith suggests how new possibilities arose for the defense of towns against the lords.

The inhabitants of cities and burghs, considered as [a set of] single individuals, had no power to defend themselves: but by entering into a league of mutual defence with their neighbours, they were capable of making no contemptible resistance. The lords despised the burghers, whom they considered not only as of a different order, but as a parcel of emancipated slaves, almost of a different species from themselves.

Third, Smith discusses the interests of the three parties, king, lord, and town.

The wealth of the burghers never failed to provoke their envy and indignation, and [the lords] plundered them upon every occasion without mercy or remorse. The burghers

naturally hated and feared the lords. The king hated and feared them too; but though perhaps he might despise, he had no reason either to hate or fear the burghers.

And finally, Smith explains the basis for political exchange between king and town in which the king granted the town political freedom in exchange for fixed taxes and military support.

Mutual interest, therefore, disposed [the burghers] to support the king, and the king to support them against the lords. They were the enemies of his enemies, and it was his interest to render them as secure and independent of those enemies as he could. By granting them magistrates of their own, the privilege of making bye-laws for their own government, that of building walls for their own defence, and that of reducing all their inhabitants under a sort of military discipline, he gave them all the means of security and independency of the barons which it was in his power to bestow. Without the establishment of some regular government of this kind, without some authority to compel their inhabitants to act according to some certain plan or system, no voluntary league of mutual defence could either have afforded them any permanent security, or have enabled them to give the king any considerable support. By granting them the farm of their town in fee, he took away from those whom he wished to have for his friends, and, if one may say so, for his allies, all ground of jealousy and suspicion that he was ever afterwards to oppress them, either by raising the farm rent of their town, or by granting it to some other farmer. [WN III.iii.8-9:401-02]

The late feudal environment afforded the possibility for generating substantial gains for the town through commercial trade, greater specialization and division of labor, and exchange. These opportunities provided the King and the towns with strong incentives to engineer a political exchange: The king granted the town political freedom, self-governance, and independence in exchange for financial and military support against the barons (WN III.iii.3:399). This freedom allowed the town to provide its own rules, property rights, governance, justice, and the rule of law. All of these activities required organizations and, additionally, an organization of the organizations, as I discuss in the next section. The right to build walls and military organizations allow towns to protect themselves against the local lords, but also the king.

In exchange, the towns lent the king military support and paid the king taxes, which were to be fixed for all time, lowering the king's ability to expropriate the gains of investment through ex post rises in taxes. According to Smith, the tax agreement became perpetual and impersonal.<sup>12</sup>

[WN III.iii.4:400]

**5.2. Towns escape the violence trap.** The advantage of the political exchange to members of the town is obvious: they obtained greater security, protection for their investments, and growth of their economy. The king gained a security alliance with the towns and larger resources up-front with which to deal with the local lords. In this way, "the sovereigns of all the different countries of Europe ... have ... voluntarily erected a sort of independent republics in the heart of their own dominions." [WN III.iii.7:401]

These agreements led to the first real emergence of liberty in late medieval Europe. In Smith's words:

Order and good government, and along with them the liberty and security of individuals, were, in this manner, established in cities at a time when the occupiers of land in the country were exposed to every sort of violence.

Smith continues:

But men in this defenceless state naturally content themselves with their necessary subsistence; because to acquire more might only tempt the injustice of their oppressors. On the contrary, when they are secure of enjoying the fruits of their industry, they naturally exert it to better their condition, and to acquire not only the necessaries, but the conveniencies and elegancies of life. That industry, therefore, which aims at something more than necessary subsistence, was established in cities long before it was commonly practised by the occupiers of land in the country. If in the hands of a poor cultivator, oppressed with the servitude of villanage, some little stock should accumulate, he would naturally conceal it with great care from his master, to whom it would otherwise have belonged, and take the first opportunity of running away to a town. The law was at that time so indulgent to the inhabitants of towns, and so desirous of diminishing the authority

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<sup>12</sup>An interesting irony arises with respect to the king's granting freedom to the towns. Although these acts created liberty for the townsmen, the king did so by a natural state act of arbitrary behavior. The king's action transformed traders in servile relationships to the lords into free men; the king therefore appropriated the value of these relationships from the lords.

of the lords over those of the country, that if he could conceal himself there from the pursuit of his lord for a year, he was free for ever. Whatever stock, therefore, accumulated in the hands of the industrious part of the inhabitants of the country, naturally took refuge in cities, as the only sanctuaries in which it could be secure to the person that acquired it." [WN III.iii.12:405]

Another aspect of the political exchange is that the king granted the burgers political representation, in part as a counterbalance to the great lords, especially as the towns grew richer and more powerful.

In countries such as France or England, where the authority of the sovereign, though frequently very low, never was destroyed altogether, the cities had no opportunity of becoming entirely independent. They became, however, so considerable that the sovereign could impose no tax upon them, besides the stated farm-rent of the town, without their own consent. They were, therefore, called upon to send deputies to the general assembly of the states of the kingdom, where they might join with the clergy and the barons in granting, upon urgent occasions, some extraordinary aid to the king. Being generally too more favourable to his power, their deputies seem, sometimes, to have been employed by him as a counterbalance in those assemblies to the authority of the great lords. Hence the origin of the representation of burghs in the states general of all the great monarchies in Europe. [WN III.iii.11:404]

Representation, in turn, provided additional credibility to the political exchange between king and town for two reasons. First, because the king valued his political alliance with the towns against the lords, representation raised the costs to the king from abrogating the agreement with the towns; and second, representation granted the towns an extra bargaining tool with which to protect their interests.

**5.3. The towns incrementally extend their reach into the countryside.** Smith titled chapter IV of Book III, "How the Commerce of the Towns Contributed to the Improvement of the Country." [WN III.iv:411] As the towns grew, he explains, they had incentives to expand their reach – including military security, the security of property rights, and markets – into the surrounding countryside.

As subsistence is, in the nature of things, prior to conveniency and luxury, so the industry which procures the former, must necessarily be prior to that which ministers to the latter. The cultivation and improvement of the country, therefore, which affords subsistence, must, necessarily, be prior to the increase of the town, which furnishes only the means of conveniency and luxury. It is the surplus produce of the country only, or what is over and above the maintenance of the cultivators, that constitutes the subsistence of the town, which can therefore increase only with the increase of this surplus produce. The town, indeed, may not always derive its whole subsistence from the country in its neighbourhood, or even from the territory to which it belongs, but from very distant countries; and this, though it forms no exception from the general rule, has occasioned considerable variations in the progress of opulence in different ages and nations. [WN III.i.2:377]

Smith argued that the towns' military advantage over the local lords fostered the extension of the towns' reach: "The militia of the cities seems, in those times, not to have been inferior to that of the country, and as they could be more readily assembled upon any sudden occasion, they frequently had the advantage in their disputes with the neighbouring lords."<sup>13</sup> [WN III.iii.10:403ea]

The towns more easily coordinated men, weapons, and supplies; and they could assemble their forces more quickly than the local lords. And over time, the towns became far richer than the local lords. All this granted the towns a competitive military advantage, allowing them to extend their reach into the local countryside, provide a growing area secure from the predation of local lords.

The extension of local security from external violence and predation transformed the agricultural areas surrounding the town. In combination with the town's system property rights, security fostered growing specialization and exchange whereby the agricultural products went to the town (for consumption and for long distance trade), and the products of the town moved to the countryside.

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<sup>13</sup>Smith reports that, in Switzerland, "the cities generally became independent republicks, and conquered all the nobility in their neighbourhood; obliging them to pull down their castles in the country, and to live, like other peaceable inhabitants, in the city." [WN III.iii.10:403]

**5.4. The growing reach of the towns transformed economic and social relations, undermining feudalism.** As explained in section 2, asymmetric information, the lack of credible commitments, and the low economic costs from violence combined to prevent local lords from solving the problem of violence among themselves. Reflecting the violence trap, this environment produced violence, low investment, and a subsistence economy for most people.

In terms of our theory, the towns subdued the local lords. As an unintended consequence, this change solved the security problem for nearby lords, with far-reaching long-term consequences. The extension of a town's influence and security umbrella into a local lord's area diminished the lord's need for military organization and security against neighboring lords. The new security implied that the lords' retainers became an expensive burden with little benefit, so the lords de-militarized and let go of their retainers (cite).

Under the town's security and legal umbrella, incentives to invest and specialize in agriculture increased. Lords had incentives to grant – and tenants had incentives to pay for – longer leases, which encouraged investment, specialization and exchange. The towns provided security in nearby agricultural areas, fostering the transformation of self-sufficient farmers into specialists in complex and growing markets. Greater division of labor made these farmers better off. Better rules on devising property upon death also emerged. At the same time, prosperous burghers moved into the countryside, bringing with them their ambitions and their culture of investment, specialization, and exchange (WN III.iv.3).

Smith's central pillars of economic growth, the division of labor and capital accumulation, appear throughout this process, as we have indicated by emphasizing growing specialization and exchange. With the growth of market exchange surrounding the towns, the

division of labor greatly deepened, as did capital accumulation, investment, and specialization and exchange.

The non-incremental changes in local security, Smith argues, had further unintended consequences in the countryside surrounding the towns. First, in Smith's words,

commerce and manufactures gradually introduced order and good government, and with them, the liberty and security of individuals, among the inhabitants of the country, who had before lived almost in a continual state of war with their neighbours, and of servile dependency upon their superiors. This, though it has been the least observed, is by far the most important of all their effects.<sup>14</sup> [WN III.iv.4:412]

Second, the towns' security umbrella destroyed the military and economic bases for feudalism in the countryside surrounding the town. In the process the reach of the towns transformed social relations of feudalism. Many non-monetary exchanges central to the feudal economy, such as military service obligations of retainers in exchange for support and land, diminished or disappeared. The lords leased out their lands and lived off the rents combined with the profits from the portion of their estates that they managed directly. In the absence of expensive military obligations, local lords became consumers, taking advantage of the growing opportunities provided by the town's commercial economy. Retainers were released, leaving the barons with fewer obligations and more disposable income. Obligations transformed from direct service to monetary payments. In consequence, Smith argued,

[W]hat all the violence of the feudal institutions could never have effected, the silent and insensible operation of foreign commerce and manufactures gradually brought about. These gradually furnished the great proprietors with something for which they could

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<sup>14</sup>Smith here observes that "Mr. Hume is the only writer who, so far as I know, has hitherto taken notice of it." [WN III.iv.4:412] In his famous essay "Of Commerce," David Hume (1752a:255) argues, "The greatness of a state, and the happiness of its subjects, how independent soever they may be supposed in some respects, are commonly allowed to be inseparable with regard to commerce; and as private men receive greater security, in the possession of their trade and riches, from the power of the public, so the public becomes powerful in proportion to the opulence and extensive commerce of private men." See also Hume (1752b,277-78).

exchange the whole surplus produce of their lands, and which they could consume themselves without sharing it either with tenants or retainers. [WN III.iv.10:418]

A revolution of the greatest importance to the publick happiness, was in this manner brought about by two different orders of people, who had not the least intention to serve the publick. To gratify the most childish vanity was the sole motive of the great proprietors. The merchants and artificers, much less ridiculous, acted merely from a view to their own interest, and in pursuit of their own pedlar principle of turning a penny wherever a penny was to be got. Neither of them had either knowledge or foresight of that great revolution which the folly of the one, and the industry of the other, was gradually bringing about.

It is thus that through the greater part of Europe the commerce and manufactures of cities, instead of being the effect, have been the cause and occasion of the improvement and cultivation of the country. [WN III.iv.17-18:422]

Over time, the town's long-distance trade grew, it became richer (more merchants, ships, etc.), it produced more manufactured goods, and it carried local agricultural surplus to foreign destinations. As this process occurred across Europe, overall trade expanded; and with this expansion of the market, so too the division of labor. The commercial trading economy grew richer. Feudalism disappeared in many areas.

## **6. Interpreting the Transition of the Towns**

To explain the towns' escape from violence of the feudal basic natural state, we need two different but complementary arguments, one at the micro-institutional level involving organizations; one at the macro-institutional level involving political exchange and the (small-c) constitution.

At the micro-institutional level is the organizational revolution involved in the town's provision of liberty, exploiting commercial opportunities, and providing security. This organizational revolution is represented as the growth of the civil society. The success of the town's governance, security and commerce all rested on this organizational revolution.

Moreover, the sets of organizations must also fit together well in the sense that they complement one another rather than get in each other's way or, worse, plunder and fight one another.

Organizations direct and coordinate the efforts of people to produce the outcomes we characterize as liberty, commerce, and security. We have too little theory that explains how separate but complementary organizations work together to create a functioning society capable of long-term economic growth. Although economic theory does a good job of this for economic organizations in the market, we lack the extensions of this theory to include political and social organizations (NWW ch 4 provides an initial attempt for open access orders).

The macro-institutional or constitutional level involves the forces that foster the movement from basic natural state of feudalism to that of the towns on the doorstep. The political exchange between king and town created a new constitutional order for the towns – the corporate form of organization – essential to the town's success. To explain the macro-level forces underlying the towns' escape from the violence trap, I draw on CNW, as summarized in section 2. Both king and town had to have the appropriate incentives to initiate the transition; in particular, the towns had to have the incentive and ability to create and sustain the escape.

Addressing both of these issues is necessary to understand the rise and economic growth of towns. I consider them in turn.

**6.1. Micro-institutional analysis.** Building commercial towns capable of providing liberty, maintaining security, and supporting long-distance trade required an organizational revolution – the growth of the civil society – with dozens if not hundreds of new types of organizations.

**The medieval town as an organization of organizations.** At the highest level, the town's corporate charter formed the town as an organization vested with various rights, including

the right to self-governance and to provide security. All the other organizations flow from this charter, so the town was truly an organization of organizations. Many of these organizations were independent of the state, although sanctioned by the official system restricting access.

Consider the basis for implementing each of the three revolutions associated with the towns: liberty, commerce, and security.

**Liberty:** Liberty is a term that has fallen into disuse in economics. In the mid- to late-twentieth century, many of the great economists used it; notably, James M. Buchanan, Milton Friedman, and Friedrich Hayek. Smith also used this term (see Aspromourgos 2009:223-38; Forbes 1975:\*\*; see also Lieberman 2006 and Rothschild and Sen 2006:334-37) in a way that parallels issues raised in the modern literatures on economic development and economic history, for example, by Douglass North (1990); namely liberty as freedom from predation and expropriation; secure property rights; and protection against the arbitrary action by the state.

The town's right to be a self-governing unit was vested in its charter granting authority for its corporate organization. Town government was more highly differentiated than that in the surrounding countryside, a form of "mixed government" delegating powers divided in a republican manner; a form of governing body, an executive, and a judiciary. Each of these functions required organizations.

If commerce represents the development of markets in Smith's approach, we can think of liberty and society as providing the legal and military infrastructure necessary to sustain markets. As Smith argues, markets require the legal infrastructure of justice, secure property rights, and protection from predation. Commerce and economic growth also depends on a military advantage by which the commercial society could defend itself in a world of potential hostile

groups, both internal and external. Smith in this manner explains the economic and political development of Europe.

A central piece of the towns' success was the ability to create and enforce a system of liberty, ensuring private property rights and limited risk on predation and expropriation. Although Smith does not explain how, the system of liberty provided for perpetuity and impersonality (at least for the elite), two critical ingredients in the rule of law (Weingast 2010). Liberty provided merchants with the incentives to specialize and to accumulate capital; for the towns to grow, both in the sense of economic growth and in the sense of extension into the surrounding countryside.

**Commerce:** Central to the towns' economic and political success were the guild organizations and merchant firms. These organizations created and coordinated much of the town's economic activities and many of its political functions. In addition, the trading towns created the exchanges represented in long-distance trade. Moreover, all of this had to be organized efficiently so that the towns could compete successfully on the international market and with neighboring towns which were often close substitutes.

The infamous apprenticeship system represented another organization at once creating barriers to entry, ensuring the education of an apprentice into the skills of the trade or craft, and organizing the entry of potentially talented individuals into the business.

**Security:** Each town also had a carefully crafted military organization necessary to provide security for the town itself but also for the surrounding countryside, especially as the orbit of the town increased overtime. Survival required that the town possess a military organization superior to that of the lords in the surrounding countryside.

In addition to these sets of organizations, towns made use – indeed, often required – a wide range of other organizations. Some provided public goods, such as schools and hospitals. Other organizations involved various products and services sought after by citizens, such as clothing, linens, ale houses, inns, and food establishments.

Finally, the Church was generally represented through organizations, notably the local parish. Over time, as the town grew larger, other Church organizations established a presence in the towns, such as the mendicant order (see Ekelund, Hebert, Tollison 2006).

**6.2. Macro-institutional analysis: Political exchange and the constitution.** In this subsection, we use our approach to interpret Smith’s account of the feudal equilibrium and initiation of the transition to the commercial economy. In NWW terms, the feudal equilibrium was a natural state, not very differentiated, and hence quite poor. Many localities experiencing considerable violence were fragile natural states, while the more stable and developed ones were basic natural states. In comparison with mature natural state, the feudal state had relatively few organizations, with military organizations being among the most well-developed.

Executive moral hazard was a major problem at many levels<sup>15</sup>; for example, the local lord was at once the local executive, law-maker, and judge with all the usual problems of governance that such an arrangement implies, often leading to “arbitrary decisions” in which the lord expropriated the assets of an individual or group. Predation was an omnipresent problem. Fighting and violence characterized this world. In 900, the feudal world provided minimal incentives for investment, specialization, and exchange. Most people lived at subsistence.

This pattern is consistent with our bargaining approach. The feudal equilibrium reflected the violence trap writ large. In this world of mostly subsistence agriculture, the economic costs

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<sup>15</sup> Besley and Persson (2011) provide an extended study of the relationship of executive moral hazard and economic performance.

of violence were low. Neither king nor lord had the ability to create security or credible commitments to preserve the peace. Given regular shocks, the theory suggests that the low costs of violence combined with problems of commitment and asymmetric information to produce regular violence as bargaining to reallocate privileges and assets in the face of shocks broke down. This setting resulted in widespread predation, violence, and periodic destruction.

### **6.3. The Emergence of Towns**

The towns also engineered political development, creating new governance structures that differed radically from those of the feudal system. Perpetuity, impersonality, and inclusion in governance all appeared to varying degrees. These steps toward political development resulted in justice, secure property rights, and mechanisms for contract enforcement. Economic development proceeded in tandem, fostering investments, specialization and exchange, and the growing reach of markets and the price mechanism (*WN III.iv*).

These economic and political developments arose simultaneously as part of a single process; neither antedated nor caused the other. As Winch (1978,70) emphasizes, Smith studied the “reciprocal relationship between commerce and liberty.” Much of the *Wealth of Nations* examines “the benefits of a regime of economic liberty for the growth and diffusion of commercial prosperity,” especially Books I, II, and IV. Yet, Winch argues, the literature has neglected “Smith's interest in the other side of the relationship – the effect of the emergence of commercial society in producing a regime of liberty and justice.” Skinner (1975, 164), an obvious exception, explains that the arrangements Smith described are political, not simply

economic; these institutions “had themselves been developed and protected in an attempt to solve a political problem” generated from the economic desire to foster trade.<sup>16</sup>

The political exchange between king and town granted the towns the ability to make non-incremental changes, allowing the towns to enter the positive feedback loop leading to a new and better equilibrium than feudalism. The political exchange altered the condition of the towns sufficiently that they became more powerful than the local lords. A central feature of the town’s economy was economic integration. The specialists in long-distance trade depended on the local economy for many raw materials and food. Local specialists in food and raw products depended on the town’s demand for their products. In Smith’s terms, this economic integration at once expanded the scope of the market, created greater division of labor, and fostered investment, all features of economic growth.

In terms of the violence trap, economic integration raised the economic costs of violence. High costs of violence lowered the value of violence and hence encouraged disputing parties to solve their problems non-violently. Moreover, the towns had strong incentives to expand markets. As they extended their reach into the countryside, the towns sought to earn profits from long-distance trade and from encouraging local marketization that transformed local, highly inefficient, and self-sufficient agriculture into market specialists. The towns typically did not use their military might to become another type local lord who extracted from the local economy. Instead, the towns used their economic and military power to create markets and political freedom (for the elite, at least).

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<sup>16</sup>A number of Smith’s contemporaries made similar observations about the relationship between commerce and liberty, including Montesquieu (1748), Hume (1752a,b), Cantillon (17\*\*), and Abbé de Condillac (17\*\*).

In our terms, the opportunities for expanding commerce made possible a new form of political exchange, producing new political institutions governing the towns. These political institutions, in turn, fostered the townsmen's ability to exploit new economic opportunities provided by trade. Here too political and economic development is inextricably intertwined, that is, Winch's "reciprocal relationship."

The non-incremental change – affording simultaneous changes in perpetuity, impersonality, inclusion, and in investment, specialization and exchange, and military organization – allowed the towns to escape the violence trap and enter the positive feedback loop. Once the towns were organized and generated sufficient security, they extended their reach into the countryside, increasing the size of the market and the division of labor. Expanding long distance trade increased the town's wealth. In combination, all these changes led the town to extend yet again the reach of larger security umbrella, with greater expansion of its reach into the countryside, further deepening the division of labor, and so on through the positive feedback loop. Moreover, as Winch (1978,\*) suggests, the result is that the:

Commercial society is not merely one in which more people are engaged in producing capital goods.... it is one in which more people are drawn into the wider circle of commercial relationships. It is the situation arrived at once the division of labor has been thoroughly established, and men can supply only part of their needs from their own produce. It is the form of society in which "every man ... lives by exchanging, or becomes in some measure, a merchant."

A final and important aspect of the non-incremental changes in governance also created the doorstep conditions. As noted, the towns created liberty, justice and property rights for the elites, hence significant elements of the rule of law (doorstep condition 1). They also created perpetuity, often through the use of the town's merchant guild (doorstep condition 2).<sup>17</sup>

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<sup>17</sup> Greif's (2005, ch 9) terrific analysis of the community responsibility system shows has the system was independent of the identity of the guild's members.

Two other factors also contributed to perpetuity – the ability of the merchants to gain wealth through specialization and exchange involved in long-distance trade; and the ability of the towns to provide security within the larger violent world (doorstep condition 3). Finally, towns expanded access beyond a narrow elite in comparison with the feudal world, although it did not come close to achieving open access. For one, the towns absorbed many from the country-side in their market system, allowing the towns and markets to draw on a larger talent pool. The very specialized apprenticeship system organized by the guilds did the same thing for the most specialized production and merchant activities.

## **7. Smith and the Modern Literature on the Political Economics of Development**

Adam Smith's discussion of the transition from feudalism to the commercial society fits well with parts of the emerging literature on the political economics of development; and it adds ideas relatively lacking.

Economic and political development are not separate tasks in Smith's view, but inextricably intertwined as a single process. One cannot occur without the other; attempts to reform one without reform of the other generally fail. Smith's view of the rise of towns and the commercial society out of feudalism demonstrates that the escape from the poverty and violence of the feudal society required simultaneous changes in economics, politics, and security. None of these three elements were a precursor for the others; all arose at the same time. When the three elements coexist, growing opulence is the result. Similarly, when any of the three elements is missing, growing opulence fails. These general Smithian laws of jurisprudence hold regardless of time and place. These lessons are equally valid and important for today.

As to Smith's fit in the literature, his ideas directly relate to Acemoglu and Robinson's (2006) famous argument about the political incentives that prevent economic development. They focus on the risk incumbent political officials face of being deposed. They suggest that reform typically increases this risk of being deposed; for example, by fostering the growth and power of potential rivals. Incumbents therefore have incentives to block reform. Acemoglu and Robinson's argument reveals an important insight about why development has proved so illusive for much of the world, and it covers a great many cases. Nonetheless, something is missing from Acemoglu and Robinson's approach since a portion of the world has, in fact, developed.

Acemoglu and Robinson's model involves two groups – effectively the incumbents and the challengers. In context studied above, Smith studies the interaction of three groups – the king, the towns, and the lords. Smith's argument shows that the incumbent – here, the king – may undertake reform that enhances the wealth and power of another group – here, the towns – if the other group is an ally of the incumbent's, allowing these two groups to gain at the expense of the third.

Smith's argument also relates to Tilly's (1993) well-known argument that “war made the modern state.” Military advantage was an important motive for the alliance of king and town against the lords. Indeed, a necessary condition for the agreement to succeed is that the towns had a military advantage over the local lords. Had this condition failed, the local lords would have over-ran the towns and prevented the economic expansion and destroyed the new source of political liberty.

As a third example, recall section 2's summary of CNW's argument that incremental changes could not allow a state to escape the violence trap. The political exchange between king and town created a non-incremental change in circumstances. The towns obtained the right to

defend themselves, create new governance structures, and take advantage of the potential gains from specialization and exchange, and they made non-marginal, simultaneous changes on all three dimensions at once, creating a three different revolutions; in liberty, commerce, and security.

Finally, the central importance of violence in Smith's approach is relatively lacking in the literature (but see CNW and NWW).<sup>18</sup> Reflecting the tradeoff between security and efficiency, societies facing existential threats take actions to defend themselves, and these actions – as Smith argues – force substantial deviations from political institutions and policies that generate opulence or long-term economic growth. Smith explains that, although growing opulence is the natural path, European development deviated from this (was “entirely inverted” in Smith's terms WN III.i.8-9:380; see also Hont 1988) path due to various factors, especially violence and oppression. Put simply, violence is inseparable from the state of the economy and especially from the process of economic development.

## 8. Conclusions

Adam Smith's *Wealth of Nations* is, among so many other things, a study in why so many countries remain poor and why a few have become “opulent” or rich. Smith provided many different explanations for this question in his rambling work, making it hard to say any one of his answers is definitive. In Book I, he explains that the secret to opulence is the division of labor. In Book two, it is savings and capital accumulation. In Book four, it is the appropriate public policies, explaining, for example, why mercantilism makes states worse off and hinders their

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<sup>18</sup> Some obvious exceptions exist to the dominant view that ignores violence, such as Collier (2007) and Hirschleifer (1994). Other exceptions involve rationalist explanations for interstate war (Fearon 1994, Powell 1999, Wittman 2009) and a large literature on the relationship between interstate conflict and development outside of economics (e.g., Bates 2001, Tilly 1993).

progress toward opulence. Each of these arguments resonates with modern economics. All of these explanations of economic growth presume a context of a state with a serviceable judiciary, property rights, and liberty.

But Smith provides a fourth explanation, one that differs in kind from the other three. In Book III of the *Wealth of Nations*, Smith discusses the necessary political foundations of markets and how, absent these foundations, countries cannot grow. He presents this argument, not in the abstract as he does with, say, the division of labor; but in what appears superficially as a historical narrative about feudalism and the rise of towns. Embedded in the narrative is a theory that drives the logic of the development of a commercial society out of the natural state of feudalism.

Using NWW and CNW, I interpret Smith's argument as follows. Feudalism was an equilibrium based on the violence trap. The prevalence of violence meant that property rights were insecure, as, therefore, were savings, investment, and innovation. In this world, most people lived at subsistence level. No one, neither king nor great lord, was capable of providing order.

The towns arose through political exchange between king and town that granted them the right to a corporate form of self-governance. This exchange allowed the towns to create a non-incremental change and escape the violence trap through a three-fold revolution that simultaneously created liberty (including justice and the security of property rights), commerce and hence economic growth, and security from the menacing outside world. The town grew, both through long-distance trade, specialization and exchange, and expansion into the local countryside where it helped transform the local economy from poor, self-sufficient agriculture into specialists in food and inputs into manufacturing shipped to the town and often entering long-distance trade.

I interpret the central elements of the escape from the violence trap as follows. The town's escape allowed it to enter the positive feedback loop of economic growth. The political exchange granted the town the ability to make non-incremental changes in security and investment in economic activities. They subdued the local lords, expanding both long-distance trade and trade with the local countryside. As the towns extended their security umbrella, the local countryside experienced a non-incremental increase in the security of property rights, with incentives for investment, hard work, and exchange. The towns also transformed what Smith called "unproductive labor" (labor facing predation which had no incentive to work hard or invest) into productive labor. At the same time, the local lords coming under the town's jurisdiction no longer needed their expensive retainers for defense. As they de-militarized, the lords became consumers, expanding the demand for the traders' service.

Towns also represented an explosion of new organizations – the corporate form, as mentioned, the overall government, specific units within the government, such as the executive, the judiciary, and a town council. Merchants organized their guilds and their firms; and the town's military organization provided defense. The Church also had its organizational reach into the town. As noted above, the town became an organization of organizations.

The explanation provided of the escape from violence satisfies the three conditions mentioned at the outside: a micro-level analysis of the organizations providing the heavy lifting of ensuring the various parts of the transition to the doorstep conditions occurred; a macro analysis of the political exchange and constitution necessary to make the escape work; and an analysis showing why the new arrangements were stable, i.e., and equilibrium, so that the towns were not a temporary aberration that would fall back into the old, feudal equilibrium.

## Abbreviations

- CNW Cox, Gary W., Douglass C. North, and Barry R. Weingast. 2014. "The Violence Trap: A Political-Economic Approach To the Problems of Development," Working Paper, Hoover Institution, Stanford University.
- NWW North, Douglass C., John Joseph Wallis, and Barry R. Weingast. 2009. *Violence and Social Orders: A Conceptual Framework for Interpreting Recorded Human History*. Cambridge: Cambridge University Press.

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- WN Smith, Adam. 1776 [1981]. *An Inquiry into the Nature and Causes of The Wealth of Nations*. R.H. Campbell, A.S. Skinner, and W.B. Todd, eds., Indianapolis: Liberty Fund

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