CHAPTER 17. WHAT WE HAVE LEARNED

Preliminary draft: not for circulation or citation!

In this, the concluding, part of the book, we will summarize the theory and explore some of its implications. The current chapter reviews the theory of economic progress that we have derived from the evidence of preindustrial Europe and preindustrial China.

That theory sees economic progress as the outcome of the interaction of three fundamental economic activities—commerce, predation, and production. This interaction may be divided conceptually into two inter-related processes. In the first, commerce interacts with production to generate economic progress. This process is self-perpetuating: it requires no outside causes and, in the absence of impediments, continues indefinitely. Predation is the principal impediment. The interaction between predation and economic progress generates the second process—the process of the predation trap.

We will examine each of these two processes in turn. With respect to the first, the Chinese evidence largely confirmed and reinforced the theory we developed earlier from the European evidence, without requiring much modification. Since there is little to add to the summaries offered in earlier chapters, the discussion here can be brief. With regard to the predation trap process, however, the Chinese evidence necessitates some rethinking. In particular, it suggests that our earlier understanding, while not wrong, was too narrow—too specific to the European case. That rethinking will necessitate a more extensive treatment.

After reviewing the theory, we will examine its implications for the central question of economic policy—what does economic progress require of government? We reached some tentative conclusions in Chapters 12 and 16, and we will develop and elaborate them here. This question has received considerable attention recently from other economists, so it will be illuminating to compare our conclusions with theirs.

The chapter concludes by considering how the theory developed here differs from the conventional theory and from the Classical theory.

THE PROCESS THAT GENERATES ECONOMIC PROGRESS

The process that generates economic progress is itself composed of several sub-processes—a core sub-process and several auxiliary sub-processes that interact with it and reinforce it.

The core sub-process

The core sub-process is the one first described by Adam Smith.[1] Expansion of the market induces changes in production that increase its productivity; this increase in productivity creates opportunities for further expansion of the market.

Expansion of the market

Expansion of the market means an increase in the volume of potential exchange among people connected through relations of exchange. This may be the result of an increase in the number of those connected in this way. Or it may be the result of an increasing potential volume of exchange among those connected already.

The possible causes of market expansion are an increase in demand, an increase in supply, or a decrease in trading costs. These changes, in turn, may be caused by extrinsic factors, originating outside the process, or they may be the result of multiplier effects originating within the process itself.

Increased productivity

Expansion of the market creates opportunities to increase productivity—either by producing more of the same output from given resources or by producing different output that is more valuable. Market expansion also intensifies competition, which exerts pressure to exploit these new opportunities.

One major source of increased productivity is the reorganization of production. Production in all human societies is social—that is, the work of producers is coordinated through some form of organization. Such coordination makes it possible to capture the benefits of the division of labor and of joint action. The potential gains from coordination are, however, limited by the extent of the market. Consequently, market expansion

[1] And later elaborated by others: for references, see fn 27 in the Introduction.

increases the potential gains, and realizing them generally involves changes in the organization of production.

A second major source of increased productivity is technological progress. Expansion of the market and the resulting reorganization create opportunities for the adoption of more productive technologies. And the adoption of a technology leads to many small adaptations and improvements that further increase productivity. The technologies adopted may be newly invented or they may have become available through diffusion from other places. But they may have been available for some time, while their adoption had not previously been profitable.

Further expansion of the market

The increased productivity that results from these changes raises incomes. Higher incomes, together with the consequent growth in population and increasing urbanization, generate a greater demand for goods. At the same time, increased productivity lowers the cost of existing goods and makes new goods available, resulting in a greater supply. Greater demand and greater supply create new opportunities for market expansion—the demand and supply multipliers.

Auxiliary sub-processes

The core sub-process sets in motion several auxiliary sub-processes that feed back to reinforce it.

A parallel sub-process in commerce

As the market for goods expands, the growing volume of exchange expands the market for the services of commerce in mediating that exchange. This drives a sub-process within commerce that parallels the core sub-process in production. Expansion of the market for the services of commerce increases the overall scale of that activity, and this induces productivity-enhancing reorganization and technological progress. Increasing overall scale also justifies investment in commercial and transportation infrastructure

All of these changes increase the productivity of commerce, which reduces trading costs. The reduction in trading costs opens up new opportunities for expansion of the market for goods—the trading cost multiplier. And this further expands the market for the services of commerce.

The creation of new work

The core sub-process and the parallel sub-process in commerce interact to create opportunities for new kinds of work. They create a demand for new producer goods and services—for example specialists in land reclamation, in the production of machinery, and in the provision of transportation and financial services. Expansion of the market also brings new kinds of imports that can be imitated locally, and perhaps improved or produced more cheaply, so they can become new exports. The division of labor in production creates a host of intermediate goods that can be recombined to create new products.

This new work creates additional opportunities for market expansion through the demand and supply multipliers, as well as opportunities for yet more new work.

The process of invention

All of these sub-processes create new opportunities for the adoption of technology. The resulting demand for technology is partly satisfied by existing technologies, but it also stimulates the invention of new technologies. When the resulting new technologies are adopted, they increase the productivity of production and of commerce, thereby contributing to further market expansion.

Invention works by combining existing technologies to create new ones. So the invention of new technologies adds to the pool of existing technologies, thereby opening the way for yet more invention.

Common features

Each of the sub-processes is driven by the exploiting of new opportunities. Of course, exploiting new opportunities also closes off old ones by making them unprofitable. So competition, too, is an important driving force.

In each sub-process, exploiting new opportunities creates yet more new opportunities: that is, each of the sub-processes is self-perpetuating. In addition, the different sub-processes are mutually reinforcing: exploiting opportunities in one sub-process creates new opportunities in the others.

Exploiting a new opportunity in any of the sub-processes requires entrepreneurship. That is, it requires that someone recognize the new opportunity, marshal the necessary

resources, and do whatever is required to exploit it. And they must also bear the associated risk.

All of the sub-processes take place in or near cities—especially, commercial cities.[2] The concentrated demand of growing cities is a stimulus to market expansion.[3] Their low internal and external trading costs facilitate the reorganization of production. Commercial cities are at the center of the organization of commerce and therefore where the development of commerce takes place. The creation of new work is entirely an urban phenomenon. And cities provide the environment most conducive to invention.

Commerce plays a central role throughout. Since commerce mediates exchange, it is the profitability of commerce that determines the extent of the market. Commerce is also an integral component in the organization of production—mediating exchange in inputs and intermediate goods. And commerce is responsible for the diffusion of technology. The trading-cost multiplier process takes place entirely within commerce. Commerce creates the opportunities for new work and markets the results. For all of the sub-processes, commerce is the principal source of entrepreneurship—the financial system, a branch of commerce, supplying the necessary financing. And, of course, it is commerce that creates commercial cities.

THE PREDATION TRAP PROCESS

Economic progress makes predation more rewarding and creates new opportunities for predation; the consequent increase in predation tends to choke off economic progress. This predation trap, not the Malthusian trap beloved of historians, is the primary obstacle to continued economic progress.

Economic progress, however, 'wants to be free', and it evolves to escape the predation trap. Predation too evolves—sometimes in ways that prevent that escape, but sometimes in ways that facilitate it. The working of the predation trap and the escape from it constitute our second basic process.

---

[2]The meaning of 'near' depends on trading costs.

[3]This is also true of non-commercial cities.

Predation and government

Predation, like production and commerce, is more productive when organized. In particular, organization is required to capture the advantages of scale in the deployment of force. So it is organized predation rather than individual predation that is the principal obstacle to economic progress. And the most important form of organized predation is government.

Indeed, predation is the origin of government—either as an instrument of predation or as a means of protecting against it. A group may organize to take control of a territory for the purpose of predation: this is predatory government. Or the population of a territory may organize to defend it against organized predation, particularly by governments: this is associational government. However, despite the original purpose of associational government, it too may become an instrument of predation on its own population. And both types of government may engage in predation on territories other than their own.

The nature of the process

The predation trap process evolves over time. Both government and economic progress change and develop—each as a result of its own internal dynamics and as a result of its interaction with the other.

The internal dynamics of government

The internal dynamics of government is driven by the interplay between the advantages of scale in the deployment of force and the disadvantages of scale in organization.

Because of the advantages of scale, the territories of governments tend to expand over time. This is partly a deliberate strategy on their part, both offensive and defensive, and partly the result of 'survival of the largest'. Territorial expansion is sometimes achieved through peaceful means—dynastic mergers and acquisitions or the formation of leagues and confederations. But often, it is the result of war and conquest.[4] In either case, the result of consolidation is fewer and larger independent territories.

---

[4]War is often motivated by the desire of governments to expand their territories so as to become more powerful and therefore safer. But predatory governments sometimes follow a fiscal strategy of financing

Larger territories mean larger government organizations, and larger organizations are more susceptible to problems of reliance. For predatory governments, these problems stem mainly from their dependence on distant representatives to execute their will. For associational governments, they stem from the need to appoint leaders to make day-to-day decisions and to see to their execution. As government organizations grow larger, it becomes increasingly difficult to monitor and control representatives and leaders, respectively.

With predatory government, the failure of control can result in fragmentation, generating a cycle of alternating fragmentation and consolidation. With associational government, failure of control can result in leaders making themselves rulers, so that associational government degenerates into predatory government.

The organization of government changes and evolves over time. It does so to address the problems of reliance. It does so too as governments find new ways to mobilize resources, which often involve changes in organization.

The interaction of government with economic progress

Governments affect economic progress and are in turn affected by it.

Exaction and war impede economic progress by taking or destroying the resources of those engaged in commerce and production.[5] Because of the central role commerce plays in the process, it is the harm to commerce that is the most damaging. The harm to commerce impedes market expansion, the reorganization of production, and technological progress. With the core process immobilized, so too are the auxiliary processes.

The harm to commerce may be compounded significantly by the *system* of exaction. The need to control their populations may lead governments to suppress commercial

---

themselves through plunder, and this too leads to the acquisition of territory (examples include the Roman empire, Napoleon, and Hitler).

[5]Private predation has similar effects, but generally on a much smaller scale.

cities and to constrain voluntary organization. And the machinery of exaction may offer such attractive opportunities that it diverts entrepreneurship away from commerce.[6]

Commerce, however, is neither passive nor helpless in the face of predation. Indeed, as we have seen, defending itself against predation is one of its fundamental challenges. It does so through joint action in the deployment of force and, even more, through the mobilization of economic power. Commerce also adapts to make itself less vulnerable to the effects of government predation. And its response to predation can lead to changes in government itself that make government behavior less harmful.

The path of the process

The internal dynamics of government and of economic progress and the interaction between them generates the predation trap process. The process goes through periods in which the predation trap closes and chokes off economic progress altogether, and it goes through periods in which the predation trap opens sufficiently to allow economic progress to proceed.

The actual path of the process depends on initial conditions, on specific circumstances, and on its own history. Later in the chapter we will draw some general conclusions about how economic progress can escape the predation trap. In anticipation of this, it is useful to review briefly the very different paths the process took in our two samples—preindustrial Europe and preindustrial China.

The process in preindustrial Europe

Throughout our period of observation, preindustrial Europe was in the consolidation phase of the consolidation-fragmentation cycle. This followed the fiscal collapse and fragmentation of the Roman Empire.

Predatory governments were initially small and weak and the associational governments of the emerging cities comparatively strong. The cities were able, therefore, to protect commerce against predation—partly through the deployment of force and partly by exercising their economic power.

---

[6]Of course, the impact of government on economic progress is not exclusively negative, and we will discuss below the positive role it can play.

Subject cities had much to offer rulers in the form of military and fiscal support and, especially, liquidity. In exchange, they obtained less harmful exaction, rights of self-government, and trading rights. Treating with commerce in this way 'civilized' predatory governments—creating frameworks of representation and establishing the rule of law.

The resulting economic recovery strengthened governments fiscally, enabling them to go to war. War and the consequent increase in exaction set back economic progress, creating a political-economic cycle within the overall process of territorial consolidation.

The process of consolidation created larger and more powerful predatory governments. Some responded to the continuing fiscal pressure of war by establishing predatory bureaucracies as a workaround to the civilizing constraints they had accepted earlier: the result was the predatory state. The associational governments of cities, despite some consolidation, were not powerful enough to protect commerce against the new predatory states. And, the increase in the scale of these associational governments often resulted in their degeneration into predatory government.

Fortuitously, particular circumstances in the Netherlands gave rise to a new form of associational government—the associational state. This was of sufficient scale and wealth to defend itself successfully against predatory states. And it was organized in such a way as to prevent its degeneration into predatory government. In the subsequent evolutionary struggle among states and forms of government, the associational state eventually prevailed.

The process in preindustrial China

Our period of observation in China was preceded by its consolidation into a universal empire under a tribute state. Under this regime, there were no commercial cities, association was suppressed, and commerce was minimal. The universal empire faced no challenges from other states, but it was subject to incursions from nomadic tribes.[7] During our period, the empire underwent several cycles of fragmentation and re-consolidation.

---

[7]No such incursions occurred in Europe during our period. However, the early medieval recovery immediately before it had been interrupted by incursions by Magyars, Vikings, and Arabs. And the Ottomans were a significant threat towards the end of our period.

The first major fragmentation allowed commerce to emerge and commercial cities to form, although the cities did not develop associational governments. With renewed consolidation under the Song, the state responded to profitable commerce by increasing its exaction from it and sometimes by taking it over. This behavior was exacerbated by the fiscal pressure created by war with the nomadic tribes and by civil unrest. The predation trap closed completely with the re-establishment of the classical tribute state under the first Ming emperor.

The subsequent fiscal collapse of the Ming state led to the withdrawal of central government and to a *de facto* regime of *laissez-faire*. This allowed commerce to recover and prosper. The withdrawal of the state deprived the extensive predatory class—the gentry—of opportunities in predation, pushing it into commerce and production. In this role, it provided commerce and production with some protection against official and private exaction.

Comparison

The predation trap manifested itself differently in the two cases. In Europe, it took the form of the political-economic cycle, of the degeneration of associational government, and of the development of the predatory bureaucracy. In China, it took the form of incursions by the nomadic tribes, and of the negative feedback of increasing exaction in response to profitable commerce.

The ways in which economic progress escaped from the predation trap also differed. In Europe, early in the period, commerce was able to defend itself against predation and to bargain with predatory governments to mitigate the harm of exaction. Later, a competitive environment for governments selected for regimes that were able to mobilize resources with minimal harm to the economy.

In China, government was much more powerful and commerce much weaker. Competitive pressure was intermittent, and even when it was present there was little underlying variation for it to work on: in particular, there was no associational government. Consequently, escape from the predation trap, when it occurred, was not, as in Europe, the result of interaction between government and commerce. Rather, it was a consequence of the internal dynamics of government. The First Transformation was the result of the fragmentation of the empire. The Second was the result of fiscal exhaustion

and ‘desertion’ by the gentry. To the extent that commerce contributed to the escape, it was by fleeing offshore, by adaptation, and by co-opting government officials and the gentry.

What the predation trap process has in common with the process that generates economic progress

The predation trap process has much in common, as a process, with the process that generates economic progress. In both cases, change is inherently unpredictable. It is driven by entrepreneurs exploiting potential and by this creating new potential to be exploited.

In particular, entrepreneurs of predation drive both the internal dynamics of government and its interaction with economic progress. For example, during the commercial revolution, the commercialization of predatory government involved many acts of entrepreneurship—the replacement of a feudal military with mercenaries, the sale of offices and tax farms, borrowing against securitized export taxes. Later changes too involved entrepreneurship—for example, the creation of representative assemblies and of systems of courts. A particularly important later example is the creation of a bureaucracy by the predatory state to circumvent constitutional constraints. In every case, some predatory entrepreneur was responsible for the original innovation; when it was successful, entrepreneurs in other governments imitated it.

As in the process of economic progress, competition plays an important role in motivating entrepreneurship in predation. In preindustrial Europe, competitive pressure was largely the result of war or the threat of war—mainly a consequence of the process of consolidation. Competition played a much smaller role in China.

Commerce, at the center of the process of economic progress, plays an important role in the predation trap process too. It is by no means a passive victim of government predation: commerce resists governments, bargains with them, and co-opts them. Commerce was much more powerful in Europe than it was in China and so its impact on the predation trap process was correspondingly greater there.

Cities, especially commercial cities, can play as important a role in the predation trap process as in the process of economic progress. In preindustrial Europe, commercial cities were the bastions of associational government—central players in the evolution of

government. Commercial cities protected commerce and represented its interests. Once again, the absence of self-governing commercial cities in China had important implications for the course of the predation trap process there.

GETTING GOVERNMENT RIGHT

Ultimately, then, economic progress depends on escaping the predation trap. Whatever the mechanism, it requires the establishment of a regime of government that permits economic progress to proceed. Indeed, differences in the pace of economic progress—both between countries and over time—can largely be explained by differences in the nature of government.

This raises a number of questions. What exactly is required of government for economic progress to proceed?[8] What forms of government can be expected to meet these requirements? In particular, what political institutions are desirable, and what sorts of government embody those institutions? How does government with these desirable institutions arise? And once it arises, can such a government be expected to endure?

The evidence of preindustrial Europe and preindustrial China offers some answers. Examining that evidence, we have seen what worked—and what did not—and attempted to understand why. The theory we derived from that evidence informs and explains our conclusions, but ultimately they rest on the evidence. Of course, counter-examples are possible—in other times and other places—so our conclusions must remain tentative.

What are the requirements?

The first requirement of government is a negative one—not what it should do, but what it should not do. What it should not do is itself block economic progress.

Why would a government do this? For a predatory government, blocking economic progress is clearly against its own long-term interests, since it depends on its economy for resources. For an associational government, doing so makes no sense, since an

---

[8]Obviously, government that is right in this sense may not be right in terms of other criteria—religious values, philosophical principles, or human happiness in general. With respect to the last, however, the evidence suggests that an environment conducive to economic progress is also more compatible with human happiness than any of the known alternatives: on this, see, for example, (Brooks 2012).

associational government is supposed to serve the interests of the population that created it.

We have seen, however, that there are several reasons why governments do, in fact, block economic progress.[9] The first is urgency: their need for resources may be so pressing, especially in times of war, that long-term considerations count for little. A second reason is that government is not a single individual, but an organization of many individuals. Each, to a greater or lesser extent, acts in his own interests, and the combined effect may be against the best interests of the organization. A third reason is that other, more important, needs of government may simply conflict with those of economic progress—for example, the need of a predatory government to maintain control may lead it to suppress association and the self-government of cities. And the fourth reason is that power corrupts: governments intervene in their economies because they can, and, even when well-intentioned, such intervention is often harmful.

Is the solution, then, anarchy—no government at all? It is not, because of the need for protection against harm by other sources of organized force. The most important such source is foreign governments, but other examples include domestic sources of organized force such as coups and insurrections and non-government organizations that deploy force, such as pirates and nomadic tribes.

Why is it necessary that this protection be provided by government? Because of the benefits of scale in the deployment of force: it takes a large force to protect against other large forces. So the second requirement of government is that it protect its population from harm by other sources of organized force.

For economic progress to take place at all—for it to escape the predation trap—government must meet the first requirement. For economic progress to be sustained, it must meet the second.

The result—economic freedom

Government that meets these two requirements creates an environment that is free of harm by government and by other sources of organized force, and that is therefore

---

[9]For a detailed discussion of how governments block economic progress, see Chapters 12 and 14.

hospitable to economic progress. Such an environment can be characterized as one of economic freedom.

Economic freedom has several dimensions—security of possession, freedom of disposal, freedom of movement, and freedom of association. Security of possession means that people are safe from others taking without their consent or destroying their possessions. Freedom of disposal means that people may dispose of their possessions as they wish—in particular through exchange with others. Together with freedom of movement this implies free trade. Freedom of association means that there are no obstacles in the way of people creating their own organizations—associations and enterprises.

It is not necessary that economic freedom be a right, granted or recognized by government. All that is necessary is that it obtain in fact—economic freedom *de facto*, not necessarily *de jure*.[10]

Neither does economic freedom need to be perfect or universal. For example, we have seen that in Ming-Qing China, a minority of the population—the gentry—enjoyed considerable economic freedom. Although it was far from perfect, this made possible considerable economic progress for the society as a whole.

Correspondingly, for our two requirements of government, it is not a matter of yes or no, but rather of a continuum. Economic progress, like life itself, can survive in some remarkably hostile environments. The less harm government does, the more economic progress there will be. The better protection it provides, the more economic progress will be sustained,

Is it necessary for government to do anything else?

In protecting its territory against harm by other sources of organized force, government acts as a vehicle of joint action—literally in the case of associational government and functionally in the case of predatory government. Is it necessary, or helpful, for government to act as a vehicle of joint action to perform other functions? Certainly, it is able to do so: any vehicle of joint action, created for one purpose, can be

[10]For illuminating discussions of the distinction, see (Holcombe 2014) and (Friedman 2010).

adapted to others. But is it necessary or desirable for government to take on other functions?

The three functions most commonly suggested are protection against private predation, the enforcement of contracts (the provision of formal order), and the provision of infrastructure and other public goods.[11] Performance of these functions certainly facilitates economic progress: if they are not performed by someone, economic progress will definitely be hindered. Let us call them, therefore, the facilitating functions.

It is by no means necessary, however, for the facilitating functions to be performed by government, because there exist other vehicles of joint action that are quite able to do so. Indeed, we have seen that households are capable in general of organizing themselves for joint action as needed—so long as government allows them to. In preindustrial Europe, and to a lesser extent in preindustrial China, households created a variety of associations and large enterprises for joint action in commerce and production. They also created such organizations for social, religious, and cultural purposes. Taken together, such non-government vehicles of joint action constitute civil society. Civil society can—and in preindustrial Europe and China it did—perform the facilitating functions.[12]

Even if it is not *necessary* for government to perform the facilitating functions, might it not, nonetheless, be desirable? Does government do a better job? It is important here to distinguish between different levels of government—central government or the state on the one hand; local government on the other. In preindustrial Europe and China, central government played a relatively minor role in performing the facilitating functions and generally did so badly. Local government did much more, and often did so relatively well. In many ways, local government—especially local associational government—resembles civil society. Like civil society, it is close to the public it serves, it is well-informed as to what that public needs, and it is responsive to its wishes.[13]

---

[11]Various forms of economic intervention are also often suggested. We have seen that interventions were often motivated by fiscal considerations rather than the public good. And even when well-intentioned, they generally did more harm than good—for example, policies of provision.

[12](Dixit 2004) makes the case in general.

[13]Of course, this is far more true of *small* local government. It is not so true of the government of a modern city of ten or twenty million!

As an example, consider contract enforcement. We saw in Chapter 12 that in preindustrial Europe contract enforcement by central governments was neither necessary nor particularly useful. Rather, commerce developed its own mechanisms of contract enforcement through its associations and organized markets, often with the help of the associational governments of commercial cities.

And commerce also developed *alternatives* to contract enforcement. It created forums of arbitration better suited than courts of law to the resolution of complex commercial disputes. And it developed intermediaries—disciplined primarily by reputation and informal order—that obviated the need, in many case, for transactions between strangers that required contracts. So not only is it not necessary that government perform this function, but civil society is capable of improvements in social technology that render the function itself at least partially unnecessary.[14]

What sort of government meets the requirements?

What sort of government meets the two requirements for economic progress—that it do no harm itself and that it protect its territory against harm by other sources of organized force? Of our two basic forms of government—predatory and associational—neither automatically satisfies both requirements.

Predatory government, by its very nature, tends to fail the first: its purpose, after all, is predation. But because it is usually large, it does better at protecting its territory against harm by other sources of organize force. In contrast, small-scale associational government satisfies the first requirement but not the second. It does not itself place obstacles in the way of economic progress and even helps by performing important facilitating functions. However, because it is small, it provides limited protection against other sources of organized force. When it grows larger, it does better at protection, but it also tends to degenerate into predatory government and so ceases to meet the first requirement.

Nonetheless, we have seen that several regimes did emerge, variants both of associational and of predatory government, that did satisfy both requirements—at least

---

[14]Not completely unnecessary, however. We have seen that contract enforcement is necessary for the development of financial markets.

well enough to permit significant economic progress. What were the properties that made such regimes more conducive to economic progress?

Powerful but limited government

For the second requirement, the answer seems obvious. To provide effective protection—especially against other powerful governments—a government needs to be sufficiently powerful in terms of the resources it can mobilize and, therefore, the force it can command.[15] So our question reduces to this: what are the properties that limit the harm that powerful governments themselves do to economic progress—whether they are predatory or associational?

If a government is not to do harm, it must either not desire to do harm or not be able to do harm. The first possibility, even when true, is unreliable. We have seen, in Song China for example, that predatory governments that desire to promote economic progress can do considerable harm.[16] Moreover, we have also seen that when associational governments grow larger their desires tends to change, as governing elites finds predation increasingly attractive relative to commerce and production. The safer alternative, then, is for government to be unable to do harm.

Indeed, we concluded in Chapter 12 that among the different regimes of preindustrial Europe that did allow economic progress, the fundamental property they all had in common was the limited power of the central government. This finding was reinforced by the Chinese evidence reviewed in Chapters 14 and 16.[17]

---

[15]Size is not, however, the only way. As we have seen, association is a common way to capture advantages of scale. There were, in fact, examples in preindustrial Europe of small associational governments coming together to form military alliances for mutual defense—the Lombard League, the Old Swiss Confederacy, and the Hanseatic League. These alliances did not endure, however, except for the Swiss confederation, which evolved into an associational state.

[16]Medieval Sicily was another example. The Angevin Charles I, who ruled in the late thirteenth century attempted to stimulate economic progress by building ports, but he simultaneously imposed heavy taxes, suppressed urban liberties, and manipulated the currency. The net effect was strongly negative. (Pryor 1979)

[17](Rosenberg and Birdzell 1986) and (Powelson 2005 [1994]) emphasize the connection between the dispersion of political power and economic progress.

But does the need for limited power not conflict with the need for sufficient power to protect against harm by others? It can—as in the case of Qing China. But it need not. A government with limited power to do harm makes possible more rapid economic progress, and this can, in the right circumstances, place sufficient resources in the government's hands to enable it to protect its territory against other sources of organized force. This proved to be the case with the associational state.

Ideally, then, limited power, does not mean weakness—as it did in the case of Qing China. Power is needed to fulfill the second requirement of government. But the exercise of that power must be constrained or limited in order to meet the first requirement.

What are the political institutions that limit government's power to do harm? Our evidence suggests the following four—although there may well be others—decentralization of government power; a strong civil society; consultation with the governed; and the rule of law. We will consider each in turn.

Decentralization of government power

Government power is decentralized when it is divided between the central government and local governments. When this is so, the power of local governments, taken together, acts as a counterweight to the power of the central government.[18]

The local governments in question may be associational, as in the associational state, or predatory, as in the early feudal regime, or they may be a mix of the two, as in the late feudal regime or the conglomerate state. Power may be decentralized *de jure*, is in the feudal regime or in the Dutch Republic, or it may be decentralized *de facto* as in early modern England or in Qing China. Whatever the case, decentralization reduces the power of central government internally and so its ability to do harm.[19]

Of course, decentralization simultaneously increases the ability of local governments to do harm. We have seen examples: feudal lords oppressed their peasants and preyed on

---

[18]There are other forms of decentralization, not observed in our particular body of evidence. For example, the separation of powers established by the constitution of the United States, divides or 'decentralizes' power *within* the central government.

[19](Olson 1969; Olson 1971) and (Weingast 1995) describe the benefits of decentralization and of a federal structure in particular.

passing merchants; cities in the associational state engaged in local protectionism and imposed tolls on trade.

Should not the central government, therefore, police the behavior of local governments? This is undesirable, because it would compromise decentralization and forfeit its benefits. It is also unnecessary, because there is an alternative 'policeman'—competition. We have seen evidence of the power of competition at work: peasants could flee to seek land elsewhere or to find work in the cities, and merchants could use alternative routes and markets. Such competition led local lords to improve their treatment of their peasants and to offer better terms to passing merchants. Competition also constrained city monopoly power and protectionism.[20]

A strong civil society

Another source of power that can to balance the power of central government is civil society—the totality of non-government associations and large enterprises. We have seen that such organizations are created for various forms of joint action—both economic and social. Some are voluntary, usually the economic ones, and some less so, such as those based on kinship or religion.

Once in existence, however, any vehicle of joint action can readily take on additional functions, beyond those for which it was created initially. In particular, even if not part of its original purpose, it can protect the interests of its members against the actions of central or local government—if necessary, even rising up against it. That is precisely why governments often seek to prevent the formation of such organizations (in China, for example) or, when they do exist, try to control them (the European predatory state).

Civil society is closely related to local government. We have seen that in preindustrial Europe city government often emerged from civil society and that it was beginning to do so in Qing China. Civil society and local government often perform similar functions—the three facilitating functions we discussed above, as well as functions of welfare, religion, and education.

---

[20](Gelderblom 2013).

Of course, like local government, civil society can take actions that are harmful to economic progress. But, in this case too, competition among different organizations tends to limit the damage.

An implication for the facilitating functions

Thinking about civil society and local government in the context of limiting the power of central government offers a new perspective on the question we addressed earlier of which level of government should be responsible for the facilitating functions. We saw that it is not necessary for central government to do so: local government and civil society are quite capable of performing these functions, and they generally make a better job of it.

But even if central government could perform some of the functions better, we now see a strong reason why, even so, it should not do so: expanding the role of central government increases its power. Conversely, expanding the role of local government and civil society increases their power, helping to balance the power of central government.

Consultation with the governed

Consultation with the governed can be a constraint on the power of government. For associational government, such consultation is natural. At a sufficiently small scale, the population can govern directly by means of a regular assembly. At a larger scale, it becomes necessary to appoint leaders, but these are, at least in principle, answerable to the population.

For predatory government, consultation is not natural. However, there are two conditions that, together, may give rise to it. The first is a balance of power between ruler and subjects: when the ruler is weak in comparison to his subjects, he can mobilize more resources with their cooperation than he can by coercion alone. The second condition is fiscal pressure: this makes it necessary for the ruler to exploit every means available—including consultation—to mobilize all the resources he can. We have seen that both conditions frequently obtained in preindustrial Europe but not in preindustrial China.

When numbers are small, government can consult with the governed as a whole—for example, through the assembly of a small associational government or through a ruler's council of nobles. When numbers are larger, some form of representation becomes

necessary: direct consultation with the governed is replaced by consultation with their representatives. This creates yet another problem of reliance and, again, a need for mechanisms of governance. One solution is indirect representation through existing structures of local government or civil society: these organizations already have in place the necessary mechanisms of governance.

Consultation will be meaningful—that is, the wishes of the governed will carry weight—only if the governed possess sufficient power. Such power can take the form of a command of force or of a command of resources (economic power). In preindustrial Europe, rulers consulted groups that possessed such power—with the nobility, temporal and spiritual, with representatives of the cities and, in some cases, with those of the villages.

We saw in Chapter 11 that the convening of representative assemblies magnified the countervailing power of local government and civil society. It did so by bringing their representatives together, so that they could negotiate with one another and possibly coordinate a common position: it created an association of associations.

The rule of law

The rule of law obtains when the actions of government are constrained by pre-existing norms, customs, and laws. The constraints may take the form of formal laws and commitments previously established, either by the government itself or by some external authority. The constraints may also take the form of expectations created by the behavior of the government in the past. In either case, the constraints imposed by the rule of law restrict the government's freedom to act arbitrarily and thereby limit its power.

For the rule of law to be effective, its violation must have consequences that are sufficiently costly for the government. For example, we saw that rulers in preindustrial Europe came to rely on various types of voluntary contract with other parties, such as loans and the sale of offices. The ability of governments to enter into such contracts depended on their 'credit'—on others' expectation that they would honor their commitments. Any failure to do so would have destroyed their credit, with costly fiscal consequences.

The rule of law, apart from its value in limiting government power, reduces directly the harm government can do to economic progress. For example, we saw in Chapter 12

that the harm of exaction is magnified greatly when the exaction is arbitrary and therefore unpredictable. The rule of law makes government behavior more predictable, which reduces the uncertainty that is itself an obstacle to commerce and production.

The rule of law can work quite well as a self-enforcing informal order based on reputation. But it can also be strengthened by an effective formal order enforced by an independent judiciary—a judiciary that is both willing and able to rule against the government in a dispute. Such independent judiciaries did develop in preindustrial Europe—in particular in Spain, France, and England.[21]

The four political institutions are mutually supporting and reinforcing

These four political institutions work together to limit the power of central government. The decentralization of government and the existence of a strong civil society create countervailing centers of power. Consultation provides a peaceful framework for asserting that countervailing power and reaching mutually beneficial agreements. The rule of law gives consultation meaning, for without it the resulting agreements would not bind the central government's actions.

Also, each property is supported by the others. The rule of law depends on the existence of sources of countervailing power able to punish, and so deter, violations. Similarly, consultation is meaningless unless those consulted can offer valuable cooperation or threaten effective resistance—that is, unless they possess countervailing power. Conversely, the sources of countervailing power—government decentralization and a strong civil society are themselves strengthened by consultation and protected by the rule of law.

Are these political institutions sufficient or necessary for economic progress?

Are these four political institutions sufficient for economic progress? In preindustrial Europe, the feudal regime, the conglomerate state, and the associational state possessed all four to some degree and these regimes all experienced considerable economic progress.

---

[21]On Spain, see (Thompson 1994); on France, (Strayer 1970) Ch. 2 and (Henshall 1992) Ch. 1; on England, (Finer 1997) V2 Ch. 8.

The feudal regime was politically unstable, and in times of war, the central government found workarounds to evade the limits on its power. The rule of law and economic progress suffered. The conglomerate state was transitional and soon evolved into either the predatory state or the associational state. The associational state exhibited all four political institutions to the greatest degree, and it was also politically stable. It enjoyed the most rapid economic progress.

The predatory state possessed three of the four political institutions. There was considerable decentralization: the territory was divided into provinces, each with its own representative assembly, with which the ruler was obliged to consult. The ruler was also constrained by the rule of law—enforced by an independent judiciary. However, rulers of predatory states found a way to circumvent these formal constraints on their power. They creating bureaucracies to which they delegated most of the power of the central government, and these were not subject to any of the constraints. As a result, central government was unrestrained in its ability to obstruct economic progress. Tellingly, civil society was also weak—undermined by the predatory bureaucracy.

So these political institutions seem to have no value in and of themselves—at least in terms of economic progress. Only when they are effective in limiting the power of central government do they create an environment conducive to economic progress.

Are the four political institutions necessary for economic progress? The classical Chinese tribute state (Qin through Early Tang and again in the Early Ming) possessed none of them, the power of the central government was unconstrained, and economic progress was almost non-existent. During the First Transformation, fragmentation of the empire brought considerable decentralization, some signs of civil society and significant economic progress. During the Second Transformation, there was no formal decentralization of government, no consultation, and no formal rule of law. However, central government was weak and civil society, led by the gentry class, was powerful; effectively, it played the role of local government. So power was decentralized, *de facto,* to the local gentry, who were protected by an informal rule of law. In this environment, there was significant economic progress.

So the four political institutions no not seem necessary either. What matters ultimately is that government satisfy the two basic requirements—that it do no harm itself

and that it prevent other governments from doing harm. A central government strong enough to provide protection but whose power is limited internally is one solution. The four political institutions can work to limit the government's power, but none of them is immune to circumvention. And there are other ways to limit the power of central government.

How does a regime favorable to economic progress arise?

What can we say about how societies escape the predation trap—about how they arrive at a regime of government that allows economic progress to proceed?

Both in preindustrial Europe and in preindustrial China, the grip of the predation trap was loosened initially by fragmentation: fragmentation destroyed central government—the ultimate in decentralization. The result both in Europe (the Commercial Revolution) and in China (the First Transformation) was rapid economic progress. However, fragmentation is inherently unstable. Because of the advantages of scale in the deployment of force, it tends to be resolved through renewed consolidation, largely through war.

In Europe, the process of consolidation exerted intense fiscal pressure. On the one hand, the fiscal pressure helped to create and to sustain the four political institutions that limited the power of central government. On the other hand, it also led to the circumvention of these same institutions in the predatory state. And it led too to the revolt that created the associational state.

The different regimes created in this way were tested against one another in a process of selection for the fiscally fittest. The ultimate winner, because of its thriving economy and consequent fiscal strength, was the associational state. Fiscal pressure created the predatory state, but it also eventually eliminated it.

The triumph of the associational state prevented the completion of the process of consolidation. Unlike predatory states, associational states had no interest in expanding their territories—at least within Europe. To have done so would have been of no great benefit to their governing elites, who made their living from commerce rather than from predation. As a result, associational states could follow a strategy of 'balance of power'.

And it was their doing so that sustained a 'system of states' in Europe—a system of stable fragmentation.[22]

None of this worked in China because of the very different circumstances. In particular, from very early on, there was no associational government in the cities; and, without the protection of self-governing commercial cities, commerce was weak. Consequently, fiscal pressure did not lead to bargaining between government and commerce and to the favorable political evolution that this produced in Europe. Moreover, in the absence of powerful associational governments, there was no obstacle to renewed consolidation in China, so that a united empire, eventually under a tribute state, was re-established.

Nonetheless, the grip of the predation trap was eventually loosened again in China, but this time it was not through fragmentation. Instead, the regime was steadily weakened internally by fiscal exhaustion.[23] As a result, the government gradually abdicated much of its internal role to the gentry. This produced a regime of decentralization, strong civil society, and limited rule of law. And this in turn made possible the considerable economic progress of China's Second Transformation.

The very different histories of Europe and China suggest that,
while the underlying forces may be universal, the actual path of the predation-trap process depends on circumstances. That is, it depends on initial conditions, on its own history, and on chance. There is no unique regime that is favorable to economic progress, and there is no unique way of reaching such a regime.

Do favorable regimes endure?

A regime of government that allows economic progress to proceed must at least satisfy the first requirement of government—that it not do excessive harm itself. However, regimes that meet this requirement often do so out of weakness. This was true

---

[22]Many historians have attributed Europe's comparatively rapid economic progress to its political fragmentation. This is true, however, only insofar as fragmentation, and the resulting competition, led to limits on the power of governments. The key was the limits, not the political fragmentation *per se*. Indeed, within the fragmented European polity, some economies did far better than others: as we have seen, success was related to the presence of political institutions that limited the power of central government.

[23]Exacerbated by the fiscal constraints placed on it by its founder, the first Ming emperor.

of the early fragmentation in both Europe and China and of the regime of the late Ming and Qing. Such regimes are unlikely to endure, because they do not satisfy the second requirement. Their weakness leaves them vulnerable to conquest by foreign governments and to overthrow by domestic sources of organized force.

The associational state, however, satisfies both requirements. And, indeed, it has survived and allowed continuing economic progress for centuries. The emergence of such a regime has loosened the grip of the predation trap.

But unfortunately, the associational state is not immune to internal predation. Entrepreneurs of predation find and exploit new opportunities, increasingly obstructing economic progress. We will examine this further in Chapter 18.

More generally, predation evolves. If one avenue is blocked, it finds others. So any reprieve from the predation trap is likely to be temporary.

A comparison with the work of North, Wallis, and Weingast

We saw in the Introduction that there has been considerable interest recently among economists and political scientists in the political obstacles to economic progress. Douglass North and his collaborators and followers have been at the forefront of this work. The culmination of their efforts are two recent books by North and John Wallis and Barry Weingast—*Violence and Social Orders* and *In the Shadow of Violence* (the latter also with Steven Webb).[24] It is illuminating to compare our conclusions about getting government right with theirs.

They agree that getting government right is the key to economic progress and that the development of government and economic progress are closely intertwined. However, they differ on what it means to get government right, on what sort of regime of government that implies, on how such a regime arises, and on whether such a regime can be expected to endure.

[24](North, Wallis et al. 2009), (North, Wallis et al. 2013). Another recent book on the same theme, aimed at a more general audience, is (Acemoglu and Robinson 2012).

A summary of their conclusions

North and his coauthors (NWW) understand government in relation to violence: violence is the problem and government is the solution. Government exists—indeed, is created—to control violence, especially organized violence.[25]

More broadly, the role of government is to set the 'rules of the game' under which economic progress can proceed. In the absence of such rules, individuals will pursue their interests in ways, such as violence, that are socially destructive. If government sets the rules appropriately, their efforts will be channeled instead in directions that are socially constructive. NWW emphasize, in particular, the role of government in enforcing contracts; this, they believe, makes possible the creation of the large enterprises required to exploit economies of scale in production.[26]

Good government, therefore, creates an environment of secure property rights. This is a precondition for economic progress: only when individuals are secure against the violent taking of their property by others will they be willing to devote their efforts and their resources to productive activity. To provide secure property rights, government must be sufficiently powerful. With a powerful government, violence is no longer a problem, property rights are secure, and economic progress is possible.

Government initially comes into being through a coalition of the violent elite. These agree to give up the fruits of individual violence in exchange for the economic rents to be obtained from a more productive economy through their control of the government. NWW emphasize in particular the rents to be obtained by limiting to the elite the right to form large enterprises.[27] Because of such distortions, this regime, a Limited Access

---

[25]"Every society has to solve the fundamental problem of providing social order. In the simplest terms, human violence must be prevented or contained. Providing order is the primary function of a state." (North, Wallis et al. 2006) p4. "Our primary concern is with organized violence; the use of violence or threats of violence by groups." (North, Wallis et al. 2009) p14

[26]First argued by North in (North and Thomas 1970). NWW also suggest that government should enforce competition and provide infrastructure and other public goods, performing what we have called the facilitating functions (see for example (North, Wallis et al. 2006) pp71-2).

[27]

Order, is not economically efficient. However, because it does control violence, it supports far greater productivity than is achievable without a strong government.[28]

But an Open Access Order is preferable. Under such a regime, the elite give up their privileges, ensuring economic efficiency. In particular, the right to form large enterprises is opened to all. The transition from a Limited Access Order to an Open Access Order takes place when elites see that the their loss of privileges is outweighed by the potential benefits to them of the resulting increase in prosperity. The Open Access Order is supported, not by violence, but by mechanisms of political governance such as democracy.

NWW see the different social orders as stable political equilibria. A change in social order—from no government to Limited Access Order or from Limited to Open Access Order—is a transition from one such equilibrium to another. Transition can be triggered by exogenous shocks, but the ground is laid by underlying economic progress.

Why their conclusions differ

Their different conclusions stem from fundamental differences in their understanding of government and of the economy. NWW understand government in terms of violence rather than predation. And they understand the economy largely in terms of the conventional theory.

NWW do recognize the connection between predation and violence: they see private violence as a problem because its purpose is predation—the violation of individual property rights. However, in general, they identify the problem simply as being one of violence, without explicitly invoking predation.

The purpose of violence, however, need not be predation: it can be defense against predation. For example, all of the early associational states had their origins in violence—the Dutch Revolt, the English Civil War, the American Revolution. By failing to

[28](North, Wallis et al. 2013) explores the economic consequences of different types of Limited Access Order, with different degrees of open access. They agree with our conclusion here that economic progress can proceed under less than perfect government.

recognize that violence can be used to defend against predation, NWW miss the vital distinction between predatory government and associational government.[29]

Conversely, predation need not involve violence. Indeed, predation that does so is inefficient, and it therefore tends to be replaced by predation that is backed by the implicit threat of force but does not involve the actual use of force. We have seen, for example, how banditry by the medieval nobility tended to be replaced by tolls—to the benefit of predator and prey alike.

The problem, therefore, is not violence but predation. When the purpose of violence is not predation, violence need not obstruct economic progress—indeed, in some cases it may facilitate it. And non-violent predation is no less an obstacle to economic progress.

In particular, predation by government is generally non-violent. And, presumably because it does not involve violence, government predation—exaction—receives much less attention from NWW than it merits. Exaction is central to everything government does, the power of government—particularly its deployment of force—depends upon it.

Moreover, as the state becomes more powerful, predation by private individuals adapts to the changing environment. Rather than engaging in independent predation—violent or not—individuals engage instead in private exaction. That is, rather than relying on their own force, they subvert the force of the state to their own benefit. For example, we have seen how, with the creation of the conglomerate state, nobles gave up their private armies to become courtiers and government officials. The rewards for doing so certainly included the economic rents that NWW note. But they included too peculation, corruption, and extortion. So the suppression of private violence does not solve the problem of predation by individuals: it merely changes its form.

The neglect of exaction—both official and private—by NWW has significant consequences. In particular, it leads them to greatly underestimate the obstacles governments can place in the way of economic progress. They emphasize the creation of economic rents—one form of non-violent predation—but they have little to say about the exaction that does far more damage.

---

[29]Of course, violence need not be related to predation at all. It can be social rather than economic—domestic violence or religious violence, for example.

Their underestimation of the harm done by government is exacerbated by their theory of the economy. NWW do not discuss in any detail the functioning of the economy or the process of economic progress, but they seem to assume implicitly the conventional theory.[30] For example, individual violence is bad because of its effect on the incentives of producers. NWW do not consider the impact of private violence or—more important—of official and private exaction on commerce. They therefore neglect its impact on the extent of the market and on the self-perpetuating process of economic progress.

As a result, NWW emphasize the positive role government can play rather than the harm it can do. They see bad government as being bad principally for what it fails to do rather than for what it does do. They focus on the protection of property *by* government rather than on the protection of property *against* government—'secure property rights' rather than 'economic freedom'.[31] They stress the need for government to be powerful enough rather than the need for effective limits on government power. And they have little to say about mechanisms to control the misbehavior of government and its agents, beyond governance through broad political participation.[32]

Because of their neglect of government predation, NWW also miss the dynamics of the predation trap process. They do not consider the imperative of consolidation and the resulting competition among governments.[33] Indeed, for NWW, all of the action takes

---

[30]Their emphasis on the importance of organization—large enterprises—is an exception. They explicitly link this to the ideas of Smith.

[31]In particular, some of the property rights secured by governments are harmful—for example, rights to economic rents and rights to private exaction.

[32]They do, however, recognize the role of civil society in strengthening governance ((North, Wallis et al. 2006) p43 and (North, Wallis et al. 2013)).Their neglect of decentralization, and federalism in particular, is remarkable given Barry Weingast's seminal contributions in this area. See, for example, (Weingast 1995). Their only discussion of federalism in (North, Wallis et al. 2009) is a justification, on page 120, of the increasing power of the central government!

[33]This neglect is again surprising, given North's emphasis elsewhere on the importance of competition among governments. See, for example, (North 2005).

place within a single polity.[34] Change, when it happens, is entirely the result of internal forces. NWW miss the role of fiscal pressure in changing the nature of government, and they miss the evolutionary process of selection of the fiscally fittest.

Consequently, NWW see the emergence of a regime of government (social order) that is favorable to economic progress not as the result of a process, but as a voluntary shift by the elite from one political equilibrium to another. And, since the equilibrium of the Open Access Order is 'economically efficient', there is no reason why it should not endure—why it should not constitute 'the end of history'.

CONCLUSION: WHAT IS DIFFERENT ABOUT THE NEW THEORY

Having reviewed the new theory and considered its implications for getting government right, it is useful to revisit the question, first raised in the Introduction, of how the new theory differs from the conventional theory, and of how it both resembles and differs from Classical economic theory.

How it differs from the conventional theory

The conventional theory sees the economy as being in equilibrium. There is no reason for anything to change, because the economy is fully exploiting its potential. The nature of the equilibrium depends on outside factors—such as technology or political institutions—and the equilibrium changes only when those factors change.

In contrast, the new theory sees the economy as a self-perpetuating process. Change comes from within the economy as entrepreneurs exploit unexploited potential. The process is self-perpetuating, because exploiting existing potential creates new potential.

The conventional theory attempts to understand the economy purely in terms of production. It recognizes only the ghosts of commerce and predation—'the market' and 'government'. It assumes that these ethereal entities exist in the background and that they perform their respective functions perfectly, but it takes no interest in their working.

The new theory recognizes commerce and predation—no less than production—as economic activities. It understands the self-perpetuating process of economic change in

---

[34]Correspondingly, they see government as protecting against internal organized violence rather than against external threats. This emphasis is not unreasonable in the context of today's developing countries that are the focus of (North, Wallis et al. 2013). We will discuss this further in Chapter 18.

terms of the interaction of the three activities. Commerce and production interact to generate economic progress. Predation and economic progress interact in the predation trap process, holding economic progress back and generating political change.

The relation of the new theory to Classical theory

The new theory has much in common with Classical economic theory. The most fundamental similarity is that both understand the economy in terms of process rather than equilibrium. Indeed, Classical theory recognizes both of the processes described by the new theory.

The Classical theory, too, sees economic progress as a self-perpetuating process: if nothing holds it back, it is the "natural course of things." And what holds it back is predation and government: the predation trap process is an integral part of Classical theory.[35]

This similarity with the new theory is no coincidence. It is partly a result of imitation: the new theory adopts many of its ideas from the Classical theory. But it is also the result of following a similar method in deriving the theory—induction from the historical evidence. Because the method is similar, and relies on similar evidence, it is not surprising that the new theory arrives at similar conclusions.[36]

The method of the conventional theory, in contrast, is deduction. Rather than starting with observation, it starts with assumptions—like the assumption that the economy is at its full potential—and then explores the logical consequences of those assumptions. It is an exercise in philosophy rather than in science.[37] For example, its understanding of the

---

[35]See (Macfarlane 2000) Ch. 14.

[36]Some of the differences are the result of the availability of more detailed and broader evidence and the development of new analytical tools.

[37]This is not to suggest that economists do not engage in empirical work. Indeed, the profession has, in recent decades, taken a turn away from mathematical modeling towards the statistical analysis of quantitative data. However, the theory that underlies this work—to the extent that it relies on theory—is purely the product of deduction. It is a maintained assumption that is never tested against empirical evidence.

role of 'government' rests on the concepts of 'efficiency' and 'market failure', both of which are philosophical constructs rather than observable phenomena.[38]

The crucial difference between the new theory and the Classical theory is that the new theory is framed explicitly in terms of the three economic activities and their interaction. It is not the recognition of the three activities and their interaction that is new: as we have seen the Classical theory recognizes predation and the predation trap process, and it recognizes commerce too, although to a much lesser degree. What is new is the integration of the three activities into a single coherent whole. The result is a theory that is richer and more coherent.

In its understanding of the process generating economic progress, the new theory adds recognition of the central role of commerce and of commercial cities. It also offers a richer theory of organization—not just the division of labor, but also the combination of labor and the combination of resources (financing). The structures of organization include not only the firm (the enterprise) and the market, but also the association and the group. To the core process of Smith and Young, the new theory adds several auxiliary processes—processes going on within commercial cities (identified by Jane Jacobs), the self-perpetuating process of invention (identified by W. Brian Arthur), and the trading cost multiplier process (a process like the core process, but taking place within commerce).

To the theory of the predation trap process, the new theory adds explicit consideration of the connection between government and predation—in particular, the distinction between predatory government and associational government. This distinction is critical to understanding the evolution of government. The new theory's attention to commerce as an economic activity and to its role in generating economic progress provides a much improved understanding of the impact of government and predation on economic progress. Similarly, recognizing the role of commerce and of commercial cities—and the importance of fiscal considerations in general—in the evolution of political institutions leads to a better understanding of that process.

---

[38]Both are possible properties of economic equilibrium, and neither is even defined for a self-perpetuating process of economic progress.

To illustrate why these differences matter, Chapter 18 explores the implications of the new theory for the two contemporary problems with which we began—the lack of economic development in large parts of the world and the difficulties currently afflicting many of the developed countries. And Chapter 19 explores the implications for economics as a discipline.

REFERENCES

Acemoglu, D. and J. A. Robinson (2012). Why nations fail : the origins of power, prosperity and poverty. New York, Crown Publishers.

Brooks, A. C. (2012). The road to freedom : how to win the fight for free enterprise. New York, Basic Books.

Dixit, A. K. (2004). Lawlessness and economics : alternative modes of governance. Princeton, N.J., Princeton University Press.

Finer, S. E. (1997). The history of government from the earliest times. Oxford, Oxford University Press.

Friedman, D. D. (2010) "A Positive Account of Rights." Cato Unbound.

Gelderblom, O. (2013). Cities of commerce : the institutional foundations of international trade in the Low Countries, 1250-1650.

Henshall, N. (1992). The Myth of Absolutism: Change and Continuity in Early Modern European Monarchy. London, Longman.

Holcombe, R. G. (2014). "The economic theory of rights." Journal of Institutional Economics **10**(3): 471–449.

Macfarlane, A. (2000). The riddle of the modern world : of liberty, wealth and equality. Houndmills, Basingstoke, Hampshire

New York, Macmillan Press ; St. Martin's Press.

North, D. C. (2005). Understanding the process of economic change. Princeton, N.J., Princeton University Press.

North, D. C. and R. P. Thomas (1970). "An economic theory of the growth of the Western world." The Economic History Review **23 (1)**: 1-17.

North, D. C., J. J. Wallis, et al. (2013). In the shadow of violence : politics, economics, and the problem of development. New York, Cambridge University Press.

North, D. C., J. J. Wallis, et al. (2013). Limited access orders: An introduction to the conceptual framework. In the shadow of violence : politics, economics, and the problem of development. D. C. North, J. J. Wallis, S. B. Webb and B. R. Weingast. New York, Cambridge University Press**:** x, 366 pages.

North, D. C., J. J. Wallis, et al. (2006). A conceptual framework for understanding recorded human history. W12795. NBER. December.

North, D. C., J. J. Wallis, et al. (2009). Violence and social orders : a conceptual framework for interpreting recorded human history. New York, Cambridge University Press.

Olson, M. (1969). "The Principle of "Fiscal Equivalence": The Division of Responsibilities among Different Levels of Government." American Economic Review **Vol. 59, No. 2**(May): 479-487.

Olson, M. (1971). The logic of collective action; public goods and the theory of groups. Cambridge, Mass.,, Harvard University Press.

Powelson, J. P. (2005 [1994]). A History of Wealth and Poverty: Why a Few Nations are Rich and Many Poor. http://tqe.quaker.org/wealth-and-poverty/index.html, The Quaker Economist with permission from the University of Michigan Press.

Pryor, J. (1979). Foreign policy and economic policy: the Angevins of Sicily and the economic decline of Southern Italy, 1266-1343. Principalities, Powers and Estates. L. O. Frappell. Adelaide, Adelaide Universtity Union Press.

Rosenberg, N. and L. E. Birdzell, Jr. (1986). How the West Grew Rich: The Economic Transformation of the Industrial World. New York, Basic Books.

Strayer, J. R. (1970). On the medieval origins of the modern state. Princeton, N.J.,, Princeton University Press.

Thompson, I. A. A. (1994). Castile: Polity, fiscality, and fiscal crisis. Fiscal crises, liberty, and representative government, 1450-1789. P. T. Hoffman and K. Norberg. Stanford, Calif., Stanford University Press.

Weingast, B. R. (1995). "The Economic Role of Political Institutions: Market-Preserving Federalism and Economic Development." Journal of Law, Economics, and Organization **11 (1)**: 1-31.