28. Commitment, Coercion, and Markets: The Nature and Dynamics of Institutions Supporting Exchange

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Markets rest upon institutions. The development of market-based exchange relies on the support of two institutional pillars that are, in turn, shaped by the development of markets. Research in the field of new institutional economics has largely focused upon one such institutional pillar—'contract-enforcement institutions'—that determine the range of transactions in which individuals can commit to keep their contractual obligations. Yet, markets also require institutions that constrain those with coercive power from abusing others' property rights. These 'coercion-constraining' institutions influence whether individuals will bring their goods to the market in the first place.

This chapter's discussion of market-supporting institutions is geared toward the issues we know the least about. First, the dynamics of market-supporting institutions and the implied dynamics of markets; second, the inter-relationships between the dynamics of market-supporting and political institutions where the latter comprise the rules for collective decision-making, political rights, and the legitimate use of coercive power. It argues, in particular, that neither the assertion that liberal political institutions lead to markets nor that markets lead to liberal governance are supported by theory or history. Markets and political institutions co-evolve through a dynamic inter-play between contract-enforcement and coercion-constraining institutions.

Many successful market economies have prevailed in the past; there were adequate market-supporting institutions. Early successes, such as those in the Islamic world or China, were not indicators of later development. It was the commercial expansion that began in Europe during the late medieval period that led to the development of markets that support the complex, dynamic modern economy with its wide-scale reliance on impersonal exchange. Why didn't early success lead to subsequent market expansion? More generally, what does determine the dynamics of market expansion? Addressing these questions is a key to understanding the 'Rise of the West,' the operation of market economies, and the factors that still hinder market development.

The argument advanced here is that markets can rest on different combinations of contract-enforcement and coercion-constraining institutions. Different

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combinations, in turn, can support distinct sets of exchange relationships, implying that their relative efficiency depends on the details of the related economy. In particular, under conditions elaborated upon below, markets can prosper even in the absence of limited government and the rule of law. Equally important, different initial combinations of contract-enforcement and coercion-constraining institutions lead, in a non-deterministic way, to distinct dynamics of markets and political institutions.

The core idea developed here regarding this dynamic is the following. Contract-enforcement institutions *organically* (spontaneously) emerge in the initial stages of market development as unintended and unforeseeable results from the pursuit of individual interests. Yet, even in the same economic situation, different institutions can emerge as their details are influenced by various factors, including those that are cultural and social (e.g., Greif 1994a; McMillan 2002). The details of these initial contract-enforcement institutions influence which additional institutions the economic agents will find it profitable to use if made available and establish if possible. *Ceteris paribus*, initial contract-enforcement institutions influence what additional, *designed* (intentionally created) institutions the economic agents will 'demand.'

The ability to effectively supply designed—private- or public-order—contract-enforcement institutions, depends on the prevailing coercion-constraining institutions, which are those that influence decisions regarding the acquisition and use of coercive power. This is the case because many designed institutions reveal information about wealth to those with coercive power. Wealth-revealing, designed, contract-enforcement institutions will be utilized only if coercion-constraining institutions are such that this information does not undermine the security of property rights.

Consider, for example, public-order, contract-enforcement institutions. When appealing to the court, using a land registry, applying for a business licence, or submitting to a regulatory agency information regarding one's wealth is generated. This information can be used by those with coercive power to identify and capture this wealth. Wealth-revealing public-order institutions can be *effectively* supplied only if the generation of this type of information does not lead to wealth confiscation. If this is not the case, even if public-order, contract-enforcement institutions are established, they will be underutilized. Distinct coercion-constraining institutions imply distinct abilities for *effectively* supplying various, designed, contract-enforcement institutions that further extend the market.

Interestingly, the coercion-constraining institutions conducive to the growth of the market also likely to lead to the endogenous emergence of political institutions associated with liberal societies in which market participants (the 'commercial sector') have political representation and influence. Political institutions—rules for collective decision-making, political rights, and the legitimate use of coercive power—that are actually followed are self-enforcing in the sense that following them is each political actor's best response. (E.g.,