

This is an excerpt from a paper that I gave at the EHA meetings this October, forthcoming as “The Public Promotion of Private Interest (Groups)” Collective Choice: Essays in Honor of Mancur Olson, Jac Heckelman and Dennis Coates, ed. Springer-Verlag, 2003.

The central question in our inquiry is how and why do governments promote or retard markets?

This piece formulates a general principle of how governments promote markets: by allowing the number and extent of organizations to grow and develop. Then it lays out why governments usually will not allow organizations to grow in number or powers. The idea is to tie a “fiscal interest” model of government with a “predatory state” model of government and a specific form of institutions that promote growth.

See you next week.

John Wallis

I. Some Propositions:

The basic argument can be summarized in four related propositions:

Proposition 1) The degree of economic productivity of any society is a function of the degree of specialization and division of labor.

The proposition could be stated in a stronger form as the major source of economic growth is specialization and division of labor. Such a claim would immediately become entangled in debate over the independent role of technology and factor accumulation (resources, physical capital, and human capital). As I will discuss later, the argument is not dependent on which source of growth dominates.

Proposition 2) The degree of specialization and division of labor is limited by the extent of the market.

Proposition 3) The extent of the market is limited by the nature of organizations operating within the market.

By “nature” I mean the scope, range, depth, and density of the existing organizations. Individuals in a state of nature rarely find themselves in face to face contact with other, unknown individuals with whom they wish to trade. Exchange requires either a framework of repeated interaction or third party enforcement of agreements before anything much of value can be traded. Organizations are a way to regularize repeated dealings through organizational forms like partnerships and through specialization in trading which increases the number of interactions between a small number of traders. Organizations of all types, public and private, religious and secular, fraternal and competitive, also provide frameworks for third party enforcement of contracts. The extent of the market is limited by the extent of organizations operating in that market.

Proposition 4) The nature and extent of organizations is limited by the government.

In most societies, governments place significant limits on what organizations are allowed to exist and further limits on what organizations are allowed to do. For much of human history, any organization of individuals was a potential military threat.¹ Throughout the middle ages, trade over any distance was carried out only by individuals operating in organizations who had obtained permission to enter into foreign domains. It was not until the 1820s that individuals were allowed to form organizations with the privileges of corporate status without applying to the crown or the legislature. As late as the 1770s, individuals who did not belong to a recognized church in Massachusetts were forced to support the state sponsored church, in Virginia the Anglican church was not disestablished until 1785, and in their revolutionary constitutions several states still required office holders swear an oath that they were good protestant Christians.²

¹?? when a “group of ten was a band, of twenty a brigade, and of forty an army”

²Article 22 of the Delaware constitution of 1776 required that:

Every person who shall be chosen a member of either house, or appointed to any office or place of trust, before taking his seat, or entering upon the execution of his office, shall take the following oath, or affirmation, if conscientiously scrupulous of taking an oath, to wit: I, A B [name], will bear true allegiance to the Delaware State, submit to its constitution and laws, and do no act wittingly whereby the freedom thereof may be prejudiced."

And also make and subscribe the following declaration, to wit:

"I, A B [name], do profess faith in God the Father, and in Jesus Christ His only Son, and in the Holy Ghost, one God, blessed for evermore; and I do acknowledge the holy scriptures of the Old and New Testament to be given by divine inspiration."

And all officers shall also take an oath of office.

The passage of the “Statute of Religious Freedom” in Virginia on December 17, 1785 was the central act in providing religious freedom in Virginia, and also played a key role in shaping Madison’s thoughts about the organization of political society in America, as discussed by

Together these four propositions can be combined into the following statement:

If governments limit the extent of organizations,

Then the extent of the market will be limited,

Then the degree of specialization and division of labor will be limited, and

The level of economic productivity will be reduced.

This statement is logically complete: if governments limit organizations they will lower the level of economic productivity. In logical terms, relaxing the limits that governments impose on organizations does not necessarily lead to an increase in the extent of the market, the degree of specialization and division of labor, and the level of economic productivity. Nonetheless, it is an intriguing possibility. Do economies grow and develop when governments allow more and more varied organizations to exist? It is a question that modern economics, economic development, and economic history have failed to ask.

II. A framework

The concepts of individuals, organizations, governments, institutions and markets are generically defined, but what, if any, special connotations do they have here?

Individuals are individual human beings. They interact with each other in a number of different ways. Some interactions between individuals occur within markets, others occur in a variety of social environments.

Organizations are distinct from groups -- here I differ from Olson. A group is any

number of individuals with a common interest. A group can be a crowd of people waiting at a bus stop (the bus being the common interest), tobacco farmers, or all people over seven feet tall. An organization is a group of people who act in a coordinated manner.³ Organizations can be as loosely organized as my wife's book group or as tightly organized as a football team. They range in size from the very small to the very large. Membership in an organization can be limited or completely open. The structure of an organization can be highly articulated, contractual, and enforced by legal systems or it can be casual and voluntary. In Olsonian terms, an interest group need not be an organization, it could simply be a group of individuals with a common interest, but only organizations pursue collective action – coordinated behavior.

In *The Logic*, Olson focused on a subset of organizations in which membership was voluntary and the coordinated action of the members was directed toward the production of a public good. He was uninterested in the existence of profit maximizing firms and why they were able to coordinate individual action through the use of wages and other economic incentives: there was no challenge in understanding why they existed. Given the focus of *The Logic* on the problem of collective action, this emphasis was appropriate. Although Olson continued to identify voluntary organizations as his focus *Rise and Decline*, he had, in fact, switched his focus. *Rise and Decline* is about the growth of redistributive coalitions, and many of those coalitions and actors are themselves profit maximizing firms or organizations. The distinction between profit maximizing firms and voluntary groups, even in Olson's own terms, is a matter of degree rather than structure. There is no bright line separating voluntary and profit maximizing firms in this paper.

³So all organizations are groups, but not all groups are organizations, since not all groups act in a coordinated manner.

The limits to successful organization in pursuit of any collective goal, either public or private, depends on the size of the group and the availability of selective incentives. Members of small groups can more easily monitor each other's behavior and see that agreements are enforced. Selective incentives allow the group leaders to insure cooperation in the provision of the collective good by allowing access to valued group benefits that only cooperators can enjoy. Profit maximizing organizations have ready access to selective incentives – work or you do not get paid – and thus do not, in Olson's world, face the same problems as voluntary organizations. The recent spate of corporate accounting fraud ala Enron, however, highlights just how difficult it is for a profit maximizing organization to insure cooperative behavior. Some of Enron's owners, the stockholders, were unable to elicit appropriate behavior on the part of their partners, the stock option holding management. Selective incentives may always exist for profit maximizing firms, but they don't always work. In the absence of effective selective incentives, even profit maximizing firms will not come into existence.

I accept Olson's logical assertion that in the absence of small numbers or selective incentives organizations will not arise. But many of the selective incentives that organizations use to coordinate their members are not inherently incentive compatible, that is, they are not self-enforcing relationships. Many organizations rely on the use of third party enforced agreements to structure their internal affairs. To the extent that governments are the third parties used to enforce agreements, the range of selective incentives available to organizations depends on the range of contractual arrangements that the government agrees to enforce. The existence of public and private organizations, of voluntary and for profit organizations depends on the policies of the government towards organizations.

What then is a government? Barzel defines a state as:

The **state** consists of (1) a set of individuals who are subject to a single ultimate third party who uses violence for enforcement and (2) a territory where those individuals reside, demarcated by the reach of the enforcer's power.⁴

The government is the “single ultimate third party enforcer.” While government's are not the only third party enforcer, they are the ultimate third party enforcer because of their superior access to violence.⁵ No government agrees to be a third party enforcer to any and every agreement that individuals and organizations make. Governments limit the kind of contracts they will enforce.⁶ Because they limit the kind of arrangements they will enforce, governments explicitly place limits on the selective incentives available to organizations.

The entirety of society – individual, organizations, and governments – operate within a set of endogenous institutions.⁷ Institutions are the rules of the game: the social norms, laws, formal rules, and informal arrangements that structure human relationships. A full description of the institutions in a society would require descriptions of the institutions governing the autonomous behavior of individuals, organizations, and governments as well as descriptions of the interaction of those groups. The relationship between governments and organizations, that is, how governments constrain or promote the activities of organizations, is of particular interest in this paper, but it is only one of six possible relationships.

My definition of a market again draws on Barzel. He distinguishes between economic

⁴Barzel, *A Theory of the State*, 2002, p. 22. Many of the ideas in this paper are discussed in greater detail and sophistication in Barzel's excellent book.

⁵Barzel's discussion of power is especially interesting. Power is the ability to impose costs on other individuals. Governments, organizations, and individuals all possess power, governments just garner a larger share of theirs from the threat of violence.

⁶See Hurst's discussion of the development of American commercial law as an example of just this point. *Law and the Conditions of Freedom*.

⁷The concepts of institutions and organizations follow the lines suggested by North (199 ??).

and legal rights. Economic rights are what you actually possess, legal rights are what a third party enforcer will delineate and enforce. “Contractual exchange” is the exchange of goods and services whose rights are legally defined and supported. The market is the sum of all contractual exchange between individuals, organizations, and governments. Many exchanges and interactions between individuals, between organizations, and between individuals and organizations do not involve contractual exchange and are thus outside of the market. For example, many of the activities within a church are reciprocal exchange, but not within the context of the market. In the early twenty-first century United States most impersonal exchange occurs within an explicit, if sometimes background, framework of third party enforcement, and thus is almost completely market exchange.

Connections:

Figure 1 depicts a stylized way of thinking about the connections between individuals, organizations, and governments. Olson focused on two of the possible six connections. *The Logic* examined how individuals came together to form organizations, *Rise and Decline* how those organizations used their influence on governments to redistribute income to themselves.⁸ In “Dictatorship, Democracy, and Development” and *Power and Prosperity*, Mancur began asking how government affected individuals, the dotted outside line in the figure.

Economics and political science usually focus on the pair of relationships between governments and individuals. In the simplest explanation for why economies grow, political systems become democratic and the interaction between the voters and the government lead the

⁸I do not mean to imply in any way that Olson was not aware that all of the connections were important, only that he focused on two in his work.

government to adopt policies that promote the well being of the voters in order to secure reelection. This virtuous cycle, however attractive, appears to be inconsistent with the logic of collective choice.⁹ That is, there is no automatically self-enforcing political-economic equilibrium in which democracy leads to economic growth and happiness. A great deal of economic theory and its applications are about the effect of governments on individuals. A great deal of political theory and its applications are about the effect of individuals on government. For two centuries now, a primary concern of both disciplines has been to discover how governments can be constrained in their relationships with individuals to promote secure property rights, the rule of law, and the economic development that follows.

The second pair of relationships is between individuals and organizations. Economic theory posits rational individuals who interact via the market to maximize individual utility. Organizations (in this case firms) are just another kind of individual with slightly more complicated internal dynamics, but a much simpler objective function: firms maximize profits rather than utility. In the simplest of economic worlds there is only production and consumption. All decisions about the allocation of production and consumption, about the distribution of goods and services across individuals and firms, is made impersonally by the market.

When individuals interact in a market, however, they face positive transaction costs. They do not have complete information about the nature of their trading partner, about all relevant prices, about the quality of the good or service they are purchasing or selling, and they cannot costlessly write enforceable contracts. People have developed millions of ways to deal with these problems, and we can heroically characterize them as one of two types. One solution to the problem of costly exchange is repeated interaction between individuals. At the simplest

⁹See Buchanan and Tullock, and Downs.

level, repeat dealings allows pairs of individuals to develop trust in one another. At a higher level, repeat dealings in the context of a community enables some individuals to develop a reputation for honesty, probity, product quality, trustworthiness, or some other desirable quality through repeated specialization in an activity. Individuals with, for example, a reputation for honesty earn rents from the perception that they can be honest third parties, and the loss of those potential rents in the future creates an incentive for the honest to remain honest. The second solution to the problem of costly exchange is the use of third party enforcement mechanisms. Parties to an exchange agree to involve a third party, who may be an individual, organization, or government, to resolve disputes and disagreements over terms of their exchange.¹⁰ Third party enforcement takes many forms and is ubiquitous in modern developed economies.

Individual people interacting through a primitive market with only individual participants (that is, without any organizations) face very high transaction costs. Goods cannot move across long distances because it is costly for individuals to develop reputations across long distances. We expect to see, and indeed do see historically, the emergence of individuals who specialize in creating relationships with like minded individuals across long distances. We call these people traders. In order to perform their task, traders must be heavily networked. They must possess reputational capital that allows them to enact trades in multiple geographic locations and they must be connected, at home, to a distribution network of “retailers and wholesalers” with whom they had reputational capital. At the heart of every trader’s network are a set of durable, bilateral, and reciprocal relationships with people the trader trusts exceptionally: his partners. Partners act in a coordinated manner to pursue common goals. In a word, partnerships are

¹⁰From the definition of a market given earlier, it is clear that all exchange enforced by a third party is market exchange, that is, contractual exchange, while reputation enforced exchange may or may not be market exchange.

organizations.

No market beyond a simple gathering place for local produce can function without the organizational support of partnerships. This is the canonical example of how the extent of organizations limit the extent of the market. It is possible for a ruby mined in India to end up in Britain through a long series of impersonal hand to hand exchanges, without the agency of an organization. Such links, however, are historically irrelevant. Trade over any substantial distance historically is always supported by organizations. In the beginning, trade is supported by simple organizations, like partnerships, whose internal relationships are governed by self-enforcing reputational arrangements. By the end of the 18th and beginning of the 19th century, organizationally simple but economically sophisticated firms composed of a few partners, like Barings and Browns, conducted extensive trade operations throughout the world. Moreover, long distance trade, from the earliest times, regulated and supported (or suppressed) by governments.

It would be exceedingly naive and narrow minded to argue that the origin of human organization is to be found in trade. People need to belong to organizations and groups. Human beings are social animals whose very utility/well-being/happiness is determined in part by the social relationships they maintain. People organize for many reasons other than the production and consumption of goods and services. Religion, procreation, mutual defense, and mutual interests head the list.¹¹ While participation in these organizations yields returns that can be physically measured, it also seems that belonging, in and of itself, is a valued activity. People

¹¹I am fully aware that all of these organizations can be thought to provide a good or service, and thus are “economic,” but at that point what is economic versus what is sociological losses all meaning. All is economics.

define who they are in terms of the people they interact with and how they interact.¹² The strongest evidence of this comes from studies of health in large organizations. Upper level managers, subject to the stress, strain, and long working hours of their jobs, live significantly longer than workers in low stress, low responsibility jobs: one's place in the organization even has biological implications. It must be acknowledged that organizations exert a tremendous influence on the behavior of their members. Comparing the behavior of individuals across geographic regions or across societies without reference to the organizations that constrain and shape their behavior, is certain to be a frustrating exercise.

How then do we explain the existence and structure of organizations? One approach is to focus on the connections between individuals and organizations. This is the approach of industrial organization and of Mancur Olson in *The Logic*. The other approach is to focus on the connections between governments and organizations, the last pair in the framework. This way of thinking about organizational development has been neglected. Based on the assumption that human organization is ubiquitous, the limited number of organizations that we find in undeveloped economies must be the result of some other constraint.¹³ The constraints that government places on the number and type of organizations shape the existence and structure of organizations until that constraint is relaxed. Until the last two hundred years in the politically liberal democracies of the developed world, organizations have never been free to develop as they pleased. The "right to organize" was as severely restricted as any individual liberty.

¹²For an attempt to understand some these issues in an economic framework see Kranton and Akerloff, "Identity," *QJE*.

¹³For evidence on the limited number of groups in developing countries relative to developed countries see Knack (2002), Knack and Keefer (1997), and Coates and Heckelman (2002)..

An important element in the development of organizations and their relationship to government is the second solution to the problem of high transaction costs trade: third party enforcement. Parties to an exchange may significantly lower their transactions costs *ex ante* if they can agree on a third party who will, *ex post*, resolve disputes between the parties. The use of a third party involves several requirements: a third party whom both the first and second party trust (either because of the third party's inherent character or because the third party is himself constrained to be impartial and honest by reputational considerations or other third party arrangements); a willing third party; and an *ex ante* agreement on the jurisdiction of the third party and the rules under which decisions are to be rendered. The last requirement is enormously important. Third parties never agree to enforce any and all contracts. The type of contracts that third parties will and can enforce shapes the structure of individual contracting and market exchange, but it also shapes the structure of organizations.

Organizations are natural places for members to resolve their disputes and for third party enforcement arrangements to evolve. Grief's (1989) Mahgribi traders, for example, are an organization that developed sophisticated internal third party arrangements to enforce contracts between members, enforced by incentive compatible collective choice action on the part of the whole organization. Not only can organizations provide third party services to their members, they can also market third party services to non-members. An integral part of the financial services of a firm like Barings or Browns was assuring individuals who dealt with the firms that the contracts they were making through the agency of the firm, would be enforced with the resources of the firm. So a cotton grower in Mississippi selling to a textile firm in Manchester through Barings, could rely on Barings to see that the terms of the sale were met. An integral part of the services of an intermediary is the provision of third party enforcement.

Governments and organizations are always potential competitors in the provision of third party enforcement. Since governments are themselves organizations, any private organization is always a potential threat to the government. Following Barzel, governments are the ultimate third party enforcers who use, or threaten to use, violence to enforce their decisions. Governments never have a monopoly on power or violence (every one has some power and any person can become violent), but governments that rule by force rather than agreement have strong incentives to minimize the amount of violence potential possessed by their subjects. Since the effective use of violence requires coordination and leadership, violence is always more effectively deployed by organizations. This leads to the following conjecture:

Conjecture 1) Under the right conditions, particularly when governments rule by force or their tenure as the government is uncertain, governments view all organizations as potential military threats. Under these conditions government will limit the number and type of organizations that are allowed to exist, will regulate the internal structure of the organizations that do exist, and will prohibit all other organizations from forming.

This conjecture is not absolute, nor everywhere binding. Yet, in many societies the level of development of organizations is quite limited. For most of human history, any significant number of organized men was a potential military force. American law inherited from British law the concept of “conspiracy:” whenever two or more are gathered together a conspiracy is possible. For a time in the Soviet Union, in Communist China, and other statist societies the right to form any organization was monopolized by the state.

While states rarely monopolize all organizations, they do have an incentive to limit them. First, states themselves are organizations whose ability to create and project violence requires significant coordination. Military action requires a hierarchy of authority, thus a hierarchy of

organization. Only modern nation-states find it feasible to maintain a large standing army. The government must possess a preponderance of military authority, but the leader's military authority is maintained through the allegiance and cooperation of lesser military leaders. The "king" creates or recognizes the military authority and organizations of his subordinates. He must continually devote his attention to maintaining incentive compatible arrangements with the lesser military leaders and stay on top of a constantly changing and evolving political/military situation..¹⁴

In a parallel fashion, governments have an incentive to create organizations in order to obtain the resources necessary to rule. For the feudal king, fiscal and military requirements were identical: he raised an army directly in the form of the military service of earls, dukes, and knights rather than in the form of tax revenues to hire military labor. For all governments, however, access to tax revenues at relatively low costs requires physically tapping into the exchange of goods and services. Conceptually, governments have incentives to create markets by allowing organizations that promote market exchange to form, because the very existence of the organizations produces lower cost sources of revenue to the government. Historically, the commercial history of Europe in the middle ages is replete with examples where governments create and promote the existence of organizations whose primary use to the government is mobilizing fiscal and military resources. In northern Europe free towns with written charters developed when powerful lords who granted the towns the physical and economic freedom from expropriation necessary to develop markets, in return for a steady flow of tax revenues from the town's markets. In Italy, city-states like Venice and Genoa, developed where the state and the

¹⁴I tend to think of this problem in terms of feudalism, but the problems described here are not unique to northwestern Europe.

traders were identical. Within the “commune” of the political body the interests of the traders and the government were identical.

The fiscal side of the relationship between governments and organizations is of primary importance. North (1981) and Olson both begin their theories of the state with “revenue maximizing monarchs.” Military considerations prevent any ruler from being strictly revenue maximizing, so a critical “*ceteris paribus*” condition always applies. Nonetheless, the fiscal interests of government are the place to investigate how and why governments create organizations.¹⁵ The driving force in the relationship is a *quid pro quo*: the government grants a special privilege or franchise to a specific organization, in return for which the organization provides revenues to the government. Keep in mind that the historical, if not theoretical, starting point for this development is an economy with very limited markets, low levels of specialization and division of labor, very high transaction costs, and endemic violence, e.g. Europe around 1000 A.D. The *quid pro quo* leads directly to another conjecture:

Conjecture 2) When governments do not have access to broad, market based, low cost tax instruments (e.g. sales, property, or income taxes), it will often be in the government’s interest to generate revenue by granting special privileges to a limited number of organizations. By their very nature, the value of these special grants of privilege, and thus the revenues that the government realizes from making the grants, is higher when the number of organizations receiving the grants is smaller. As a result, there is an inherent fiscal motivation to limit

¹⁵In my own work I have tried to develop a “fiscal interest” model of government behavior, and to tie that model to the behavior of American state governments in the 19th century. See Heckelman and Wallis, 1997, Wallis, Sylla, and Legler, 1994, and Wallis 2000 and 2002.

absolutely the number of organizations the government creates for fiscal purposes.¹⁶

This conjecture is the heart of the paper. Governments have natural reasons to treat private organizations as potential competitors and so to limit their numbers and nature. At the same time, if the number of organizations is limited, there are substantial rents to be had by the organizations that do exist. The government taps into these rents by charging for the privilege of having an organization. The amount the government can charge for the privilege, however, is a decreasing function of the number of organizations the government creates, resulting in a “revenue maximizing” number of organizations that is less than we observe with free entry into organizations.

Tax farming is an obvious case of granting special privileges to a limited number of organizations, common in both England and France. Regulation of foreign trade was another source of rents. In England in the 14th, 15th, and 16th century, the monarch constantly attempted to maximize the value of the taxes imposed on wool exports, a policy that typically resulted in granting a monopoly on the wool staple (control over the export of wool to the continent).¹⁷ Sometimes monopoly rights over foreign trade in England were granted to English merchants, but there were time when it was in the fiscal interest of the English king to grant the monopoly rights to German merchants.

¹⁶ One can illustrate the conjecture with the granting of bank charters by American states in the early nineteenth century. States could sell bank charters to organizations, but the value of the bank charter was a decreasing function of the number of banks chartered by the state. The revenue maximizing number of bank charters occurred where the demand for bank charters was unit elastic, and that number of banks was likely to be far less than the number of banks that would come into existence under a system of open entry with a fixed fee, such as the free banking systems that developed after the 1830s. For empirical substantiation of this assertion see Wallis, Sylla, and Legler (1994).

¹⁷See Postan’s discussion in the Cambridge Economic History. ?? There is undoubtedly a more current discussion of this somewhere.

The limitation of organizations, in turn, produces “rent seeking” behavior on the part of the organizations. There is both a supply and a demand side to this market. The organizations owe their existence not to the provision of low cost/high quality services to the market, but instead to the provision of revenues and political favors to the government. Pursuit of these rents creates an opportunity for incentive compatible relationships between the government and the organizations. Kings and dictators perpetually worry about assassination and coups. By creating rents for a small number of powerful associates, and surrounding oneself with those associates, the king purchases some modicum of security. Since contracts with the king, by their very nature, cannot be enforced by third parties, the rents created by limiting organizations opens up the possibility for incentive compatible reputational relationships between the government and the limited organizations.¹⁸

As an example, in his history of British government finance in the 18th century, Brewer reaches the following conclusion about the nature of financial markets and the interaction between the government and financial markets in the 17th century:

Such seventeenth-century bankers had a way of worming themselves into the fabric of the state. In order to recoup their loans, or at least to protect their interest, they combined lending to the monarch with tax farming, the operation of monopolies granted by royal fiat, or the tenure of offices in the fiscal apparatus. All of these provided financiers with privileged access to royal income which thereby acted as collateral for the king’s loans. This meant that it was difficult to identify clearly a ‘financial interest’ when the government’s creditors were neither state fish nor society fowl. (Page 207)

This is the world Mancur Olson described in the *Rise and Decline of Nations*. A number of small, well organized groups who used their collective weight to influence government to redistribute income to them at the cost of the larger public welfare. This predatory state was

¹⁸ Greif, Milgrom, and Weingast’s characterization of the merchant guild in medieval Europe illustrates how limited organizations with special access to governments can arrange incentive compatible arrangements that constrain both the rulers and the traders.

Olson's stationary bandit. It actively uses its ability to regulate the number and nature of organizations to create rents that it can tax, increasing its revenues at the same time that it reduces overall output (*ceteris paribus*). All of the predictions of *Rise and Decline* go through at this stage of economic development.

In addition, as is often the case when dealing with organizations, the social implications are more far reaching than the economic. Just as governments have an incentive to limit organizations to maximize revenues, governments (rulers) create and/or sustain social arrangements that limit access to the higher reaches of society to those that are politically connected, that is, to those from whom the government benefits. The noble aristocracy is a case in point.¹⁹ The infinite shades of status and position in an aristocracy are, at root, planted in one's usefulness to the monarch. Much misery, suffering, and unhappiness would be eliminated if human societies did not separate those that are "in" from those that are "out," but such distinctions seem so ubiquitous as to be inevitable. Which brings us to the final conjecture:

Conjecture 3) While governments may limit the extent of organization for perfectly understandable economic reasons, they are unlikely to open up access to organizations to everyone in society simply for fiscal expediency. That is, governments only open up organizational forms if there is a strong social consensus for reducing or eliminating the social hierarchy and privileges that come from limited organizational forms.

So, for example, when in their search for revenues British and French kings began expanding the aristocracy by creating new peerages, the existing nobles and lords resisted. As already discussed, in societies where governments are not regularly replaced by electoral or other measures, rulers live in constant awareness of assassination and overthrow. A social

¹⁹Olson, for example, discussed the aristocracy in Europe and the caste system in India

hierarchy in which those who are near the ruler depend on the ruler for social status as well as economic well-being, buys the leader some measure of insurance (not perfect). Social and economic privilege are a coin with which the ruler can purchase loyalty and safety, and no ruler can ever buy enough of those commodities. Privilege permeates most societies.

The existence of these privileges is perhaps the most fundamental problem in establishing a workable rule of law. In a privileged society, access to justice and other public services is limited by your position in the hierarchy. Not only is access to organizational forms limited, but only those individuals in certain organizations have access to justice. Your standing in the community was reflected in your standing in court. As North and Weingast point out, one of the major problems that debtors had in recovering their loans from the British Kings was that cases against the king were tried in the Star Court, whose judges were appointed by the king. The privilege of suing the king to recover your debts was unavailable to most people. The only creditors with a reasonable chance of repayment were those with the social and economic resources to make recourse to the courts immaterial, and their most effective threat was withholding future loans.