

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

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March 2015

## Abstract

What accounts for the differences in the “wealth of nations”; that is, the differing levels of opulence across countries? Adam Smith’s answer is complex and has yet to be fully understood. Moreover, Smith’s argument is as relevant today as it was in his time. On the economic side, his answer is well-known: the division of labor, the role of capital, and the absence laws and regulations that encumber competition and markets. Yet Smith’s appreciation for the lack of development did not confine him to economic issues, instead turning equally to politics. Violence is central to Smith’s approach to development, and Smith scholars have systematically under-appreciated the importance of violence in his approach to economic and political development. In the face of episodic violence, individuals have little incentives to be industrious, to save, or to invest. Smith argued that development required attending to three mutually reinforcing elements, liberty, commerce, and security. If commerce represents the development of markets, liberty and security provided the political, legal, and military infrastructure necessary to sustain markets in a potentially hostile environment.

## 1. Introduction

What accounts for the differing levels of opulence across countries? Why do so many countries fail to achieve opulence? In short, what accounts for the differences in the “wealth of nations”? Smith poses this issue as a puzzle in his *Lectures on Jurisprudence* (*LJ*)<sup>2</sup>: “Given the important effects of the division of labour, what an immediate tendency it has to improve the arts, it appears somewhat surprizing that every nation should continue so long in a poor and indigent state as we find it does.” [*LJ(B*) 521] With

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<sup>2</sup> Abbreviations for Smith’s works are given at the end of the text, just before the references.

persistently high levels of poverty throughout the world (Collier 2007), these questions are as relevant today as they were in Smith's time. So too, I argue, are Smith's answers.

Smith's answers to these questions are complex and multifaceted; and they have yet to be fully understood. On the economic side, his answer is well-known and includes the division of labor, the role of capital, and the absence laws and regulations that encumber competition and markets, such as mercantilism and barriers to free trade.<sup>3</sup>

Yet Smith did not confine himself to economic issues when addressing the problem of development, instead turning also to politics. His discussion of the transformation of feudalism into the commercial society hinges on politics, political exchange, and, also, on violence.<sup>4</sup>

As I shall demonstrate, violence is central to Smith's approach to these issues. Just as modern scholars of development systematically under-appreciate problems of violence (see North, Wallis, and Weingast 2009 – hereinafter NWW), scholars studying Adam Smith have systematically ignored or under-appreciated the importance of violence in his theories of economics, politics and development. Smith does not provide a systematic, abstract theory about the role of violence. Smith instead embeds his analysis of the politics and economics of development of Western Europe in a narrative, so the underlying theory is easy to miss.<sup>5</sup> Nonetheless, we can extract a theory of Smith's political economics of development from his many discussions of this topic,

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<sup>3</sup> See, for example, Aspromourgos (2009); Eltis (1975); Hollander (1973); Myint (1977); O'Brien (1975[2004]); and Rothschild and Sen (2006).

<sup>4</sup> Skinner (1975:168), in his famous characterization of Smith's argument about development, concludes that "the motivation behind many of the most important changes was in fact political rather than simply economic."

<sup>5</sup> Most economists studying the history of economic thought dismiss WN book III, one of the main sources of Smith's theory of political development in the *Wealth of Nations*. See, e.g., Blaug (1978), Brue and Grant (2007), and Robbins (1998). Although Schumpeter (1954, 187) observed that "This third Book did not attract the attention it seems to merit," he devotes only two other sentences to this topic. Skinner (1975, 1996) is an obvious exception.

especially, his analyses of European history from the fall of Rome through the rise of the commercial society.<sup>6</sup> Smith's analysis represents what economists and political scientists call applied theory – or, in this case, an “analytic narrative” (Bates, et al. 1998) – explaining the evolution of Western Europe from the fall of Rome to Smith's time.

Violence is a principal impediment to economic growth in Smith's approach. Moreover, violence arises in multiple ways; it can occur within a society as different lords, factions, religions, or regions fight one another; or it can occur when the government plunders its citizenry. Smith's answer to the puzzle of the “slow progress of opulence” or the lack of economic development involves violence: “The causes of this may be considered under these two heads, first, natural impediments [such as geography], and secondly, the oppression of civil government.” [LJ(B) 521]

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

The purpose of this paper is to develop Smith's answer to the questions asked at the outset about the differences in the wealth of nations. His analysis can be summarized as follows. The invasions of the Roman Empire ultimately forced it to collapse, and with it, the Roman system of property rights, division of labor, and exchange. Smith characterizes the consequences of the invasions and the violent

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<sup>6</sup> Smith presents sustained historical analyses in *WN* Book III; in Book V on the medieval Church; and in both *LJ(A)* and *LJ(B)*.

environment that followed, “The rapine and violence which the barbarians exercised against the antient inhabitants, interrupted the commerce between the towns and the country. The towns were deserted, and the country was left uncultivated, and the western provinces of Europe, which had enjoyed a considerable degree of opulence under the Roman empire, sunk into the lowest state of poverty and barbarism.” [WN III.II.1:381-2] Eventually, the feudal form of governance arose.<sup>7</sup> In this system, land represented the means to power, wealth, and security. Violence, as Smith emphasizes, was a constant presence under feudalism. The most powerful lords typically obtained the largest and best land, allowing them to support many retainers and large armies. The lords constantly fought each other and the king.

The feudal society can be characterized by the “violence trap” (Cox, North, and Weingast 2014 – CNW),<sup>8</sup> which works as follows. Economic growth requires both capital accumulation and economic integration that accompany an increasing division of labor; moreover, economic integration raises the costs of fighting. But violence threatens the value of the investments necessary for economic integration, especially integration across regions or factions that might fight each other. Smith again and again explains that, given the risk of violence, rational investors will not invest in economic integration:

In the infancy of society, as has been often observed, government must be weak and feeble, and it is long before its authority can protect the industry of individuals from the rapacity of their neighbours. When people find themselves every moment in danger of being robbed of all they possess, they have no motive to be industrious. There could be little accumulation of stock, because the

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<sup>7</sup> Smith argues that allodial arrangements arose following the fall of Rome. Eventually the feudal system replaced the allodial one. My analysis begins at this point, once the feudal system has been established. [WN III \*\*]

<sup>8</sup> Poverty traps are common in economics as explanations of the persistence of poverty and the lack of economic development (Azariadis and Stachurski 2005 provide a recent survey).

indolent, which would be the greatest number, would live upon the industrious, and spend whatever they produced. Nothing can be more an obstacle to the progress of opulence. [LJ(B) 522]

Given these incentives, the violence trap is self-sustaining and hard to escape; most incremental changes – a modest increase in investment or economic integration – are insufficient to escape the trap.

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

How did Western Europe escape the violence trap? According to Smith, the rise of towns represented the essential step in the political economic development of Europe. In the midst of the feudal equilibrium, the king and town (small groups of traders) engaged in a political exchange, forming a coalition against their common enemy, the local lords. The king granted the towns rights of self-governance, trading, and defense in exchange for taxes and military service. The new system represented a non-incremental change that simultaneously produced liberty, commerce, and security, allowing the town to escape the violence trap and a positive feedback system with increasing returns.<sup>9</sup>

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<sup>9</sup> “Increasing returns and economic progress” – the title of Young’s (1928) well-known paper – have long been a part of the literature on Smith. See also the “virtuous circle” of MacFarlane (2000:\*\*) and Rothschild and Sen (2006: 334-37).

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

This paper proceeds as follows. In the second section, I discuss the NWW and CNW approach to violence and economic development. Section 3 presents several abstract propositions summarizing Smith's arguments. Section 4 analyzes Smith's approach to the feudal equilibrium, while sections 5 and 6 explain his theory of the towns' escape from that equilibrium and interpret it, respectively. My conclusions follow.

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

Violence is a tool by which some groups survive by plundering the efforts of others (Hirschleifer 1994, Dixit 2004).<sup>10</sup> As CNW show, intra-state violence is remarkably high in the developing world. Violent takeover of leadership, for example, occurs once every seven years for the median developing country in the poorest half of the distribution of countries by income.

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<sup>10</sup> Students of development fail to incorporate violence in their approaches (as NWW emphasize). For example, almost all models of the political development of the state assume that the state is a unified actor with monopoly control on violence (Barzel 1999, Bates 2001, Levi 1998, North 1981, ch 5, Olson 1993, Tilly 1992). This reads the solution to the problem of multiple sources of intra-state violence back into history long before the problem was solved. These models therefore cannot explain the emergence of the modern, developed state with a monopoly on violence since they assume the result from the outset. To understand this aspect of development we must start elsewhere.

All developing states, past and present, must devise a means of mitigating the manifestation of violence, even if they cannot rid themselves of multiple and independent sources of violence potential. How they do so affects their ability to develop. NWW/ CNW argue developing countries limit violence by inducing individuals and groups with violence potential to cooperate rather than fight. They induce cooperation through rent-creation. Developing countries create and limit access to privileges, rights, state services, organizations, and competition; they distribute the implied rents to powerful constituencies with violence potential. Because violence typically lowers rents, rents targeted to those with violence potential makes the latter better off than fighting. NWW calls these societies *natural states* because this has been the dominant way of organizing states throughout history and remains so today.

CNW provide a bargaining approach to model the natural state; the model produces several results relevant for this paper. Suppose two groups compete for a total surplus normalized to 1. The two groups may either fight or bargain to an agreement. Let  $p$  be probability the first wins if a fight occurs;  $c_1$  is the first's costs; and, as is standard, the group which wins the fight captures the entire surplus of 1. The expected value of fighting to group 1 is  $p*1 - c_1 = p - c_1$ . A similar logic for 2 yields that 2's expected value from fighting is  $(1-p) - c_2$ .

To prevent violence, natural states distribute rents and privileges according to the *proportionality principle*, the idea that benefits from cooperation among those with violence potential must be distributed in proportion to power. To maintain peace and cooperation among the powerful, the following inequalities – the “no fight conditions” – must hold:  $R_1 \geq p - c_1$  and  $R_2 \geq 1 - p - c_2$ , where  $R_i$  is the value of the rents and

privileges going to powerful group i. These inequalities simply state that a bargain to support peace among 1 and 2 requires that the rents and privileges to each player be higher than the expected value of fighting.<sup>11</sup> If either of these inequalities fails, then one of the bargaining parties is better off resorting to violence, so the natural state is not stable. The inequalities also imply that more powerful groups – those with larger expected values of fighting – must, in turn, receive more privileges and rents to cooperate rather than fight.

CNW introduce a dynamic element to the bargaining framework. The world is constantly changing, even non-ergodic (North 2005), and all states experience episodic shocks, such as changes in relative prices, changes in military technology, or the appearance of a hostile and threatening neighboring regime. In natural states, these shocks often alter the relative power of groups with violence potential.

Sufficiently large shocks in a natural state's environment alter the distribution of relative power so that the proportionality principle no longer holds. In the face of such shocks, the old bargaining agreement breaks down so that the parties must bargain to reallocate benefits or risk violence. Absent any change in the allocation of benefits, at least one group now prefers to fight. If the effects of the shock on power are common knowledge, then it is possible for the two parties to reach a new bargaining agreement to prevent violence by transferring some rents and privileges from player 2 to player 1, so that the no-fight inequality holds again.

Yet peaceful adjustment is not always possible. A problem arises when the common knowledge assumption about the effects of the shock fails. In this case, three

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<sup>11</sup>Because war wastes value – i.e.,  $c_1 + c_2$  – we know that allocations of rents exist that make both players better off cooperating rather than fighting.

major problems make renegotiation difficult, low economic costs of violence, commitment problems, and asymmetric information. For example, given uncertainty about the implications of a shock, asymmetric information hinders renegotiation: one party might believe itself far more powerful after a shock than the other party so that the minimum bargain the first is willing to accept is higher than the maximum the other is willing to grant. These problems impede the success of bargaining so that the parties often fail to arrive at a peaceful a solution. This result is standard in the literature (see Fearon 1995; but also Powell 1999 and Moothu 1999).

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

What prevents most natural states from developing? The NWW framework, as refined by CNW, suggests that the problem of development involves two equilibria with very different characteristics. In the first equilibrium, a violence trap prevents nearly all natural states from developing; the need to solve the problem of distributed violence leads natural states to rent-creation policies that prevent development. An important route to non-violence and development is greater economic integration, which raises the costs of intra-state violence. But in the face of distributive violence potential, investments in greater economic integration do not occur. Violence makes them too risky. Herein lays the violence trap. Economic integration is necessary to raise the costs of violence; but people will not make these investments because the threat of violence makes the investments too risky. These states are caught in a low growth, non-development equilibrium.

In the second equilibrium, the costs of violence are sufficiently high so that violence is not a credible threat. Due to high economic investments and economic integration, even powerful groups face a negative expected value of fighting.

The great difficulty for development is moving from the violence trap equilibrium to the development equilibrium. Put simply, how is this achieved? The absence of deep theories of development involving violence means we have too little theory to help us answer this question.

NWW trace many of the steps necessary for this development, suggesting the critical importance of the *doorstep conditions*; namely, establishing rule of law for the elite; perpetual lives for organizations and the state; and neutral control of the violence potential by the state. To this insight, CNW adds that the natural state equilibrium means that incremental steps toward the doorstep conditions do not work. Because the natural state is an equilibrium, incremental changes do not lead to development.

A central feature of the doorstep conditions involves the concept of *perpetuity*. A perpetual organization is one that lives beyond the individuals who create it. A traditional business partnership, for example, is not perpetual because it ceases upon the death of one of the partners. In contrast, a corporation is perpetual because its life is independent of the lives of its shareholders. Perpetual organizations have substantial advantages over ones with limited life: for example, they can more easily raise capital, pool risks, and sustain a wider range of long-term contracts.

The concept of perpetuity applies not only to all organizations but to states. In particular, some states are perpetual, although most are not. Perpetuity in a state means that the institutions of the state are self-enforcing in the sense that no actor with

the power to disrupt the state has an incentive to do so. In a perpetual state, citizen rights and political and economic institutions are independent of the identity of those in power. In these states, new leaders have no incentive to alter the political rules of the game. Perpetuity also requires that turnover in political leadership is peaceful.

In contrast, natural states that rely on rent-creation to produce cooperation regularly experience violent leadership turnover frequently leads to sudden and major reallocations in political institutions, organizations, rights, privileges, and policies. As we have seen, states are subject to regular, if episodic, environmental shocks. Sufficiently large shocks require redistributions of rents and privileges, forcing the existing regime to redefine privileges and revise institutions regardless of what the constitution might say. Perpetuity in this environment restricts the regime's ability to adjust to shocks, making violence more likely. The absence of a perpetual state, in turn, means an absence of perpetual organizations. Significant political risk therefore attends long-term planning and investments in natural states.

More broadly, the rule of law requires perpetuity so that economic agents, for example, can depend that the rules today will also be in force tomorrow. A state lacking perpetuity cannot provide the foundations of a market economy: secure property rights and the enforcement of contracts. The main implication is that natural states are not characterized by the rule of law (see Weingast 2010).

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

In Book III of the *Wealth of Nations*, and parallel sections of his *Lectures on Jurisprudence*, Adam Smith provides a theory of the political economics of development

of Western Europe. The theory is easy to miss because Smith embeds his approach in an historical narrative. Most economists ignore or dismiss Book III.<sup>12</sup> Nonetheless, an important group of Smith scholars examine Book III carefully, helping to extract Smith's theoretical argument.<sup>13</sup> In this section, I draw on these works to explore several general theoretical propositions about the political economics of development proposed by Smith in his historical jurisprudence focusing on Western Europe. I illustrate and defend these claims in sections 4 and 5.

In reporting on Smith's understanding of development in Western Europe, I take the history as Smith conceived it, not as we think of these events today. Indeed, the importance of the history is not its fidelity with actual fact, but how Smith uses it to devise a theoretical explanation for the events of this era as he saw them.

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

**(2) The Feudal Equilibrium.** Smith shows why the violence of the feudal era created a stable political-economic equilibrium of very low growth. Because of the risk of plunder, men rationally avoided hard work, initiative, and investment. “[T]he occupiers of

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<sup>12</sup> Most economists studying the history of economic thought dismiss WN Book III. See, e.g., Blaug (1978), Brue and Grant (2007: \*\*), and Robbins (1998: \*\*). Although Schumpeter (1954, 187) observed that “This third Book did not attract the attention it seems to merit,” he devotes only two other sentences to it.

<sup>13</sup> See, e.g., Skinner (1975), Winch (1978: ch 4), Moss (1979), Haakonssen (1983: 165-71), Henderson (2006, chs 7-8), Aspromourgos (2009, ch 5), and Kennedy (2010, chs 5, 8, & 9).

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

**(3) Political exchange and the escape from the violence trap.** Although Smith never says so explicitly, his argument suggests that the escape from the violence trap was non-incremental. King and town made an alliance against their common enemies, the local lords. The political exchange accompanying the alliance reallocated and redefined rights and political authority; this exchange therefore encompassed an explicit revision of the constitution governing the towns. The alliance made the king more powerful – through revenue and military service from the town – and the towns gained a non-incremental increase in control over their own destiny.

Smith suggests three necessary conditions for the growth of towns following the political exchange with the King. The first required that the town to provide for its security. Given the plunder of the great landholders, the towns' survival required that they gain a local comparative advantage in fighting. Without this advantage, the towns could never have grown. Commerce was also necessary, for it provided the gains from exchange and hence the engine of town growth. With growth came the means for financing the towns' public goods, such as order, security, and justice, including strong property rights. Liberty – in the form of strong property rights, a system of justice, and the absence of predation – was also necessary; liberty provided economic actors, for example, with the incentives to save, invest, and take initiative.

The new arrangements were not solely a reconfiguration of existing actors. They represented both a change in the nature of organizations and of the tools available for organizations available to the towns. Towns created working governments, including court system, guilds, governing bodies, military organizations, and various business organizations.

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

In this section, I develop Smith’s argument that violence is a principal impediment to both economic growth and the escape from poverty.<sup>14</sup> Smith applies his approach to the history of the West from prehistoric times to his own (*LJ*). Along the way, he discusses the impediments to progress toward greater opulence.

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

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

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<sup>14</sup> This section draws on recent work of: Aspromougos (2009, ch5), Bell (1992), Haakonssen (1981:165-71), Henderson (2006,chs7-8), Hollander (1979), Hont (1988), Kennedy (2010,chs5,8&9), Winch (1978,ch4), and especially Skinner’s classic treatment (1975).

Reflecting the natural state logic described in section 2, no one could keep the peace. The king was insufficiently powerful to enforce their authority, law, and order throughout his domain. The result was violence and disorder. The great lords “were always at war with each other and often with the king, their whole power depended on the service of their retainers and tenants.” [LJ(A) iv.126-27:249] Kings could not keep the peace and were forced of necessity to “grant the power of jurisdiction to these lords; for as he had no standing army there could be no other way of bringing the subjects to obey rules. [LJ(A) iv.119:246]

This setting had implications for local political organization. In these times of violence, the king was insufficiently strong to impose his rule across the land. Of necessity, the great landlords ruled their territory, serving as executive, legislature and judge. The great landlords also led their tenants in war.<sup>15</sup>

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

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

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<sup>15</sup> “In those disorderly times, every great landlord was a sort of petty prince. His tenants were his subjects. He was their judge, and in some respects their legislator in peace, and their leader in war. He made war according to his own discretion, frequently against his neighbours, and sometimes against his sovereign.” [WN III.ii.3:383]

of plunder. Violence and plunder meant that people focused on subsistence “because to acquire more might only tempt the injustice of their oppressors.” [WN III.iii.12:405].

Those working the land could not acquire property. They had little incentive to work hard, indeed to work at all beyond their own maintenance. [WN III.ii.9:387-88]

More generally, Smith argues that to be independent individuals and groups needed to be powerful – that is, to possess their own violence potential to protect themselves from the violence of others. If they did not possess power, they were forced to ally with a powerful group for mere survival. [WN III.iii.8:401]

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

Military competition drove the political and organizational structure. Because of the constant threat to security, lords who failed to capture most of the surplus and use it to maintain their violence potential became vulnerable. The militarized environment afforded few gains from specialization and exchange; it also limited the possible organizations. The main agricultural products, such as grain, could not be carried profitably far over land. The absence of a state that could provide order and security (WN III.iv.9:418) meant great risks to specialization and exchange as transporting items risked being stolen in the attempt.

Virtually all secular organizations had to be associated with the local lord, or else they were destroyed or captured with their assets expropriated. As described by Smith, the feudal equilibrium reflects the logic of the natural state. Organizations existed largely to the extent they strengthened the violence capacity of the local lords. The feudal hierarchy illustrates this, involving organization of the projection of military force, the system of vassalage, the nature of rights in land (discussed below in 4.3) and the form of labor organization, which Smith considers a form of slavery. All these organizational elements reflected the feudal logic of violence.

This environment of political opportunism and predation provided poor incentives for saving and investment. Any investment or attempt to save surplus by peasants must be hidden or risk confiscation (*WN* III.iii.12:405). The feudal equilibrium qua violence trap and predation meant that investment and improvement were unprofitable. As noted in the introduction, it is clear that Smith understood the logic of traps. Violence prevented the accumulation of stock, without which the economy could not growth.

The model in section 2 suggests that the rents and privileges were distributed according to the proportionality principle and adjusted as shocks and changing circumstances required. When bargaining failed to make adjustments according to the proportionality principle, violence occurred. Agreements between lords and the king, among lords, or between lords and their retainers were constantly broken or adjusted unilaterally. Increases in inclusion could occur only if it reflected new sources of violence potential. A lord or king who sought incremental reform to increase rule of law, credible commitments to rules, or limits on their own use of violence made themselves

worse off in this environment of violence and the frequent need, in the face of changing circumstances, to adjust the distribution of privileges and rents.

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

**4.2. Economic effects of the feudal equilibrium.** Violence and predation had clear economic effects. The violence associated with the invasions and the fall of the Roman Empire produced a downward economic spiral as exchange – the necessary basis for the division of labor and of hence of opulence – became risky and vulnerable. Trade and communication fell precipitously, although they never disappeared. Speaking of the great lords, Smith says: “Their lawless and freebooting manner of life [of the great lords] also destroyed all the commerce and industry of the former inhabitants, who were obliged to leave the cities and seek possessions and protection in the lands of the several lords.” [LJ(A) iv.124:248] Put simply, plunder inhibited economic development. Saving was difficult, and individuals who could hoard money had to keep it hidden or risk plunder.<sup>16</sup>

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<sup>16</sup> In a rude state of society there are no great mercantile or manufacturing capitals. The individuals who hoard whatever money they can save, and who conceal their hoard, do so from a distrust of the justice of government, from

**4.3. Property rights in land.** Because land represented power in the feudal society, the form of property rights in the feudal system was central to its survival.<sup>17</sup> The form of rights reflected the needs of security over efficiency. In Smith's argument, the rights in land are endogenous to the larger feudal environment. Moreover, the form of property directly affected – and limited – the types of organizations that could be sustained.

Modern, developed open access orders have a complex system of legal infrastructure that facilitates exchange and efficient allocation of land based on a strong system of property rights. Some of the characteristics of this infrastructure include: (i) strong protections from expropriation and plunder by the state and by others; (ii) a system of titling, ownership rules, and a judiciary to enforce them; (iii) qualifications to rights based on preventing potential harms to others (harms recognized as externalities); (iv) the right to devise property by will among heirs; (v) rights of free alienation of land with an absence of encumbrances on selling the land and to whom the land may be sold; and (vi) a legal system that enforces contracts, including the exchange of land (see, e.g., Posner 2006; Barzel 1990, Alston *et. al.* 2015). Each of these characteristics facilitates the exchange of land from lower to higher valued users; in particular, to individuals who would improve the land.

The feudal system of property rights to land involved none of these characteristics. The problem of violence and the need to maintain security forced significant deviations from the set of characteristics just outlined. Lords regularly fought

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

<sup>17</sup> The discussion of Smith's views of property rights in land draws on Aspromougos (2009, ch5) and Henderson (2006, ch8).

one another, and the winners often forced the losers to transfer portions of their land; condition (i) therefore failed to hold. The absence of a government and a judicial system imply that conditions (ii and vi) failed. External harms (iii) were often dealt with through bargaining and violence, not through law.

A wide range of restrictions were imposed on the right of property holders to devise property by will, particularly *primogeniture*, which prevented division of the land among several sons; and *entails*, which prevented a landowner from dividing his property and alienating some of the pieces. The feudal system of land rights dramatically restricted the transfer of land from low valued users to higher valued users; and, also, of markets to engineer movement toward the optimal organization of parcels and, generally, more efficient production.

As Smith explains, the logic of the failure of conditions (iv) and (v) involve violence.<sup>18</sup> In economies where land is largely a means of subsistence, characteristics of land law can reflect the properties noted above. In contrast, “when land was considered as the means, not of subsistence merely, but of power and protection, it was thought better that it should descend undivided to one... The security of a landed estate, therefore, the protection which its owner could afford to those who dwelt on it, depended upon its greatness. To divide it was to ruin it, and to expose every part of it to be oppressed and swallowed up by the incursions of its neighbours.” [WN III.ii.3:382-83]

The relationship between lord and retainer, organizations, and power all centered on land. The feudal society bundled rights to land with service obligations to the lord.

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<sup>18</sup> The example of the deviation of rights in land from those best suited to markets to those best suited for feudalism is an illustration of Smith's contention that Europe did not take the natural path to opulence, but deviated from that path considerably (WN III.i.8-9:380).

Individuals did not own the lands in the modern sense of clear title with an absence of the ability of the government or other individuals to force the property holder to give up the land. The organization of production paralleled the military organization.

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

Primogeniture prevented lords from dividing their property among many heirs, requiring instead that all of a lord's property go to his first born son. In the violent feudal society, primogeniture enhanced security. One larger parcel had clear advantages, in Smith's account, to the same land divided up that land into many smaller parcels. Because each locality had to provide for its own security, small properties were not secure. They "could not defend [themselves] and must be entirely dependent on the assistance of some of the neighbouring great men... [A]s the only security in the other case was from the strength of the possessor, small property could be in no security. [LJ i.130-31,55] Smith then draws the main implication: "If therefore an estate which when united could easily defend itself against all its neighbours should be divided in the same manner as moveables were, that is, equally betwixt all the brothers, it would be in no state of equality with those to whom it was before far superior." [LJ i.131,55]

The same logic applies to entails. If primogeniture preserved a lord's estate at time of death; entails preserved the estate during his life. Entails "preserve[d] a certain

lineal succession, of which the law of primogeniture first gave the idea, and to hinder any part of the original estate from being carried out of the proposed line either by gift, or devise, or alienation; either by the folly, or by the misfortune of any of its successive owners" (*WN* III.ii.5:384).

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

**4.4. Summary.** The feudal world was violent, stable, and poor. In terms of section 2, we call this world an equilibrium characterized as a "violence trap" (CNW); or, in somewhat different terms, a "vicious circle of poverty" (Macfarlane 2000:98) and a "virtuous circle" (Rothschild and Sen 2006,336). This section suggests an essential tradeoff between security and growth. Endemic violence put a premium on security; while the means for providing security limited the possibilities for economic growth.

## 5. From Feudalism to the Commercial Economy

The transformation of Western Europe out of feudalism began with the chartering of towns, creating a significant, non-marginal constitutional and organizational change affecting a small but important subset of the feudal society. These changes had unintended consequences, helping specific parts of Western Europe – notably the towns and the territory surrounding them – to escape the violence trap. Small time traders during the feudal era, typically in “servile, or very nearly servile” relations to local lords, paid the lords for the right to trade (*WN* III.iii.2:397-98).<sup>19</sup> These traders, often living together in tiny towns, worked under remarkably unfavorable conditions of violence and predation. Potentially significant gains existed from specialization and exchange in long-distance trade. But the feudal systems threat of violence and plunder prevented these gains from being realized. The “wealth which [the traders] did manage to accumulate under such unfavorable conditions was subject to the arbitrary exactions of both the king and those lords on whose territories they might happen to be based on through which they might pass” (Skinner 1975:162, citing *WN* III.iii.2:397-98).

To take advantage of profitable opportunities in long-distance trade, the towns and traders needed various investments (port facilities, ships), a range of new organizations (judicial, firms, markets, military), and non-marginal increases in security from local violence and predation. Increased security, in turn, allowed the towns to govern themselves, producing islands of perpetuity, impersonality, and order for elites. The more secure political environment fostered investment, specialization and

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<sup>19</sup>Smith says in *LJ(A)* [iv.142-43:255] that the burgers: “were at first slaves or villains who belonged to a certain lord or master to whom they paid a sum of money for the liberty of trading. They lived in small towns or | villages for the convenience of trading, but in but very small numbers.”

exchange, and economic expansion. Rothschild and Sen (2006:334-37) capture this logic: "The progress of opulence can be seen as a virtuous circle, in which legal and political improvement leads to economic improvement, and economic improvement, in turn leads to further improvement in political and legal institutions" (Rothschild and Sen 2006:336)

I explore Smith's logic of the towns' escape from the violence trap in four stages; I evaluate Smith's logic in the following section.

**5.1. Political exchange between king and town.** Smith's explanation for the escape from feudalism involves three relatively independent groups: the king, the lords, and the towns. Under feudalism, as we have seen, the king and lords were constantly fighting each other; and each also plundered the towns, which were too small to defend themselves. Political uncertainty and the constant threat of predation from the lords hindered the town's ability to capture the gains from long-distance trade.

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

Smith makes four points about this political exchange, which I number:

[1] In order to understand [the kings' grant of independence to the towns], it must be remembered, that in those days the sovereign of perhaps no country in Europe, was able to protect, through the whole extent of his dominions, the weaker part of his subjects from the oppression of the great lords... [2] The inhabitants of cities and burghs, considered as [a set of] single individuals, had no power to defend themselves: but by entering into a league of mutual defence with their neighbours, they were capable of making no contemptible resistance. The lords despised the burghers... [3] The wealth of the burghers never failed to provoke their envy and indignation, and [the lords] plundered them upon every

occasion without mercy or remorse. The burghers naturally hated and feared the lords. The king hated and feared them too; but though perhaps he might despise, he had no reason either to hate or fear the burghers. [4] Mutual interest, therefore, disposed [the burghers] to support the king, and the king to support them against the lords. They were the enemies of his enemies, and it was his interest to render them as secure and independent of those enemies as he could. By granting them magistrates of their own, the privilege of making bye-laws for their own government, that of building walls for their own defence, and that of reducing all their inhabitants under a sort of military discipline, he gave them all the means of security and independency of the barons which it was in his power to bestow. Without the establishment of some regular government of this kind, without some authority to compel their inhabitants to act according to some certain plan or system, no voluntary league of mutual defence could either have afforded them any permanent security, or have enabled them to give the king any considerable support. By granting them the farm of their town in fee, he took away from those whom he wished to have for his friends, and, if one may say so, for his allies, all ground of jealousy and suspicion that he was ever afterwards to oppress them, either by raising the farm rent of their town, or by granting it to some other farmer. [WN III.iii.8:401-02]

Let's unpack this passage into Smith's four points. First, Smith describes the initial conditions involved a natural state logic based on violence potential. Autocratic lords oppressed those within their domain. Second, Smith suggests how new possibilities arose for the defense of towns against the lords. Third, Smith discusses the interests of the three parties, king, lord, and town, explaining that mutual self-interest drove the king and town together in alliance against their common enemies, the local lords. And finally, Smith explains the basis for political exchange between king and town in which the king granted the town political freedom in exchange for fixed taxes and military support.

The feudal environment afforded the possibility for generating substantial gains for the town through commercial trade, greater specialization and division of labor, and exchange. These opportunities provided the King and the towns with strong incentives to engineer a political exchange: The king granted the town political freedom, self-

governance, and independence in exchange for financial and military support against the barons (*WN* III.iii.3:399). This freedom allowed the town to provide its own rules, property rights, governance, justice, and the rule of law. All of these activities required organizations and, the town itself can be thought of as an organization of the organizations, as I discuss in the next section. The right to build walls and military organizations allow towns to protect themselves against the local lords, but also the king.

In exchange, the towns lent the king military support and paid the king taxes, which were to be fixed for all time, lowering the king's ability to expropriate the gains of investment through ex post rises in taxes. According to Smith, the tax agreement became perpetual and impersonal.<sup>20</sup> [*WN* III.iii.4:400]

**5.2. Towns escape the violence trap.** The advantage of the political exchange to members of the town is obvious: they obtained greater security, protection for their investments, and growth of their economy. The king gained a security alliance with the towns and larger resources up-front with which to deal with the local lords.

These agreements led to the first real emergence of liberty in late medieval Europe. "Order and good government, and along with them the liberty and security of individuals, were, in this manner, established in cities at a time when the occupiers of land in the country were exposed to every sort of violence." [*WN* III.iii.12:405] Smith explains insights now central to modern political economics of development. When men capture the fruits of their efforts, they exert themselves to "better their condition" and to

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<sup>20</sup> An interesting irony arises with respect to the king's granting freedom to the towns. Although these acts created liberty for the townsmen, the king did so by a natural state act of arbitrary behavior. The king's action transformed traders in servile relationships to the lords into free men; the king therefore appropriated the value of these relationships from the lords.

“acquire not only the necessaries, but the conveniences and elegancies of life.” In contrast, in the feudal environment, people had little incentive to work hard. Those living near towns who managed to accumulate a small amount sought protection of the towns as sanctuaries. [WN III.iii.12:405] Smith notes the result with some irony, “the sovereigns of all the different countries of Europe … have … voluntarily erected a sort of independent republics in the heart of their own dominions.” [WN III.iii.7:401]

Another aspect of the political exchange is that, as the towns grew richer and more powerful, the king granted the burgers political representation in “the general assembly of the states of the kingdom,” in part as a counterbalance to the great lords. The towns’ charters, backed by their growing power, meant that the king could impose no additional taxes (beyond those specified by charter) without the town’s consent.<sup>21</sup>

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

Smith argued that the towns’ military advantage over the local lords fostered the extension of the towns’ reach: “The militia of the cities seems, in those times, not to have been inferior to that of the country, and as they could be more readily assembled

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<sup>21</sup> “In countries such as France or England, where the authority of the sovereign, though frequently very low, never was destroyed altogether, the cities had no opportunity of becoming entirely independent. They became, however, so considerable that the sovereign could impose no tax upon them, besides the stated farm-rent of the town, without their own consent. They were, therefore, called upon to send deputies to the general assembly of the states of the kingdom, where they might join with the clergy and the barons in granting, upon urgent occasions, some extraordinary aid to the king. Being generally too more favourable to his power, their deputies seem, sometimes, to have been employed by him as a counterbalance in those assemblies to the authority of the great lords. Hence the origin of the representation of burghs in the states general of all the great monarchies in Europe.” [WN III.iii.11:404]

upon any sudden occasion, they frequently had the advantage in their disputes with the neighbouring lords." [WN III.iii.10:403ea] The towns more easily coordinated men, weapons, and supplies; and they could assemble their forces more quickly than the local lords. And over time, the towns became far richer than the local lords. All this granted the towns a military advantage, allowing them to extend their reach into the local countryside, provide a growing area secure from the predation of local lords.

The extension of local security from external violence and predation transformed the agricultural areas surrounding the town. In combination with the town's system property rights, security fostered growing specialization and exchange whereby the agricultural products went to the town (for consumption and for long distance trade), and the products of the town moved to the countryside. Allen (2009:106) explains the reciprocal and positive-feedback relationship; the growth of cities fostered the growth of local agriculture production; and, at the same time, a more productive agriculture led to greater urbanization.

**5.4. The growing reach of the towns transformed economic and social relations, undermining feudalism.** The towns' military superiority subdued the nearby lords, with far-reaching though unintended consequences. Indeed, this superiority solved the security problem for nearby lords. The extension of a town's influence and security umbrella into a local lord's area diminished the lord's need for military organization and defense against neighboring lords. In the new security environment, the lords reorganized their local polities, dismantling the organization of society around the projection of military force. Retainers, once a necessary part of security, became an

expensive burden with little benefit, so the lords de-militarized and let go of their retainers. [WN III.iv.10:418]

The non-incremental changes in local security, Smith argues, had further unintended consequences in the countryside surrounding the towns: “commerce and manufactures gradually introduced order and good government, and with them, the liberty and security of individuals, among the inhabitants of the country, who had before lived almost in a continual state of war with their neighbours, and of servile dependency upon their superiors. This, though it has been the least observed, is by far the most important of all their effects.”<sup>22</sup> [WN III.iv.4:412]

As the towns expanded their security and legal umbrella, a “regular government was established in the country as well as in the city, nobody having sufficient power to disturb its operations in the one, any more than in the other” (WN III.iv.14:421). The umbrella fostered a revolution in the organization of the country-side surrounding the towns.

The towns’ security umbrella destroyed the military and economic bases for feudalism in the countryside surrounding the town, transforming the social relations of feudalism. Many non-monetary exchanges central to the feudal economy – such as military service obligations of retainers in exchange for support and land – diminished or disappeared. Lords had incentives to grant – and tenants had incentives to pay for – longer leases, which encouraged investment, specialization and exchange (WN III.iv.1-

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<sup>22</sup>Smith here observes that “Mr. Hume is the only writer who, so far as I know, has hitherto taken notice of it.” [WN III.iv.4:412] In his famous essay “Of Commerce,” David Hume (1752a:255) argues, “The greatness of a state, and the happiness of its subjects … are … inseparable with regard to commerce; and as private men receive greater security, in the possession of their trade and riches, from the power of the public, so the public becomes powerful in proportion to the opulence and extensive commerce of private men.” See also Hume (1752b,277-78).

2:410; III.iv.13:421). The lords leased out their lands and lived off the rents combined with the profits from the portion of their estates that they managed directly. In the absence of expensive military obligations, local lords became consumers, taking advantage of the growing opportunities provided by the town's commercial economy.

Smith's central pillars of economic growth, the division of labor and capital accumulation, appear throughout this process. With the growth of market exchange surrounding the towns, the division of labor greatly deepened, as did capital accumulation, investment, and specialization and exchange. The towns provided security in nearby agricultural areas, fostering the transformation of self-sufficient farmers into specialists in complex and growing markets. [WN III.iv.13:420-21] Greater division of labor made these farmers better off. Better rules on devising property upon death also emerged. At the same time, prosperous burghers moved into the countryside, bringing with them their ambitions and their culture of investment, specialization, and exchange (WN III.iv.3:410).

The consequences were revolutionary.<sup>23</sup> “[W]hat all the violence of the feudal institutions could never have effected, the silent and insensible operation of foreign commerce and manufactures gradually brought about. These gradually furnished the great proprietors with something for which they could exchange the whole surplus produce of their lands, and which they could consume themselves without sharing it

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<sup>23</sup>“A revolution of the greatest importance to the publick happiness, was in this manner brought about by two different orders of people, who had not the least intention to serve the publick. To gratify the most childish vanity was the sole motive of the great proprietors. The merchants and artificers, much less ridiculous, acted merely from a view to their own interest, and in pursuit of their own pedlar principle of turning a penny wherever a penny was to be got. Neither of them had either knowledge or foresight of that great revolution which the folly of the one, and the industry of the other, was gradually bringing about... It is thus that through the greater part of Europe the commerce and manufactures of cities, instead of being the effect, have been the cause and occasion of the improvement and cultivation of the country.” [WN III.iv.17-18:422]

either with tenants or retainers.” [WN III.iv.10:418] Over time, as is long-distance trade grew, the town became richer, it produced more manufactured goods, and many carried local agricultural surplus to foreign destinations. As this process occurred across Europe, overall trade expanded; and with this expansion of the market, so too the division of labor. The commercial trading economy grew richer. Feudalism disappeared in many areas.

## 6. Interpreting the Transformation of the Towns

To explain the towns’ escape from the violence of the feudal basic natural state, we need two different but complementary arguments, one at the micro-institutional level involving organizations; one at the macro-institutional level involving political exchange and the (small-c) constitution. Addressing changes at both the micro and macro level is necessary to understand the rise and economic growth of towns. I consider them in turn.

**6.1. Micro-institutional analysis.** The micro-institutional level involves the organizational revolution following the town’s provision of liberty, exploiting commercial opportunities, and enhancing security. Building commercial towns capable of providing liberty, maintaining security, and supporting long-distance trade required an organizational revolution – the growth of the civil society – with dozens if not hundreds of new types of organizations. This organizational revolution reflects the growth of the civil society. The success of the town’s governance, security, and commerce all rested on this organizational revolution. Moreover, the sets of organizations must also fit together well in the sense that they complement one another rather than get in each

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

**The medieval town as an organization of organizations.** At the highest level, the town's corporate charter formed the town as an organization vested with various rights, including the right to self-governance and to provide security. All the other organizations flow from this charter, so the town was an organization of organizations. Many of these organizations were independent of the state, although sanctioned by the official system restricting access.

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

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

namely liberty as freedom from predation and expropriation; secure property rights; and protection against the arbitrary action by the state.

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

If commerce represents the development of markets in Smith's approach, we can think of liberty and society as providing the legal and military infrastructure necessary to sustain markets. As sections 4 and 5 demonstrate, Smith argued that markets require the legal infrastructure of justice, secure property rights, and protection from predation. Commerce and economic growth also depend on a military advantage by which the commercial society could defend itself in a world of potential hostile groups, both internal and external. Smith in this manner explains the economic and political development of Europe.

A central piece of the towns' success was the ability to create and enforce a system of liberty, ensuring private property rights and limited risk of predation and expropriation. Although Smith does not explain how, the system of liberty provided for perpetuity and impersonality (at least for the elite), two critical ingredients in the rule of law (Weingast 2010). Liberty provided merchants with the incentives to specialize, to engage in long-distance trade, and to accumulate capital. The towns experience economic growth in two related senses. The economy grew through division of labor and capital accumulation but also through extension into the surrounding countryside.

**Commerce:** Although Smith does not discuss this aspect of town organization, central to the towns' economic and political success were the guild organizations and merchant firms. These organizations created and coordinated much of the town's economic activities and many of its political functions. In addition, the trading towns created the exchanges represented in long-distance trade. All of this had to be organized efficiently so that the towns could compete successfully on the international market and with neighboring towns which were often close substitutes.

The infamous apprenticeship system represented another set of organizations at once creating barriers to entry, ensuring the education of an apprentice into the skills of the trade or craft, and organizing the entry of potentially talented individuals into the business. Smith famously criticized this system (e.g., *WN* I.x.c.1-17:135-40).

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

In addition to these sets of organizations, towns made use – indeed, often required – a wide range of other organizations. Some provided public goods, such as schools and hospitals. Other organizations involved various products and services sought after by citizens, such as clothing, shoes, linens, ale houses, inns, and food establishments. Finally, the Church was generally represented through organizations, notably the local parish. Over time, as the town grew larger, other Church organizations established a presence in the towns, such as the mendicant order (see Ekelund, Hébert, Tollison 2006).

## 6.2. Macro-institutional analysis: Political exchange and the constitution.

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

In this subsection, I interpret Smith's account of the feudal equilibrium and initiation of the transformation to the commercial economy. In NWW terms, the feudal equilibrium was a natural state, not very differentiated, and hence quite poor. Many localities experiencing considerable violence were fragile natural states, while the more stable ones were basic natural states. In comparison with a mature natural state, the feudal state had relatively few organizations, with military organizations being among the most well-developed.

Executive moral hazard was a major problem during feudalism, and at many levels<sup>24</sup>; for example, the local lord was at once the local executive, law-maker, and judge with all the usual problems of governance that such an arrangement implies. Predation was an omnipresent problem. Fighting and violence characterized this world. In Adam Smith's view, the feudal world provided minimal incentives for investment, specialization, and exchange. Most people lived at subsistence. As explained in section, this pattern is consistent with our bargaining approach.

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<sup>24</sup> Besley and Persson (2011) provide an extended study of the relationship of executive moral hazard and economic performance.

Liberty, commerce, and security brought the towns from fragile and basic natural states to a state on the doorstep. They engineered perpetuity, both of the state and of organizations. The result was rule of law, the growth of the commercial economy, and control of the military.

### 6.3. The Emergence of Towns

The towns also engineered political development, creating new governance structures that differed radically from those of the feudal system. I define political development as involving the increases in state-capacity necessary to parallel economic development of markets. This state-capacity must therefore include the ability to protect property and to enforce contracts. As we have seen, the growth of towns involved all these features. Perpetuity, impersonality, and inclusion in governance all appeared to varying degrees. These changes resulted in justice, secure property rights, and mechanisms for contract enforcement within the town. Economic and political development proceeded in tandem, fostering investments, specialization and exchange, and the growing reach of markets and the price mechanism (*WN* III.iv).

The towns' economic and political development arose simultaneously as part of a single process; neither antedated nor caused the other. Smith appreciated the "reciprocal relationship between commerce and liberty," and much of the *Wealth of Nations* examines how economic liberty fostered "the growth and diffusion of commercial prosperity," especially Books I, II, and IV (Winch 1978,70). Yet, Winch

argues, the literature has neglected Smith's arguments about the reverse relationship, namely how commerce helped promote liberty and property rights (Winch 1978,70).<sup>25</sup>

The political exchange between king and town granted the towns the ability to make non-incremental changes that, in turn, allowed the towns to enter the positive feedback loop leading to a new and better equilibrium than feudalism. The political exchange altered the condition of the towns sufficiently that they became more powerful than the local lords. A central feature of the town's economy was economic integration. The specialists in long-distance trade depended on the town's military organization for security and the town economy for many raw materials and food. Local specialists in food and raw products depended on the town's demand for their products. Put in Smith's terms, economic integration at once expanded the scope of the market, created greater division of labor, and fostered investment, all features of economic growth.<sup>26</sup>

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

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<sup>25</sup> Skinner, an exception, explains that the arrangements Smith "had themselves been developed and protected in an attempt to solve a political problem" generated from the economic desire to foster trade (Skinner 1975, 164). Many of Smith's contemporaries connected commerce and liberty, including Montesquieu (1748), Hume (1752a,b), Cantillon (1755), and Abbé de Condillac (1776). Hirschman (1977) reviews this literature.

<sup>26</sup> Smith clearly understood the nature of economic integration. For example, he explains the surprising level of economic integration in the modern commercial economy through his analysis of all the inputs necessary to produce a woolen coat (WN I.i.11:22-24). See Kennedy (2010, ch 6, especially table 6.1) for an extensive discussion.

their economic and military power to create markets and political freedom (for the elite, at least).

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

The non-incremental change – reflecting simultaneous changes in perpetuity, impersonality, inclusion, and in investment, specialization and exchange, and military organization – allowed the towns to escape the violence trap and enter the positive feedback loop. Once the towns were organized and generated sufficient security, they extended their reach into the countryside, increasing the size of the market and the division of labor. Expanding long distance trade increased the town's wealth. All these changes led the town to extend yet again the reach of larger security umbrella, with greater expansion of its reach into the countryside, further deepening the division of labor, and so on through the positive feedback loop. The result, as Winch argues, is that the, "Commercial society is not merely one in which more people are engaged in producing capital goods... it is one in which more people are drawn into the wider circle of commercial relationships. It is the situation arrived at once the division of labor has been thoroughly established, and men can supply only part of their needs from their own produce. It is the form of society in which 'every man ... lives by exchanging, or becomes in some measure, a merchant'" (Winch 1978,80; quoting WN I.iv.1:37).

A final and important aspect of the non-incremental changes in governance is that they created the doorstep conditions. As noted, the towns created liberty, justice and property rights for the elites, hence significant elements of the rule of law (doorstep condition 1). They also created perpetuity, often through the use of the town's merchant guild (doorstep condition 2).<sup>27</sup>

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

## 7. Conclusions

Adam Smith's *Wealth of Nations* is, among many other things, a study in why so many countries remain poor and why a few have become "opulent" or rich. Smith addressed this question in many different ways in his rambling work. Although many scholars focus on just one of these discussions, Smith's discussions make it hard to say any one of his answers is the definitive explanation. In Book I, he explains how the division of labor

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<sup>27</sup> Greif's (2005, ch 9) important analysis of the community responsibility system shows has the system was independent of the identity of the guild's members.

produces opulence. In Book two, he emphasizes the importance of savings and capital accumulation. Book four emphasizes the central importance of appropriate public policies, explaining, for example, why mercantilism makes states worse off and hinders their progress toward opulence. Each of these arguments resonates with modern economics. Further, each presumes a context of a state with high state-capacity; namely, a serviceable judiciary, property rights, and liberty – Smith's "peace, easy taxes, and a tolerable administration of justice" (as reported by Stewart 1793,322).

The force of this paper is that Smith provides a fourth explanation for why so many countries fail to become opulent, one that differs in kind from the other three. In Book III of the *Wealth of Nations*, Smith discusses the necessary political foundations of markets and how, absent these foundations, countries cannot grow. He presents this argument, not in the abstract as he does with, say, the division of labor; but in an historical narrative about feudalism and the rise of towns. Smith embeds in the narrative a theory that drives the logic of the development of a commercial society out of the natural state of feudalism.

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

The towns arose through political exchange between king and town that granted them the right to a corporative form of self-governance. This exchange allowed the towns to create a non-incremental change and escape the violence trap through a

three-fold revolution that simultaneously created liberty (including justice and the security of property rights), commerce and hence economic growth, and security from the menacing outside world. The town grew through long-distance trade, specialization and exchange, capital accumulation, and expansion into the local countryside where it helped transform the local economy from poor, self-sufficient agriculture into specialists in food and inputs into manufacturing shipped to the town and often entering long-distance trade.

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

Towns also represented an explosion of new organizations – the corporate form, as mentioned, the overall government, specific units within the government, such as the executive, the judiciary, and a town council. Merchants organized their guilds and their

firms; and the town's military organization provided defense. The Church also had its organizational reach into the town. As noted above, the town became an organization of organizations. In Levy's (this volume) terms, towns can be seen as organizations at once in vertical competition with the local lords and an oppositional, if generally cooperative one, with the King. As with Levy's analysis of the privileges of the *Corp Intermediere*, towns gained privileges, but ones that helped them sustain a better or more opulent social and economic outcome.

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

Adam Smith's discussion of the transformation of feudalism to the commercial society fits well with aspects of the emerging literature on the political economics of development; and it adds ideas relatively lacking. Economic and political development are not separate tasks in Smith's view, but inextricably intertwined as a single process (see such diverse scholars as Bates 2001, Acemoglu and Robinson 2006, 2012, Tilly 1993). Attempts to reform one without reform of the other generally fail. Smith's view of the rise of towns and the commercial society out of feudalism demonstrates that the escape from the poverty and violence of the feudal society required simultaneous

changes in economics, politics, and security. When the three elements coexist, growing opulence is the result. Similarly, when any of the three elements is missing, growing opulence fails.

Finally, the central importance of violence in Smith's approach is relatively lacking in the literature (but see CNW and NWW).<sup>28</sup> Reflecting the tradeoff between security and efficiency, societies facing existential threats take actions to defend themselves, and these actions – as Smith argues – force substantial deviations from political institutions and policies that generate opulence or long-term economic growth., Europe failed to develop due to violence and oppression.

## Abbreviations

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

The works of Adam Smith. All references to the Glasgow edition, as reprinted by the LibertyFund.

LJ	Smith, Adam. 1762-63; 1767. [1981]. <i>Lectures on Jurisprudence</i> . R. L. Meek., D.D. Raphael, and P.G. Stein, eds. Indianapolis: LibertyFund. The lecture notes are comprised of two parts:
LJ(A)	The first set of lecture notes, corresponding to the 1762-63 term;

<sup>28</sup> Some obvious exceptions exist to the dominant view that ignores violence, such as Collier (2007) and Hirschleifer (1994). Other exceptions involve rationalist explanations for interstate war (Fearon 1994, Powell 1999, Wittman 2009) and a large literature on the relationship between interstate conflict and development outside of economics (e.g., Bates 2001, Tilly 1993).

LJ(B) The second set of lecture notes, dated 1767 though thought to correspond to the 1763-64 term.

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

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