

# *The Natural State:* *The Political-Economy Of Non-Development*

Douglass C. North, John Joseph Wallis, and Barry R. Weingast

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## **1. Introduction**

The fundamental question of both economic history and economic development can be asked in two ways: how did a handful of countries achieve sustained rates of economic growth and development in the late 18<sup>th</sup> and early 19<sup>th</sup> centuries? and why have most nations failed to achieve sustained economic growth? This essay seeks an general answer to the second question.

For two million years, human societies lived as hunters and gatherers. Beginning 10,000 years ago, a few societies made the transition to a new social order, creating the first economic revolution: the rise of agriculture and states. Since 1700, the spread of modern technology and civilization wiped out nearly all the remaining primitive societies, but in their place remain large numbers of societies that are incapable or unwilling to participate fully in the second economic revolution: the rise of thriving markets and open access political systems.

Modern economic development is the outcome of the second economic revolution, development defined as sustained, long-term growth generated by stable, thriving, and competitive markets over multiple generations. A competitive market economy is central to

economic development, and competition requires free entry. Our focus, therefore, is on the political and economic institutions governing entry.

Although the first and second economic revolutions are identified with technological change – in agriculture and industry respectively – what distinguishes social orders on either side of the revolutions is the structure of their governments and the complexity of their societies. Primitive orders do not possess governments, and the degree of specialization and division of labor in their economies is extremely limited. The civilizations that first begin to appear 10,000 years ago, what we call “natural states,” represent major achievements that allow humans to capture the productivity benefits of the first revolution. Natural states support a range of economic specialization, including a readily identifiable group who compose the government. The natural state strictly limits access to positions of power within political, economic, and religious systems.

What we call “open access orders,” began to develop around 1700. These societies are characterized by open political and economic competition, rather than the limited political and economic privileges enjoyed solely by elites in natural states. Open access state provide the basis for thriving markets and hence sustaining long-term economic development over many generations.

Addressing why states fail to develop requires a theory of the state. The state chooses whether to maintain a system of property rights, to enforce contracts (and whose), to allow freedom to organize economic and political activity, and a stable macroeconomy. Moreover, any state strong enough to provide these valuable public goods is also strong enough to confiscate the wealth of all its citizens (Weingast 1995).

Unfortunately, political scientists and economists have failed to develop a theory of the state adequate to answering these questions. The most common models, used by both political scientists and economists, take the state as given. These models assume that the state has a monopoly or comparative advantage on the instruments of coercion and that those in power seek to maximize some form of tax revenue or rent share.<sup>1</sup> Both Barzel (2000) and Olson (2000) argue that rulers maximizing their take will create and enforce general property rights associated with the market: a larger economic pie implies more for the ruler. These models predict that all states should be developed, so they obviously fail to explain the striking fact that most states fail miserably at economic development.

These models fail because they start in the wrong place. Positing the existence of a stable state cannot explain how it gains control of the instruments of coercion, how it survives, and how it enforces its decisions, including the rights and privileges extended to various members of society. To explain these aspects of the state and why states fail to develop requires a deeper approach.

We argue that the state's foremost task is securing its own survival. In doing so, natural states also provide social order. A *natural state* is a specific way of structuring political and economic systems so that the economic rents created by limited entry are available to secure credible commitments among politically powerful groups. Potential rivals in a natural state stop fighting (or fight less) when the economic rents they enjoy depend on the continued existence of

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<sup>1</sup>These models include Barzel (2000), Brennan and Buchanan (1980), Congleton (2004), Levi (1990), North (1981, ch 3), and Olson (1993,2000). The various "rent-seeking" models also fit here, e.g., Tollison (1980), Buchanan, Tollison and Tulluck (1980). Acemoglu (2005) provides the most sophisticated embodiment of this approach, but still takes the state as given.

the state and of social order. Natural states limit economic entry to create rents and then use those rents to credibly commit powerful groups to support the state. In other words, natural states use the economic system as a tool to solidify the stability of the ruling coalition.

Natural state's create property rights to the exclusive use of land, labor, and other valuable resources, as well as rights to perform valuable economic functions, such as trade. These rights are only available to members of the dominant coalition. Limiting access to rights increases economic rents associated with the rights. The rents bind particular constituent groups to the ruler because they have something to lose if the ruler is replaced. Creating a wide range of rents allows the ruler to create a support constituency potentially capable of both maintaining power and supporting the wealth associated with specialization and exchange. The natural state therefore establishes and enforces a property rights system, whereby specific groups with specific ties to the ruler have specific rights and privileges (e.g., a group is granted the exclusive right to trade in cloth). The ruler protects the rights and privileges against encroachment by others. The ruler has incentives to honor these rights, because constituent groups whose rights are infringed can punish the ruler by withdrawing their support, thereby lowering the probability he survives.

The natural state is natural because it is based on personal exchange: privileges are granted to specific groups and differ across groups. These exchanges are enforced by the same type of mechanisms used in the primitive order, namely, face to face repeat play mechanisms. Moreover, economic exchange is also based on personal exchange mechanisms: the natural state cannot sustain impersonal exchange associated with open access orders.

Our approach implies that the natural state is self-limiting in several senses. First, a natural state's support group cannot grow too large. Increasing the size of the coalition not only dissipates the rents, it lowers the costs that every member of the coalition can impose on the ruler. Lowering this cost, in turn, threatens the entire system because it threatens the principal means that constituents use to police their rights. The set of constituents must therefore be a small portion of the society.

Second, the state is self-limiting in that it cannot honor rights to individuals outside of the narrow set of constituents. These people have no ability to punish those in power, and therefore the state has no incentive to honor any rights for them. Historically, most people living in natural state, e.g., peasants, lived at subsistence level.

Third, the natural state is self-limiting with respect to the economy. Natural states represented an important advance at the time of the first economic revolution, and remained important for centuries. But in the modern world, they have a wide range of negative economic consequences. First, the drive to create rents means that the natural state restricts markets. Indeed, the search for political stability leads the state to control as many markets as possible. The natural state's systematic "market intervention" is not the result of mis-guided policymaking, but fundamental to how they create political order and stability. Natural states therefore cannot support competitive markets based on open entry. This logic also implies that natural state view markets as instruments of political control, not sources of citizen welfare. All citizens outside of those who are privileged constituents have no incentive to invest since they cannot capture the fruits of their investment.

Because economic development requires thriving markets with open-access, natural states necessarily thwart development. Thriving markets reduce the rents available to create the natural state's political security. Markets also provide people with income apart from any direct dependency relationship on the state, creating a resource base that allows some to challenge the state.

In the last three centuries a handful of *open access orders* have emerged that provide for open access in both economics and politics. Open access in economics requires that the economy contain competitive markets, rather than highly controlled markets to create rents for favored constituents. Open access in politics requires that citizen's rights do not depend on a political relationship to those in power, but derive from the fact of citizenship; and further, that citizens have the right to organize and compete for political power. In contrast, the natural state controls access in both politics and economics, so that rights are privileges. The move from the natural state to an open access order is therefore a move from the world of privileges and personal exchange to one of rights and impersonal exchange.

Although the natural state represented a significance advance over primitive orders, enabling societies to capture the potential of the first economic revolution, they have become in modern times an impediment both to economic development and to human welfare generally. Their fundamental basis in personal exchange as the means of organizing both politics and economics means that natural state cannot be easily or incrementally adjusted in a way that produces impersonal exchange in either politics or economics. The complex set of interdependent relationships in the natural state are an impediment to reform.

In a real sense, the problem of explaining the transition from natural states to open access orders is the most important question in economic history. But this cannot be our starting place. To understand the transition, we must first understand where history has been, we must first understand the forces that create and maintain the natural state. Characterizing open access orders and the transition from the natural state to an open access order are the subject of later papers.

We develop our arguments as follows. Section 2 provides the definitions of the three orders mentioned above, the primitive order, the natural state, and the open access order. Section 3 develops the logic of our model. Our conclusions follow.

## **2. The Concept of Social Orders**

Integrating political and economic theory requires the semantic identification of a level of social organization more general than a political or economic system. The term we use is social order. A social order encompasses the political, economic, cultural, religious, military, and educational systems. A social order reflects the characteristic organizational pattern of its constituent systems. We identify three social orders and their associated characteristics:

*The Primitive Order:* Primitive orders are characterized by small groups. The typical group is 25 individuals, a band. Tribes of 500 or more may form, but intergroup ties are weak or non-existent. Repeated interaction of individuals in small groups produces personal exchange and political and social interactions based on reputation and social capital. Although there is

some specialization of economic activity by sex, primitive orders are not otherwise characterized by specialization. Limited specialization and small groups are the defining characteristics of primitive orders.

*The Natural Order (natural states)*: Natural states are characterized by larger states and more complex organization. The size of the natural states vary widely. Specialization is present, including a well defined difference between members of the dominant coalition and everyone else: between the governors and the governed. The dominant coalition is not homogenous. Socially powerful groups interact with each other to limit entry and use the rents created from limited entry to create credible commitments between powerful groups. We call these groups “elites,” and they can be political, military, religious, commercial, industrial, or educational elites. Elites are not an ex ante category of individuals, but emerge from the analysis as that subset of the population who has privileged deals.

Elites are characterized by personal relationships with the existing government. Natural states maintain personal interactions within a hierarchy of relationships, so that the overall social organization can be quite large. Specialization with limited political, economic, and social entry is the defining characteristic of a natural state.

The natural state is the natural response to increasing specialization and division of labor. The natural state relies on the same type of mechanisms for enforcing relationships as in the primitive order, namely, personal, face to face, repeated interaction. Those repeated interactions, however, are limited to a dominant coalition of political, economic, and religious elites whose commitment to the existence of the state is insured by the rents they enjoy. Political and

economic rights depend on the personal relationship of each individual to those in power. None have rights by virtue of being a citizen.

*The Open Access Order* (competitive price-making markets and a government that sustains citizen rights): Open access orders are also characterized by large numbers (size varies widely). Entry into political, economic, and other organizations is “open access.” Access does not depend on personal relationships with the government. Competitive political and economic systems are the defining characteristic of open access orders. The open access order is not natural: open access relies on impersonal exchange. In politics, people have rights by virtue of being citizens, not by virtue of their relationship with those in power. In economics, impersonal exchange vastly increases the types of transactions that can be reliably enforced, particularly over time.

Actual human societies contain elements of all three of these ideal types. Natural states build on small social groups, and open access orders may possess some natural state institutions.

This tripartite typology of social orders creates the need for a theory with five elements: models of the three social orders and models of the transition from primitive orders to natural states and from natural states to open access orders. We focus on the structure of the natural state in this essay.

### **3. The Theory of the Natural State**

For the last two million years, humans lived in small hunter-gatherer societies, what we call the *primitive order*. Face to face exchange enforced by repeat-play incentives provided the principle mechanism underpinning exchange in these societies. They also exhibited specialization by sex, but not within the sexes. The need to make face to face exchange self-enforcing implied that the society could not become very big. The modal size for hunter-gatherer bands were usually 25 people. Sedentary bands or groups of bands, tribes, living in resource rich environments reached as large as 500. This form of social organization allowed cooperation within groups but not across groups.<sup>2</sup> Primitive orders cannot sustain significant specialization of production, and their limited size and specialization place striking limits on their economies.

Historically, the degree of specialization increased with the development of settled agriculture and sedentary groups. If one group specializes as farmers, what is to stop others from taking the fruits of their labors at harvest time? Specialization implies comparative advantage: if one group has a specialty in agriculture, another must have it in violence. Those with a specialty in violence have the ability to protect the rights of farmers from both internal mischief and from external threats by neighboring groups. But an asymmetric violence potential also implies that specialists in violence can use violence to extract rents from others within their society. As Hobbes and Locke observed, without protection of property rights, a society cannot sustain specialization and significant economic activity.

The natural state emerges as a social organization in response to specialization. The central problem facing the natural state is how a coalition of individuals, including violence specialists, can create a viable political organization capable of sustaining itself. The problem is

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<sup>2</sup>Cites. Colson (19\*\*). For size see Robert Kelly, *The Foraging Spectrum*, p. 211.

one of incentives: some individuals must have sufficient incentives to specialize in production; and those specializing in violence must have incentives not to use it against one another or against members of their society. A solution requires a range of explicit and implicit agreements among society's members.

The natural state's solution to the dilemma is the creation of a state combining three elements simultaneously: a ruler or rulers; a coalition supporting the ruler in power; and a governance structure with which to make policy decisions. Although one state may be formed by a ruler who creates a coalition and a governance structure, another may be formed by an oligarchy (i.e., leaders of a coalition) who choose both a leader and a governance structure. From our perspective, all three elements must occur simultaneously in order to form of state that is internally stable and creates social order. Combining the three elements produces consequences for a variety of interesting questions, such as the implied structure of the economy, the form of political rights, and the operation of markets.

For ease of exposition, we sometimes refer to "the ruler" or to the "leaders of the coalition." These are both short hand notations. We do not mean to imply that the ruler acts independently. Rulers always act in combination with and in the context of a coalition.

For a natural state to be stable, members of the society must deem it not worthwhile to challenge those in power and hence to adhere to decisions made within the governance structure. To remain in power, a coalition must form with the capability of sustaining itself in power. How then does a stable, dominant coalition arise? As we have noted, traditional theories of the state finesse this problem by positing a ruler with a comparative or absolute advantage in violence, or even a monopoly of violence potential. To create stability, the ruler and coalition leaders must

solve two simultaneous problems. First, the coalition must create a mechanism that binds the interests of individual coalition members to the support coalition. Second, the size and composition of the entire support coalition must be determined. By doing so, the identity of the constituent and non-constituent groups is determined. These are logically simultaneous problems rather than separate pieces.

Most states in history, including most states existing today, solve the problems in the same basic way. The natural state relies on one principal mechanism: creating rents and granting rights to individuals or groups to these rents in exchange for political support. Coalitions create and enforce individuals or group rights to the most valuable economic activities, such as milling wheat, producing or selling the most valuable items, trade with neighbors, or the locally defined form of salvation. The flow of rents to each coalition member induces that member to support the coalition. The rents must be large enough to create self-enforcing incentives, which occurs when the present value of the flow of rents each member of the coalition exceeds the value of defecting and challenging the state.

To model how the natural state solves the problem coalition size, we draw on the theory in Greif, Milgrom and Weingast (1994). Here, we sketch a model to be developed in the future. The natural state must create exclusive privileges to bind coalition members, including specialists in violence, to support the state and to keep it in power. Increasing the size of the coalition increases the probability the state will survive, but at a declining rate: the marginal value of an additional individual's support declines as the size of the coalition rises. Increasing the size of the coalition, however, necessarily reduces the ability of the coalition to create rents for each member individually.

In repeated interaction, the principal mechanism by which members of the coalition police the state is by withdrawing their support. In order to insure that the coalition agreement is self-enforcing, each individual or group in the coalition must be able to impose sufficient costs on the ruler by defecting. Each member fears that the ruler will revoke (expropriate) the member's rights. Coalitional stability requires that each member perceive that its defection will cost the ruler more than the ruler gains from expropriation. This implies that if the state attempts to assemble too large a support coalition, it lowers the costs that each coalition member can impose on the coalition. This increases the threat of the defection by individual members.

So the natural state cannot expand its coalition endlessly because of three offsetting effects. On the plus side, a larger coalition increases the probability of survival. On the minus side, increasing coalition size dissipates the rents across a wider group, lowering the average value to its members of belonging to the coalition; and increasing coalition size the marginal value of each coalition members support to the coalition, which lowers the costs any member can impose on the state in the event that the state fails to honor its agreements with one of the members.

The natural state therefore faces a *fundamental trade off*: expanding the support coalition increases the probability that the coalition survives but also dissipates the rents and lowers the costs that coalition members can impose on it in the event that the state fails to honor its agreement. Because they interact, the two problems of rent creation and coalition size must be solved simultaneously.

Natural states address the tradeoff by assembling a coalition just large enough so that the cost to the state of the marginal supporter just equals the marginal value (increase in the

probability of survival) to the state of retaining that member. This also means that the state's probability of survival is generally less than one: all natural states are, to a degree, insecure.

Now return to the problem of rents. The natural state faces a *fundamental problem of insecurity*. Insecurity drives these states to control all activities that produce rents, allowing the state to bind a larger set of constituents to its support coalition and thus to increase its stability. Controlling an additional activity creates a new source of rents and hence an additional set of political resources with which to bind another group to the coalition. Of course, if the cost of creating rents are too high relative to the value of the gains, the state will leave that activity uncontrolled (Barzel 1974).

The coalition that supports the state must have a predominance of coercive power, it must be the most powerful group in society by a significant margin. If a competing group(s) has similar coercive power, violence will be a regular occurrence and a "state" will not exist, or typically multiple competing states will exist. This implies that, to survive, the coalition that supports the state must include all the members of the society with sufficient power and resources to challenge the coalition for control of the state.

The advantage of the natural state over the primitive order is that natural states create and honor a property rights system supporting specialization and exchange and hence much greater wealth. Of course, these property rights are only defined for elites: members of the support coalition all possess valuable rights that the state honors and enforced against predation from others. The natural state is therefore a system of privilege: particular individuals, and groups gain particular privileges in return for support. This enables the natural state to utilize personal exchange as the basis of these political relationships that bind coalition members to the coalition.

Further, as we discuss below, the state cannot honor rights of individuals outside of the support coalition.

The natural state is a world of asymmetries. Members of the support coalition have a particular set of privileges negotiated with the state, enforced by the repeat-play mechanism noted above. In general, the privileges of coalition members will differ from one another. If the state fails to honor the privileges accorded to particular elites, the latter will defect and punish the state. By the marginal condition noted above, the coalition is assembled in a way that this punishment is sufficient to police the state.

Incomes of coalition members rise above subsistence levels. We call members of the ruling coalition elites. Notice, however, that in contrast to most political science approaches, elites in this model are not an exogenous category of individuals, but emerge endogenously as those individuals who become part of the ruling coalition.

Moreover, the state cannot credibly protect the rights of those individuals outside of the elite. The reason is that implied by the link between the size of the coalition and the rents. Individuals and groups outside of the coalition cannot impose sufficient harm on the state to force it to honor rights. Indeed, the tendency of the natural state is to keep member outside of the ruling coalition at subsistence level.

### **Implications of the natural state**

Our approach to the natural state has a wide range of implications. First, and most important, the natural state creates the basis for social order that underpins economic specialization and exchange. Specialization need only progress as far as producers and warriors, although it seems apparent from the archeological record that specialized human societies

included artists, builders, warriors, tool makers, hunters, and farmers certainly by 10,000 years ago.<sup>3</sup> In contrast to the primitive order, natural states have complex economies and provide a level of economic surplus significantly above subsistence for at least some of its members. Historically, the natural state provided the basis for civilization as human society moved beyond the hunter-gather organization. The natural state allowed human societies to capture the gains inherent in the first economic revolution, an immense advantage. Natural states have dominated history since their appearance.

Second, because creating rents is central to the natural state's survival, the natural state has an inherent incentive to promote specialization, exchange, and trade. Without exchange there are no rents to bind the natural state together. But at the same time, the natural state is antithetical to open access, competitive markets. The need to create rents requires the natural state to control markets by limiting entry. Natural states may help create new markets, but controls those markets heavily. Natural states cannot support thriving markets with open access. They therefore cannot sustain economic development.

Third, the natural state cannot sustain a set of universal rights that all individuals enjoy by virtue of their being a citizen. The reason is that the flow of rents in exchange for political support works for only a subset of the society. Rulers of natural state cannot credibly commit to honor the property rights of those outside of the coalition. Non-coalition members cannot threaten the survival of the state, and thus cannot believe that the state will honor commitments

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<sup>3</sup>The earliest cave art appeared in Europe 35,000 years ago and in Africa, where the genetic stock of modern humans arose, perhaps 50,000 years ago. About the same time the design and workmanship of tools took a quantum leap forward. The earliest buildings and cities date from about 10,000 years ago. All of these are direct material evidence of specialized human societies.

made to them. The inability to honor property rights in general, implies another striking constraint on economic development: limits on investment in physical and human capital. If someone outside of the ruling coalition makes a significant investment, the state will eventually expropriate it. The reason is that there is nothing that this individual can do to prevent the expropriation; and the additional rents are valuable to the rulers to enhance their survival. The inability of the state to honor rights of individuals outside of the support coalition means that most of these people live at the level of subsistence.

Fourth, coercion is central to the natural state. Freedom is an anathema because it threatens the natural state's survival. Just as the natural state seeks to control markets, it seeks to control political freedom, especially the freedom to assemble and to form organizations. Any "private" organization can be used to form cooperative organizations that can threaten the state. This too implies striking limits on the civil society, economic organization, and the interaction.

Fifth, personal exchange underpins both political and economic exchange in the natural state. Political and economic rights accorded to individuals groups are all personal in the sense that they depend on the specialized relationship with those in power. The state may create the beginnings of third-party enforcement, but at best only elites can access this mechanism. This implies that economic exchange also remains personal, based on face to face and repeat play incentives.

Finally, our theory implies that natural states cannot develop. Open access competitive markets are fundamentally at variance with the natural state's political logic. Political insecurity drives natural state's to control markets, not control competitive ones. They may exhibit some growth by creating the basis for some specialization and exchange or by adopting new

technologies from elsewhere, but they cannot create thriving markets with open access and generalized incentives for all citizens to make investments.

The main implication of this point is that the label, “developing countries,” is a misnomer. These countries are not developing; indeed, our perspective implies they are anti-development. A more accurate label is that these countries are non-developing. The growing gap between the industrialized economies and most of the so-called developing world supports our conclusion.

#### **4. Implications**

In this section, we develop three implications of our approach

##### **Why the Natural state hampers markets**

The distinction between economic growth and economic development is fundamental to understanding the failure of the natural state to promote economic development. As we noted, economic development requires open access competitive markets. In contrast, growth without development can occur through growth in the factors of production or through adoption of new technologies.

Non-developing countries in the modern world are filled with markets, integrated into a world economy, possessed of access to cutting edge technology for the price of a handful of

university degrees. And yet despite the existence of all of their markets they are unable to develop into thriving market economies.<sup>4</sup> Why?

The answer is twofold. As we have emphasized, natural state place too many constraints on markets. The process of rent creation means few markets are competitive in the traditional sense. Monopolies obviously distort markets.

But there is a second way in which the natural state's control of markets distorts them at great cost to development and citizen welfare. As is well-known, denying secure property rights to most of the population slows or eliminates economic growth. But the natural state impedes development in a more fundamental way: it robs the market price of its ability to coordinate human action. Consider the simple monopoly problem depicted in Figure 1. A monopolist faces a demand curve, produces up to the point where marginal revenue equals marginal cost,  $Q_M$ , and charges a price,  $P_M$ , that yields a per unit rent of  $P_M - \text{PROBABILITY}$ . Limited entry generates economic rents and reduces social welfare.

An unconstrained monopolist is led to charge  $P_M$ . But one lodged with the political hierarchy of the natural state may be forced to charge another price; the natural state may use the creation of rents to coordinate political behavior. The monopolist might instead of charging  $P_M$ , choose to charge a monetary price of  $\text{PROBABILITY}$  and extract the rest of the rent from his

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<sup>4</sup>To illustrate the immense extension of the global economy, the *Economist* recently provided the following anecdote in an article about language and the concept of number. Experiments were carried out with a Piraha tribe of Brazil, a primitive order whose people had numbers only for one, two, and many. The objects used for the experiments were sticks, nuts, and *batteries*, noting "objects with which the subjects were familiar." These people are so linguistically primitive that they have neither the word or concept for three, yet electric batteries are objects of such daily familiarity as to be unremarkable. Markets have penetrated their society, economic development has not. *Economist*, August 21, "Language Barriers," pp. 66-7, quote from p. 67.

customers/patrons in the form of cooperation: failure to support the government risks losing a service at a subsidized price. A government might build a water supply system and sell water at  $P_M - \text{PROBABILITY}$  and then only provide water to those who are willing to transfer part of the uncollected rent,  $P_M - \text{PROBABILITY}$ , back to the government in the form of political support. Indeed, the government might build a water system and give the water away for free, subject to political support.

In the natural state, most valuable resources and markets are controlled by politically connected elites whose ownership or access to the resources and the market result from an interconnected set of bargains among the politically connected and enforced by the joint maximization of a pool or rents. In those societies, some monopolists charge  $P_M$ , some monopolists charge  $\text{PROBABILITY}$ , and some monopolists give their products away and are paid in political support.

Limiting entry creates market power, but monopoly pricing is not the biggest welfare loss in the natural state – those losses are just a matter of welfare triangles. The more serious problem is that the natural state's control of markets systematically prevents nominal prices for goods and services from reflecting costs and benefits. As a result, markets in natural state societies preclude the market's ability to coordinate resource allocation through by prices. Put simply, market prices fail to reflect scarcity and therefore prevent the efficient use of resources.

Natural states have an incentive to promote economic growth by through trade and markets. But they have no incentive to create competitive markets with unlimited entry where the price mechanism works impersonally to allocate production and consumption. As a result, natural states have markets where transaction costs are inherently high because the price

mechanism alone is not a guarantee of reputable behavior and price do not accurately convey information on relative costs and benefits. Factors of production do not flow rapidly from one sector to another; because the price mechanism does not accurately convey information and because entry into new markets requires political permission or political power.<sup>5</sup>

One of the main ways in which the natural state is able to bring order out of chaos is through the explicit use of markets to create economic rents that insure political stability. But the markets in natural state are, by nature, uncoordinated. The structure of markets prevents the price mechanism for coordinating the independent and uncoordinated decisions of individuals. Natural states can grow, but they can't develop.

### **Why the Natural state promotes trade despite controlling markets**

The most successful natural states in history, empires such as the Romans, the Chinese, or the Ottoman, were based on trade. Their engine of wealth creation was the gains from trade made possible by the extension of order and protection over vast geographic distances, enabling specialization and division of labor on a scale rarely seen before 1700. Yet, as great as these empires grew and as great as their wealth expanded with their borders, they did not create open access thriving market economies.

Natural states have an incentive to increase the number of markets to the extent that these markets can be controlled and provide another source of rent. These states therefore have an incentive to promote trade, both across regions within the state and across their boundary with

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<sup>5</sup> Batteries produced in developed countries are bought and sold, but battery factories are not built unless a powerful interest finds a way to build the factory and then continues to control the market enough to maintain the factory.

other states. Yet they will do so only if they can use this trade as another source of rents and privilege, for example, designating a specific organization or group of trades who hold exclusive rights to trade. In early civilizations, the political hierarchy firmly controlled trade.<sup>6</sup> Controlling trade requires the use of other specialists in trade and commerce, who become part of the dominant coalition.<sup>7</sup>

### **Why economist and donor advice fails**

Our perspective helps explain the persistent failure of advice from mainstream economists and donor agencies to the so-called developing countries. Our theory of the natural state shows that it is a means of promoting order. Controlling markets are a means of maintaining the state: rent-creation binds constituents and state to one another in a way that provides for political stability.

In the last century the world has witnessed genocide in Turkey, Germany and central Europe, Bosnia, Cambodia, Rwanda, and currently the Sudan. Both China and the Soviet Union deliberately pursued policies leading to the death of millions of their citizens. Throughout the world there have been hundreds of coups and military take-overs, and thousands die every year

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<sup>6</sup>“Long-distance exchanges of useful goods or raw material are also more likely to occur successfully when they can be arranged and administered by a leader. As we have seen in numerous cases, this kind of exchange, normally directly reciprocal between leaders of the exchanging societies, becomes redistributive finally in the fullest sense...” Service, *Origins of State and Civilization*, p. 292.

<sup>7</sup>Religious elites may also enter the picture. Early civilizations are all theocratic. Movement of goods occurs, in part, because religious elites use their privileged position to redistribute resources within the state, enabling the coalition easy access to the goods produced by non-elites.

in wars over political control. For much of the world, the relevant alternative to the natural state is not an open access order like the United States or France, but a descent into the hell of disorder. In countries where citizens fear disorder, rent creation through limited economic entry is an important element in providing political stability.

Governments and citizens in these countries are often – quite reasonably – unwilling to implement reforms in economic regulation and policy suggested by mainstream economists, the World Bank, the IMF, and other international donors. Opening markets to more competition is unlikely to be persuasive if, at the margin, doing so increases the probability of disorder.

Our perspective implies that natural states will only promote growth if it does not threaten the existing political system. Non-elites may have just as much incentive to prefer stability to disorder as the elites, since it is they who will do most of the suffering and dying if social order breaks down.

Natural states therefore promote trade so as to achieve some gains from specialization and exchange, but they do so by limiting entry. Natural states are the natural outcome of human specialization, in which multiple political, economic, religious, and military actors form a self-enforcing agreement to provide coordinated coercion. The economic rents created by limited entry provide the incentives to make the agreement self-enforcing. Eliminate the rents, eliminate the agreement, and go back to chaos and anarchy.

## **The Origins of States**

A theory of the state should explain the emergence of order out of disorder, the creation of a state from anarchy. The origins question, however, has to have two

answers, because there are two origins problems. The first problem is how human societies first made the transition from primitive orders to natural states, at least 10,000 years ago. The second problem is how states reconstitute themselves when order breaks down into anarchy and statelessness. Violence in primitive societies is pervasive, but not highly organized. The emergence of coordinated coercion is coextensive with the emergence of specialization in violence and the development of coordinated social action. When a state breaks down and disorder spreads, the population does not fall directly back into a “state of nature.” Specialization does not immediately disappear with the loss of order.<sup>8</sup> The critical difference between the first origins problem and the second origins problem is the presence of specialization. We cannot hope to test an explanation of how specialization first evolved, but we can examine the emergence of the first civilizations and draw similarities with modern societies plagued by endemic violence.

All societies face an external security problem and an internal security problem. As states grow in size, they transmute aspects of the external security problem into an internal one. That is, competing groups become groups governed by the same state. The creation of an economic rent explains how two competing violence specialists can reach an agreement not to fight and form a larger state. The origins of states can be seen in the process of combining smaller social units.

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<sup>8</sup>Haber, Razo, and Mauer (2003) demonstrate this point in the context of the Mexican Revolution. Despite tremendous social disorder for over a decade and a half, significant investment and industrial expansion occurred.

For simplicity, let's begin by suppose that two communities with a shared border are ruled by war lords (a violence specialist). The two communities are in a constant state of low level warfare, which diverts resources to protection, has a high cost in human life, and prevents trade between the two states.<sup>9</sup> How is it possible for neighboring war lords to commit to not fight each other, and once such a commitment is put in place, what is to insure that they honor their promise to refrain from violence against each other?

The war lords face an aspect of a prisoners' dilemma. If one war lord puts down his arms, the other kills him, takes his property, and takes control of his community. If, however, the war lords possess the ability to expropriate the economic surplus of the individuals in their community, it is possible for competing war lords to reach an incentive compatible arrangements. Since violence between war lords is a major impediment to economic activity, any peace dividend from cessation of violence between the war lords accrues to the war lords. The peace dividend potentially serves as a credible commitment device. As long as the war lords gain more from maintaining the peace than they do from defecting and seizing the property of the other war lord, order can be maintained.

Several aspects of the example are important. First, the agreement between the war lords creates a larger state, defined in terms of the coalition members, the war lords, who credibly commit to support the coalition and, critically, not to fight each other.

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<sup>9</sup>Keeley, *War Before Civilization*, documents the pervasive nature of violence in primitive societies.

Larger states can be created by building larger coalitions of war lords.<sup>10</sup> Second, the state created by agreement between the war lords is self-enforcing because of the credible commitment they make to each other. The new state is not credibly committing to protect the property of their own non-elites.<sup>11</sup> Third, what binds the interests of the war lords together is the existence of rents that are directly dependent on the continued existence and operation of their state. The rents are derived from the war lord's exclusive rights to the output of their subjects. In general, however, a dominant coalition includes the full panoply of military, political, economic, religious, and educational elites.

Finally, and most important, the natural state provides a solution to the problem of endemic violence. In this respect the natural state is good. It is the natural solution to the inevitable problems raised by the existence of specialization within society. The natural state is "natural." Perhaps the main reason that the natural state is such a durable form of social organization is that it provides a real workable solution to the problem of endemic violence. That it, ultimately, prevents societies from moving on to open access orders is a pressing problem, but it should not blind us to the fact that

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<sup>10</sup>This appears to be what happens in classic civilizations. In such an arrangement, "The threat to the integrity of a new state is from the important components, normally the larger chiefdoms, whose chiefs or war leaders may not have fully accepted the authority of the center and might wish to break away from it or take it over or otherwise resist it." Service, *Origins of State and Civilization*, pp. 301-2.

<sup>11</sup>The non-elites, of course, are also made better off by the provision of relative order. Even if they do not end up possessing more physical goods, they enjoy more physical security. Thus non-elites may rationally prefer life under a stable natural state than in a society with high levels of disorder.

natural states perform a valuable, indeed irreplaceable, function in the evolution of human societies.<sup>12</sup>

## 5. Conclusions

The natural state represents a major achievement, allowing human society to rise above subsistence associated with the primitive order. It provides the basis for specialization and exchange, for income levels above subsistence, and, more generally, the basis of civilization. It also solves the problem of endemic violence. For many millennia, natural states were the sole means of providing social order.

But natural states also have striking limits as a form of social organization. They constrain their citizens' freedom. The drive for survival means that the state employs coercion and restricts peoples freedom to assemble and organize – and of course, to compete for power. Further, the drive to create rents to bind constituents within the support coalition implies striking restrictions on markets, necessarily precluding thriving markets with open access that support sustained economic development.

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<sup>12</sup> Elman Service has a great phrase for this: waging peace. “Political evolution can be thought of as consisting, in important part, of successfully “waging peace” in ever-wider contexts. The successful wars - or internally, the successfully applied deterrents to feud, revolt, or other disorder - are only sporadic episodes that spotlight the failures of the political system to sufficiently control the behavior of its own and other groups.” *Origins of State and Civilization*, pp. 297-8.

Our model moves beyond the existing class of models of the state that take the state as given and assume that it maximizes some form of tax revenue or rent share. These models start in the wrong place because they posit a state without worrying about how it survives. Both Barzel (2000) and Olson (2000) argue that maximizing their take leads rulers to create and enforce general property rights associated with the market: a larger economic pie implies more for the state. This argument is widely at variance with the empirical of non-development; something is missing.

The problem with these models is that they ignore the fundamental problems of how the state solves the problem of social order, the control of violence, and the enforcement of its arrangements. As we have shown, survival about survival force rulers to use rent creation as a means of binding groups to support them. This driving need to maintain themselves in power by creating rents is inconsistent with creating thriving markets based on universal property rights. Indeed, moving toward such markets makes rulers worse off by lowering the probability they survive.

The natural state is a complex set of interdependent relationships, all of which are based on personal exchange in the sense that repeated, face to face interaction is the principal mechanism of enforcing exchange. This holds in both politics and economics. Indeed, the natural state is natural precisely because it builds on the face to face method of personal exchange that support human society throughout its first two million years.

The natural state is an equilibrium political structure based on the solution to the problems of social order, emerging specialization and exchange, including specialists in violence. As an equilibrium, it is stable and difficult to change.

The natural state's political logic has striking economic implications. Natural states may promote some trade, but they are fundamentally anti-market. They seek to control markets for political ends, to help create political security and prevent disorder. Given the immense problems of disorder in the last century, this is a non-trivial achievement.

The drive to control markets to create rents distorts markets in several ways. Most obviously, rent creation creates monopolies. But the natural state's control of so many markets both distorts prices and diverts rents in non-obvious ways. Governments that transfer rents to themselves by charging monopoly prices effect simple income transfers. But governments often instead grant highly subsidized water in exchange for political support; that is they threaten to withhold water from citizens who fail to support them.<sup>13</sup> This form of rent distribution not only transfers income (in non-transparent ways), but it distorts the price mechanism as a means of coordinating the economy. Put simply, prices in natural state fail to reflect scarcity and resource costs and therefore provide perverse economic incentives. These distortions do not result from policymakers who are simply misguided but due to the political forces that drive policymakers to use markets for political ends.

Finally, the driving need to control markets implies that those natural state that exist today are non-developing. Indeed, our perspective implies that it is wishful thinking to call them "developing countries" as is customary in the literature.

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<sup>13</sup>Diaz, Magaloni and Weingast (2004) develop this theme. Most often this threat is indirect: budgets to run local government, which in turn runs the local water distribution system, depend on whether the community supports the government.

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Figure 1

