Chapter 4: The Origins of Territorial Governance

Two meanings of the term government are common in English. One refers to the decisionmaking or policymaking part of a formal organization. Every club, nonprofit organization, and firm has a government in this sense, as noted in the previous two chapters. These policymaking bodies devise and enforce rules for their team members to solve team production problems and to direct an organization's resources to advance specific purposes. The other meaning of the term refers to the subset of organizations that have extensive ability to impose rules on persons within a particular geographical territory. Chapter 4 provide an explanation for how the former can become the latter

All organizations can impose rules on their own team members, because realizing the fruits of team production normally requires team members to perform certain tasks at particular times with particular persons in a particular manner. The range of behaviors that can be induced by organizations varies substantially, but many organizations exercise significant control over their members. An organization's management is often able to tell team members how to dress, when and what to eat, and when and how to work, and even who their friends should be (other team members). The organization's management may induce team members to go on trips far away from families and friends (as with hunting clubs, commercial transport shipping, and military operations), via means and to settings that involve risks to life and limb. They may induce persons to sacrifice the necessities of life for a period—fasting and abstinence, for example, are often required for the members in religious organizations.

Many organizations can also impose rules on "outsiders." Both suppliers and customers may have to accept some rules in order to sell their products to an organization or purchase an organization's output. "Deliveries at the back," "Sales of our products take place only on Saturday from 10:00–14:00." Territorial governments are the rule-making, policymaking bodies of organizations that have relatively great ability to impose rules on outsiders within a geographic territory.

This chapter provides a theory of the emergence of territorial governments as one of many productive organizations in an initially peaceful territory. The analysis draws from and extends the productive theories of the state found in the work of Aristotle (350 BCE), Montesquieu (1748), Nozick (1974), and Buchanan (1975). The general approach differ from other theories of the state by stressing the advantages of collective action, rather than coercive aspects of governance. The analysis of this chapter focuses on the incentives of formeteurs in such settings and the gradual emergence of governments, rather than a sudden shift from anarchy to statehood through conquest or social contract. It also notes that organizations with monopoly power over critical services in a region can impose rules on persons outside their organization. The ability of monopolists to do so, however, is constrained by the mobility of the persons "ruled."

Problems with Hobbes-Based Theories of Territorial Governance

It seems clear that a Hobbesian (1651) war of "every man against every other" would not last very long in practice, because formeteurs would quickly organize teams for purposes of defense (and aggression), as noted by Montesquieu (1748). However, the Hobbesian low-income trap of "war of every man against every man," does not literally require conflict among individuals. The same logic applies for "wars of every tribe against every tribe," and "wars of every state against every state." Peace treaties are notoriously difficult to negotiate and enforce, so wars among organizations can easily be all engrossing, perpetual, impoverishing affairs. The Hobbesian approach explains why persons and organizations tend to fight and why they would want to escape from an all-consuming conflict, but the solution proposed by Hobbes seems to require an all-powerful world ruler, or at least a continental, government, which we have never seen. The creation of military clubs cannot really explain how civil societies emerge in settings in which there is a good deal of natural conflict.[26]

It is likely to be the case that somewhat prosperous communities emerge before, rather than after, territorial governance and warfare. If there is nothing worth taking, why invest in theft or conquest?

Prosperous communities are far more likely to emerge, if conflict is initially limited, rather than all-encompassing, or if at least a few islands of relative tranquility exist. They may, for example, be initially protected by natural barriers of one kind or another. After prosperous communities emerge, their relative prosperity provides formeteurs in other places with incentives to organize theft and conquest. The existence of such organizations also provides prosperous communities with reasons to organize themselves against such attacks. In this manner, warfare is likely to be induced by the

[26] See, Tullock (1972) for an early collection of rational choice–based analysis of the emergence of the state from anarchy. Oye (1986), Garfinkel and Skaperdas (1996), and Stringham (2006) provide more recent collections. See Konrad and Skaperdas (2005) for a game theoretic treatment of "protection services" and the emergence of coercive states in a setting without exit possibilities. See Congleton (1980) for an early discussion of how institutional reforms can reduce losses from conflict in Hobbesian settings.

relative success of early organizations, rather than their failures, but the resulting warfare cannot be all encompassing without eliminating the rational for theft, conquest, and defense.

The nonviolent theory of the origins of territorial governance developed in this chapter does not imply that military organization and violent conflict are irrelevant. Rather, it implies that local prosperity does not require an initial escape from the Hobbesian jungle, nor does it require an initial monopoly of organized violence, as argued by many political theorists, including most recently Olson (2000) and North, Wallis, and Weingast (2009).

The approach and conclusions of this chapter are broadly consistent with the historical analyses of Spruyt (1994) and Ertman (1997), among others, who stress that nation-states emerged in the fifteenth, sixteenth, and seventeenth centuries as one of many organizational types through various coercive and non-coercive forms of competition. It is also consistent with Nozick's (1974) analysis of voluntary association within productive states, although no normative inferences are drawn from the present analysis. Territorial governments for the purposes of this book are simply organizations that have a relatively great ability to impose rules on persons outside their organization within a specific geographic area.

A. A Digression on Rule by "Strong Men"

Brute force theories of the state often begin with discussions of "pecking orders," common in many animal groups, in which the biggest, strongest animal gains privileged access to food and sex. By analogy, it is often argued that in early human societies, a strong man simply uses his brute strength to dominate a group and profited by "taxing" other group members who "paid up" to avoid being attacked. Such theories often note that the first human organization, the nuclear family, is often dominated by such strong men for decades at a time. The patriarch is often the physically strongest member of his extended family.

In less biologically–based groups, the physically strongest man may simply be a better formeteur than others, because he can solve many internal enforcement problems directly by threatening to punish shirking team members. Such forceful leadership is evident in the mythic histories of famous kings in the past, from Odysseus to Arthur.

The critical weakness of the brute force theories of the state is that organizational talent and physical strength are not necessarily correlated with each other. Thus, in many cases, it would be possible for the second and third strongest members of a group to organize a team of two or three and defeat the strongest man. Even a very strong man needs to sleep. Consequently, if the second strongest man is a better organizer than the first, he will tend to emerge as the community's "strong man," as might also the third or fourth strongest, and so forth.

Physical strength is not of central importance for leadership posts in large organizations, even in cases in which the organization is largely based on the ability to make credible coercive threats. Napoleon, Hitler, and Mao were not unusually tall or strong men, although they ran powerful coercive organizations. Once durable organizations emerge, the "strong man" is simply the pivotal decisionmaker within his or her organization's government.

B. A Model of Coercive Rule of Communities where Exit Is Possible

An organization's ability to impose rules on "insiders" and "outsiders" makes the boundary of an organization less than perfectly sharp, although that distinction is a useful one for the purposes of this chapter and as a description of relationships between territorial governments and their residents for much of recorded history. A commercial organization's "customers" are not "insiders," because they do not ordinarily participate in the firm's team production, although they clearly affect the viability of such organizations and indirectly affect their decisions. A religious organization's congregation participates in church services, but does not produce the sermons nor the doctrines being espoused. Similarly, community residents pay taxes and obtained benefits from their territorial governments, but rarely participate in decisions about taxes or the production of government services. The distinction between insiders and outsiders is less sharp in contemporary democracies grounded on popular sovereignty, but there is still a clear distinction between those who directly participate in government decisionmaking (elected representatives, the courts, and the bureaucracy) and ordinary citizens.[27]

Commercial, religious, and governing organizations can often impose rules on "outsiders," but only within limits. Those limits are not consequences of the size of an organization. Very large successful organizations are often created by energetic formeteurs, such as Henry Ford, Kiichiro Toyoda, Thomas Edison, Friedrich Krupp, Henry Dunant, Clara Barton, and the like. Such talented formeteurs can impose many rules on their team members, but relatively few rules on people outside their own organizations. Henry Ford once attempted to reduce his production costs by imposing a

[27] The concepts of popular sovereignty and social contracts emerged during the seventeenth and eighteenth centuries. These theories, in effect, make the entire community the "true" formeteurs of governing organizations, whose authority is delegated to them by the residents. Although there are very few cases in which community governments were formed in this way, the ideas of popular sovereignty and social contracts can affect the willingness of subject-citizens to resist arbitrary rules and to lobby for constitutional reform as developed below.

particular color on his customers at the height of his monopoly power. Ford's customers could purchase his automobiles in "any color they want, as long as it is black." Many of his potential customers preferred other colors and purchased automobiles produced by his less demanding rivals, and Ford's monopoly power quickly disappeared. The ability to impose rules on outsides is limited by the exit opportunities of outsiders, rather than organizational size or wealth.

Coercive Rule with Mobile Subjects

The essential logic for requesting that outsiders follow particular rules, and for accepting such requests is represented in Table 4.1. It is sensible for an organization to make such requests of outsiders (that is, please follow rule D) as long as the organization's surplus will be increased by the outsider's compliance ($\Pi - R > C > X$ or $\Pi - R > X > C$). The outsider-resident expects to receive benefit *R* if he or she complies with the demand, expects to receive benefit *B* if he or she does not comply along with penalty *P*. He or she expects to receive $A - E$ if he or she chooses to leave the community, where A is the expected net benefits from residence in the best alternative community and *E* is the member's exit cost. The outsider-resident accepts the organization's demand (obeys *D*) only if the (long term) reward, *R*, from doing is greater than the alternatives of (long term) noncompliance and exit, $R > B\text{-}P$ and $R > A\text{-}E$.

Table 4.1:
Payoffs for Formeteur-Ruler and Community Members

	Formeteur	Resident
Community member accepts the organization's demand.	Π - R	R
Community member(s) rejects the organization's demand.	C	B-P
Former community member Emigrates.	X	A-E

In perfectly ruled polities, the productivity of the rules enforced is always greater than the cost of enforcement and the reward to community members is always sufficient to induce compliance. In such polities, community members always follow their government's rules, because punishments are precisely targeted at community members that violate the rules. Residents remain in those communities, because the rewards are greater than those in alternatives communities, net of exit costs. Such well-ordered communities are rare, however, because the information available to territorial governments is rarely sufficient for choosing only productive rules or for perfectly enforcing the rules chosen.

Nonetheless, the rules chosen and enforced have to advance organizational and community interests tolerably well, given the exit and cost constraints of territorial governments. Unless following community rules generates sufficient net benefits for residents, they will quietly depart for other communities with better governing organizations.

Exit Costs and Exit Control

It bears noting that exit costs are not entirely determined by the natural physical and emotional costs of relocating, but are partly determined by the policies of governments.

Exit may be discouraged by encouraging the dissemination of information about hardships in other communities and about the dangers of travel to them. "You are lucky to be here, rather than there!" Information about hardships inside the community and about better alternatives may also be suppressed through censorship laws. Exit costs can be directly increased by punishing exit with fees of various kinds. Organizations may attempt to damage the departing member's reputation by declaring that the person leaving "is a shirker," "has never done his duties," "has violated our trust," "is a thief," and so on. Exit may be illegal. There may be harsh punishments for even attempting to exit. Extreme examples of the latter include the fugitive slave laws common in all slave-holding societies, restrictions on peasant and serf mobility that were common in feudal Europe and Japan, and the Berlin Wall and "Iron Curtain" of the former Soviet Union.

Territorial governments that increase the cost of exit can reduce their rewards for compliance and/or increase their penalties for noncompliance without inducing mass exit by residents and team members, albeit at the risk of attracting fewer immigrants.

Exit costs are also partly a consequence of the "entrance costs" of other organizations and territorial governments. Because there are cases in which it pays to banish a person for shirking (as when $X > C$ in table 4.1), it will be difficult for other organizations to judge whether a particular departure is a "voluntary exit" from a dysfunctional community or the "banishment" of a person for poor performance or criminal acts. Other organizations will not want to include shirkers or criminals from other communities on their teams, because they increase the cost of team production without producing sufficient offsetting benefits. Similarly, regional governments will hesitate to allow immigrants of questionable character to resettle in their communities. Rule-breakers increase enforcement costs and reduce the productivity of territorial rules. Productive rule-followers would normally be welcome, insofar as they contribute to team or community output, but they may need to prove themselves before being accepted.[28]

In cases in which it is not easy to exit or join a given community, the calculus of remaining or becoming a resident will be based on the long-term average (expected) net benefits of affiliation relative to those available in other communities net of exit costs. Governments of communities whose residents have relatively high exit costs can use relatively severe penalties to enforce their rules, even if alternatives outside the community are somewhat better than those inside.

Predictable Rules and Penalties

Whenever exit possibilities exist, there are limits to the feasible range of rules and punishments that can be imposed, as noted above. Exit possibilities also tend to encourage accuracy in the imposition of whatever punishments are used.

Organizations and communities that routinely impose penalties on the wrong persons have lower risk-adjusted net benefits for community members than otherwise similar organizations with smaller errors or less severe punishments. The expected reward of following a community's rules falls to $[(1-p)(R) + (p)(B-P)]$, when the probability of being wrongly punished, rather than rewarded, for following the rules, is $p > 0$. Persons in such communities would leave for other communities when punishments are relatively severe [$(B-P)$ is below $(A-E)$] and the probability of wrongful punishment, p, is relatively high.

This does not imply that arbitrary punishment is impossible, only that one community's error rate cannot be much greater than another's, net of exit costs, other things being equal. That is to say, punishment systems are constrained to fall within a band determined by exit costs and those used elsewhere.

A pirate ship captain can use more severe and arbitrary penalties—denial of food and water or accommodation on the ship itself—while at sea than at port. However, unless the bounty is unusually plentiful, a harshly sanctioned crew will depart for other ships as soon as a port is reached. Similarly, communities whose residents face unusually arbitrary and harsh treatment tend to

[28] Communities with labor shortages and little fear of shirkers thus may attract new residents by eliminating entrance fees or rewarding people for joining their community with "citizenship" and other "signing bonuses." During the medieval period, independent cities often rewarded serf immigrants with freedom from feudal duties after a period of residence. "City air makes one free" in such cases.

evaporate as residents (and team members) quietly depart for other locations where punishments are less arbitrary and harsh, unless the rewards from continued association are also unusually great. The anticipated net rewards of continued association have to be kept above those of the available alternatives.[29]

Inequality Before the Law

To say that community governments are constrained in their ability to use arbitrary and harsh punishment is not to say that the rules enforced will be the same for all community members or that the rules will be enforced in a uniform manner.

In many cases, a community's residents are heterogeneous in ways that affect a government's return from rules and enforcement. Some residents and some team members provide services that are more important for their communities and organizations than others. Some residents have better exit opportunities than others. The minimum acceptable combination of rewards, punishments, and punishment errors varies among community members, as does the extent to which governments profit through their association with particular residents. In such cases, organizations will treat different residents or classes of residents differently, because they cannot afford to over pay for compliance, nor can they afford to provide rewards below those required for retention.

As a consequence, unusually productive community members who could easily move to other communities will be more carefully treated (subject to less arbitrary punishment) and receive higher rewards for their efforts (or subject to lower taxes). A wealthy merchant may be subject to different rules and penalties than a wealthy farmer, because the merchant is more mobile than the farmer.

C. Territorial Monopoly as a Foundation for Coercive Rule

Economists devote a good deal of their time to thinking about settings in which customers may acquire the same services from a variety of organizations and exit costs are low. In such cases, no organization and no territorial government can demand a higher price for its services than any other, whether in cash or kind. In cases in which an organization provides an important, unique service, a much higher price can be charged, because in monopolized markets, customers must pay "the price" or "do without."

Figure 4.1 depicts the pricing decision of a local monopolist that charges a uniform price for its services, modified slightly to take account of the possibility of exit. Here, one can imagine a water

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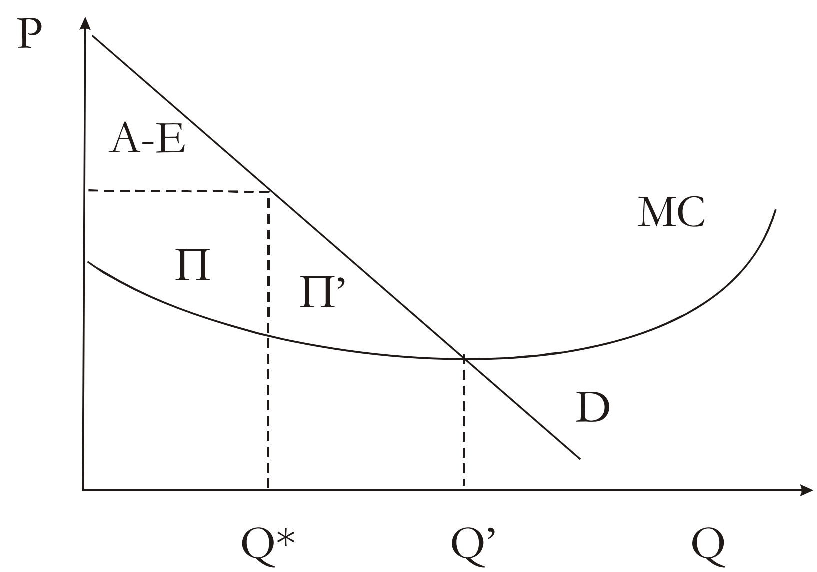
[29] Even greater exit would occur under some asymmetric theories of behavior under uncertainty. Avoiding possible losses may be considered to be more important than obtaining possible gains.

monopoly that controls the local irrigation network. If a farmer wishes to have food on the table next year, he must have a reliable source of water and so is willing to pay a high price to the local water monopolist. The highest possible uniform price reduces water user net benefits from a maximum of *A-E* +Π+Π' to *A-E*, the level which could be obtained from alternative sources of the water in other communities. If the prices is set any higher, the farmer would sell his land and move, although prices would have to be very high to induce abandonment of fertile farmland and buildings. In such cases, the quality and extent of fixed assets partly determine exit costs.

Figure 4.1

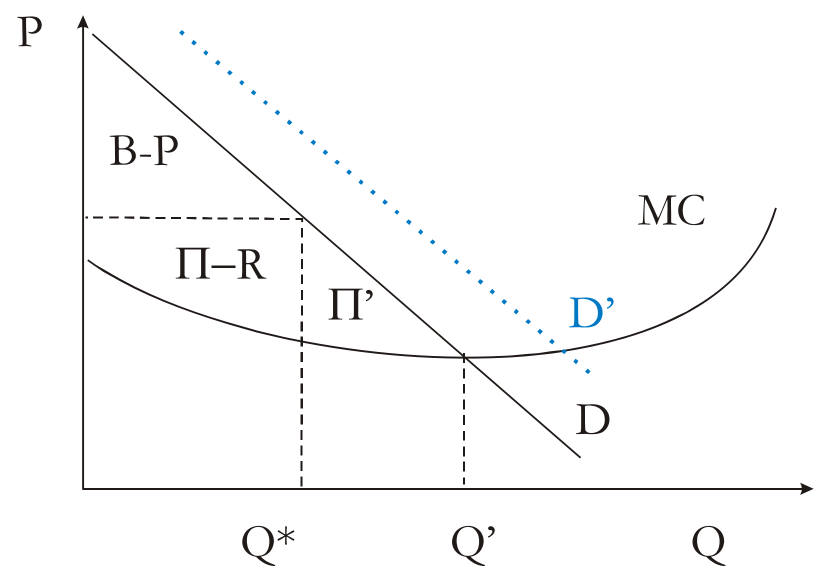


Monopolists are often said to extract "rents" (net benefits or profits) from their customers by controlling access to their services. The monopolist of figure 4.1 can be said to have "extracted" monopoly rents (profits) equal to area Π from its consumers.

It bears noting that the rents extracted from consumers may involve more than a simply transfer of money from customers to the monopolist's treasury. In cases in which money economies are not well developed, a monopolist organization may find it useful to accept a combination of money, farm output, hours of work, and deference to the organization's leadership as payment for the monopolized services. Such pricing can generate significant improvements in the resources available to the water monopolist and in the psychic rewards associated with leadership positions in the organization. Deference, for example, may be valued greatly by the monopoly's leadership, yet may not be directly purchased in markets.

It also bears noting that "all or nothing offers" and price discrimination potentially allow a monopolist to increase its net receipts by up to the amount characterized by area Π'. In either case, the price paid for similar services varies among consumers. Some customers value the service more than others (have more inelastic demands), have less attractive exit alternatives, or can provide the water monopoly with especially valuable services. There may well be inequality before the monopolist's "law" when price discrimination is feasible.

Figure 4.2



Monopolists have a greater ability to impose rules on their client-customers, than non monopolists, because exit options are more limited. The logic of table 4.1, however, implies that monopolists may have to reduce their money price and profit somewhat to compensate their customers for rule-following behavior. In such cases, imposing rules is profitable for monopolists only if the rules reduce production costs or increase demand enough to offset the cost of inducing rule-following behavior. Figure 4.2 illustrates the case in which the demand for services is increased by changes in the rules. Requiring orderly queues and refusing to bargain over posted prices may be said to increase effective demand by reducing transactions costs.

Note that the ability of a local monopoly to impose rules in such cases arises not from the exercise of military power (although some police power may be necessary to protect their claims to their monopolized service), but rather from their ability to deny access to extremely valuable services and the inability of their customers to substitute services from other organizations (exit). If a person fails to pay for water, he or she might face dehydration or starvation in the future. If a person fails to pay their dues to a defensive-wall cooperative, he or she may be banished from the walled community, and so lose all to roving bandits.

In cases in which more than more than one organization has monopoly power in a territory, more than one organization will be able to impose rules on the residents of that territory. There may also be sub-territories in which other smaller monopolists benefit from imposing a few rules on their client-customers.[30] There tends to be both a maximum and minimum efficient sized service district for a given technology, because the cost of the services varies with the technologies of production and distribution. By controlling the magnitude and mix of payments required for access to its services, the governing bodies of important local monopolies (and cartels) can exercise significant control over all who live in its service territory.

D. Encompassing Interests, Rent Extraction, and the Rule of Law

Economics implies that regional monopolists have incentives to increase the demand for their services through every method that can increase their organizational surplus. Rent extraction can be increased, for example, by monopolizing several critical services, rather than just one. Rent-extraction can also be increased by reducing the availability of substitutes by blocking the entry of rivals in various ways. Such methods for increasing rent extraction tend to make community members worse off by shifting the terms of exchange in favor of the ruling organization—although

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[30] Even firms in fairly competitive markets can also impose rules on their customers: a grocery store or restaurant may demand "suitable attire," and/or may exclude unruly customers who impose negative externalities on other customers or significantly increase a firm's production costs by disturbing the arrangement of inventory on shelves or other displays. In competitive markets, however, the rules must directly or indirectly benefit customers, or they would shop elsewhere. For example, limiting shopping hours must allow firms to provide their services at lower costs to the customers or improve ambiance for their customers. Dress codes may similarly be imposed to create ambiance desired by a restaurant's customers.

Ease of substitution (exit), however, clearly limits the ability of rival organizations to impose rules on their customers. McDonalds, for example, could not require all of its customers to wear tuxedos when eating one of its hamburgers, although restaurants with monopoly power might be able to do so.

there are, as noted above, limits to a monopoly organization's ability to extract rents from its client-customers.

Perhaps surprisingly, there are also methods for increasing rent extraction opportunities that provide additional benefits to a community's residents. For example, the demand for a monopolist's services can be increased by reducing transactions costs and increasing client-consumer income. Such effects gives regional monopolists what Olson (2000) calls an "encompassing interest" in their communities' economic development. For example, a local monopolist may undertake or subsidize the construction of a network of roads to reduce production and distribution costs for all consumers and non-rival firms in its territory. Similarly, a regional monopolist may provide dispute resolution and other legal services, because "law and order" increases local prosperity and the demand for its services.

Any public or private service that directly or indirectly increases net revenues for the monopolist may be provided.

On the Provision of Law and Order by Local Monopolists

It is interesting to note that "dispute resolution services" can be provided at a relatively low cost by large regional monopolists, because their "rulings" can be enforced by simply threatening to increase prices or deny services to those who fail to follow its rulings.

To produce dispute resolution services, a monopolist may create and delegate the authority to an arbitration board and head arbitrator. A network of more or less permanent locations and times may be established at which disputes will be evaluated and judged by company arbitrator-judges. Again the logic of rational conservatism applies. It will normally be the case that the rules enforced by local authorities will be based on older successful bodies of law rather than invented whole cloth for each dispute or each community. The rules may modified slightly for the cases or communities at hand, insofar as doing so increases the surplus of the monopoly organization.

Consistency can be assured by writing down the rules and allowing appeals of particular decisions that end with a single individual or committee, such as the governor (formeteur or successor) or supreme court. Such procedures also tend to reduce the risks associated with arbitrary treatment by ruling authorities for much the same reason that written contracts reduce risks from relationships among organizations and customers. It clarifies what is expected and reduces the extent to which the rules may be changed after decisions based on them have already been made.

Predictable, rule-governed, enforcement systems tend to make retention of a community's residents easier for community rulers, although, for reasons already noted, equal protection of the law may not. Deference to established laws and court decisions tends to reinforce institutional conservatism, because "the law" in most countries is regarded as a long-standing collection of rules and procedures with a high degree of functionality and normative support. The long-standing rules the emerge from such procedures are often regarded as "natural laws" or "rights."

It bears noting that the earliest known written laws are from the Euphrates valley where governments were based at least in part on monopolized irrigation networks. These early laws are known, because they were literally written in stone. The Code of Ur-Nammu was carved into tablets about 4,000 years ago and the Code of Hammurabi was chiseled into basalt a few hundred years later. These legal codes subsequently affected the standing rules of many other communities in the Middle East, including what became Jewish law (Finkelstein 1968–69).

Religious services were also among the core monopoly services provided by many ancient governments (Bailkey 1967). The monopoly power of state religions allows them to impose rules on believers and nonbelievers by espousing universal norms for behavior. "Thou shalt not ..." Formal laws and norms are often enforced through religious court systems. Such courts were run, for example, by Catholic, Jewish, and Islamic churches during the medieval period. When supernatural threats are believed, they can be a cost-effective method of encouraging compliance with the rules, and also for reducing resistance to the decisions reached in court proceedings. When religious services are not directly provided by governments, religious monopolies are often supported by regional governments. The state-supported church, in turn, normally reciprocates by encouraging support for the government. Even today, the sovereign of England is the head of the Church of England, and hold the title "Supreme Governor of the Church of England."

Just as a consistent predictable set of rules can increase an organization's viability by solving coordination and team production problems, so can a predictable set of community rules (laws) increase the prosperity of a community. Stable sets of community rules can solve coordination and externality problems. They can reduce the extent and cost of unproductive conflict among persons and organizations in the community. They can also facilitate (and encourage) long-term planning by individuals and organizations by increasing expected returns and/or reducing the variance from capital investments and specialization. The value added by "law and order" services is emphasized in the early enlightenment contract theories of the state developed by Hobbes (1651) and Locke (1689) and in contemporary game theoretic explorations of shifts from anarchy to civil society, as in Nozick

(1974), Skogh (1982), and Volckart (2000). There is also a substantial body of empirical research in economics that links the provision of law and order services with increased national income.[31]

Providing such services tends to encourage the development of prosperous communities, which increases potential rent extraction for ruling monopolists by increasing the demand for their services.

E. Military Threats, Rent Extraction, and Defense

As profits and deference are produced, rivals inside and outside the organization may attempt to take over the leadership posts in regional governments in order to enjoy the rewards associated with those positions. Such take over efforts may include threats of violence. Both formeteurs and their successors naturally take steps to avoid both internal and external overthrows. With respect to the latter, they will defend themselves, their organization, and their territory. They do so by organizing defensive teams and investing in defensive capital. The organization may fortify its offices and production facilities. The monopolist's team members and customers may be encouraged to turn out and defend the organization's capital assets (the irrigation system, wind mills, buildings, etc.).

An implication of the analysis of chapter 2 is that the cost of defensive teams can be reduced by encouraging militaristic norms (the warrior ethic) and other forms of loyalty (community patriotism) that tend to promote rule-following behavior, toughness, and a willingness to sacrifice for the government and its community. Defensive norms, teams, and capital can also be used to drive up exit costs, which allows greater penalties to be used to assure compliance with its rules adopted to defend the government's interests.

Artificial and Natural Monopolies

The infrastructure and teams organized to provide defense can also be used to increase an organization's monopoly power.

Economists often distinguish between natural and artificial monopolies, and this distinction is of some relevance for the present analysis. Natural regional monopolies tend to emerge when there are significant economies of scale in production that a regional market supports only a single efficiently sized firm, or when particular skills or natural resources are available from only a single source within the region of interest, because of natural genetic or geological variation. Examples of services that exhibit significant economies of scale include irrigation systems, village defense,

[31] See, for example, Keefer and Knack (1995, 1997) or Feld and Voigt (2006).

theology, dispute settlement, urban planning, education, sanitation services, and social insurance. Regional monopolies also occur when a single organization or cartel controls a critical natural resources such as an artesian well or salt mine.

In contrast, artificial monopolies arise when an "entry barrier" is created that allows only privileged organizations or persons to provide particular services in the region of interest. For example, religious services, exports and imports, and military training are often monopolized by making rival organizations illegal. Such barriers to entry tend to induce competition to join privileged groups, which can further increase income, authority, and support within the privilege organizations and groups. The possibility that such barriers can be created naturally induces competition for the government's favor, which can be a useful source of in-kind services for regional governments. Monopoly privileges may also be sold or rented to other organizations as an additional source of government revenue (Congleton and Lee, 2009).

Artificial monopolies can be created by government policies. A monopolist's rule making and dispute resolution services, for example, can be used to enforce requirements that producers of particular products belong to specific clubs or families, or obtain special permission from the ruling organization. Rivals may also be prevented from serving particular markets, by forcibly closed them down through force of arms. Monopoly power can also be increased by adopting and enforcing rules that reduce the viability of potential rivals (Lott 1990).

To help pay for fortifications and defensive teams, a monopolist may also rent out well-defended positions to persons in the community when military risks are significant. Indeed, community-wide defense services is another area in which monopolies may emerge. Persons whose life or property are at risk are willing to pay very high fees for access to a fortress or redoubt when external security risks are high, because exit options are of little value at such times. Those seeking protection are willing to pay essentially any price, which may include promises of cash payments and other services in the future. The implied offer is essentially "your money or your life," although in this case, the monopolist offers a service, rather than a threat.

All these effects imply that a regional monopolist with military power will tend to have a greater organizational surplus than ones without such power. The organization of military force helps monopolists protect and extend their monopolized markets. The highest levels of dispute resolution will tend to be those run by the physically strongest organization in a given territory, because there are economies of scale in making credible military threats. In such cases, "might" may literally be said to make "right." Rule-enforcement may be enhanced by including physical punishments, as well as denial of services. The confiscatory powers and credible threats associated with military power also make it easier for such organizations to obtain the resources required to sustain their team members and to weather temporary setbacks.

Military power thus tends to increase organizational viability in the short and medium term, as long as mass exodus is not induced and the cost of producing it is not too great.

Military Power and the Dissipation of Monopoly Rents

In the long run, however, success tends to intensify efforts to overthrow territorial governments. The greater are the local monopoly profits and the more prosperous is a given community, the more it pays rivals to invest in internal and external takeovers (Thompson 1974, Tullock 1974). The former may undermine stable governance in the long run, as noted in chapter 3; the latter may cause a territorial government to be absorbed into another at great cost to its leaders and their communities.

The winner-take-all nature of external takeovers implies that when conflict occurs, it will generally consume substantial resources. To be prepared for wars of conquest, requires significant investments in training, fortifications, and arms. The intense short-term nature of wars also tends to attract the full attention of the government, which tends to reduce its productivity in other areas. Monopoly fees and tariffs tend to rise and productive investments tend to fall as governments shift resources from peaceful to military purposes in order to resist the takeover efforts of rival organizations.

Contest theory implies that essentially all of a regional monopoly's profits may be dissipated by such conflict, as in a rent-seeking contest (Congleton, Hillman, and Konrad 2008). History suggests that such risks are not simply a matter of conjecture. There are many cases in which prosperous communities have been plundered by roving bandits and annexed by rival armies. The border conflicts of medieval and early modern Europe often took European kings and princes to the verge of bankruptcy (Ertman 1997, Ferguson 2002).

The all-encompassing nature of conflict during times of intensive border conflict helps remind us that military power is not likely to provide an explanation for the origin of civil society, although it does enhance the ability of regional monopolists to impose rules on persons outsider their organizations. Fortunately, the same natural barriers that increase regional monopoly power and increase exit costs also provide a good deal of free defense for many communities around the world. Natural defenses such as mountain ranges, deserts, rivers, and oceans simultaneously increase monopoly power and reduce threats from rivals, which reduces the need for military organization. Great empires have often been assembled by overcoming such national defenses, but they did not create the prosperity that made empire-building a profitable activity.

F. Conclusions: The Form, Basis, and Limits of Territorial Governments

The ability of territorial monopolists to impose rules on their "customers" increases their command over resources and thereby provides those organizations with additional resources that can be used to weather difficult times. This makes territorial governments unusually robust and durable organizations. Few organizations last as long as territorial governments, and those that do, such as religious organizations, often have similar monopoly powers and rule-imposing abilities. Economies of scale in the core services of major territorial monopolies often require, or at least support, relatively large organizations. Territorial governments are often the largest organization within the territory of interest.

The rules imposed by governments are still backed by threats that include denial of services (banishment from the community) and threats to take property, life, or limb forcibly. However, a regional government is not free simply to take (or threaten to take) everything from those outside their organizations, as long as that which to be taken is produced by other organizations in the community (who may refuse to comply) or exit is possible. Moreover, a territorial monopoly that has its own interests at heart often has good reason to increase general prosperity, insofar as it profits directly or indirectly from greater demands for its services.

The rules enforced by regional governments tends to be stable, but unequal. A rent-extracting regime has little interest in civic or economic equality for its own sake. Some persons are more important to their organization than others, and such persons may be privileged in various ways. Opportunities to profit from price and rule discrimination and from the direct sale of market privileges imply that the prevailing rules will be substantially unequal.

In other respects, regional governments are predicted to be very similar to other durable organizations. As true of other organizations, a mixture of pecuniary and nonpecuniary rewards and punishments, as well as local norms, will be used to solve the government's internal (and external) incentive problems. As true of other organizations, their policymaking architecture will tend to be drawn from existing templates, among which the king and council template is likely to be prominent. The balance of authority within that template will reflect the origin of the governing organization. If founded by a single formeteur, a good deal of policymaking authority initially will reside with the organization's chief executive—mayor, governor, or king—and somewhat less authority will tend to be available to its council—town council, cabinet, or parliament. If founded as an alliance of local residents or a confederation of regional governments, the council will tend to be the dominant policymaking authority and the chief executive officer will, for the most part, simply implement council decisions.

As true of other organizations, durable territorial governments are predicted to have standing procedures for making policy decisions and for replacing their leaders. Standing procedures for making policy decisions tend to remain in place, because of the advantages that those rules have for government leaders and because f uncertainties associated with experimentation. As a consequence, the persons inhabiting the policymaking offices of durable organizations normally change more frequently than the core procedures of governance. As the English saying goes, "the king is dead, long live the king." Succession problems will often be solved by allowing kings and/or councils to appoint one another and through mechanistic succession based in family bloodlines. Even in cases in which an internal overthrow takes place, the preexisting procedures of governance are predicted to be retained for the most part.

Relevance of Analysis for European History

These predictions are consistent with most accounts of regional governments in recorded history, which it must be acknowledged occurred somewhat after territorial governance and large prosperous communities emerged. There is substantial evidence that durable governments had stable procedures of succession and stable public policies. There is evidence that privileges of various kinds inside and outside government were commonplace, and to a significant extent engineered by important regional governments with monopoly churches. There is evidence that mobility was a concern for governments and a balm for community residents. Natural barriers thus influenced the course of political and economic development (Jones 2003). Very large migrations also occasionally took place to escape from governments with reputations for arbitrary rewards and harsh punishments. There is substantial evidence that the king and council template for governance was widely used.

Of greater importance for the historical purposes of this book is that chapter 4 explains the core architecture and policies of national governments in late medieval Europe and Japan. National governments in Europe and Japan emerged in this period and so were relatively new organizations. In cases in which a single person can be said to have organized the amalgamation of the territories governed, the CEO of the subsequent government tended to be dominated by the formeteur, as with the kings of England, France, and Sweden and the Shogun of Japan. In cases in which the government was initially organized as a defense alliance, a council of formeteur representatives tends to be the dominant chamber of government. The Netherlands was founded in the sixteenth century as a defense alliance and initially had a relatively strong parliament and weak executive (stadhouder). Similar balances of authority are also found in Switzerland and the United States.

A broad variety of barriers to trade were adopted within and among the medieval kingdoms. These were often used as revenue sources for the state of interest, as with tariffs and sales of monopoly privileges. Medieval laws also treated members of different "classes" of families differently. Nobles and royals had many privileges. European councils and parliaments were largely populated by "blue bloods," persons from wealthy and privileged families, many of whom held their seats in government as an inherited birthright. Many positions in the military and in the bureaucracy were reserved for privileged families. Slave and serf families had restrictions that others did not. The members of families in between these extremes had intermediate privileges and restrictions.

By the end of the medieval period, the economic foundation for territorial governments had evolved substantially toward tariffs and property taxes, which can be thought of as charges for defense services, although many governments also had significant monopoly power over dispute resolution services, transport networks, potable water, and sanitation. There was normally a state church with monopoly power over religious and moral theory. "Deviant" ideas (new entrants) were discouraged by widespread norms of deference to religious and state authority. The authority of the medieval church and state were, after all, the consequences of divine intent. To challenge their authority was blasphemous and traitorous. Informal religious and cultural sanctions were further buttressed by censorship and treason laws enforced in religious and state courts.