The Bonds of Trade

The Bonds of Trade: Economic Institutions in Pre-modern Northern Europe

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To Sara and Jan

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PREFACE

This book is about human competition and co-operation. These topics have fascinated me for a long time, and I have dealt with them in several books covering (mostly) Finnish economic history from the Middle Ages until the emergence of the early industrial cartels. Anyone who aims at explaining why economic agents not only compete but also constantly evolve cooperative strategies for the common good cannot avoid the study of institutions. I first bumped into the concept of institutions when I was working on my Ph.D. thesis in the early 1990s. Since then, institutional analysis has taken a giant step toward a more coherent approach.

Although many points are clarified, there still remain surprisingly many questions requiring investigation. Institutionalists are not even unanimous about what they mean by an “institution” and even less so about the forces by which institutions emerge and change. Many theoretical and empirical studies nevertheless suggest that institutions have played an important, perhaps decisive, role in the shaping of history. These observations encouraged me to write this book. It sheds light on institutional development in medieval and early modern Northern Europe and, more generally, participates in the intensive discussion about institutions. It seems to me that if we truly want to deepen our understanding about institutions, we must necessarily integrate theoretical and empirical approaches. This is exactly what this book endeavors to do.

It is customary in acknowledgements to provide a long list of persons who have contributed to the writing of the book at hand. I simply want to express my thanks to my students and colleagues over the past two decades whose interest has supported me, along with their questioning of my arguments, in rethinking many issues. I especially wish to show my gratitude to the Turku Institute of Advanced Studies that three years ago accepted me as its member. During this time, I have had an excellent opportunity to concentrate on this project and to have lively discussions with the other members of the TIAS. Finally, as always when I have been writing a book, my wife and two wonderful children have shown forbearance and understanding even at moments when my thoughts have been somewhere in the world centuries ago.

Chapter One

Trade in an Uncertain World

When the Finnish merchant, Hans van Eken, sailed across the Gulf of Finland towards Tallinn in the spring of 1507, the voyage became his last. Outside Tallinn, by the island of Naissaar, two privateers hired by the King of Denmark robbed van Eken's ship with its cargo. According to Skipper van Eken, he managed to save himself by plunging into the sea and swimming to shore. The crew was not that lucky: the privateers cut off their arms and legs before jettisoning them into the sea.[1]

This case illustrates the brutal behavior of the time, but it also reflects the problems related to pre-modern long-distance trade in general. Besides for a lack of personal security, trade was characterized by slow communication, asymmetric information, different interpretations of facts among merchants, and limited contract enforceability. Merchants operated in a highly complex and uncertain environment. Unanticipated events and multiple interpretations of existing agreements were always possible under these circumstances, implying that the definition of a "contract violation" was often ambiguous. Moreover, the trading parties negotiated their contracts with their domestic customs of trade and informal rules of conduct in mind. Thus, in addition to everyday problems such as various exchange rates, different units of measure, or the condition in which the goods would arrive, risks encountered in overseas trading were characterized by legal and political uncertainties. Consequently, pre-modern long-distance trade seems to have involved particularly high transaction costs.

Most of these problems originated from the costliness of generating and commuting information. In the pre-modern era, information was a scarce resource. As trading communities and merchants' networks grew larger and as trade among different regions expanded, it became increasingly difficult both for individual merchants and communities to

[1] FMU 5243.

monitor one another's behavior. However, trade is basically about gathering information and taking advantage of that information. Trade requires contacts between individuals, communication of personal needs, and, for example, negotiation of prices. Because information can be considered as an essential tool in business, gathering information and making choices on the basis of information is just as critical a part of business as handling the merchandise, among other things.[2]

Today, written laws, the police, the judicial system, and other authorities provide enforcement mechanisms to mitigate cheating and other types of opportunistic behavior. Basically, no such authorities invested with territorial monopolies of coercion existed in pre-modern Europe. Even if there were rulers interested and capable in protecting the merchants' property rights, their power was usually geographically limited. It is hardly a novel observation, however, that even without the services of the state, order could prevail and gains from trade could be realized. In close-knit social groups, in particular, members tend to encourage each other to engage in cooperative behavior. If individuals know each other well, reputational mechanisms based on frequent communication could be enough to restrain opportunism. In fact, it is one of the main insights of anthropology, and of exchange theory in sociology, that in relatively small groups, even fairly sophisticated forms of cooperation may emerge.[3]

Long-distance trade, however, is a different case. Compared to pre-modern local exchange, there typically was much less or no political authority able to protect property rights or to enforce legitimate claims between merchants from distant localities. In addition, unlike local trade, payment and the delivery of goods did not usually coincide. Thus, exchange that was characterized by the separation over time and space was less likely to be supported by a reputational mechanism. As the market extends, it sharply increases the number of trading partners.[4] In this stage, the individuals hardly have an intimate understanding of each other, just as one would expect in the small scale local exchange. If it was not barter trade, where goods and payment were exchanged at the same time on the

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[2] Greif – Milgrom – Weingast 1994, 752; Mangels – Volckart 1999, 428; Milgrom – North – Weingast 1990, 4.
[3] For example, see Axelrod 1984, 3-4; Mantzavinos 2001, 128-130; Volckart 2004, 283-284.
[4] I use the term "market" here as an abstraction involved with individuals making "economic" decisions. I may also refer, in another context, to "a market" in the sense of a "marketplace", as a physical place where goods are bought and sold. C.f. McMillan 2002, 5-6.

spot, deceit was possible. Consider, for example, a Finnish merchant in the Middle Ages who sailed or sent his goods overseas to a Hanseatic town, say Lübeck. What means did he possess to find a partner who would behave in a good manner and who would not cheat him? How could he monitor the actions taken by his foreign colleague, as a voyage trip to Lübeck and back took easily five or even seven weeks? And if something went wrong, what coercive powers, if any, did he have to get justice?

Despite these seemingly overwhelming problems, trade, and even overseas trade, did flourish in medieval Europe. In the 1950s, the economic historian Roberto Sabatino Lopez coined, on the analogy of the industrial revolution, the term *commercial revolution* by which he referred to the rapid expansion of European trade from about the tenth century until the devastating plague pandemic in the middle of the fourteenth century. During this period, "commerce…became the most dynamic sector of the economy in one country after another, and merchants were the main promoters of change".[5]

It is a widely accepted fact that the High Middle Ages marked an era of extensive economic growth in most parts of Europe. The economic expansion seems to have slowed down in the fourteenth century, however. The Black Death was followed by a depression, which lasted until the end of Middle Ages. The following sixteenth century, on the other hand, marked an economic upswing that continued well into the seventeenth century. Several indicators point to the favorable development in the early modern period. On the basis of the data from different parts of Europe, the population increased considerably and consequently prices went up as wages dropped. However, this development was not identical in every part of the continent and it did not necessarily have a straightforward impact on trade. The overseas trade of England, for instance, increased to a great extent between 1300 and 1525. [6] The Baltic Sea region, on the other hand, seems to have been an exception to other parts of Europe. The Baltic Sea was far behind the core regions of Europe to begin with and, on the other hand, the continuous migration gave an economic impetus. The effects of plague epidemics were also less dramatic than elsewhere. The peripheral

[5] Lopez 1976, 86. Even before Lopez, another prominent economic historian, Henri Pirenne (1936, 79), talked about *revival of trade*, referring to the same economic expansion.

[6] Bernard 1972, 274-27; Cipolla 1989, 204-219; Brittnell 1993, 360; Pounds 1988, 403-404, 440-483.

Finland is a case in point: foreign trade and the economy as a whole expanded rapidly until the late sixteenth century.[7]

Thus, there seems to be an obvious paradox: even in the absence of the state and under uncertainties of many kinds, trade thrived and the economy expanded.[8] Medieval merchants had apparently somehow managed to deal with the fundamental problem of exchange, as Greif aptly calls it: one will not enter into an objectively profitable exchange relationship unless the other party can *ex-ante* (when a decision is made whether or not to exchange) commit to fulfill his contractual obligations *ex-post* (when he can renege).[9]

It might be argued that opportunism is an integral part of human nature. Opportunism, deceitful behavior intended to improve one's own welfare at the expense of others, may take many forms, from inconsequential, perhaps subconscious, shirking to a carefully calculated effort to defraud others with whom one is engaged in ongoing relationships. Examples of opportunism can be as rude as simply refusing to make an agreed payment. More sophisticated forms of cheating include the offering of high quality goods for sale and delivering low quality, or delivering slightly fewer goods than agreed, so that the buyer can hardly notice the difference.[10]

The idea of opportunism has been central to game-theory that analyzes competition as a game in which one individual does better at another's expense. Many economic interactions have the character of the prisoner's dilemma, a primary problem in game theory that demonstrates why two people might not cooperate even if it is in both their best interests to do so. The best outcome for both would be that neither cheats. In a single transaction, however, both parties may have an incentive to cheat, leading to an outcome that does not necessarily benefit either. What makes the model so important is that it is claimed to be a common feature of social and economic life.

Every medieval trader had to keep in mind the possible opportunism of other merchants. As game theory would suggest, people are not angels, and they may look after themselves and their own first. Under what conditions, then, will cooperation emerge without central authority in a

[7] Damsgaard 2001, 45-46; Dollinger 1971, 215-216; Kallioinen 2000, 197-198; Malowist 1959, 187; Pounds 1988, 472.
[8] Volckart (2004, 284) was among the first historians to notice this paradox.
[9] Greif 2000, 254; 2005, 730.
[10] For example, see Ostrom 2005, 51; Rubin 2005, 213; Söllner 1997, 229.

world of egoists? How can cooperation ever develop in situations where each individual has an incentive to be selfish? Nevertheless, we know that cooperation does occur and that our civilization is based upon it. Empirical findings show that cooperation is common because people are motivated by social preferences: they care about the well-being of others and value fairness and other norms of decent behavior. Historically, it has been the ubiquitous effort of humans to render the world intelligible by making their environment more predictable. Reducing uncertainties is basically a key problem of human cooperation.[11]

In medieval society, merchants were not without means to deter opportunistic behavior. Among the most important ones making cooperation possible were repeated interaction, reputational mechanisms, and other institutions based partly on these two. These were not alternative methods, but instead every trader was able to benefit from more than one of these responses to opportunism. It is well known that social commitment enhances the stability of personal ties. Individuals who repeatedly interact can successfully cooperate if they observe each others' actions and place a sufficiently high value on future transactions. The continuing relationship itself becomes a valuable asset that a party could lose by dishonest behavior. The relationship thus serves as a bond, because a merchant would be unwilling to surrender it unless the gain from opportunistic behavior was big. The cost of opportunism would be neither the cost of cheating nor even the cost of precautions taken to avoid being victimized. Rather, it is the lost social reputation from the otherwise profitable deals that would not transpire.

In game-theoretical terms, if a game is played only once, it is in each player's separate interest to cheat, since it maximizes the player's individual utility. However, in continuing relationships, if the players can observe the other players' past actions (their "reputations") then they have an instrument to reward past honest behavior and to punish cheating. In this kind of repeated interaction based on the bilateral reputation mechanism, commitment to the contract may be credible because both players would lose by breaking it. Thus, the contract is self-enforcing: the expected behavior of an individual leads the other party to behave and to

[11] Axelrod 1984, 3; Bowles – Gintis 2011, 19, 33; North 2005, 4. Trivers (2011, 6-7), however, portrays a very different view of humans. According to him, deception is a very deep feature of life. It occurs at all levels and in almost all relationships, “from gene to cell, from individual to group”.

be expected to behave in a manner motivating both parties to assume this expected behavior to begin with.[12]

More importantly, the same can apply to a larger merchant community. Within a community, if players change partners often and even if cheaters may never again have to face the cheated partner, cheaters may lose all future trading partners in the community, provided that information about the past behavior of all the merchants is widely shared by all. The incentive not to cheat is based on a multilateral reputation mechanism. The community of merchants serves as an "information agency" reporting on reputations that thus coordinates the actions of its members or, in other words, dishonest colleagues will be boycotted.[13]

The large body of network literature dealing with different historical settings and episodes indicates that long-term relationships were not only common but they were also highly valued. It may be argued that most economic actors expect to be active for a long time, and perhaps interact with other actors over and over again. Repeated personal interaction and reputation mechanisms formed the basis for making continuing and expanding exchange possible. Furthermore, they seem to be important components in what can be called the institutional structure supporting trade.

There is a wide consensus that beneficial institutions provide order and predictability to human interaction by reducing opportunism and uncertainty. The literature generally is optimistic about the efficiency of institutional arrangements that provide secure property rights, and thus tend to be wealth enhancing. Because trade, like all economic activities, is a social act, it brings together groups of people who often have very different cultural understandings of the terms of interaction. People can trade without sharing some rules of the game, but in different cultures there are different understandings about the varying trading practices. This is where shared and mutually internalized institutions can help. In order to engage in social interaction, individuals do not necessarily need to know more than the institution in the form of a social rule: it aggregates private information about the others' expected behavior and distributes it in a compressed manner.[14]

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[12] Axelrod 1984, 125; Greif 2000, 257; Kranton 1996a, 830-831; 1996b, 214; Milgrom – North – Weingast 1990, 1, 7; Rubin 2005, 214.
[13] Milgrom – North – Weingast 1990, 3, 7.
[14] Eggertsson 2001, 83; Greif 2006, 4, 134; North 1990, 3-4; Pomeranz – Topik 1999, 3, 31; Schmid 2004, 1; Söllner 1997, 230.

The institutional view is thus different from the neoclassical economics that are, by and large, interested in the markets as an abstraction that say little about how markets actually do their job.[15] The institutionalists, unlike the neoclassical economists, argue that markets are always embedded in social structures, that is, in exchange processes taking place within a set of social rules. This idea has interesting implications considering the role of the markets, whether in past or modern societies. If we accept the idea that economic development without "good" institutions is impossible, then there is only a short step to recognize that markets ("the invisible hand") are not independent forces like natural laws, but instead they are systems in need of human design and support.[16] Long before the Lehman Brothers bankruptcy and the related global financial crisis and regulatory failures, institutionalists have emphasized the importance of rules in the functioning of markets, both informal and formal.

Previous research provides some examples of how institutions may have promoted medieval trade. One of the early institutions in medieval Europe was the community responsibility system, as Greif calls it. Under this system, a local urban community court held all members of a different commune legally liable for default by anyone involved in contracts with a member of the local community. If the communal court of the defaulter's community refused to compensate the injured party, the local court could confiscate the property of any member of the defaulter's community present in its jurisdiction as compensation.

The threat of retaliation provided strong incentives for traders to stick to the terms agreed in the contract. However, with growing city sizes, the increasing number of traders and trade deals, cities became more anonymous places where social control diminished. Less credible characters were able to slip onto the stage and externalize retaliation costs to the wider community. The risk of being caught up in retaliatory actions increased. Moreover, the unwinding of retaliatory actions was a costly affair. It involved substantial time losses for all traders involved and often required a lot of bargaining between many parties. By the thirteenth century, if not earlier, the community responsibility system and its retaliatory action scheme had to be abandoned and replaced by enforcement systems that were not based on the control of collective reputations of communities.[17]

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[15] McMillan 2002, 8.
[16] Ankarloo 2002, 9-10; Mantzavinos 2001, 161-166.
[17] Greif 2006, 309-311, 318-349.

Another response to overcome some of the transaction costs associated with medieval trade was based on the private code of laws (the *law merchant)* and private judges that adjudicated disputes among pairs of traders. This institution that existed in the Champagne fairs in France in the twelfth and thirteenth centuries provided a more cost-efficient alternative to the community responsibility system. Rather than forcing all traders to check one another's reputations and impose costs collectively, the law merchant provided for independent, private judges to keep records of those transactions where a dispute had arisen. While the judges had no power to enforce their judgments, reputation effects alone were usually sufficient to induce traders to accept the judgments and pay whatever dues they owed. The law merchant did away with the necessity of repeated interactions between any pair of traders. It made reputations portable across the community of traders and thereby overcame the problem of asymmetrically distributed information. The institution was, however, limited to a single market place where a single judge could keep track of all trade disputes, so it was not effective in a larger setting of trading localities.[18]

The third example of a medieval economic institution comes from the eleventh century Jewish Maghribi community in the Mediterranean. As showed by Greif, reputation was of upmost importance in the Maghribis' trading system. The Maghribis formed "coalitions" and relied on agency services by other members of the coalition to handle their commercial interests in other trading ports and cities. They had an apparently effective system to deal with agency problems. In the Maghribi community, any agent accused of dishonesty was rejected by the entire community. Among the Maghribis, agency relations were governed by an institution that was based on self-enforcing collective punishment and was supported by an intrinsic social communication network. They did not need formal courts or judges to enforce contracts because the informal mechanism of collective retaliation and community-based sharing of information worked well within their homogenous cultural system. Ultimately, however, the Maghribis’ failure to rely on such third party enforcement mechanisms as

[18] Milgrom – North – Weingast 1990. Recently it has been argued, however, that there were no private judges at the Champagne fairs. Instead, the fairs offered a combination of different courts that the visiting merchants could make use of. This system was supplemented by a dedicated fair court, but its judges, the fair-wardens, were also princely officials and did not prevent foreign merchants from enforcing contracts at other levels of the princely justice-system. Edwards – Ogilvie 2012, 141-142.

courts required great social investments in reputation and restricted their trade to socially narrow circles. Their collectivist institution turned out to be a dead end, because it was not particularly effective in meeting the needs of impersonal exchange, a necessary condition for an expanding trade.[19]

This study builds on these and other earlier attempts to explain the role that institutions have played in past economies. Recent decades have witnessed major contributions in institutional economic history by Douglass North (1990), Avner Greif (2006), and Sheilagh Ogilvie (2011), just to mention three. North was one of first scholars to bring history into the study of economic institutions and institutional change by using an analytical framework developed for this purpose. Greif, on the other hand, demonstrated with inventiveness and theoretical skill that institutional analysis can be based on solid theoretical tools. Ogilvie's study convincingly challenges the common view that merchant guilds, central and lasting organizations coordinating European trade from the Middle Ages until the eighteenth century, benefitted the entire economy. Her book shows that institutions may persist even if they are not economically efficient, and that institutions cannot be exclusively explained in terms of efficiency.

It seems, however, that we still have a limited understanding about institutions in actual historical situations. What is missing, above all, is empirical evidence of institutions in different political and social environments, as well as careful empirical examination of institutional development over long periods of time. Institutional analysis has been advanced more by economists and other scholars concerned with theoretical explanations than by historians dealing with the manifoldness of past events. It could be argued that institutional analysis would benefit from a dynamic examination of change over time instead of a static view. Therefore, there is an apparent need for a deeper understanding of the historical context of economic institutions. This is exactly what this book endeavors to do: the aim is to take history as the driving force of the argument and improve our knowledge of the actual operation of historical institutions.

The book is based on a detailed study of institutions that prevailed in overseas trade in the Baltic Sea region in the late Middle Ages and the early modern period. In the Middle Ages, the Baltic Sea used to be a politically divided, but culturally somewhat unified, region, where regular

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[19] Greif 1989; 1993; 2006, 58-90.

and lively maritime trade was carried between different towns. It was a peripheral region, although it was connected by numerous commercial ties to the more centrally located economic regions of Europe. It is thus likely that several innovations, including institutions, were easily adopted by the Baltic Sea region from other parts of Europe.

This study is motivated by the observation that none of the above mentioned three examples of medieval economic institutions seem to have played a role in the pre-modern Northern Europe. The community responsibility system and the Maghribi-type coalitions may not have been functional in the Baltic Sea, as trade had rapidly expanded. There were a few dozen towns along the coasts, and the total number of merchants must have exceeded several thousand. In an environment of lively inter-communal interactions, the economic costs of the community responsibility system would have been high. Non-anonymous reputation based mechanisms, such as the coalitions of the Maghribis, on the other hand, would have faced great difficulties overcoming problems of asymmetric information, considering the large number of traders in the Baltic Sea region. Finally, private judges similar to those of the Champagne fairs were not an option either, because that institution required repeated interaction within a limited group. Furthermore, it was restricted to a single market place in which a single judge could keep track of all trade disputes, so it was not suitable for trade between various communities and an almost infinite number of traders.

The Middle Ages in the Baltic Sea region could be best described as the formative period of regular and stable trade connections, and market integration in general. Towns, which were the bases of commercial networks, were founded from the late twelfth century onwards. In all probability it was during the twelfth and thirteenth centuries that the institutional structure of trade was created. Unfortunately, the very few documents that have been preserved from this early period do not offer much information on this process. This is, however, an extremely important phase, because the institutional structure that was (allegedly) created then may have survived a long time. Therefore, the study of (early) medieval institutions must be based on documents surviving from the late medieval period, starting from the fourteenth century. It has been tentatively suggested that the roots of the success of the Western world may very well lie in the past institutions.[20] If this conjecture holds, then the examination of medieval institutions is even more significant.

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[20] Greif 2006, 25-27.

This book explores the cooperation between merchants in overseas trade in the medieval and early modern Baltic Sea. The focus is on economic institutions. By taking institutions as the basis of the analysis it is, of course, about choosing between institutions and other possible explanations for cooperation. This choice is based on the assertion that institutions do matter and that they can explain historical processes. In doing so, this study will be in line with what could be called the "institutionalist program": the aim is to explain which institutions affect the well-being of individuals and societies, and which institutions fail to do so.

The first task is to identify the institutional structure (if any) in operation. This also includes the examination of the possible enforcement mechanisms related to institutions. For this purpose, a method referred to as the historical method is developed to identify the relevant institutions. Second, the aim is to explain the change or persistence of institutions. The study of change, more than anything else, is at the heart of any historical explanation of institutions. This is even more important because within institutional economics, understanding the change of institutions is still in its infancy. It is of particular interest to know if there are general rules of institutional change that we could identify.

Third, the book is concerned with the problem of institutional outcomes. As discussed briefly above, the economies around the Baltic Sea expanded through the Middle Ages and, as in the rest of the Western world, economic development was again very rapid from the nineteenth century onwards. If institutions do matter and if they can explain historical processes, one must necessarily analyze their role in promoting welfare. Are institutions genuinely important and, if so, which ones are most important? Towards the end of the book, institutions and possible other sources of economic growth in the pre-modern period will be discussed.

The core idea behind this study is a systematic analysis of a long time period. If we want to understand the work of institutions in pre-modern trade, and particularly their change, then citing historical documents as examples illustrating such institutions is hardly enough. What is needed is a thorough and careful close reading of all the relevant documents covering the whole period under examination, instead of a static and selective case-study. This book tries to meet these requirements by analyzing a period of over two centuries, from about 1360 to 1590. All the documents related to Finnish long-distance trade in the Baltic Sea region are systematically examined from these years. The study thus covers the period from the appearance of the earliest documents of the 1360s until the early modern era, in other words from the interest-based, self-governed urban communities to the early phase of absolutism. This makes it possible to examine the interplay between merchants' self-governing organizations and the rising states, and the impact of this process on institutional development.

Finland, which used to be the eastern part of the Swedish realm, is the object of the study. Keeping the long time-period in mind, it would not be possible to examine all the documents from the whole of the Baltic Sea region, or even from a few parts of it. The Finnish merchants had regular commercial contacts with most towns around the Baltic Sea, from Stockholm and Tallinn to Danzig (Gdansk) and Lübeck. Because of the close connections, it is likely that the documents of this trade reflect the institutional structure of the Baltic Sea region in general. The starting point for this study has been to read and carefully analyze all the relevant documents of trade between the Finnish and foreign merchants. The number of documents exceeds 260 from four Finnish towns, most notably Turku and Viipuri. The number of documents is not extensive, especially if one considers the long period under examination, but in the context of the medieval archival sources it is nevertheless significant. The examination is based on correspondence between Finnish and foreign town councils (*Rat*) and, to a lesser degree, on correspondence between individual merchants. This correspondence is often related to different disputes in trade. One may assume that these situations reveal even more of the institutional structure than the daily routine of trade.[21]

[21] Over the course of time, most medieval documents have been lost in Finland. Therefore, the overwhelming majority of documents related to Finnish medieval history have been preserved in foreign archives, for instance in Tallinn, Gdansk, Stockholm, and other Baltic towns. For this reason, we often have the documents sent from Finland to towns overseas, but not the ones sent to Finland. Most documents analyzed for this study have been published in a printed collection of Finnish medieval documents, *Finlands medeltidsurkunder* (FMU), with eight volumes. A revised version of this collection is available online as *Diplomatarium Fennicum*: http://extranet.narc.fi/DF/index.htm.

CHAPTER TWO

INSTITUTIONS: THEORY, HISTORY, AND BOTH

1. What are institutions and what do they do?

For a few decades now, the term institution has been one of the key concepts of analysis not only in economics but also in other social sciences. In economics, the "new institutional economics" has modified the established ways of thinking about production, exchange, and consumption. As a response to limits of the mainstream neoclassical theory, the new institutional economics has gained substantial influence because it attempts to make neoclassical theory more realistic, social, and historical. It has accordingly brought economics more closely in touch with other social sciences and economic history. As such, the new institutional economics has been welcome by opening the way for a genuine interdisciplinary analysis.[1]

Institutional analysis has a strong interest in understanding how societies solve the basic problem of human cooperation. There have been two fundamental issues common to most institutional studies: how institutions affect behavior, and how to explain the process whereby institutions originate and change. In economic history, for the institutionalist program, the aim has been to show how economic outcomes depend on institutional structures and then to explain why efficient institutions were so rare before industrialization.[2] The task adopted by the institutionalists is not insignificant. In fact, their attempt to explain human behavior goes into the very heart of social sciences and history. Needless to say, it is all but easy, and many problems related to institutional analysis still remain unsolved.

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[1] See, for example, Ankarloo 2002, 10-11; Hodgson 1998, 178; 2009, 3-4; Matthews 1986, 903; Ogilvie 2007, 649-650.
[2] Clark 2007b, 729; Eggertsson 2001, 81; Hall – Taylor 1996, 937.

The new institutionalism, whether in economics, political science, sociology, or economic history, is far from being a unified body of thought. It can take different focuses and draw its inspiration from different disciplines. As a result, there are several sub-fields within the new institutionalism, for example historical institutionalism, rational choice institutionalism, and sociological institutionalism, each approach having its own theoretical background. There is no single foundational paradigm, and not even a single set of definitions of basic concepts. The vagueness of concepts in institutional economics may be due to the fact that it is a young domain of research.[3] From the start, the new institutional economics emphasized the analysis of the role of different formal institutions (contracts, property rights, laws, regulations, and the state) in structuring the framework of choice. Later on, the focus has been more on various informal institutions, such as conventions and codes of behavior that are usually more difficult to identify than formal institutions, because of their implicit nature.

In the institutionalist view, institutions are the key to understanding how economies and societies have evolved. They constitute much of the structure that influences behavior by providing a guide to cooperation. Institutions are the "language of interaction", an essential component of all societies.[4] The common argument of institutionalists is that economic institutions, in some way or another, improve the performance of markets. According to Williamson, institutions do this by minimizing the costs of using the market, the transaction costs.[5] Others emphasize the role of institutions in securing property rights: no economic development is possible without secure property rights.[6] North has promoted the view that institutions are the "rules of the game" that structure incentives in exchange and shape the choice-set of actors.[7]

These notions of institutional functions explain what institutions do, but they do not elucidate how they do it. This is an important point, because if we want to comprehend the role of institutions in economy,

[3] See, for example, Hall – Taylor 1996, 936; Martens 2004, 143; Thelen 1999, 369-382.
[4] Greif 2006, 379; North 1990, 3. Benson (1989, 646) called the medieval law merchant as a "language of interaction".
[5] Williamson 1985, 1, 20-22. See also Brousseau - Raynaud 2011, 67; Schmid 2004, 85.
[6] Cohen 1996, 63-64; Matthews 1986, 904.
[7] North 1990, 3. See also Mantzavinos 2001, 169; Nee 1998, 8; Scott 2001, 50, 52-53; Zysman 1994, 245-247.

knowing their functions is not enough. What is needed is a conception of how institutions coordinate behavior. The explanation suggested here, in line with several institutionalists, is that, from an individual's point of view, institutions provide invaluable information about how to respond to different situations that people meet in markets. More precisely, institutions convey tacit or explicit information about the expected actions of others and work as devices that allow economizing on information and information-processing capacity. Consequently, by economizing on the scarce resource of cognition and by providing agents with ready-made anchors of sense, institutions reduce uncertainties and promote exchange.[8]

Consider a medieval merchant who faced unexpected problems in his business. It would have been difficult and costly to react *ad hoc*, to decide each time in which way to respond to conflicts and how to solve them. The need for institutions arises from the combination of complex environment and limited cognitive capacity. Not only did medieval merchants (like all people at all times) have limited means to get information of the particulars of trade, for example prices or supply of different products, but also because of their limited cognitive capacity their environment appeared rather complicated and needed simplification in order to be mastered. To deal with the perceived complexity of the environment, they adopted, consciously or unconsciously, institutions as solutions to their problems. Institutions provide a collective and predesigned structure of behavior, instead of each individual having to decide separately and each time how to behave. Even more importantly, institutions provide individuals with information on how they can expect others to behave. This explanation thus suggests why institutions exist and what they do: institutions unify, coordinate, and increase the predictability of behavior because they provide individuals with a cognitive foundation to orient themselves to their environment.[9]

Institutions have puzzled social scientists for a long time, and they still continue to do so. It is perhaps not surprising that there is no unanimity

[8] Hall 1996, 939; Loasby 1999, 46; Rutherford 1994, 79; Schotter 1981, 109. The examination of how informational problems affect performance, though from different angles, is a common characteristic to all schools of institutional economic thought. That is precisely what distinguishes neo-classical from neo-institutional economics. While the former generally assumes that (near-) perfect information is available in transactions at (near-) zero costs, the latter assumes positive information costs. Martens 2004, 143-144.

[9] For an elaborated view of the cognitive model, see Greif 2006, 128-138. See also Mantzavinos 2001, 86-89.

how to define the concept. The literature provides us with an abundance of definitions. It seems that institutions try to escape all systematic accounts. The term apparently means significantly different things to different authors. In the colloquial language the term "institution" is used in various ways, and in each academic discipline there are controversies of their own about what an institution actually is. It is hard to make much progress in the study of institutions if scholars define the term to mean almost anything.

A major confusion exists between scholars who use the term to refer to an organizational entity such as the parliament, a business firm, a political party, or a family, and scholars who identify institutions with the rules of the game, with the governing structures controlling the players, the way the game is played, or with systems of beliefs and expectations. Some might even define institutions to include "all the above". Of course, choosing one definition, instead of another, marks an attitude on the role institutions play in societies in general. Defining institutions is also about making a stand on how they operate. Despite the difficulties associated with a definition, one cannot dodge it. It is not possible to carry out any empirical or theoretical analysis on how institutions work without having some adequate notion of the concept.[10]

To begin with, there are several ways to categorize between different institutions, based on different institutional qualities. Typically, institutions have been conceived as belonging to one of the two separate categories: formal or informal. According to North, institutional arrangements are the combination of formal constraints, such as rules that human beings devise, informal constraints, such as conventions and codes of behavior, and their enforcement characteristics. Formal institutions are defined as political constraints on government behavior enforced by legal systems. In contrast, informal institutions are private constraints stemming from norms, culture, and customs that emerge spontaneously. They are not designed or enforced by rulers or other public authorities. The key difference between formal and informal institutions is that informal institutions remain in the private realm, whereas formal constraints are centrally designed and enforced.[11]

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[10] C. f. Hodgson 2006, 1; Nelson – Sampat 2001, 32, 37; Ostrom 2005a, 823; Sened 1997, 55-56. According to Hodgson (2006, 1), the long history of usage of the term in the social sciences dates back at least to Giambattista Vico and his *Scienza Nuova* of 1725.

[11] North 1990, 4; 2005, 50. See also Mantzavinos 2001, 84-85; Nee – Ingram 1998, 19; Williamson 2009, 372.

North, however, does not make his distinction between "formal" and "informal" sufficiently clear. This dichotomy has been used in different and confusing ways by several authors. Some identify the formal with the legal and see informal institutions as nonlegal (that is, not expressed in the law). Another possibility is to make the formal/informal distinction one of explicit versus tacit institutions, or the formal with designed, and the informal with spontaneous institutions. Still another variant is to identify institutions supporting private contracts ("contraction institutions") and those constraining government and elite expropriation ("property rights institutions").[12]

In this book, a more fine-grained categorization is used that attempts to avoid the ambiguity of North's dichotomy. This categorization builds on an individual agent's point of view and it is based on three dimensions: does the institution reflect the coordinated responses of two or more individuals, how does it emerge, and how is it enforced. As a result, institutions can broadly be conceived as belonging to one of the four categories: bilateral decentralized, multilateral decentralized, multilateral centralized, and public institutions.[13]

An important aspect of any institution is whether it affects the behavior between two individuals (bilateral institutions) or in a wider community of actors (multilateral institutions). Typically, bilateral institutions need a less purposeful design than other institutions, and usually their enforcement is based on the personal actions of the party who was harmed ("decentralized"), instead of third-party enforcement ("centralized"). Whether an institution has emerged spontaneously, as an unintended and unforeseeable result of the pursuit of individual interests, or it is based on purposeful design, is often an indeterminate matter. Arguably many "designed" institutions can be found to exhibit some degree of "organic" origins, especially in the pre-modern era, prior to modern legislative processes. However, medieval Kings and other territorial rulers imposed rules in a centralized manner, and so did towns and guilds, for example.

There are also multilateral institutions that coordinate the behavior of even large numbers of individuals without any centralized enforcement through reputational effects. This could be the case in a group of individuals, if information about the past behavior of all members is

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[12] For this criticism see Hodgson 2006, 11. See also Acemoglu – Johnson 2005, 950-951.

[13] This categorization relies on Greif (2005, 731) and Ingram - Clay (2000, 530-539).

shared by all. On the other hand, if some private centralized organization is responsible for the enforcement of an institution, then we can refer to a multilateral centralized institution. In the context of medieval trade, towns, guilds, and other organizations run independently by merchants were able to enforce such multilateral centralized institutions. Of course, they also had the ability to introduce those institutions, as mentioned above. Finally, public institutions are multilateral institutions that are designed and enforced in a centralized manner by rulers (the "state").

In analyzing the institutional structure in medieval trade, public institutions may not have played an equally important role compared to other institutions, considering the limited powers of rulers. Decentralized institutions, both bilateral and multilateral, were widely ignored until recently, most likely because they are less visible than centralized institutions. They have provided, however, the foundation for cooperation long before powerful states even existed. Furthermore, as Nee and Ingram argue, they are critical to enforcing rules as the most immediate control on individuals. As such, they also determine the effectiveness of institutions of the other two forms. If multilateral centralized and public institutions will have their intended effects, however, it depends on whether decentralized institutions encourage individuals to accede to or oppose them.[14]

At the most general level, institutions have been defined as "a web of interrelated norms governing social relationships",[15] "sets of rights and obligations affecting people in their economic lives",[16] "prescriptions that humans use to organize all forms of repetitive and structured interaction",[17] "rules of the game" or "the humanly devised constraints that shape human interaction",[18] "the structure that humans impose on the human landscape in order to produce the desired outcome",[19] "durable systems of established and embedded social rules that structure social interactions",[20] or "a dominant system of interrelated informal and formal elements - customs, shared beliefs, norms, and rules - which actors orient their actions to when they pursue their interests".[21]

[14] Nee – Ingram 1998, 21; Ingram - Clay 2000, 536-537.
[15] Nee – Ingram 1998, 19.
[16] Matthews 1986, 905.
[17] Ostrom 2005b, 3.
[18] North 1990, 3; Persson 2010, 74.
[19] North 2005, 49.
[20] Hogdson 2006, 13.
[21] Nee 2005, 55; Nee – Swedberg 2005, 797.

Despite the plurality of definitions, there are common elements to most attempts to define institutions. Many scholars refer to institutions as "durable" and "internalized" systems that individuals "share" or "mutually believe". Furthermore, institutions generate "regularities of behavior" in "repetitive situations". Thirty years ago, Schotter defined an institution as "a regularity in social behavior that is agreed to by all members of society, specifies behavior in specific recurrent situations, and is either self-policed or policed by some external authority", a definition that covers most of what seems to be essential to any institution.[22]

More recently, Greif has presented an elaborated attempt to formally define the concept. According to him, "an institution is a system of rules, beliefs, norms, and organizations that together generate a regularity of (social) behavior". Greif states that institutions are composed of man-made, nonphysical factors that are exogenous to each individual whose behavior they influence. By "regularity of behavior" he means behavior that is followed and is expected to be followed in a given social situation by (most) individuals. Greif aims at explaining how institutions affect individual choices in actual situations that are not cognitively well understood. He, therefore, specifies that an institution comprises cognitive, coordinative, informational, and normative social elements that jointly generate a regularity of behavior by enabling, guiding, and motivating it.[23]

The above definitions cover several important elements of what we would usually understand by an "institution". One could ask, however, if efforts to define such a broad concept on an abstract and general level are doomed to fail. None of these theoretical definitions is hardly operational in the sense that it could be tested. Or, to be more precise, because of their general nature, they could be applied to so many different cases that they are likely to lose their explanatory power. A further problem is that many definitions include component terms like "customs", "beliefs", "norms", or "rules" that in turn are difficult to define and involve a long history of academic debate in the social sciences. A full definition should account for each individual case and provide all details of causal relations, which may be impossible. Considering the high complexity of the social world, there has been an almost endless number of institutions in different geographical environments and in different times, making a "final" definition even less likely. This is not to say that efforts of definition are useless. On the contrary, they indisputably increase our understanding of what institutions

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[22] Schotter 1981, 11.
[23] Greif 2006, 30-35, 151.

are. However, the question of which definition to adopt is not an issue of right or wrong: it depends on the purpose of the analysis. Furthermore, it would be counterproductive to consider different definitions as mutually exclusive, as they apparently have many common elements.[24]

Instead of a deductive approach, this book tries to inductively examine the relevant elements of institutions that prevailed in medieval overseas trade in the Baltic Sea region. This is exactly what has been missing in institutional theory, by and large. We can assume that institutional analysis could be further advanced by the empirical observation of actual, specific institutions, as the first step toward a more general conception. Thus, in this book, the (possible) context-specific definition of an institution will be the result of empirical analysis rather than the starting point of the study. Although no formal definition of an institution will be presented here, drawing from the above definitions, five institutional attributes will be taken as given. These attributes do not explain how institutions work, but they specify the main components necessary for every institution.

First, an institution can be described as a *mental, cognitive, and social constraint of behavior*. By mental, I mean that it exists only in individuals' minds. It is not a man-made object or an organization put together by a group of individuals (see below) for some purpose. It is irrelevant whether an institution is written down or not; in both cases it is essentially a mental construction, although potentially codifiable. An institution is cognitive in the sense that it guides individuals in a social environment by helping them to process information about that environment. It is social because it only exists in interaction between individuals, irrespective of whether they are aware of it or not. Therefore, an institution can only respond to problems that arise between humans. In the medieval world, for example, merchants had to develop solutions other than institutions to limit the risks caused by the forces of nature, such as suffering shipwrecks because of storms. Institutions are socially transmitted, which means that their replication is dependent on language and possibly also the social structures of the society. Institutions may have no direct or obvious representation in our genetic makeup.[25] The social, collective nature also implies that an institution is exogenous to everyone whose behavior it affects, beyond the direct control of any individual.

Furthermore, an institution is fundamentally a constraint, because it motivates a particular trajectory of behavior by counting as a reason for

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[24] Aoki 2001, 10; Greif 2006, 40; Nelson – Sampat 2001, 33.
[25] Hogdson 2006, 3.