

**HOW AND WHY ECONOMIES DEVELOP AND GROW: LESSONS  
FROM PREINDUSTRIAL EUROPE AND CHINA**

**CHAPTER 6**

**COMMERCE AS AN ECONOMIC ACTIVITY**

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**ABSTRACT:** Commerce in preindustrial Europe was an economic activity in its own right, distinct from production and largely undertaken by different people. Its development paralleled that of production. Expansion of the market increased productivity in commerce, just as it did in production, and in much the same way—by inducing reorganization and promoting technological progress. Increasing productivity in commerce lowered trading costs, which led to further expansion of the market—the trading cost multiplier.

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It is time to take stock. We began in Chapter 1 by setting out a simple theory of economic progress:

Commerce promotes production; predation inhibits it. Limit predation—get government right—and economic progress will take care of itself.

In the previous section we saw how, in preindustrial Europe, commerce promoted production—by lowering trading costs and facilitating expansion of the market. We also saw something of how economic progress took care of itself—of how it was self-perpetuating.

In Chapter 2 we broke the process down into autonomous changes and multiplier effects. Autonomous changes came mainly from increases or decreases in predation. Multiplier effects amplified the impact of the autonomous changes and interacted with each other to sustain a process of self-perpetuating economic progress.

In Chapters 3 through 5 we examined the workings of the supply multiplier—the response of production to expansion of the market.

We saw that expansion of the market induced a reorganization of production and that the two together stimulated technological progress. We saw too that commerce played an essential role in the new organization of production, and that the agents of commerce and places of commerce—merchants and cities—were instrumental in bringing it into being.

In this section, we turn to commerce itself. We need to understand how commerce worked and how it developed in order to complete our picture of the self-perpetuating nature of economic progress. We also need to understand commerce because of its central role in the final part of our story—in how predation inhibited production and in how preindustrial Europe ‘got government right’.

Commerce in preindustrial Europe was an economic activity in its own right, distinct from production and largely undertaken by different people. Its development paralleled that of production. Expansion of the market increased productivity in commerce, just as it did in production, and in much the same way—by inducing reorganization and promoting technological progress. Increasing productivity in commerce lowered trading costs, which led to further expansion of the market—the trading cost multiplier.

In the current chapter, we will see how commerce was organized, focusing on its organization during the Commercial Revolution. In Chapter 7 we will see how commerce evolved in subsequent centuries. In Chapters 8 and 9, we will examine the development of finance, which largely grew out of commerce through a process of division of labor and specialization.

In order to understand the organization of commerce, we must begin with its economics.

### **THE ECONOMICS OF COMMERCE**

Commerce is the mediation of exchange. In preindustrial Europe it was in particular long-distance exchange that required mediation—trade between large cities and their hinterlands, trade between one region and another, and trade between zones. Commerce, consequently, involved the purchase of goods in one place and their resale in another, distant from the first. This dictated how commerce was organized.

#### **Venturing**

Commerce normally took the form of venturing: merchants brought goods to a market ‘on spec’ in search of a buyer. This was necessary, because the alternative—shipping to order—was rarely feasible. Slow communications and transportation constituted a major obstacle. But so did the heterogeneity and uncertain quality of goods. Potential buyers wanted to inspect goods before they purchased them.

Venturing placed certain demands on the organization of commerce. First, it required a presence both in the place where the goods were purchased and in the place where they were to be sold. A merchant had either to travel himself with his goods or to rely on someone else—a representative or agent—to act for him in the distant market.

Second, venturing required a merchant to take ownership of the goods between purchase and resale. To be able to do this, he needed considerable working capital. As an example, consider the sixteenth-century trade in woad, a blue dye, grown in the region around Toulouse. Growing woad and drying and processing it took over a year: local merchants financed production by paying producers in advance for their output. Shipping the dye to market and selling it might take another year, and, since woad was normally sold on long credit, it might be yet one more year before the merchants recouped their

initial outlay. A woad merchant therefore needed to possess working capital equal to something like three times his annual turnover.<sup>1</sup> In general, merchants financed part of their working capital out of their own resources. However, given the large sums they needed, most had to supplement their own resources with borrowing.

### **Reliance**

Borrowing, extension of credit, payment in advance, and representation all involved reliance on the promises of others. A merchant relied on his representative to act on his behalf and on others to pay or deliver what they had promised him. Similarly, others relied on him to pay his debts. The pervasiveness of reliance meant that commerce depended on trust—on the expectation that promises would be kept.

There are two distinct reasons why a promise might *not* be kept—why the promisor might default. The promisor might simply be unable to keep his promise: this was not uncommon in the unpredictable and hazardous environment of pre-industrial Europe. Or he might choose to renege on his promise. He might do this if the gain from breaking the promise were greater than the cost. So trust depended both on the promisor's *ability* to keep his promise and on his *interest* in doing so.

When there was insufficient trust between parties to permit the acceptance of promises, trade might still be possible with the assistance of a third party. The third party could act either as enforcer, guarantor, or intermediary.

An enforcer coerces performance of promises or punishes non-performance. To be effective, the enforcer must possess *power* over the promisor. This power could derive from the threat or use of force—for example, the ability to seize the promisor's goods to pay an unpaid debt. Or it could derive from the threat or use of economic sanctions—for example, a denial of future transactions or benefits. To be effective, the enforcer must also be credible: it must be in the enforcer's interest to enforce the promise.

Enforcement changes the promisor's incentives and makes it less likely he will renege. It does not, however, help, except perhaps by spurring greater effort, with the other cause of broken promises—an inability to keep them. A guarantee does help,

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<sup>1</sup>Ball (1977) p166

however, because the guarantor pays compensation in case of default—whatever the reason.

Of course, a guarantee is itself a promise. So for a guarantee to have value, the guarantor must have a greater ability than the promisor himself to keep the promise and a sufficiently strong interest in doing so. The guarantee also suffers from a subsidiary reliance problem—between the guarantor and the promisor. The guarantor must rely on the promisor not to abuse the guarantee by making promises he does not expect to keep, relying on the guarantor to make good. Consequently, for a guarantee to be viable, the guarantor must possess sufficient power over the promisor to mitigate this problem.<sup>2</sup>

While enforcer and guarantor strengthen trust between the parties, intermediaries offers a substitute for it. The intermediary does this by interposing itself between the parties, so that they transacts with the intermediary rather than with each other.<sup>3</sup> To play this role, the intermediary must be more trustworthy than the parties themselves: that is, they must prefer the intermediary's promises to each other's. The intermediary must, therefore, have a greater capacity to keep its promises and a stronger interest in doing so.

Guarantees and intermediation are substitutes for enforcement. However, since both themselves involve promises, enforcement can enhance their effectiveness.

### **Predation**

Long-distance trade was especially vulnerable to predation. Bandits, pirates, and governments found it easy to prey on goods en route. Markets, where goods were concentrated in large quantities, also made attractive targets for predation. So too did merchants themselves: as we have seen, their business required the marshalling of considerable capital.

Predation took a variety of forms. Goods on the road or at sea might be taken by force; goods brought to market might be 'purchased' at an arbitrarily low price set by the rulers; rulers might expropriate merchant wealth. Or, under the threat of such actions, rulers might extract tolls, taxes, and interest-free loans.<sup>4</sup>

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<sup>2</sup>On guarantees, see Katz (1999).

<sup>3</sup>Casson (1997)

<sup>4</sup>We will discuss predation in greater detail in Chapters 10 and 11.

The cost of predation was a considerable part of trading costs. It included not only actual losses but also the cost of avoiding predation and the cost of protecting against it. The risk of loss was a major source of uncertainty and was itself an important obstacle to trade. Merchants who were particularly successful in reducing the cost and risk of predation enjoyed a considerable advantage over their competitors.<sup>5</sup>

Protecting against predation required the exercise of power on the part of merchants. This might involve the deployment of force to defend against seizure by force. Or it might involve the use or threat of economic sanctions to negotiate the reduction or even elimination of predation.

### **The rivalry for trade**

A merchant could profit from a given trade only if he was the one who mediated it. Merchants, therefore, were rivals: one merchant could mediate a trade only if others did not.

A merchant could capture a particular trade through competition—by offering buyers and sellers better terms. He could do this if his trading costs were lower—for example, if he was more successful in dealing with the problems of reliance or predation. But a merchant could also capture a particular trade in a different way—by preventing others from competing with him. This had the added benefit of allowing him to strike a better bargain (better for him) with buyers and sellers.

Other merchants could be prevented from competing only by restricting their access to the trade in question. The parties concerned—buyers, sellers, and the excluded merchants—would not, however, willingly comply with such a restriction. So its imposition required the exercise of power.

### **Power and a role for government**

The exercise of power was an essential part of the technology of commerce: it was essential in the enforcement of promises, in protecting against predation, and in the rivalry for trade. One form of power is force, and deployment of force is the essence of government. Government's command of force created a place for it in the organization of commerce.

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<sup>5</sup>Lane (1941) calls the advantage conferred by lower predation costs a 'protection rent'.

It is important, however, to distinguish in this context between the two different types of government—predatory and associational. We saw in Chapter 1 that predatory government is established when an armed group takes control of a territory and its population for the purpose of predation: the Norman conquest of England is a classic example. Territorial rulers—kings and local lords—were predatory governments. Associational government comes into being when a group engages in joint action in the deployment of force, primarily to protect the territory of the group against predation.

Territorial rulers deployed force primarily for the purpose of predation. But they could also supplement their incomes by selling ‘force services’. They could act as enforcers, provide protection against predation by others, or restrict access to trade. Associational governments, deployed force primarily to protect their members against predation, but they could also provide force services to their members—enforcing agreements between them and restricting trade to their benefit.<sup>6</sup> And, like territorial rulers, they could offer force services to others. For example, both Venice and Genoa provided military help to various rulers in exchange for trade concessions or cash.

The economics of commerce determined its organization. The organization of commerce, like that of production, was social, because social organization offered the advantages of the division of labor and of joint action. The social organization of commerce, like that of production, was made up of three elements—the enterprise, the association, and the market. We begin with the enterprise.

### **THE ENTERPRISE**

There were important benefits of scale in commerce. Some derived from indivisibilities. We saw in Chapter 2 that information costs, transactions costs, and some transportation costs were the same whether a venture was large or small. Similarly, the cost of sending a representative to a distant market, or of maintaining one there, was the same however little or much business he transacted. There were benefits of scale too in trustworthiness. Greater wealth meant a greater ability to keep commitments; larger scale meant more future business to lose and so a greater interest in keeping them.

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<sup>6</sup>And, of course, associational governments could—and did—engage in predation.

In production, benefits of scale were largely captured *across* enterprises. In commerce this was more difficult. So, at least initially, benefits of scale were captured to a greater extent *within* the enterprise. This tended to make enterprises larger than they were in production. The basic form of enterprise remained the family firm—in this case, the merchant house—but this was often based on an extended rather than on a nuclear family. And new, larger types of enterprise emerged in which members of several families could combine their efforts.

### **The family**

Family as such was more important in commerce than it was in production because of the problem of reliance. Merchants preferred to employ sons, brothers, and cousins as representatives. They relied on their families for startup capital and for additional financing when needed. They could rely on their families in this way because the family was such an effective enforcer. It was effective because of the power it had over its members. So important was family support that its potential loss was terrifying.

In addition to being a source of trustworthy agents and financing, the family also guaranteed the transactions of its members with others. It was an effective guarantor because of its greater ability to pay. The family possessed more property, any of which was forfeit if a member of the family defaulted. The family was also longer-lived than the individual, addressing an important cause of default—the premature death of the debtor. The family had a strong interest in standing behind its members promises because a family’s reputation was indivisible. Moreover, the family’s guarantee was credible because it was involuntary: families were universally held responsible by others for the conduct of their members. The role of the family as guarantor was reinforced by its power as enforcer, which reduced the likelihood that a member of the family would abuse the guarantee.

The family played a role too in protecting its members against predation. It provided physical protection against violence through the principle of vendetta: anyone harming a member of the family could expect retribution from his relatives.<sup>7</sup> Family connections—‘favor at court’—were important in protecting against predation by government. Family

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<sup>7</sup>Pospisil (1971) Ch. 1

connections were essential too in commerce itself—for access to information and for a helping hand in the rivalry for trade. The family also provided its members with a safety net: a merchant knew that if he lost his fortune or his life his wife and children would be provided for.

### **Joint enterprise**

While the family firm was relatively large in commerce, it was not large enough to capture all the potential economies of scale. On the one hand, economies of scale in trading costs favored large ventures. On the other, the advantages of diversification favored a multiplicity of ventures. To engage simultaneously in many large ventures took more capital than a single family firm possessed and required the efforts of more people. So merchant houses found ways to pool resources and personnel in various types of joint enterprise.

The participants in a joint enterprise were, by definition, not members of the same family. It was therefore helpful to reinforce mutual trust by enlisting a third-party enforcer (we will see that several possible candidates were available). To facilitate enforcement, the agreement among the participants was formalized through the use of a written contract.<sup>8</sup> This spelled out the terms of the agreement and, if a conflict arose, served as evidence of it that could be brought to a court for adjudication.

There were two forms of joint enterprise—the venture enterprise and the company. The venture enterprise provided a framework for pooling resources in a single venture—a single trading voyage or a single shipment of goods. The company provided a framework for pooling resources for a fixed period of time, for a sequence of ventures.

### **The venture enterprise**

Trade was conducted initially by merchants who traveled from place to place with their goods. For example, in the early twelfth century Genoa traded by sea with the eastern Mediterranean and by land with the Low Countries and the Fairs of Champagne: both trades were conducted by traveling merchants. Over time, however, rather than traveling themselves, merchants increasingly sent representatives with their goods. This allowed them to diversify: by using multiple representatives, they could trade with

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<sup>8</sup>This was sometimes done even among members of the same family (especially distant members).

several markets simultaneously. It also allowed them to increase the scale of their operations. So long as merchants or their representatives traveled with their goods, the natural form of structure was the venture enterprise.

Initially, the predominant form of venture enterprise was the sea loan. Under this arrangement, a lender advanced goods or money to a traveling merchant, with repayment contingent on the safe arrival of the goods in question. From the late twelfth century, as merchants increasingly relied on traveling representatives, the sea loan was replaced by a different structure—the *commenda*. This was a partnership rather than a loan: one partner was the merchant who provided the goods to be traded or the money to purchase the goods; the other partner was a representative who traveled with the goods to a distant market and traded them there. On the return of the representative, the two divided the profits of the venture between them; the representative's share was normally a quarter.

By the mid-thirteenth century, the *commenda* being used in a different way—not as an employment contract, but rather as an instrument of financing.<sup>9</sup> Here, the traveling partner was a merchant, and the partner who stayed behind was a financial investor. A traveling merchant could mobilize a significant sum money in this way by writing commenda contracts with multiple investors. Investors could diversify by placing funds with multiple merchants. *Commenda* contracts became a popular financial asset.

For a ventures requiring broader participation, either because of its size or its risk, there was a different structure that could accommodate multiple participants—the share venture. This seems to have been used first for the ownership and operation of ships<sup>10</sup>. A group of investors—from 16 to as many as 70—would purchase a ship, or have it built, and outfit it for a voyage. Many of the investors were merchants who planned to sail on the ship in question. However, the risk could be spread by selling shares to purely financial investors not directly involved in the voyage themselves.<sup>11</sup>

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<sup>9</sup>Postan (1973) Ch. 3.

<sup>10</sup>In Venice from the eleventh century and in Genoa from the twelfth, Lane (1934) p 116; Byrne (1916).

<sup>11</sup>The number of shares often corresponded to the number of mariners, with each shareholder responsible for advancing the expenses and wages of 'his' mariner.

## The company

As the volume of trade increased, it made more sense for a merchant to maintain a representative in a distant market permanently rather than have him constantly traveling back and forth. A permanent presence meant better market information—the key to successful trading. It also meant greater freedom in the timing of purchases and sales: there was no rush to buy or sell before the fleet or caravan departed. Continued residence also allowed agents to develop local contacts. Resident representatives could establish their own credit and ascertain the credit of others, enabling them to buy and sell on credit (it helped that they remained in place to pay and collect debts).<sup>12</sup>

Of course, these advantages had to be weighed against the cost. Maintaining a representative permanently in a distant market was expensive, and it could be justified only if the volume of business was sufficiently large. Moreover, the use of resident representatives required reliable means of sending them and receiving from them information, goods, and funds. These emerged only when the scale of trade created a sufficient demand for them.

The *commenda* contract made it hard to exploit fully the advantages of using a resident representative because it did not provide him with strong enough credit. The non-traveling partner of a *commenda* was not liable for debts incurred in the distant market by his representative.<sup>13</sup> This, of course, made it harder for the representative to buy on credit or borrow.

The company was a structure better suited to the use of resident representatives. A company was established for a predetermined number of years, after which it was liquidated and the profits calculated and distributed to the partners. Often, the company was reconstituted, frequently with the same partners. The company began as a formalization of the family firm. This became desirable as more distant members of the family became involved: a formal contract spelled out their rights and obligations and provided them with better legal protection. Formalization also made it easier to expand the enterprise to include partners who were not kin and to allow members of different

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<sup>12</sup>Willan (1959) Ch 1; Spufford (1988)

<sup>13</sup>Lane (1944) Ch. 3; Kedar (1976)

families to form joint enterprises (both arrangements were common by the fourteenth century). Extending the company in this way allowed it to grow larger both in capital and in the number of representatives it could deploy in different distant markets.

A representative employed by a company enjoyed stronger credit than one operating under *commenda*. All the partners of a company were fully liable for any debts their representatives incurred. Moreover, the greater size and diversification of the company made it more trustworthy. This was particularly important for merchant banks—companies that borrowing not only to finance their own working capital but also in order to lend to others.<sup>14</sup> Particularly notable in this respect were the Florentine ‘supercompanies’ of the fourteenth century—the Peruzzi, Bardi, and Accaiuli. The Peruzzi, for example, had 15 branches across Western Europe and the Levant and employed some 120 partners and representatives.<sup>15</sup> The size of the supercompanies enabled them to borrow on an exceptionally large scale. They used the funds they raised to make loans to rulers in exchange for valuable trading monopolies—most notably monopolies of grain exports from Sicily and of wool exports from England.

### **Internal problems of reliance and record keeping**

While size enabled enterprises to capture economies of scale, it also exposed them to significant diseconomies—particularly those arising from internal problems of reliance. Although formally all participants in a company or share venture had a voice in running it, many were purely financial investors with no interest in day-to-day management. This created a problem of governance: how could those in control be prevented from putting their own interests ahead of the interests of the participants as a whole.

A second, even more severe, problem was the possible malfeasance or incompetence of representatives. The problem was especially serious for large companies with branches in many distant cities. Because of the slowness of communications, they had to grant branch managers the authority to make their own decision. However, because of the unlimited liability of the company for their actions, this put them in a position to harm or

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<sup>14</sup>We will learn more about merchant banks in Chapter 9.

<sup>15</sup>Hunt (1994) In comparison, the papal curia, the largest existing government bureaucracy, numbered only about 250.

even destroy the company. This danger was particularly acute for merchant banks, since their branch managers handled large sums of money and made large loans.

Problems of reliance, internal and external, created a need for record-keeping and accounting. Merchants and their representatives had to keep track of the goods they sent one another, of the prices at which they were bought and sold, and of the costs incurred. Creditors and debtors needed to keep a record of what was owed. And participants in joint enterprises needed to calculate the profits so that the parties could receive what was due to them.<sup>16</sup>

Initially, with literacy still rare, written records were usually created and kept by some sort of public scribe or notary. But by 1200, merchants in Italy were keeping their own records in the form of account books.<sup>17</sup> The use of account books soon spread throughout southern Europe, although the practice remained uncommon in the North, where merchants generally recorded debts by means of promissory notes. Account books and promissory notes provided less legal protection to the creditor than formal, publicly recorded debt, since non-mercantile courts did not initially recognize them. Nevertheless, in their dealings with one another, merchants found that the additional security provided by a public record was not enough to justify the additional expense and delay.<sup>18</sup>

While double-entry accounting was invented during the Commercial Revolution, it was not widely used, then or later. Most merchants continued to rely on ‘single entry’ methods, which they found quite adequate to their needs.<sup>19</sup> The only exception was in merchant banking, which involved a host of complex transactions.<sup>20</sup>

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<sup>16</sup>de Roover (1956)

<sup>17</sup>Reynolds (1952)

<sup>18</sup>Postan (1973 [1930]); Muldrew (1998). Private records also provided greater confidentiality (Reyerson (2002)). Notaries continued to be important in transactions between non-merchants (Berman (1983)).

<sup>19</sup>Yamey (1949)

<sup>20</sup>This explains why accounting methods were most advanced in northern Italy, where most merchant banks were headquartered. de Roover (1956).

## ASSOCIATIONS

The second element in the organization of commerce was the association. Like producers, merchants formed associations as vehicles of joint action. Merchant associations took a variety of forms. The merchant guild predated the artisan guild and indeed served as a model for it.<sup>21</sup> Merchants formed associations not only in their home cities, but also in distant markets where they traded. Merchants from Mediterranean Europe had established colonies in the markets of the Levant by the early twelfth century, and by the end of the thirteenth there were merchant colonies in most of the market centers of Europe.<sup>22</sup> The fairs of Champagne hosted some fifteen merchant colonies or ‘nations’ from different cities and regions.<sup>23</sup> Sometimes merchants from different cities formed joint colonies. For example, merchants from dozens of cities in north Germany and the Rhineland formed joint colonies, called *kontore*, in the markets of Scandinavia, Russia, Bruges and London. Cooperation among merchants in these colonies eventually led to a political alliance among their home cities—the Hanseatic League.<sup>24</sup>

There was a close connection between merchant associations and the associational governments of cities. In northern Europe, where cities were subject to territorial rulers, merchant guilds took on many of the tasks of local government—maintaining streets and city walls and organizing relief for the poor. Rulers were happy to let them do this. Later, when local government was formally established in these cities, it was often built on a foundation of the existing merchant guilds.<sup>25</sup> In northern Italy, the process was different. There, cities achieved considerable independence quite early on, so that formal city government preceded the emergence of merchant guilds. In some cities, most notably in Genoa and Venice, merchants were from the beginning so firmly in control of city government that merchant guilds proved unnecessary: city government itself functioned

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<sup>21</sup>Nicholas (1997). Records of merchant guilds go back to the eleventh century.

<sup>22</sup>Spufford (1988); Coornaert (1967)

<sup>23</sup>Verlinden (1971); Bautier (1970)

<sup>24</sup>de Roover (1971)

<sup>25</sup>Reynolds (1997) Ch 3

as a merchant association.<sup>26</sup> Elsewhere in Italy, guilds were established, top-down, by city governments as a form of self-regulating organization to which many municipal functions were delegated.

The various forms of merchant association, like associations of producers, performed a number of economic and social functions. Their key economic functions were to address the problem of reliance, to protect their members against predation, to further their members' interests in the rivalry for trade, and to provide essential infrastructure.

### **Addressing the problem of reliance**

The merchant association, like the family, acted both as enforcer of transactions among its members and as a guarantor of transactions between its members and outsiders. The association was, in this sense, a compounding of the family—a sort of family of families.<sup>27</sup> As with the family, its main sanction in disciplining its members was ostracism.<sup>28</sup> Ostracism in this case meant the loss of potential transactions with all members of the association. Further, if the association had acquired trading privileges, these too were lost. And, as with ostracism from the family, there was the additional loss of protection and of the social benefits of membership.

The threatened loss of future transactions could also be used to protect members in their dealings with outsiders. For example, at the English fairs of the thirteenth and fourteenth centuries, if an English merchant cheated a Flemish merchant or defaulted on a debt owed to him, the Flemish 'nation' would declare an embargo on the Englishman, so that no Flemish merchant would have any further dealings with him.<sup>29</sup>

Of course, such an embargo was effective only insofar as the association could ensure that it would be honored by all its members. This was a problem, because the individual

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<sup>26</sup>In Venice and Genoa "the commune itself was simply the ruling organ of the wealthy bourgeoisie" (Luzzatto (1953) p46). In contrast, early Florence was dominated by the landed aristocracy, and merchants and artisans organized themselves in fraternities to defend their interests. (Goldthwaite (1987)).

<sup>27</sup>Compounding is a way of creating larger organizational structures. We will encounter it again when we discuss federal forms of government in Chapter 12.

<sup>28</sup>Grief has written extensively on this mechanism in the context of representation (e.g., Greif (1989), Greif (1997)). However, it applied more broadly to any relationship of reliance.

<sup>29</sup>Moore (1985)

member could do better for himself by ignoring the embargo, even though his doing so undermined the position of the association as a whole. Ostracism and embargo were therefore effective only if the association was able to enforce discipline on its own members.

Enforcement, whether of ostracism or embargo or of transactions between members, required a system of order—a set of rules regulating behavior and a mechanism to identify and punish violations. Merchant associations possessed not one system of order but two—an informal order and a formal order.

An informal order emerges in any group out of prolonged interaction. Over time, the group develops a shared culture—shared beliefs and values—and out of this culture, norms evolve to regulate behavior.<sup>30</sup> Through the sharing of information, members of the group acquire reputations.<sup>31</sup> An individual who violates the norms damages his reputation, making others less willing to interact with him. This makes violating the norms costly. Reputation is the mechanism of enforcement in an informal order.

Merchant associations, like any other group, developed such an informal order, sharing information through social interaction, marketplace gossip, and correspondence.<sup>32</sup> This informal order played an important role, for example, in policing representatives. Representatives generally traveled together and resided together in colonies: they were sometimes required to do so. Gossip, reported via correspondence, informed merchants at home of the misbehavior of their representatives.<sup>33</sup> Market information, verified by multiple reports, enabled them to monitor their representatives' trading.

Merchant associations also possessed a formal order. A formal order has explicit laws and regulations together with some sort of court to judge violations and impose sanctions. In addition to enforcing the laws and regulations of the association, the court could also adjudicate disputes between its members. As we have seen, merchants formalized their agreements as written contracts to facilitate such adjudication.

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<sup>30</sup>Reynolds (1997) Ch. 1; Schlicht (1993)

<sup>31</sup>Granovetter (1973).

<sup>32</sup>Even less structured groups, such as ethnic or religious merchant diasporas, boasted an informal order. Greif (1989); Powell (1990).

<sup>33</sup>de Roover (1948) p 20

Formal and informal systems of order complemented one another. Contracts and courts were most useful in enforcing agreements where the nature of the obligation was clear, where performance was relatively easy to assess, and where the remedy was simple and obvious. These conditions were most closely approximated with debts. If the debtor defaulted, courts enforced performance by seizing the debtor's property (or his person, until his family paid the debt). If the debtor fled or failed to pay up, the court would order his ostracism. If there were guarantors, the same measures could be taken against them.

In other agreements, however, contracts and courts were less useful, because the obligations were less easy to specify precisely.<sup>34</sup> They were not very useful, for example, in resolving disputes between merchants and their representatives. A court could help with egregious violations: merchants did take to court representatives who failed to remit the proceeds of sales or failed to give account. However, most problems with representatives did not lend themselves to resolution in a court of law: it was hard, for example, to sue someone for being lazy or stupid. So merchants had to rely more on positive incentives for good performance and on the informal order—on the reputational cost of being fired. Similarly, courts were of limited use in addressing the problem of governance. Partners not active in managing a company could sue if they did not receive an accounting or were not paid their share of the profits. However, a court could not oversee the calculation of the profits or monitor the insiders whose actions determined them.

Even in the case of debt, matters were not quite so simple. In the unpredictable world of pre-industrial commerce, debtors frequently found themselves unable to pay on time. Their creditors, who often found themselves in the same position, did not rush to court but tended, rather, to be flexible. Even in cases of outright default, merchants did their best to work things out through negotiation and arbitration, resorting to litigation only as a costly last resort. So even with debt, informal order had an important role to play: a merchant who failed to pay his debts destroyed his reputation—his 'credit'—as did one who was too litigious.

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<sup>34</sup>Greif (1989)

More generally, the informal order fleshed out the formal order. Since no contract could ever cover all possible contingencies, merchants relied on general standards of behavior—on norms—to fill in the gaps.<sup>35</sup> For the courts, the norms of the merchant community provided a model against which performance could be judged.

Not surprisingly, merchants preferred to do business when possible with members of their own associations and with their fellow citizens. They shared the same norms and culture, so that their behavior was more predictable. Moreover, they were of known reputation. And they had stronger incentives to perform as promised: nonperformance damaged their reputations and they could, if necessary, be brought before a court of the association or city.<sup>36</sup>

Despite these advantages of dealing with their own, merchants engaged in long-distance trade had no choice but to transact with strangers. These transactions inevitably involved financial relationships: merchants bought and sold on credit, and most trading involved some element of deferred payment.

In supporting transactions between strangers, the available mechanisms of enforcement were of limited value. The courts of merchant associations could not be relied upon to enforce in favor of strangers against their own members. Government courts initially were either unavailable or unsuitable for commercial disputes.<sup>37</sup> And the courts of organized markets, which would later play an important role, were only beginning to develop.

Consequently, transactions between strangers came to depend, not on enforcement but on guarantee—on guarantee by the parties' respective associations.<sup>38</sup> The custom of reprisal allowed an unsatisfied creditor to seize the property of any member of the debtor's association, wherever he was able to do so.<sup>39</sup> In general, to obtain the right to proceed in this way, the creditor had to receive authorization from his own association,

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<sup>35</sup>Greif (1993)

<sup>36</sup>The tendency of members of an association to trade with fellow members raised the value of belonging to an association and raised the cost of ostracism.

<sup>37</sup>For example, government courts would not enforce debts they considered 'usurious': see Chapter 9.

<sup>38</sup>Greif (2001) calls this the Community Responsibility System.

<sup>39</sup>Origo (1986); Greif (2001); Favier (1998) Ch 4

granted only after investigation of the justice of his claim.<sup>40</sup> By the mid-thirteenth century the custom of reprisal was almost universal throughout western Europe.<sup>41</sup>

While the merchant association guarantee did facilitate trade between strangers, it was not without its problems. Reprisal became a hazard for any merchant traveling abroad: his goods or even his person might be seized at any time to satisfy the unpaid debts of someone else, his only recourse being to seek compensation from the original debtor.<sup>42</sup> Moreover, the guarantee was open to abuse, with small merchants benefiting disproportionately at the expense of large. The system made some sense when merchants or their representatives visited distant markets briefly and then left. However, as merchants came increasingly to rely on resident representatives, who could more easily be held to account for their debts, reprisal became redundant. Consequently, by the late fifteenth century reprisal had become a rarity.<sup>43</sup>

### **Protection against predation**

A merchant association protected its members against predation. Protection was a function of the association rather than of the individual merchant because it required the exercise of power, and the exercise of power involved significant advantages of scale. There were, of course, advantages of scale in the deployment of force: other things equal, a larger number of men could prevail against a smaller number. But there were also benefits of scale in the application of economic sanctions: a denial of future transactions or benefits was more painful when it was imposed by a larger entity or group.

To protect their members against bandits and pirates, merchant associations organized caravans and convoys. For example, Flemish merchants attending the English fairs in the thirteenth and fourteenth centuries traveled together in convoys organized by their municipal guilds.<sup>44</sup> Venice went even further: from the thirteenth century the city invested in fleets of galleys to provide secure shipping for its merchants.

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<sup>40</sup>Origo (1986) Florence, for example, appointed a special official for this purpose.

<sup>41</sup>Greif (2001)

<sup>42</sup>Cheyette (1970)

<sup>43</sup>Mitchell (1904)

<sup>44</sup>Moore (1985)

To protect their members against predation by governments, merchant associations sometimes relied on force. Genoa, for example, responded to Cueta's expropriation of Genoese merchants by attacking the city.<sup>45</sup> And the Hanseatic League frequently responded militarily to expropriations of its members or to violation of their rights.<sup>46</sup> Often, however, merchant associations relied not on force but on the threat or imposition of an embargo. For example, when the ruler of Tabriz seized the goods of the Genoese merchants there, Genoa declared an embargo until the ruler paid an indemnity and promised better behavior.<sup>47</sup> However, as we have seen, an effective embargo required discipline and enforcement. It may therefore have been the relatively weak control of the Hanseatic League over its own merchant members that obliged it to resort so often to force rather than embargo.<sup>48</sup>

Governments feared an embargo, partly because they did not wish to be deprived of foreign goods, but mainly because their predation on trade was an important source of revenue for them. It is clear from this, therefore, that predation by governments could not be prevented entirely. Rather, associations were able, at best, to negotiate with governments a mutually acceptable level and form of predation.

### **The rivalry for trade**

We have seen that controlling access to trade required the deployment of force and that force was the province of governments. Merchant associations that were themselves governments—independent commercial cities such as Venice and Genoa and the members of the Hanseatic League—could deploy the necessary force themselves to obtain access for their members or to restrict access to others.

When territorial rulers restricted access to trade, they did so in order to be able to sell trading rights to merchants. For example, the rulers of England and Sicily restricted access to their principal export commodities—wool and grain, respectively—and then sold the monopolies they had created to the Italian supercompanies.

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<sup>45</sup>Reynolds (1945) p12

<sup>46</sup>Mauro (1990)

<sup>47</sup>Greif, et al. (1994)

<sup>48</sup>Greif, et al. (1994)

There were significant advantages of scale in acquiring trading rights from rulers. The cost of negotiation was indivisible and substantial; the required payment, large. There were also advantages of scale in defending the rights once they were purchased: rulers had an unfortunate tendency to renege on their agreements.

The supercompanies were large enough to take on the task, but most merchant enterprises were not. So it was natural that the acquisition of trading rights should be a function of merchant associations. In many cases, negotiations for trading rights accompanied or closely followed negotiations for protection from predation. The colony of English merchants at Bruges, for example, obtained trading rights from the Count of Flanders in 1359 in the same charter that assured them safe conduct.<sup>49</sup>

The benefits of scale in purchasing and operating a monopoly gave rise to a new type of merchant association—one created specifically for this purpose. The earliest example was the Company of the Staple, established in 1363 by a group of 26 English merchants. The Staplers took over the wool export monopoly after the Italian supercompanies had been ruined by a financial crisis.<sup>50</sup>

### **Commercial infrastructure and services**

Merchant associations played an important role in providing various commercial infrastructure and services. Their provision required joint action either because of indivisibility or because of their being to some extent a public good.

Two types of infrastructure were of particular interest to merchants—market infrastructure and transportation infrastructure. Merchant associations, either as cities or working with cities, developed the infrastructure of markets. This included the booths, halls, port facilities, and courts in their own markets and the compounds and trading facilities of their colonies abroad.<sup>51</sup> Merchant associations invested too in improving the ports they used: for example, the *consulado* of Burgos, an inland city that dominated the export of Spanish wool, invested in the Cantabrian ports it used in its trade with the Low

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<sup>49</sup>Nicholas (1979)

<sup>50</sup>Power (1942)

<sup>51</sup>Greif, et al. (1994).

Countries.<sup>52</sup> Cities also invested in inland transportation. In Italy, they developed inter-urban roads, built bridges, and improved rivers. In the Low Countries, they were involved in building canals.

Most merchants relied on the mail services provided by their associations. A number of Italian cities and merchant guilds organized regular mail services to the fairs of Champagne. Pisa first organized one in the twelfth century, and the cloth merchants guild of Florence, the *Arte di Calimala*, was sending two messengers a day to the fairs by the thirteenth.<sup>53</sup>

Although most education for merchants was private and some provided by the Church, many Italian cities established or subsidized schools, especially at the primary level (grammar school).<sup>54</sup> Some cities, for example Lucca in the fourteenth century, even provided secondary education.<sup>55</sup>

### **ORGANIZED MARKETS**

We saw in Chapter 3 that ‘the market’—that is, commerce—played a vital coordinating role in the organization of production. In the organization of commerce itself, the same sort of role was played by organized markets.

It is important to distinguish organized markets from the simple markets of market towns. The latter were retail markets serving local producers and consumers. In them, trading was structured, bringing the parties together at a set location and time, but it was not mediated: the parties traded with one another directly and unaided. In contrast, the organized markets of commercial cities were wholesale markets, that primarily served merchants. Trading was structured but it was also mediated: specialized professionals made it easier for buyers and sellers to trade with one another. There was a trading system to help traders to find and close a deal, a system of settlement to facilitate payment, and a system of formal order to resolve the disputes that inevitably arose.

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<sup>52</sup>Grafe (2001)

<sup>53</sup>de Roover (1971); Origo (1986) Some large companies had their own private mail services.

<sup>54</sup>Nicholas (1997); Swetz (1987)

<sup>55</sup>Goldthwaite (1972)

## Trading and settlement

In most markets, the embodiment of the trading system was the broker, a specialized professional who brought buyers and sellers together for a commission. The fundamental requirement of trading is information—information about trading opportunities (qualities and prices) and information about the reliability of potential trading partners. Brokers were able to lower the cost of information, because it was less costly for a broker to acquire information and ‘sell’ it to multiple traders than it was for each trader to acquire the information directly himself.<sup>56</sup>

Brokers were generally regulated, partly to protect traders, but mostly to ensure they served the authorities in collecting tolls and taxes and in enforcing market regulations. Merchants were generally required to trade through an authorized broker. In Venice, for example, every visiting merchant was assigned one by lot.<sup>57</sup> The broker assisted him in his trading, but he also kept track of every transaction to ensure the proper tolls and taxes were paid.

Trading in a commercial city was dispersed rather than being concentrated in a central marketplace. Merchants conducted business in public squares and streets and near the port. Inns, apart from providing accommodation and storage, offered a convenient place to trade. Since buyers needed to inspect merchandise before they purchased, trading generally took place close to the cellars or storehouses where goods were kept.<sup>58</sup> Cloth and other valuable goods were often displayed in special halls so that they could be inspected easily while protected from the elements. Trade in particular products tended to concentrate in particular places. Inns, for example, often specialized in a particular product or served merchants from a particular region or city.<sup>59</sup> Trading halls specialized too: in Bruges, for example, cloth was traded in the Waterhalle and drugs and spices in the Cruudhalle, while wool was traded in the adjacent Rue aux Laines.<sup>60</sup>

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<sup>56</sup>Bernstein (1992)

<sup>57</sup>Hoffmann (1932)

<sup>58</sup>Letts (1924)

<sup>59</sup> Kümin (1999) p 163

<sup>60</sup>Letts (1924)

Innkeepers often acted as unofficial brokers. Merchants negotiated over a meal and sealed the bargain with a drink, with the innkeeper often acting as witness. Moreover, because of the large number of merchants passing through, inns were natural centers of information. Innkeepers, in addition to brokering transactions, would often offer their guests additional commercial services. In Bruges, for example, they commonly guaranteed their guests' transactions with locals and provided them with banking, accounting, and debt-collection services.<sup>61</sup>

Not all organized markets relied solely on brokers to structure trading. Some fairs, particularly the great fairs of Champagne, used a different system to match buyers and sellers.<sup>62</sup> The six annual fairs of Champagne rotated among four towns of the region, with each individual fair lasting about seven weeks. At each fair, trading was divided into discrete periods. The first week was reserved for the entry of goods—including payment of the required tolls. There were then ten days for the sale of cloth—six days for exhibition and four days for actual trading. This was followed by an eleven-day period for the sale of leather (cordovans). The final two weeks of trading were devoted to the sale of spices, drugs, and other goods sold by weight. Following this, there were four weeks for settlement.

Whatever the trading system, once merchants agreed on a bargain, it had to be closed by the giving or exchanging of binding promises. Most bargains involved promises of future payment, future delivery, or both: the spot exchange of goods for cash was rare. In petty trade, promises were often given orally before witnesses, typically with the payment of earnest money or 'God's penny'. But in commerce, with large sums involved, it was customary and prudent to have a written record. For this reason, organized markets provided notaries or other officials to register debts, bills of sale, contracts, and other commercial and non-commercial agreements.<sup>63</sup>

Completion of a transaction involved, at some predetermined date, delivery of the goods and full payment. Often, however, there were problems. One party might perform,

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<sup>61</sup>Blockmans (1992); de Roover (1971).

<sup>62</sup>Face (1958); Berlow (1971); Abu-Lughod (1989)

<sup>63</sup>de Roover (1971); Reyerson (2002) Chs. 3 and 6. Notaries also acted as informal brokers, particularly between those seeking financing and those with funds to invest. Kedar (1977)

delivering the goods as promised, while the other did not, failing to pay for the goods (the risk of this happening is called principal risk). Or the first party might deliver and the second pay—but not on time (liquidity risk). Such late payment could have a domino effect, with the creditor now unable to fulfill his own obligations to others. Organized markets helped to mitigate both principal risk and liquidity risk. As protection against principal risk, they offered guarantees of payment—by innkeepers, for example. As protection against liquidity risk they provided credit facilities where a merchant temporarily embarrassed by a delay in receipts could borrow to carry him over until the funds arrived (more on this in Chapter 8).

The mechanics of payment was complicated by the scarcity of coinage and by its poor quality. Counting out and examining individual coins was a time-consuming and painstaking process, and it was often difficult to marshal enough coin to make large payments. Organized markets helped to alleviate the problems of coinage by providing moneychangers and mints. As we will see in Chapter 8, they also developed ways to reduce the need for cash settlement through the use of banks and instruments of remittance.

### **Resolution of disputes**

When performance by one or both parties is deferred, disputes are inevitable. Goods may not be of the quality promised or not delivered on time; money may not be paid as promised, or not paid at all. Disputes are particularly likely to arise in transactions between strangers. Organized markets provided ways to resolve disputes—both informal and formal. Quick, impartial, and inexpensive resolution of disputes created a better trading environment. This attracted more traders and increased the revenue of the market.

As we have seen, merchants preferred to resolve disputes informally whenever they could, avoiding the cost and uncertainty of litigation. Organized markets facilitated such informal resolution. The same market professionals who helped merchants find and close a deal—brokers, innkeepers, and notaries—also helped them resolve any dispute that subsequently arose. Others, too, provided informal mediation. In the cities of thirteenth century Flanders, for example, the cloth halls where cloths were displayed for sale

appointed ‘hall lords’ to resolve disputes. Some commercial cities appointed special arbitrators to resolve petty disputes.<sup>64</sup>

When merchants did go to court, they usually had a choice of venue. There were courts established by different merchant associations—by guilds, towns, and merchant colonies. And there were non-mercantile courts—the seigniorial court of the local lord, the court of the territorial ruler, and the ecclesiastical court. Generally, merchants preferred the mercantile courts, but they did use non-mercantile courts when they had to, to appeal the decision of a mercantile court, or simply in the hope of a more favorable outcome.

All of these courts tended to rely on the norms and customs of merchant practice in adjudicating commercial disputes. These norms and customs were fairly similar throughout Europe.<sup>65</sup> This was partly a result of borrowing and imitation and partly of similar problems giving rise to similar solutions. Merchant practice evolved to regulate various types of commercial transaction such as sales, debt, and insurance. It also developed forms and procedures for the basic commercial relationships of representation and financing. A substantial part of merchant practice crystallized in the standard documents and contracts that merchants used—bills of sale, bills of exchange, insurance contracts, partnership agreements, and so on.

All the courts that served organized markets, mercantile and non-mercantile alike, adopted procedures that met the needs of merchants. Justice was expeditious. For example, in one case in Colchester in 1458, the plaintiff filed suit for recovery of debt at eight in the morning; when the defendant failed to answer the court’s summons at nine, ten, and eleven, the court, at noon, ordered his goods seized and valued; the appraiser reported back at four, and the court immediately delivered the goods to the plaintiff.<sup>66</sup> To prevent delay and to keep costs low, there was often no right of appeal, and courts that

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<sup>64</sup>Nicholas (1992) p135

<sup>65</sup>Despite the similarities, recent research questions the once-popular notion of a ‘universal’ Law Merchant governing commerce throughout Europe. For new evidence and a summary of the debate see Sachs (2006) and Kadens (2004-2005).

<sup>66</sup>Farmer (1991)

served merchants tended to dispense with formalities.<sup>67</sup> For example, they recognized account books or handwritten IOUs as evidence of debt and did not require registration with an official notary. Such courts also tended to frown on legalism: they excluded professional lawyers and discouraged technical legal argumentation.<sup>68</sup>

The principal sanction of organized markets, as of families and associations, was exclusion. For a merchant, exclusion from an important market represented a significant cost because it limited his opportunities to trade. Exclusion was sometimes extended to the merchant's whole association. For example, 'nations' at the fairs of Champagne were held responsible collectively for the debts of each member. In case of default, the entire nation was excluded until the debt was paid.<sup>69</sup> Thus, enforcement by organized markets exploited the association guarantee—just as enforcement by the association exploited the family guarantee.

### **Exploiting the monopoly power of markets**

The more trading that is concentrated in a market, the better the market functions. Because concentration makes for a better market, markets are a natural monopoly: other things equal, trading costs are lowest if trading is all concentrated in a single market. Other things, however, are not equal: the quality of a market has to be weighed against the cost of reaching it. As a result, as we saw in Chapter 2, preindustrial Europe had a network of markets. Within this network, because of the benefits of concentration, each market enjoyed some degree of monopoly power. Consequently, those controlled access to a market could exploit this power for their own gain.

Access to markets was controlled by governments—both city governments and territorial rulers. The two, however, exploited their power differently. City governments, as we have seen, were often *de facto* merchant associations. They therefore exploited their power to rig the market in favor of their own members. Independent cities could do

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<sup>67</sup>Mitchell (1904)

<sup>68</sup>Berman (1983) Ch 11

<sup>69</sup>Bautier (1970); Bautier (1971)

this at will. Venice was perhaps the most extreme example, strictly controlling the trading of foreigners in the city and allowing them to trade only with Venetians.<sup>70</sup>

Territorial rulers, on the other hand, were interested mainly in revenue.<sup>71</sup> We have seen that they used force both to prey on trade and to restrict it in order to sell trading rights. For them, markets were convenient ‘choke points’ through which trade had to pass, facilitating both predation and the restriction of trade. Moreover, the markets themselves were highly profitable, and rulers found ways to appropriate a share of this profit. The simplest was to demand protection money from those organizing the market by requiring them to pay for the ‘privilege’ of doing so.<sup>72</sup>

A city subject to a territorial ruler, if it wished to restrict access to its market in favor of its own merchants, typically had to purchase the right to do so from the ruler. This was not just another way for the ruler to share in the profits. Rulers understood that restrictions on foreigners would discourage them from coming to the market, thereby reducing the rulers’ revenue from predation. Indeed, rulers sometimes found it more profitable to sell foreigners an exemption from city-imposed restrictions. For example, the kings of England in the fourteenth century freed foreign merchants from all restrictions imposed on them by English cities—in return, of course, for cash payments and concessionary loans.<sup>73</sup>

Even within cities the politics of restricting trade could be complex. While local merchants wanted to discriminate against foreign traders, market professionals who earned their living from trading volume wanted to attract as many foreigners as possible to the city to trade. Bruges, for example, initially restricted the trading of foreigners. However, as the city elite increasingly made its living from the market—as brokers, innkeepers, and bankers—rather than from actual trading, Bruges gradually eased many of its restrictions.<sup>74</sup>

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<sup>70</sup>Lane (1973) Favier (1998) Hoffmann (1932)

<sup>71</sup>We will see in Chapter 11 that rulers had other interests in trade and in markets, but revenue was usually the dominant concern.

<sup>72</sup>Bridbury (1986)

<sup>73</sup>Mitchell (1904)

<sup>74</sup>Letts (1924)

In the case of fairs, there was no such conflict. Fairs were established by rulers to generate revenue.<sup>75</sup> Although some were held in commercial cities, most were held in relatively small towns, where there were few local merchants to worry about. Fairs consequently did all they could to attract foreign merchants. The absence of restrictions on foreigners was indeed one of their main attractions. Fairs constituted a sort of ‘offshore market’—a place where merchants could trade in the greatest possible freedom.<sup>76</sup>

The ability of those who controlled access to markets to exploit their power—whether to bias trade or to tax it—was limited. Both actions drove business away, reducing trading volume. This made the market even less attractive, leading to a further loss of business—the economics of concentration in reverse. Just how much business was lost depended, of course, on the availability of substitutes. Were alternative markets available at reasonable cost? How difficult was it for people to trade ‘off-market’?<sup>77</sup>

Territorial rulers could increase the monopoly power of a market by suppressing substitutes. For example, when a town purchased the right to hold a market, it was understood that no other town nearby would be sold a similar right. Similarly, rulers often designated a particular market as a ‘staple’ for a certain trade with exclusive rights to mediate that trade. In the fourteenth century, for example, the English crown designated Calais as the staple for the export of English wool.<sup>78</sup> Exclusive rights increased the value of the market and so, of course, the potential take of the ruler. And a staple offered the additional benefit of making it easier to monitor and to tax the trade in question.

## CONCLUSION

We can understand the effect of commercial organization on economic progress through its impact on trading costs. Trading costs place a wedge between the price

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<sup>75</sup>The first major fairs in northwest Europe, the Lendit fairs, were established by the abbey of St. Denis in the eighth century.

<sup>76</sup>Freedom went beyond the commercial, with entertainment also tending to the offshore—gambling, theatres, prostitution, and plenty of drink. Everitt (1967) p536; Pirenne (1937)

<sup>77</sup>We will look at ‘off-market’ trading in Chapter 7.

<sup>78</sup>Gross (1890)

producers receive for their goods and the price consumers pay for them. Reducing trading costs raises the price for producers and lowers it for consumers, increasing the quantity traded. The consequent stimulus to production raises productivity through the mechanisms with which we are now familiar.

Trading costs are made up of pure trading costs, monopoly profits, and predation costs. As we saw in Chapter 2, pure trading costs include the cost of information, the cost of transactions, the cost of transportation, and the cost of financing. They also include a ‘normal’ profit for merchants and market makers—a profit sufficient to induce them to mediate the trade in question. Monopoly profits are profits in excess of ‘normal’. Predation costs require no explanation. Total trading costs, then are the sum of these three components:

total trading costs = pure trading costs + monopoly profits + predation costs.

Merchants, associations, and organized markets could increase their profits either by competing for trade or by preventing others from competing for it. Competition for trade tended to eliminate monopoly profits. Moreover, it motivated efforts to lower pure trading costs. Success in doing so meant higher profits from existing business until others could match the lower costs. Moreover, by undercutting competitors, it meant an expansion of business at their expense. And—vitaly important for the expansion of trade—lower pure trading costs opened up additional trade that had previously been unprofitable. The second route to higher profits, blocking the competition of others, increased total trading costs, not only by increasing monopoly profits, but also by removing any pressure to lower pure trading costs.

Commerce was organized to serve the interests of those engaged in it, not the interests of society as a whole. The goal of commercial organization was to increase the profits of those involved by whatever means were possible. Merchant enterprises, merchant associations, and organized markets worked to lower pure trading costs. But they also did their best to monopolize trade. If total trading costs fell overall, it was because efforts by one group to monopolize trade were generally frustrated by the efforts of others. Commerce on its own generally lacked the power to enforce a monopoly. Only

when it enlisted the power of governments did it have much success in establishing monopolies.<sup>79</sup>

We can understand the impact of government on commerce in similar terms, through its net effect on trading costs. Governments lowered pure trading costs by offering less costly means of enforcement, and they lowered predation costs by providing protection.<sup>80</sup> However, they also increased monopoly profits by creating and selling trading monopolies, and they raised predation costs through their own predation. Usually, the net effect was an increase in total trading costs. As we will see in Chapter 11, it was ultimately competition among governments that limited the harm they did and permitted economic progress to proceed.

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<sup>79</sup>There is a debate among economic historians over the role of merchant guilds, that parallels the debate over artisan guilds mentioned in Chapter 3. Those who see merchant guilds as benign emphasize their role in lowering pure trading costs (for example, Greif, et al. (1994)). Those who see them as malign emphasize their pursuit of monopoly profits (for example, Dessí (2005)). There is, of course, truth in both positions. The net effect depended on how successful in fact merchant guilds were in monopolizing trade in the face of resistance from other merchants.

<sup>80</sup>Epstein (2000)

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