COMMERCE IN PRE-INDUSTRIAL EUROPE: AN INTRODUCTION*

Meir Kohn

Department of Economics
Dartmouth College
Hanover, NH 03755
email: mkohn@dartmouth.edu

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ABSTRACT: Economic growth in pre-industrial Europe was driven by the expansion of the market. The 'market' was a complex commercial structure made up of merchant firms, merchant associations, and organized markets. This paper provides an overview of the pre-industrial commercial structure, of how it functioned, and of how it evolved.

JEL Categories: N13, D23, L14, L81, O12

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Economic growth in pre-industrial Europe was driven by the expansion of the market. Increasing opportunities for trade motivated a reorganization of production to exploit comparative advantage and the division of labor. This reorganization raised productivity and so increased incomes. The 'market' whose expansion brought this about was no abstract concept. It was itself a sector of the economy, a commercial structure made up of merchant firms, merchant associations, and organized markets. The purpose of this section is to understand the nature of this commercial structure, how it functioned, and how it evolved.[1] The purpose, in other words, is to understand how and why the market expanded. The current chapter sets the scene and provides an overview.

THE NATURE OF COMMERCE

To understand how the commercial structure functioned, we need first to understand the nature of the activity in which it was engaged—commerce.

The separation of commerce from production

Today, commerce and production are usually combined within a single firm: the same entity produces the goods and markets them. In the pre-industrial economy this was not so: production and commerce were largely separate and distinct activities. In the absence of significant economies of scale, most producers were small household enterprises. Sometimes, they sold their output directly to local consumers. However, as the market expanded and producers specialized, their output increasingly went to satisfy the demand of consumers at a considerable distance. Producers did not deal directly with these consumers, but rather sold their output to middlemen or merchants. Indeed, it was the arrival of the merchant, 'knocking on the door' of the producer, that signaled the expansion of the market.

In some cases—for example, when goods needed to be modified to suit a particular market—merchants became directly involved in production. However, for the most part merchants specialized in commerce and traded goods that were produced by others. Business, therefore, primarily meant commerce. The typical business firm of the period was largely or exclusively commercial: it engaged in trading rather than production. In

[1]This section consists of the current chapter as well as Kohn (2003a), Kohn (2003b), Kohn (2003c), and Kohn (2003d).

this respect, it resembled today's Merrill Lynch more closely than it did today's General Motors.[2]

The centrality of information

A merchant was in the business of seeking out and capturing gains from trade. The potential for such gains existed whenever a particular good could be acquired in one place and resold in another at a higher price.[3] The business of a merchant, essentially, was to seek out and to exploit such opportunities. That is, he made his living by buying low and selling high. It was the pursuit of potential gains from trade that drove merchants to create markets, to connect markets, and to expand markets.

Information was the merchant's raw material. While a producer is a processor of physical materials, a trader is primarily a processor of information.[4]

The most critical information for a merchant was, of course, information on prices—information that something purchased here and now could be resold at a profit in another place or at another time. In the pre-industrial economy, timely information on prices was particularly difficult to acquire: slow communications meant that markets were separated

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[2]"Before the Industrial Revolution especially, the hand that turned the wheel of commerce was not the producing craftsman but the merchant and tradesman. …a most significant feature of the period before 1760 was the almost absolute dependence of the producing class upon the trading class." Westerfield (1915) p 125. Forward vertical integration by producers into commerce began on a large scale only after 1850: see Chandler (1977).

The merging of commerce and production is perhaps the reason that modern economics tends to focus on the latter, almost to the exclusion of the former. "[Textbook economics] equates the firm with a producer, ignoring the fact that many firms are actually responsible for the organization of the market process itself" "… firms are specialized mediators." "The materialistic view of the economy suggests that the essence of intermediation is production… The information-based view of the economy suggests that the essence of intermediation is the organization of trade instead." Casson (1997) p5

[3]The price the final purchaser is willing to pay for the good is higher than the price the original seller demands for it. This indicates that the good is worth more to the purchaser than to the seller. The difference in valuation, as reflected in the difference between the selling price and the buying price, is a measure of the gains from trade.

[4]Casson (1997)

by weeks and months. For example, in the sixteenth century, a letter might take two weeks to reach Venice from the Low Countries or two months from Alexandria.[5]

A second type of information that was essential to a merchant was information on product quality. Because units of production were small and conditions and techniques of production extremely variable, output was highly heterogeneous. For example, Pegolotti, the author of a fourteenth-century manual for merchants, listed some 23 different types of raw silk.[6] Even such basic materials as wood and iron came in dozens or even hundreds of qualities.[7] A merchant who could not tell one quality from another would soon find himself the victim of someone who could: "Whenever wine was bought or sold, special precautions had to be observed, for slight variations in appearance denoting different types, good or bad, were often visible only to the eye of the expert and the amateur was often duped into buying a mixture of dregs of many good wines, or bad wines mixed with white of egg, honey and other sweetening matter."[8] Similarly, "quality was everything in wool and an expert eye essential if losses were to be avoided…"[9]

Merchants needed information not only on goods but also on people. They needed such information, because—as we shall see presently—they often had to rely on others, and they needed to know whether or not these others could be trusted.

The costs and the risks of commerce

Potential gains from trade did not necessarily indicate a profit opportunity: it all depended on the costs. First, there was the cost of finding a potentially profitable trade—the cost of information. Then there was the cost of moving the goods from where they were less valued to where they were more valued—the cost of transportation. There was also the cost of the actual trading—the cost of transactions. To these costs had to be added the cost of avoiding, mitigating, and bearing risk.

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[5]Braudel (1972)

[6]Lopez (1987) p372

[7]Grantham (1999)

[8]James (1971) p161

[9]Kermode (1998) p199

The first source of risk was transportation. Moving goods from one place to another exposed the merchant to all the hazards of nature and man. The hazards of nature included loss due to storm or flood and damage by damp and rodents. Even if goods were not lost or damaged, their time of arrival was highly uncertain: a voyage that normally took a month would frequently take two or even three.[10] The hazards of man included not only predation by pirates, brigands, and governments, but pilferage and negligence on the part of those entrusted with transporting the goods.

The second source of risk was trading itself. Since almost all trading took the form of venturing, merchants shipped goods with no certainty of the price at which they would sell. The uncertainty was considerable, because markets were thin and fragmented, and prices consequently volatile. With demand often inelastic and supply irregular, local markets were subject to sharp temporary imbalances, and prices could skyrocket or plummet in a matter of days. In the fog of uncertainty, prices were highly sensitive to news, rumor, and manipulation. Moreover, the inherent volatility was often exacerbated by the actions of the merchants themselves: "Scarcity and high prices often attracted excessive supplies and were followed by a glut on the market. If a merchant shipped goods to a place where there was scarcity, he would frequently discover that others had been doing the same and had spoiled the market."[11]

The two fundamental requirements of commerce

Commerce generally involved trading between places—purchasing goods in one place and reselling them in another. In such trading, it was rarely possible to ship goods to order. Slow communications and transportation were a major obstacle, but no less of an obstacle was the heterogeneity of the goods themselves. Because of this, buyers wanted to inspect the goods before they purchased them. As a result, almost all commerce took the form of venturing. Goods purchased in one place were taken to another before a buyer could be sought.

Venturing required representation both in the place where the goods were bought and in the place where they were to be sold. Representation in multiple markets was,

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[10]See Kohn (2001d) on the hazards of transporting goods.

[11]de Roover (1948)p 42

therefore, the first fundamental requirement of commerce. To meet this requirement, a merchant either had either to travel himself with his goods or to rely on someone else—an agent—to act for him.

Venturing required a merchant to take a position. He needed to buy the goods in order to take or to send them to another market for resale.[12] That is, he had to take ownership of the goods he traded. The greater a merchant's capacity to take a position—the greater his command over goods—the greater his potential profits.[13] A command over goods was the second fundamental requirement of commerce.

A command over goods necessitated working capital. Consider, for example, the situation faced by the sixteenth-century merchants of Toulouse who specialized in the trade in woad (a blue dyestuff). Production of the woad—growing it, drying it, and processing it—took over a year. The woad merchants financed production by paying growers and processors in advance. Shipping the dye to market and selling it off might take another year. Since woad was typically sold on long credit, it might be yet another year before the merchant recouped his initial outlay. A woad merchant therefore had to have working capital of three times the annual value of the woad he traded.[14]

Working capital had to be financed either out of the merchant's own resources (his capital) or out of the resources of others (credit). Commerce was therefore inextricably bound up with credit. Merchants sold to others on credit and they bought from others on credit. Merchants also borrowed money to finance their working capital and lent money to others.

COMMERCIAL STRUCTURE

Those who engaged in commerce—who sought out the gains, bore the costs, and worried about the risks—were merchants. They did not, however, act as isolated individuals. Rather, they acted within the framework of a complex commercial structure

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[12] "Ownership is the principal route by which a market-making firm extracts rents from information." Casson (1997) p65 It is not, however, the only route. Brokers use their information to bring buyers and sellers together for a fee, without themselves taking a position in the goods in question. See Kohn (2003d) on the important role of brokers in the markets of pre-industrial Europe.

[13] The term 'command over goods' is due to Reynolds (1952).

[14] Ball (1977) p166

made up of merchant firms, merchant associations, and organized markets. Non-commercial institutions such as the family and government also played an important role in supporting commerce.

Merchant firms

The basic unit of the commercial structure was the merchant household. In commerce, as in agriculture and industry the predominant form of organization was small-scale household enterprise based on the nuclear or the extended family.[15] Household enterprise predominated because of its incentive advantages. Other things equal, a merchant, like a farmer or an artisan, would work more carefully, more intelligently, and more diligently when he worked for himself and his own.

Other things, however were not entirely equal: the 'technology' of trading exhibited some economies of scale that warranted a larger size of enterprise.[16] Trading itself was easily divisible and required no fixed investment. And, to a considerable extent, individual merchant households were able to meet on their own the two fundamental requirements of commerce—representation in distant markets and command over goods. With respect to representation, it was common for a brother or a son to represent a merchant household in a distant market. With respect to command over goods, merchant households relied to a considerable extent on their own capital. There were, however, advantages to having more representatives in more markets and to having a greater command over goods. Both would help to amortize overhead expenses over a larger volume of business and both would facilitate diversification as a safeguard against risk. In addition, scarce information on trading opportunities could better be exploited if larger amounts could be traded and if there was access to a larger number of markets.

To achieve these economies of scale in trading, merchants often found it advantageous to join together with others in various forms of joint enterprise. The use of

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[15]This was true throughout the period, and, in fact, well into the nineteenth century. And it was true throughout Europe. For commerce see, for example Van Houtte (1977) on Antwerp and Muldrew (1998) and Grassby (2001) on sixteenth century England. On agriculture and industry, see Kohn (2001b) and Kohn (2001c).

[16]A technology exhibits economies of scale (over some range of scale)when a larger economic unit enjoys lower average costs than a smaller unit.

non-family agents extended the scope of trading and the use of external financing increased command over goods.

Joint enterprise took one of two forms—the venture and the company. In a venture, a merchant joined with others for the purpose of undertaking a single trade—a single trading voyage or a single shipment of goods. In a company, merchants came together for a fixed period of time to engage in a series of trades. Ventures and companies each served in varying degrees to expand representation and to increase the command over goods.[17]

The merchant firm, therefore, was either a household enterprise or a company encompassing a number of households. The venture form of enterprise was not a firm, but rather a limited joint undertaking of two or more merchants, households, or firms.

Merchant firms, even when they extended beyond the single household, generally remained small. The technologies of administration and of communications were relatively primitive. As a result, growing firms soon encountered serious problems of coordination and monitoring.[18] At a fairly small size, these diseconomies offset any economies of scale in trading. The main exception was firms whose business was predominantly financial such as merchant banks. For such firms, there were additional financial economies of scale and economies of reputation that made the typical financial firm somewhat larger than the typical purely commercial firm.[19]

Merchant associations

Today, firms are much larger than they were in pre-industrial Europe. This is partly a consequence of greater economies of scale in production and better technologies of administration and communications. However, another reason is that large corporations today perform many of the functions that were performed in the pre-industrial economy not by the individual firm but by merchant associations.

Merchant associations were organizations of merchants that provided a vehicle for joint action. They took a variety of forms. The best known is the merchant guild or hanse

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[17]See Kohn (2003a) for more on ventures, companies, and business organization.

[18]On the challenges of managing a commercial firm, seeKohn (2003).

[19]See Kohn (1999b) on merchant banking.

of the Middle Ages, which evolved later into the merchant company (not to be confused with the company as individual firm). In many cases, cities were controlled by merchant elites and the cities themselves served the function of a merchant association: Venice is the most striking example. Some merchant associations were organized not in the merchants' home city but in distant markets. There, foreign merchants from a particular city or region came together to pursue their common interests in associations known as 'nations' or 'colonies'.

Some of the explanations for the size business firms today are the achievement of market power, the internalization of transactions to address problems of 'opportunism', and reputational economies of scale. As we shall see, in the pre-industrial economy it was the merchant association rather than the individual firm that vied for market power. It was the merchant association that addressed problems of 'opportunism'. It was the merchant association that provided a 'brand name'.

Merchant associations not only performed many of the functions we associate today with large corporations, but also performed many of the functions we associate with government. They provided their members with protection and with law and order. They provided social services such as welfare and education. They invested in the infrastructure of transportation and communications and provided mail services and sometimes 'public transportation'.[20]

Market centers and organized markets

Commerce was largely concentrated in market centers. There are enormous benefits to concentrating trading in a single place. It makes it easier for traders to find one another and to find an attractive deal. The quality of the market is better: a 'thicker' market offers better liquidity and prices that are more competitive and more stable. The volume of business justifies investment in infrastructure to lower the costs of trading.

In pre-industrial Europe, market centers formed a hierarchy that paralleled the hierarchy of trade. Market towns and fairs served local and regional trade. Commercial cities and a few international fairs served trade among regions, as well as trade between

[20]The seminal work on merchant associations has been done by Avner Greif. For references, and for further discussion of the role of merchant associations, see Kohn (2003c).

the two major zones of European trade, and trade between Europe and the rest of the world.

Trading in a market center took place in an organized market. There was a physical location for trading and a trading system to make it easier. Brokers played an important role in this as information specialists who brought the parties together. There were facilities for the settlement of trades. These included arrangements for offsetting trades against one another to minimize the need for actual payment. And they included facilities for credit to ensure that payment could be made in a timely fashion. Finally, organized markets provided a system of order to resolve the many disputes that naturally arose as a result of trading.[21]

Non-commercial adjuncts to the commercial structure

There were also several primarily non-commercial institutions that played an important commercial role. They were therefore important adjuncts to the commercial structure.

The family was in general of far greater importance than it is today, both in its economic role and in its social role. Good family connections provided a merchant with valuable information and trading opportunities.[22] The family protected its members against predation and violence and provided emergency aid in the face of adversity. And, as we shall see, the family was a source of reliable agents and of willing finance.

'Government' in the form of local lords, territorial rulers, and the Church also played an important commercial role.[23] Local lords and territorial rulers were in the business of violence. We shall see that they used violence and the threat of violence both to prey on commerce and to protect commerce from the predation of others; to intervene in the rivalry among merchants for trade, and to resolve disputes between merchants. The Church, on the other hand, was in the business of salvation. It used its power over the

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[21]See Kohn (2003d) on organized markets.

[22]See Kohn (2003b) on the importance of connections and family.

[23]For a more thorough discussion of the interaction between government and commerce, see Section IV of "The Origins of Western Economic Success" (to be written).

individual's afterlife to generate revenue in a variety of ways.[24] We shall see that one of these was the resolution of commercial disputes.

Commercial structure and the extent of the market

The commercial structure extended the market by lowering trading costs. We have seen that it was the level of trading costs that determined whether or not a particular trade was potentially profitable and consequently whether or not it would actually take place. It was, therefore, the level of trading costs that determined the extent of the market.

The commercial structure lowered trading costs in a variety of ways. Commercial structure lowered the cost of finding potentially profitable trades. Families and merchant associations conveyed and shared information among their members; organized markets provided information to attract potential traders. Organized markets and specialized intermediaries reduced the cost of searching for trading opportunities by providing focal points for trading. Commercial structure lowered the cost of transportation. Merchant associations, organized markets, and governments invested in transportation infrastructure and provided protection against pirates and brigands. Perhaps most important, commercial structure lowered the cost of transactions. It did so mainly by addressing the problem of reliance.

COMMERCIAL STRUCTURE AND RELIANCE

The problem of reliance was largely a consequence of the two fundamental requirements of commerce. Representation involved the use of agents. Command over goods involved external financing. Agency and external financing created reliance because both involved promises: a promise to act in the interest of another in the case of agency; a promise to pay in the case of financing. It was the acceptance of a promise—of an assurance of future performance—that created reliance and vulnerability. If the promise was not kept, the party accepting the promise stood to be harmed. The dishonesty and incompetence of agents and default on debts were the two main causes of failure of merchant enterprises.

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[24] On the Church as a business see Ekelund, Tollison et al. (1996).

Because promises were central to trading, trading required *trust*—the expectation that people would keep their promises: "Trading is trading in promises; but it is futile to trade in promises unless there is some reasonable assurance that the promises will be kept."[25]

Promises, reliance, and trust

There are two reasons why someone might not keep a promise. The first is that it proves impossible to keep: in the high-risk commercial environment of pre-industrial Europe this was not uncommon. Or they might choose to break the promise. Such a choice—a rational decision to 'defect'—must weigh the immediate gain from breaking a promise against the potential long-term harm that will result. Merchants, in accepting the promises of others, had to judge, therefore, both their capacity to keep their promises and their interest in doing so.

The parties themselves could do a great deal to reinforce trust between them and, of course, both had an interest in doing so. The trick was to make the cost of defection sufficiently high.[26] The party offering the promise, wishing to make himself a more desirable counterparty, could punish himself for defection. In an age of strong religious faith, feelings of guilt and shame and the anticipated consequences of a broken oath represented significant costs. The Church played an important role in reinforcing this mechanism. But most of the burden fell on the party accepting the promise. A resort to violence in case of defection was one possibility, but in the realm of commerce, the most common and natural sanction was the loss of future business. A continuing relationship between the parties constituted a performance bond: the cost of defection was the loss of this relationship.

Where such a continuing relationship was absent, or where the potential gain from defection was too large, it was sometimes possible to raise the cost of defection *ad hoc*. This could be done, for example, with a pledge of valuables or property to be sacrificed in the event of defection (or famously of a pound of flesh). In the wine trade of fourteenth century England, for example, a merchant relied on an agent to sell his wine. But he

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[25]Hicks (1969)p 34

[26]Having the gain from defection be sufficiently low was also helpful. Defection on small transactions was less likely, other things being equal, than defection on large.

required from the agent a bond, equal to the value of the wine, to be forfeited if the agent failed to render an account of his transactions as promised.[27] Merchants of the German Hansa in the fourteenth century sent goods and money to their resident agents by way of couriers. These couriers were sometimes required to post a bond, especially if they were entrusted with a large sum of money.[28]

Enforcers, guarantors, and intermediaries

The parties themselves were not always able to create sufficient trust to support a relationship of reliance. Fortunately, they were not on their own: the various institutions of the commercial structure provided them with help. When trust between the parties, left to their own devices, was insufficient, these institutions could often make transactions between them possible.[29]

Institutions made transactions possible by reinforcing trust between the parties. They did this by intervening to alter the balance of gain and loss from defection. That is, they acted either as an enforcer or as a guarantor. An enforcer is a third party, not itself directly involved in a transaction, that imposes a cost in the case of defection. An effective enforcer must be able to impose a cost that is sufficiently high, and it must have the incentive to do so: that is, it must be credible. A guarantor, on the other hand, is a third party that itself bears a cost if the promising party defects. An effective guarantor must be sufficiently trustworthy—more so than the promising party—and it must have a superior ability to induce the promising party to keep his promise or a superior ability to

[27]James (1971) p164

[28]Gies and Gies (1972) Ch 16

[29]Fukuyama (1995) has stressed the economic importance of trust: "…a nation's well-being, as well as its ability to compete, is conditioned by a single, pervasive cultural characteristic: the level of trust inherent in the society" p7. Levi (2000) has argued, however, that a lack of trust among individuals is not necessarily a problem if a society develops institutions that nonetheless allow them to cooperate and trade. Among modern economic historians, it is Douglass North in particular who has emphasized the importance of the development of institutions that increase the cost of defection, so reducing transactions costs and facilitating the expansion of trade. See for example North (1991) p 98 and North (1993).

punish him if he does not. The cost of defection to the guarantor must be high enough to make the guarantee credible.[30]

An alternative to reinforcing trust between the parties is to eliminate their need to trust one another. This can be done by
interposing an intermediary between the two parties. Instead of having to rely on one another the parties rely instead on the intermediary. They no longer transact directly with one another, but rather transact indirectly via the intermediary. Of course, for an intermediary to play this role it must be more trustworthy than the parties themselves: it must be more capable of keeping its promises or have a stronger reason to do so or both.[31] The commercial structure provided several types of intermediary.

Transactions within a community

To see how various institutions were able to facilitate commerce, let us begin by considering transactions taking place within a community—which is, indeed, where most transactions actually did take place in the pre-industrial economy. Within a community, the trader's family acted as guarantor and the community itself acted as enforcer.

The family as guarantor

The family could act as guarantor, because it was inherently more trustworthy than its individual members. First, the family was better able to keep promises. It was longer-lived than the individual, who often died without warning in the prime of life. And it owned more property, any part of which could be forfeit if a member of the family defected. Second, the family had a stronger interest in keeping promises, because it had more to lose from defection. A family's reputation was indivisible: defection by one of its members hurt the reputation of all, and so their ability to engage in commerce.[32]

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[30]On guarantees, see Katz (1999).

[31]"A reputable intermediator can also eliminate default by creating a chain of trust in cases where the direct link between buyer and seller is very weak. Because the intermediator is a specialist, making his living by trade, he has an incentive to build up a reputation for integrity." Casson (1997) p 88

[32]The continued existence of the family beyond the life of its individual members mitigated the 'end game' problem of an individual trader approaching the end of his career. With little future remaining, the temptation to defect increased. However, defection would hurt other members of the family who continued in business after him. See Greif (1989) on this.

The family guarantee was credible because it was involuntary. Families were held responsible by others for the behavior of their members. In fifteenth century Florence, for example:

> The legal penalties extended beyond the debtor himself to his family. Father, sons, brothers, and others were all subject to seizure and imprisonment, and their property was subject to confiscation and liquidation to satisfy the creditors who had been left in the lurch.[33]

Family responsibility had its roots in the ancient customs of feud and vendetta.[34]

Transactions within the family

The role of the family as guarantor outside the family was reinforced by its role as enforcer within the family. A family is a framework for exchange among its members. Exchange within a family differs from market exchange in that members of the family often exchange goods and services on the basis of rights and obligations without keeping a running account. This is possible because family relationships are of long duration and strengthened by biological instinct.[35]

Like any exchange environment, the family possesses a system of internal order to adjudicate and to punish defection. The family's sanctions may range from disapprobation to violence to the ultimate sanction—ostracism. As we have seen, the economic role of the family was far more important in the pre-industrial economy than it is today and the consequences of ostracism were consequently far more serious. For a medieval merchant to be cut off from the support of his family would have been no less than catastrophic.

Because of the effectiveness of the family as an enforcer, merchants preferred whenever possible to employ family members as agents. Fathers sent their sons as traveling or resident agents; brothers acted as agents for one another. For example, the

[33]Kuehn (1981) p312

[34]Pospisil (1971) Ch. 1. The custom of vendetta survived into the Middle Ages. In Flanders, for example, cities were riven by blood feuds between extended families who preferred to settle grievances through bloodshed rather than through the courts. Nicholas (1992)

[35]On exchange within the family and its biological foundations see Ben-Porath (1980) and Ofek (2001).

fourteenth-century merchants of the German Hansa relied heavily on their relatives. One merchant in Lübeck, Sivert Veckinchusen, sent a shipment of cloth to his brother-in-law in Dorpat. The latter sold the cloth, bought skins with the proceeds, and forwarded them to Sivert's brother Hildebrand in Bruges to sell there.[36]

With respect to financing, the family was the source of startup capital for most merchants. When a merchant needed additional financing in the form of equity or loans, it was to his family and kin that he turned first. The internal order of the family helped to mitigate the problems associated with equity financing and to make it more likely that debts would be repaid.[37]

The community as enforcer

Just as the family acted as enforcer for transactions internal to it, so did the community act as an enforcer of transactions external to the family but internal to the community. The community in question might be a merchant association, a city, or an informal network defined by religious affiliation or place of origin.

Every community had its system of internal order—usually more formal than that of the family. Such a system consisted of three elements: rules that defined expected behavior; a mechanism of adjudication to judge when a promise had indeed been broken or rules violated; and a mechanism of enforcement.

A formal system of order supported the use of contracts—essentially, promises formalized to facilitate enforcement by the system of order. And it supported various forms of business organization—formalized relationships—to structure both agency and external financing.[38]

Enforcement by the community's system of internal order relied to some extent on violence, but, as with the family, its principal sanction was ostracism. For example, in fifteenth century Florence, a contemporary, Poggio Bracciolini, described the practice:

> By our laws we see the perfidy of debtors met with a bitter penalty. For first by proclamation they are condemned to exile as fugitives, then publicly in the podestà's

[36]Gies and Gies (1972) Ch 16

[37]See Kohn (2003a) on the problems of equity financing and Kohn (2003b) on debt.

[38]See Kohn (2003a).

palace or elsewhere their image is painted with an inscription of their name and their crime, which is to us a form of ignominy similar to eternal damnation.[39]

Ostracism meant a loss of future business, not only with the aggrieved party, but with all members of the community. This raised significantly the cost of defection. As with ostracism by the family, ostracism by the community meant the loss of other benefits of membership. It meant a loss of the protection that the community offered against violence and predation: in Florence, for example, “The debtor who had defaulted and fled to escape his creditors (the *cessans et fugitivus*) was … placed outside the law and could be injured or killed by anyone with impunity.”[40] Ostracism involved, too, a loss of mutual aid, of group privileges in trade, of access to information and credit, and of social and religious benefits. And, as we shall see, ostracism also meant the loss of the community’s guarantee in transactions with strangers.[41]

Because the community could act as an enforcer, merchants preferred to use members of their own communities as agents—if members of their own families were not available. Communities helped merchants monitor the behavior of their agents. One way they did this was by establishing ‘colonies’ in distant markets where all of the agents of the community would reside under the watchful eyes of a Consul (and of each other). In the event an agent defected, a merchant had recourse to his community’s system of internal order: lawsuits against agents were common (in England they were known as ‘actions of account’). Communities helped facilitate external financing in much the same way. They often provided means to register debts. And their systems of internal order enforced the seizure of collateral and imposed punishment.[42]

Transactions among strangers

Transactions among strangers—among members of different communities—were much more problematic than transactions within a community. Information on the credit

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[39]Quoted in Kuehn (1981) p311

[40]Kuehn (1981) p312

[41]It is Avner Greif above all who has pioneered the study of the role of merchant communities in facilitating transactions: for example, see Greif (1997).

[42]For further discussion of the role of merchant communities as enforcers of relationships of reliance, see Kohn (2003c).

of strangers was less readily available. The parties themselves were less able to punish defection. Since there was might be little repeat business, the threat of its loss meant nothing: in large anonymous markets, counterparties are easy to replace and so relationships have little value. Self-punishment by the promising party was less credible, too, since moral scruples applied less forcefully to strangers. Family guarantees added little: the family was not much easier to punish than the individual. Community enforcement was either unavailable, because the trading in question took place outside community jurisdiction, or it was biased in favor of its own members at the expense of strangers.

One way to facilitate transactions between strangers was to find third parties that could reinforce trust between the parties. As in the case of trading within a community, this role was performed both by third-party guarantors and by third-party enforcers.

The merchant association as guarantor

As we have seen, the family acted as guarantor for family members transacting with members of other families within the community. In a similar fashion, the community—in the form of merchant association—acted as guarantor for community members trading with members of other communities.[43] The reasons why the community could do this paralleled the reasons why the family could be an effective guarantor. The credit of the community was better than that of the individual member. The community had more to lose from defection, because defection by a single individual harmed the reputation of the whole community and so its ability to trade. The community had more assets that could be seized in the event of defection by one of its members. The community was longer-lived than its individual members, and it could not flee to escape its responsibilities. Moreover, the community could deter defection by its own members, because it had the means to discipline them through its system of internal order. As with the family, the community's guarantee was credible because it was involuntary: others would retaliate against it for the defection of one of its members.[44] Indeed, the idea of joint

[43]Greif has called this the Community Responsibility System. See for example, Greif (1997) Greif (2001).

[44]For more on community guarantees, see Kohn (2003c).

responsibility—whether of family, community, or nation-was pervasive in the Middle Ages. Individuals took it for granted that they would be held responsible for the actions of others with whom they were associated.[45]

Other enforcers

Organized markets acted as enforcers reinforcing trust between strangers. The fairs and commercial cities where strangers traded with one another profited from trading volume and therefore had an interest in attracting traders. One of the ways they did so was by offering impartial justice. Like families and communities, organized markets developed norms and conventions, and it was these that crystallized into the commercial law of the period—the Law Merchant. As we have seen, organized markets provided courts to adjudicate disputes, with procedures well suited to the needs of traders. As with families and communities, the principal sanction of organized markets was exclusion. For the defecting trader, exclusion from an important organized market greatly reduced his opportunities to trade and therefore constituted a significant cost. Exclusion often applied not only to the individual trader but to his community as well. In this way, enforcement by organized markets complemented the guarantee of the community—just as enforcement by the community complemented the guarantee of the family.

Trust among strangers was reinforced, too, by non-commercial enforcers. To be effective these had to be able to impose costs on members of different communities. Territorial rulers and the Church were able to do so because their authority extended beyond the individual community. The territorial ruler relied on violence as a means of enforcement: he forced compliance or extracted compensation for defection under the threat of force. The Church relied on excommunication—the withholding of salvation. For both the territorial ruler and the Church, a major incentive to enforce was pecuniary: there were financial rewards for doing so. In addition, the territorial ruler had an interest

[45]"The character of communities in the central Middle Ages was rooted and grounded in older traditions, traditions which simply assumed the existence, rights, and duties of collectivities large and small: responsibilities were owed collectively to collectives…" Reynolds (1997) p 5. As an example of joint responsibility, the Church taught that God would consider the good deeds of the entire guild on Judgment Day when he pondered the fate of each of its members. Richardson (1999)

in facilitating trade, which he could then tax. And the Church had an ideological interest in promoting good faith and the sanctity of promises.[46]

Indirect transactions through intermediaries

Intermediaries offered a different approach to facilitating transactions among strangers. Rather than reinforcing trust between the parties through enforcement or guarantee, they eliminated the need for trust between the parties. As we have seen, they did so by allowing individuals to transact with one another indirectly via the intermediary. Intermediaries in pre-industrial Europe included merchant banks, deposit banks, and specialized commission agents.[47]

To be able to intermediate transactions between traders who did not trust one another sufficiently to transact directly, an intermediary itself had to be sufficiently trustworthy: it had to create a 'bridge of trust' between the two parties. Intermediaries were more trustworthy than ordinary traders, basically because they had more to lose from defection. Size was an advantage in this respect: for a large merchant bank, the gain from defection on a single transaction was less likely to outweigh the loss of business consequent on the damage to its reputation. While merchant banks did fail—some spectacularly—they were generally more able to keep their commitments, because they were better diversified and less dependent on the survival of a single individual.[48] Deposit banks, although mostly small, were relatively more trustworthy because of their structure, and because they were supported by external regulation and monitoring.[49] Specialized commission agents were more trustworthy, because being trustworthy was the essence of their business: they depended on referrals from satisfied customers to generate new business.

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[46]For more on enforcement by non-commercial enforcers, see Kohn (2003).

[47]On merchant banks, see Kohn (1999b); on deposit banks, Kohn (1999a); and on commission agents, Kohn (2003a) and Kohn (2003d).

[48]Large firms, like families, are also frameworks of exchange internally among their members. As with families, the nature of this exchange differs from market exchange. See Ben-Porath (1980) on parallels between the family and the firm. See Breton and Wintrobe (1982) on exchange within a large organization, problems of trust, and competition.

[49]See Kohn (1999a) on deposit banks and Kohn (1999b) on merchant banks.

Commercial structure and the struggle for the gains from trade

Merchants sought out potentially profitable opportunities for trade—situations in which the potential gains from trade exceeded the cost of realizing them. However, finding opportunities for profitable trade was not enough. Merchants found themselves in a constant rivalry with others to exploit these opportunities. And even when they succeeded, they had to protect their gains from others who would take them from them.

The rivalry for trade

The rivalry for trade in the pre-industrial economy was different from the rivalry we know today. Today, the rivalry for trade is largely a rivalry of producers. In the pre-industrial economy it was a rivalry of middlemen—a rivalry over who would mediate a given trade. Of course, the outcome of this rivalry did ultimately affect the fortunes of producers, but producers were largely passive in this. The ones actively engaged in rivalry were the middlemen—the merchants.[50]

Today, the rivalry is largely a struggle for markets for manufactured goods. The pre-industrial economy, however, was predominantly agricultural.[51] Agriculture was the source not only of foodstuffs but also of most of the raw materials used in manufacturing. So the majority of trade was in commodities, and most of the rivalry for trade involved a struggle over their sources of supply. Merchants fought to be the ones to bring important commodities to the great urban markets.

Succeeding in the rivalry for trade meant excluding one's competitors. In commerce, there were no technological barriers to entry. So the only way to exclude potential competitors was through the exercise or threat of violence. Economies of scale in violence meant that the rivalry for trade was largely a rivalry among merchant associations rather than a rivalry among individual merchant firms.[52] To some extent, merchant associations struggled with one another directly to capture a particular trade. But mainly, they recruited to their cause the specialists in violence—governments.

[50]The difference between the modern and pre-industrial economies in this respect stems, of course, from the separation of commerce and production in the latter.

[51]See Kohn (2001a) on the patterns of trade in pre-industrial Europe.

[52]There were exceptions: a few unusually large firms participated directly. See, for example, Hunt (1994) on the medieval 'super-companies'.

Governments—territorial rulers especially—created market power by controlling access to a particular trade. Only rarely did governments themselves exploit the market power they had created. More usually, they sold the 'franchise' to some merchant association or other. This practice became particularly widespread in the sixteenth century, when it became an important source of revenue for many governments.[53]

Market centers too played an important role in the rivalry for trade. A government could control access to a particular trade by controlling access to the market centers that mediated that trade. In addition, market centers themselves were engaged in rivalry with one another to capture trading volume. A government could tilt the playing field in favor of a particular market center. It could do this, for example, by declaring a certain city to be a 'staple' for the trade in question, with exclusive rights to mediate that trade.

In addition to vying with one another, merchants also tried to capture as large a share of the gains from trade as possible from the original sellers and ultimate buyers. They bargained for low prices with the former and for high prices with the latter. The strength of their bargaining position, of course, depended on the extent to which other merchants were competing to buy or to sell the same goods. Consequently, competition among merchants tended to improve the bargaining position of producers and consumers and so reduce the share of gains from trade accruing to merchants as a group. When merchants or merchant associations succeeded in excluding competitors—usually with the assistance of governments—producers and consumers suffered.

Predation

Merchants, original sellers, and ultimate buyers were not the only ones trying to capture a share of the gains from trade. There were others—not themselves direct participants in trade—who sought to capture some of the gains through predation. There were pirates at sea, bandits on land, and toll and tax collectors everywhere. In addition to competing with one another, merchants had to protect their gains against these various forms of predation.

Predation means capturing resources through the exercise or threat of violence. As we have seen, governments were specialists in violence. Governments were, indeed, the

[53] Van der Wee (1963) p 319

principal predators, both through forcible seizure and through the imposition of tolls and taxes. But governments also provided commerce with protection from the predation of others. The reward to them was either direct, in the form of payment from merchants, or indirect, in the form of a higher return to their own predation.

The family played a role in protecting a merchant against predation. Family and clan provided the individual merchant with physical protection against petty violence. Family connections—'favor at court'—were important in protecting a merchant against predation by government.

However, it was the merchant association that played the principal role in providing protection against predation. This was so because economies of scale in protection favored joint action. Economies of scale in violence caused traveling merchants to band together in caravans and convoys for mutual protection. There were economies of scale, too, in dealing with governments. An association of merchants was in a stronger bargaining position when it came to negotiating the rate of government predation. A merchant association could offer more for a government's protection. And it could threaten a greater loss of revenue if the government reneged.[54]

Market centers, too, played a role in predation—mainly as targets. Market centers were natural 'choke points' where merchants tended to congregate. Consequently, routes to and from market centers provided good returns to brigands and toll-collectors, and market centers themselves were a good place to collect taxes. Organized markets were themselves highly profitable, capturing part of the gains from the trade that they mediated. This made them tempting targets for predation by governments, which took the form of license fees for the 'privilege' of holding a market.

THE EVOLUTION OF COMMERCIAL STRUCTURE

Over time, the commercial structure evolved.[55] The organization of merchant enterprises changed. Rather than traveling themselves to distant markets, merchants sent agents. Later, they kept their agents there permanently. With this transition, venture

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[54]Greif, Milgrom et al. (1994) is the seminal work on this. For an extensive discussion of the role of merchant associations in providing protection, see Kohn (2003c).

[55]See Kohn (2003a), Kohn (2003c), Kohn (2003d) for more detailed discussion.

forms of enterprise gave way increasingly to companies. Merchant associations were changing too. When merchants and their agents traveled, merchant associations played an important role as guarantors. However, as merchants came to rely more on resident agents, and as organized markets developed alternative arrangements to support trade among strangers, the role of merchant associations declined. Trading initially took place mainly in regulated public markets. However, over time public markets were undermined by increased private trading ‘off-market’. The structure of organized markets responded by becoming more open and less regulated and by adapting their trading systems to complement private trading.[56]

The evolution of the commercial structure lowered trading costs and caused trade to expand. This induced changes in production, transportation, and finance. In agricultural, as trade expanded and incomes rose, production shifted away from grain and towards horticulture and animal husbandry.[57] In manufacturing, there was a parallel shift away from luxuries for the few and towards lower-quality goods for the many.[58] In transportation, the growing volume of trade and its changing composition promoted technological progress and improvements in organization. In finance, the growing need for payment facilities, financing, and trade in risk stimulated the development of new financial institutions and instruments. The changes in the mix of goods being traded and the improvements in transportation and finance fed back and induced further changes in the commercial structure.

The evolution of the commercial structure was a process driven by merchant self-interest. Merchants, merchant associations, market centers, and governments changed the

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[56]“… the English open markets reflected an institutional framework that was antithetical to the development and integration of a true market system. The open market system is therefore not usefully viewed as an immature version or initial stage of a market economy. Market integration required fundamental changes in institutions that were in some political environments not easily forthcoming.… The transition from marketplace trade to impersonal large-scale market systems was not automatic. Indeed the transition was the key obstacle to the development of early modern economies, and similar challenges face third world and transition economies today.” Nielsen (1998) p 50

[57]Kohn (2001b)

[58]Kohn (2001c)

way they did things whenever they saw an opportunity to increase their revenues or to reduce their costs.[59] Such opportunities were sometimes a result of changes external to the commercial structure. But they were often endogenous—inherent in the imperfections of the existing commercial structure.[60] The evolution of the commercial structure was the long-term result of the accretion of many small changes.[61] Increasing productivity in commerce, as in other sectors of the economy, was mostly the result of changes in organization.[62] However, there was also technological progress—in forms of business organization, in techniques of management, and in information technology.[63]

The pursuit of merchant self-interest was not, however, always a force for the good. Merchant self-interest motivated two types of strategy: one increased the size of the pie; the other captured a larger slice of the pie at the expense of others. Merchant firms, merchant associations, and organized markets found ways to lower the cost of transactions. This benefited the parties concerned, but it also led to an expansion of trade that benefited society as a whole. However, merchant firms, merchant associations, and organized markets also engaged in a constant struggle over the gains from trade, in which governments too participated. This struggle at best redistributed the gains from trade. At worst, it raised trading costs leading to a contraction of trade and a decline in total income.

If the pie-increasing strategies ultimately outweighed the pie-decreasing strategies, it was because of competition. Merchant association competed with merchant association, and organized market competed with organized market. If one succeeded in gaining

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[59]"…understanding institutional changes requires examining the costs and benefits to those who can take the relevant actions. An institutional change will not necessarily occur just because it is efficient." Greif (2001) p38

[60]"Rather than a process driven by late medieval crisis, the expansion of the market itself stimulated the growth of the infrastructure of trade…" Reyerson (2002)p 224

[61] "Business did not, like science, develop in great strides following in the footsteps of giants and mavericks. It was fuelled by the energy and input of many thousands of individuals, whose particular contribution was small, but whose cumulative impact was significant in the long run." Grassby (1995)p 415

[62]See Kohn (2001b), Kohn (2001c), and Kohn (2001d) for discussions of technological progress in agriculture, industry, and transportation respectively.

[63]See Kohn (2003a)and Kohn (2003b).

significant market power, this only caused the others to redouble their efforts to undermine it. At the same time, there was increasing competition between one type of commercial structure and another. Specialized intermediaries competed with merchant associations as ‘trust mediators’. Indirect trading through intermediaries competed with direct trading in organized markets. Territorial rulers competed with merchant associations and with organized markets as enforcers. This incessant competition restrained market power and drove down trading costs, enabling the market to expand.

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