Impersonal Rules and Relational Contracts

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I. Introduction

In the early nineteenth century, American states began changing their legal systems to require "general laws:" laws that treated everyone the same and applied equally to everyone. The movement toward general laws began with general laws for the incorporation of churches, then other forms of business including manufacturing and banking (where it was called "free banking). General incorporation laws created an administrative procedure for granting a corporation charter to any citizen who met minimum requirements. Constitutional provisions mandating general incorporation laws and general taxation laws spread widely in the 1840s, culminating in the Indiana constitution of 1851 which required the state legislature to pass general laws for 17 purposes and a blanket provision to pass general laws whenever possible. By the 1890s similar general law provisions existed in almost every state (Hennessey and Wallis, 2017). Impersonal rules that treat everyone the same became the rule rather than the exception by the end of the 19th century in the United States. By then the U.K. and a handful of other countries had also began moving toward impersonal rules and started down the road to modern development.

This paper begins to investigate how the adoption of impersonal rules might have directly affected the productivity of the economy through the interaction of impersonal rules and relational contracting. It presents a big, sweeping idea, and makes no pretense of nailing the idea down theoretically or empirically. It seems, however, that we have ignored the implications of impersonal rules for the efficiency of any organizational relationships, whether we are thinking about for profit firms or other social organizations. How much impersonal rules might contribute to "technological change" is a question that has not even been asked.

In order to illustrate the main conceptual point I use a very simple example drawn from my own experience: the relationship between a union carpenter and his helper, a member of the laborer and hod carriers union (me). The relationship between a carpenter and his laborer (helper) is embedded in at least three higher levels of organization: the firm they both work for, the two unions whose work rules affect their relationship, and the state government whose health and safety rules affect their relationship. In each case, the rules at higher levels of organization affect the productivity (positively or negatively) of the relationship between a carpenter and his helper, and so affect the productivity of the construction process. The laborer/carpenter relationship is an example of a relational contract ala Baker, Gibbons, and Murphy (2002):

> Firms are riddled with relational contracts: informal agreements and unwritten codes of conduct that powerfully affect the behaviors of individuals within firms. There are often informal quid pro quos between coworkers, as well as unwritten understandings between bosses and subordinates about task-assignment, promotion, and termination decisions. Even ostensibly formal processes such as compensation, transfer pricing, internal auditing, and capital budgeting often cannot be understood without consideration of their associated informal agreements.
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> Business dealings are also riddled with relational contracts. Supply chains often involve long-run, hand-in-glove supplier relationships through which the parties reach accommodations when unforeseen or uncontracted-for events occur. (P. 39)

What I want to show is that the relationship between the laborer/carpenter depends on the "outside options" that each part possesses. Those outside option are determined in part by the external rules created and enforced by the organizations that the laborer/carpenter relationship is embedded in and, critically, that the value of the laborer/carpenter relationship is higher if the external rules are impersonal rules. The example appears to be quite general. When we compare relationships embedded in impersonal rules and relationships embedded in "identity rules," rules whose form and/or enforcement depend on the social identity of the people to whom the rule applies, impersonal rules convey a distinct advantage. Explicitly, relational contracts are more valuable if they are embedded in impersonal rules than if they are embedded in identity rules. Since most societies in the world today, and almost all societies before 1800 were identity rule societies incapable of creating and enforcing impersonal rules, understanding the difference in the productivity of relationships across in the two types of societies is potentially quite important.

Because the argument is very much about "rules" at different levels of organization, I need to clarify the distinction between rules and norms, a distinction that has occupied growing attention in the institutional literature. There is a tendency to associate norms with relationships. Specifically, the kind of relationships Baker, Gibbons, and Murphy identify appear to occur within the external framework of rules, but do not follow the rules explicitly. We cannot usually directly observe the terms of the agreement that shape specific relationships, for example the specific agreement between a laborer and a carpenter. Because we cannot see the idiosyncratic agreed upon rules within a relationship, we tend to treated the rules as norms.

But the logic of relational contracting, however, argues that the agreements within relationships are not norms and cannot be norms of behavior. What matters in a relationship is the idiosyncratic agreements made by partners to the relationship, who use the external rules in order to frame a more valuable agreement. Relational contracts, as a result, appear to be norms that work because rules wrap around them. If, however, norms are patterns of behavior shared across individuals, and every pair of laborer/carpenters has a different agreement and therefore different patterns of behavior, then the agreements that each laborer/carpenter pair reach cannot be norms. The laborer/carpenter pair actually agree on an idiosyncratic set of rules that apply only to their relationship, and their idiosyncratic rules are credible because they are embedded in a set of external rules. That is the central logic of relational contracting. I'll use examples drawn from Lisa Bernstein's work to illustrate this point more generally, both about relational contracts and about how we use the concept of norms.

The next section lays out the simple example, placing the laborer/carpenter relationship in the context of Aghion and Tirole's concepts of formal and real authority. The following section ties the example to the relational contracting literature using examples drawn from Bernstein. The final section draws the implications of impersonal rules for modern economic development in very general ways and speculates a but about why impersonal rules emerged when and where they did.

II. An example

The argument has three parts. First, relationships and relational contracts depend on the value of the relationship to the parties involved, but it also depends on their outside options. Outside options involve more than the threat to end the relationship, although that is an obvious option. Outside options often involve the option of invoking a rule. The rules that can be invoked are supported by the organizations that the relationship is embedded in. In the laborer/carpenter example, their relationship is embedded in the construction firm they both work for, the two labor unions, and the state.

Employment on a union construction site involves lots of rules. On a big project union reps and state safety officials make regular visits to check that the rules are being followed. And yet, many of the external rules are not followed to the letter. Viewing rules, or laws, as strictures that *must be followed* gets in the way of understanding how rules can increase the value of relationships by changing the outside options available to the parties. The simplest example is hammering (driving) nails. It is very clear from the union rules that carpenters are supposed to drive nails, laborers are not.[1] Laborers always carry hammers, however, and laborers are often asked to hammer nails. That is not thought of as breaking the rule, even though everyone involved understands the union rules about driving nails. The carpenter always has the option of driving the nail. The actual agreed upon rule for driving nails is different for every pair of laborers and carpenters, because every pair works in slightly different and idiosyncratic ways.

Aghion and Tirole examine the difference between formal and real "authority" in organizations. In Aghion and Tirole's framework, there is a "formal rule" that only carpenters drive nails, while the "real rule" is sometimes that laborers drive nails too. The carpenter has the formal authority to drive nails. We might say that carpenters have the power to drive nails, and laborers do not. Whether a laborer drives nail or not depends on the relationship between individual carpenters and laborers. Some carpenters never let laborers drive nails, other carpenters do. Even within the same firm different pairs of carpenters and laborers have different agreements. In the Aghion and Tirole framework these agreements are "real" rules. I will call them "agreed upon rules," for driving nails, where the agreement is between the laborer and carpenter .[2]

The formal external rules help order the relationship between laborers and carpenters, since every laborer/carpenter pair knows that the carpenter has the authority to make decisions

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[1]The difference between hammering a nail and driving a nail is only obvious to people who know how to drive nails. On a construction site you are expected to "drive" home a nail with one or two blows of the hammer, not the dozen or so that an amateur requires. Even laborers who do not drive nails carry claw hammers, because an important function of claw hammers is to remove nails. Laborers spend a lot of time taking nails out of wood.

[2]My first construction job was not a union job and I had to quickly learn how to drive a nail. Obviously, later on when I joined the laborer's union and started working with union carpenters, whether I would be allowed to drive nails or not depended in part on my ability to do so.

about who drives nails. Laborer/carpenter pairs do not start their relationship willy-nilly with a long negotiation about who should be deciding who drives nails. Nonetheless, laborers and carpenters can enter into contractual relationships (agreements) with each other in which either drives nails. Given the external formal rules, carpenters cannot credibly promise not to drive nails, since carpenters always posses the authority under the formal rules to drive nails. If there is a dispute between laborers and carpenters that has to be resolved by management or the union, according to the formal rules, carpenters drive nails.

As in Aghion and Tirole, we can think of the agreed upon formal rules as allocating discretion over some aspects of a relationship to one partner or the other. In the laborer/carpenter example, the formal rules about driving nails are formed at the higher organizational level of the labor unions. The rule that carpenter's drive nails is an agreed upon rule at the level of the unions. The relationship between carpenters and laborers is asymmetric. That is the second aspect of the argument: rules often allocate discretion over certain decisions or functions to one party, and the actual allocation of resources (who drives the nail) need not reflect the allocation of authority. Aghion and Tirole show how allowing a difference between real and formal authority can increase the value of the firm. Indeed, they show that sometimes the best formal rules are rules *that are not followed* in practice. It works bests to give carpenters the authority to drive nails, but it also works best to let laborers drive them too.

The third aspect is the enforcement of rules by third parties. If there is a dispute the formal rule is supposed to be applied. Much of the contracting literature assumes that third parties exist that will enforce rules in an unbiased manner.[3] Suppose, however, that enforcement

[3]Bolton and Dewatripont explicitly start with the assumption that such third party rules can be enforced.

depends on the individual identity of the parties involved. For example, suppose a highly experienced laborer may be able to bend the enforcement of the rules in his relationship with an inexperienced carpenter, because the unions may not be willing to enforce the rules against a proven experienced member. If so, the carpenter's formal authority becomes weaker, in the sense that the third parties who enforce the formal rules are unwilling to side with a specific carpenter against a specific laborer. In a world of identity rules, third party enforcement may differ across individuals. What if the three possible sources of external rule enforcement: the firm, the unions, and the state, vary in how and whether individuals who are more powerful may get biased enforcement of external rules in their favor?

To be explicit: the value of the relational contract between the laborer and carpenter is enhanced by allocating the formal authority over driving nails to the carpenter. An unstated assumption is that the rules apply equally to everyone, to all pairs of laborer/carpenters. The categories of laborers and carpenters are treated differently under the external rules, nonethess we assume that every laborer is treated the same within those rules and every carpenter is treated the same within those rules. A carpenter does not have to know who his laborer is as an individual *ex ante* because he know that he always possess the discretionary authority to drive nails. If, on the other hand, there are some laborers out there over whom he may not have discretionary authority, then he needs to know who individual laborers are before entering into a relationship with them. In very general terms, the value of any relationship may be reduced, or eliminated, if the laborer has disproportional power to influence third party enforcement at other levels of the organization. As a result, the *ex ante* value of any relationship between a carpenter and a laborer is reduced if the carpenter cannot know who the laborer is (in the sense of not knowing how much *ex post* power a laborer has). Extending the logic to all forms of relationships within a given set of externally enforced rules, if individuals have differential ability to influence rule enforcement because of their standing, status, or power the value of relational contracting will be reduced.

III. Relational contracting and default rules

The laborer/carpenter example illustrates a fundamental point. The value of a construction project is created by the dozens, hundreds, or thousands of relationship that are realized in the actual hands on actions of carpenters, laborers, and other workers. The productivity of those relationships must be the standard by which the effectiveness of any set of institutional rules are judged. This is true of every coordinated human endeavor, not just construction projects.

The central point to grasp is that external the rules at higher levels of organization that help the laborer and carpenter coordinate are not rules that the laborer and carpenter actually follow. They are rules that frame the relationship that the laborer and carpenter can support. By altering the outside options for both parties, the external rules enable the relationship to realize a higher value. It is critically important that the external rules are not rules that the laborer and carpenter must follow. Lisa Bernstein (1996) calls the agreed upon rules that the laborer and carpenter actually follow within their relationship "extralegal" rules, or alternatively, extralegal obligations (pp. 1777-78 and examples on the pages that follow.) The extralegal rules interact with the legal rules created and enforced by third parties, in the example the firm, the unions, and the state.

In order to keep track of rules and norms in what follows we need some terminology. "Agreed upon rules" are rules that are reached by an act of agreement. As in Hart's notion of primary and secondary rules, all organizations include some form of secondary rule (formal or not) that specifies how primary rules are agreed upon. The rule about driving nails is a primary rule. The carpenter and laborer reach an agreement about who is to drive nails under what circumstances, that is their agreed upon rule. They reach their agreement within the context of the agreed upon rules of the firm they work for. At the level of the firm, the secondary rule for forming primaray rules is often "whatever management says is the rule, is the formal rule." Of course, the management is constrained by the agreed upon rules reached at higher levels of organization by labor unions and by the state authorities. At each level of organization there are both primary and secondary rules.

Agreed upon rules *are not norms of behavior*. Norms of behavior are patterns of actual behavior observed in a group of people. Just as agreed upon rules exist at the level of the laborer/carpenter pair, the firm, the unions, and the state, norms of behavior exist at multiple levels of aggregation. People draw inferences about how other people will behave by observing patterns of behavior around them. Sometimes these behavioral norms are called "the rules of the game" (North, 1990), but clearly they are not the result of agreements between people. In order for a norm to exist, some minimum number of people must behave in a similar matter.

In contrast, agreed upon rules can exist that are not followed. To be clear, what Bernstein calls an extralegal rule is a primary rule at some level of organization that will not be actively enforced by a higher level of organization (thereby the extralegality). The fact that the rule will not be enforced at the higher level unless there is a dispute, makes the rule a "default" rule (see Bernstein 1993). If necessary to resolve a dispute, the dispute will be settled according to the legal rule. Nonetheless the higher level organization does not prohibit the use of the extralegal rule at lower levels of organization. Union rules prohibit laborers from driving nails, but those rules do not prevent individual carpenters from allowing laborers to drive nails.

In two detailed papers Bernstein studies how private legal systems in the cotton market and in the grain and feed market operate to support relational contracting in those industries. Trade associations have established rule based system to arbitrate disputes among their members. In the grain and feed trade it is the National Feed and Grain Association (NFGA) and in cotton it is a combination of the American Cotton Shippers Association (ACSA) representing merchants and the American Textile Manufacturers Institute (ATMI) representing mills. In both cases the trade groups have established formal institutional rules and organizations to administer the rules that are binding on all the associations members. The rules are formal and applied in a narrow and legalistically.

In the merchant law paper, which uses the NFGA as its example, Bernstein argues that the policy of the Uniform Commercial Code to consciously adapt the Code through time to fit with current business practices is problematic. Current business practices are norms of behavior, they are patterns of behavior that many people share and, in this case, are not prescribed by formal rules. The heart of Bernstein's argument is that the strict rules of the NFGA, ACSA, and ATMI do not follow the norms of business in the grain and cotton markets, and that is an integral part of how the formal association rules are able to sustain higher value relationships between their members. Members are free to write "extralegal" contracts which contain provisions that cannot be enforced through the association's procedures or in the regular court system. These agreements between merchants and mills, in the case of cotton, are the real agreements that enable each pair of contractors to structure a better arrangement, even though terms of their agreement cannot be enforced by the third-party. Section II of the merchant law paper is evocatively titled "The Theory of Legally Uneforceable Contracts." (p. 1767)

The terminology in the papers can be a bit confusing, because the point of her argument is to show that the Commercial Code may err when it follow the norms that businessmen use. What the trade associations enforce corresponds to Aghion and Tirole's real rules, what I have called the agreed rules, and Bernstein calls "relationship-preserving norms" (RPN) and the extralegal realm. These are the rules or arrangements that individual contracting partners reach. The formal rules, or the external higher order rules, Bernstein calls "end-game norms" (EGN) or the legal realm. The use of the term "norms" here is a bit confusing, but makes sense in light of the argument that the Commercial Code should not embody norms, but should adopt clear rules that enable more valuable, if unenforceable, contracts to be reached between parties.

Bernstein summarizes the logic of such rules in the section on the theory of unenforcea ble contracts:

> "Part II discusses the reasons that sophisticated transactors might allocate some aspects of their contracting relationship to the legal realm and some to the extralegal realm, or might include a provision in their written contract while acting or areeing to act in another, perhaps contradictory, way. It suggests that recognizing the reasons that rational transactors may act or agree to act in ways that may contradict the terms of their contract undermines an important assumption underlying the Code's definition of agreement, namely that "the course of actual performance by the parties is . . . the best indication of what they intended the[ir] writing to mean." (Bernstein, 1996, p. 1770).

And then in the next section on trade usage and norms:

> "Part III is the core of the analysis. It begins by suggesting that transactors do not necessarily want the relationship-preserving norms they follow in performing contracts and cooperatively resolving disputes among themselves to be used by third-party neutrals to decide cases when they are in an end-game situation. After presenting evidence that merchants implicitly recognize the distinction between relationship-preserving and end-game norms, it suggests that when courts apply the Code's usage of trade, course of dealing, and course of performance provisions, they will often be using relationship-preserving norms to resolve end-game disputes." (Bernstein, 1996, p. 1771)

In order for lower level relationships to utilize lower level (extralegal) rules that do not correspond to the higher level (legal) rules, it must be the case that the higher level rules are not enforced prescriptively. That is, the higher level rules must be "default" rules: rules that will only be enforced if the parties in a relationship, contractual or not, ask the higher level organizations to apply the rule.[4] If we think of Bernstein's argument in light of the laborer/carpenter relationship, it seems clear that even within an individual firm the agreements between individual pairs of laborer/carpenter differ across pairs. As a result, the agreements reached between laborers and carpenters *cannot be behavioral norms*. The relationships to be preserved are agreements about rules, idiosyncratic rules perhaps, but certainly not norms of behavior. The central point of relational contracting is that individuals reach agreements between themselves, contracts, that cannot be enforced by an external third party. The agreements are idiosyncratic to the individuals in the relationship.

Within the conceptual framework of contract theory, the point of a default rule is to frame external alternatives so that the actual agreed upon rules that individuals follow in their relationship, the agreed upon rules that each laborer/carpenter pair actually adopt, are sustained by the default rules at higher levels of organization. The whole point of relational contracting is to enable individuals to enter into idiosyncratic agreements which cannot be enforced at a higher level, but idiosyncratic agreements that are credible because of the outside option of invoking the default rule at the higher level. The whole point of the arrangements in the cotton and grain trades is to enable individual traders to agree to contracts, i.e. agree to a set of rules that will govern their behavior uniquely, in the way best enhances the value of their relationship.

If we adopt a more narrow definition of institutions as agreed upon rules, then the role of relational contracting in the organization of a society and economy becomes much clearer.

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[4]In a full blown journal article, space would have to be devoted to discussing legal theories about default rules, how they work and how they should best be designed (Bernstein 1993 and 1996; Ayers and Gertler, 1989 and 1992; Feinman 1992; and I am sure many others that I would like to be aware of).

There is a ladder, perhaps not a strict hierarchy, of agreed upon rules.[5] Agreed upon rules are always embedded in organizations. Some of the organizations, like governments, can be quite broad based, others are more narrow. The ability of societies to coordinate depends, in part, on the interaction of the agreed upon rules at the different levels. Some of the rules at higher levels are prescriptive, they require individuals to act in a specific way. Many rules at higher levels, however, are default rules. They are rules that will be enforced if the partners in a relationship ask that the rules be enforced. But the actual behavior of the partners need not follow the higher level rule. Unlike norms of behavior, which only exist if enough people actually exhibit the behavior that makes up the norm, higher level agreed upon rules may often not reflected directy in observable behavior. On most construction sites, both carpenters and laborers drive nails.

If you ponder that for a moment you will realize what formidable problem that insight raises for the notion that good rules are rules that are always enforced.

Behavioral norms really matter. Nonetheless, norms and institutions are very different kinds of social phenomena. Institutions are agreed upon rules. They require deliberation and agreement under a set of secondary rules (ala Hart). Norms of behavior are the result of individual human decisions, but no single individual or group of individuals decides what the norms will be. Another way of saying this is that there are no secondary rules for the formation of norms. Norms and institutions interact, constantly, but they are not the same thing.

IV. Identity rules, impersonal rules, and relational contracts

The connection between impersonal rules and relational contracts already occupies a

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[5]The ladder analogy seems more appropriate, as there may be rules at lower levels whose enforcement makes relationships more valuable at higher levels of organization.

prominent place in the institutional history of modern growth, particularly in Greif's *Institutions and the Path to the Modern Economy* (2006) and North's *Institutions, Institutional Change and Economic Performance* (1990). Unfortunately, their definition of impersonal rules differs from mine. They are both concerned with explaining impersonal exchange: exchange between two or more people who do not know one another and have no expectation of meeting again, and therefore individual reputations can not matter. What sustains the ability of individuals who do not know one another to believe their commitments will be honored? It is the organizations they belong to. When we review their arguments we can see how the logic of both Greif and North shows how, in the absence of impersonal rules, the logic of relational contracting makes it possible to use organizations to provide the identities that can support identity rules. Relational contracting within organizations make exchange possible with people you do not know personally, but only because the identity of the organizations substitutes for the identity of the individual.

Their arguments and evidence strongly suggests that nothing in the logic of relational contracting itself that moves societies towards impersonal rules, rules that treat everyone the same. In the absence of impersonal rules, the forces created by relational contracting create powerful incentives to create and maintain identity rules. Instead, as I have been arguing, it is much more likely that the benefits of impersonal rules that lead societies to adopt them may come through enhancing the value of relational contracting, rather than the other way around. After considering North and Greif, I try to suggest how powerful elite individuals and organizations might find it in their interest to renounce the privileges associated with their privileged social identies and move toward impersonal rules. That discussion will be suggestive rather than definitive. Again, I will draw on examples from Bernstein's work.

One of the central questions in economic history is the origins and causes of modern economic growth. The "new" economic history that developed in the 1950s and 1960s emphasized the use of economic concepts and tools in history, particularly the ability to quantify relevant economic variables. From the beginning of his academic career, Doug North was focused on the role of specialization and division of labor and the extent of the market as a source of economic growth. He always focused on how peeople coordinate (Wallis, 2016). When the "new" institutional economics began to grow rapidly in the 1970s and 1980s, North, Coase, and Williamson were early intellectual leaders. North remained focused on the sources of growth, Coase and Williamson on contracting and organization. All three were asking questions about coordination. Their shared interest in the role of transaction costs in shaping the form that institutions took had its growth corrollary: high transaction costs were an impediment to expanding the scale of exchange and the extent of markets and, thus, a damper on growth.

As economic historians interested in the institutional sources of economic performance, both North and Greif wanted to understand how institutions affected the size and scope of markets. They both sought to understand how impersonal exchange, exchange between two people who did not know each other, grew over time.[6] They defined impersonal rules as rules that enable people to deal credibly with people who they did not know.

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[6]"What were the institutions, if any, that supported interjurisdictional exchange characterized by separation between the *quid* and the *quo* over space and time? Specifically, were there institutions that enabled such exchange that was also impersonal, in the sense that transacting did not depend on expectations of future gains from interactions among the current exchange partners, or on knowledge of past conduct, or on the ability to report misconduct to future trading partners?

The theoretical and historical analysis presented here substantiates that in premodern Europe impersonal exchange characterized by separation between the *quid* and the *quo* across jurisdictional boundaries was facilitated by a self-enforcing institution: the community responsibility system." (Greif, 2006, p. 309) See North (1990, pp. 34 and 35) and Wallis, 2011.

Greif explicitly models the ability of some individuals who are associated with organizations to draw on the identity of the organizations they belong to to make credible agreements between individuals who may not know each other personally, but can identify which organizations their partners belong to. His “community responsibility system” showed how in medieval Europe, trade over long distance could be sustained by merchant guilds. The guilds recognized each other. An individual merchant, say from Genoa, could go to Hamburg even though he was not known in Hamburg, identify himself as a member of the Genoese guild, and expect to deal in good faith without being cheated. The enforcement mechanism lay in the two organizations, the guild in Genoa and Hamburg. If the Genoese merchant was cheated in Hamburg and the Hamburg guild did not give him satisfaction, he would return to Genoa and make his case. If the Genoese guild found his claims to be credible, they would expropriate the Hamburg merchants who happened to be in Genoa.

The merchants in both cities enjoyed rents from membership in their guilds. They were socially identifiable as members of the guild. They could trade in other cities with guilds because of their organizational identities. The relationship that the Genoese merchants had with each other made their guild organization credible and sustainable. They limited membership in the guild to create economic rents, then used those the rents associated with their organization to enable credible rule enforcement among people who they did not know and would never meet again. In Greif’s analysis, impersonal exchange was made possible by identity rules.

North’s approach was less formal. His 1990 book was focused on institutions and institutional change as sources of economic performance. A key element in modern development was the emergence of impersonal rules. Like Greif, North identifies two general classes of exchange, which correspond to rules: personal rules and impersonal rules. In fact, the book lays out three categories of rules:

> *Personal exchange* involving small-scale production. Repeat dealing, cultural homogeneity (that is a common set of values), and a lack of third-party enforcement (indeed little need for it) ...
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> Therefore a second general pattern of exchange has evolved, that is *impersonal exchange*, in which the parties are constrained by kinship ties, bonding, exchanging hostages, or merchant codes of conduct. Frequently the exchange is set within the context of elaborate rituals and religious precepts to constrain the participants.
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> The third form of exchange is *impersonal exchange* with third-party enforcement. It has been the critical underpinning of successful modern economies involved in the complex contracting necessary for modern economic growth. Third-party enforcement is never ideal, never perfect, and the parties to exchange still devote enormous resources to attempting to clientize exchange relationships. But neither self-enforcement by parties nor trust can be completely successful. (North, 1990, pp. 34-35)

North's second general pattern of exchange is exchange supported by identity rules.[7] Both North and Grief used the logic of identity rules to explain how organizations of a variety of types, "parties ... constrained by kinship ties, bonding, exchanging hostages, or merchant codes of conduct" could support impersonal exchange. The logic of relational contracts is a specific form of the logic. Aghion and Tirole or Baker, Gibbons, and Murphy enable us to understand the internal dynamics of organizations and rules.

I am making an argument that suggests the opposite of North and Grief: *impersonal rules increase the value of relationships with people you already know*. The key to the argument is that default rules are much more powerful coordinating devices in the context of relational contracts if the default rules are written and enforced impersonally. What happened in the early 19th century in the United States and Britain, and then spread slowly to a handful of societies by 1900 was the implementation of a range of impersonal rules that dramatically enhanced the

[7] In Wallis (2011), I use the term "anonymous rules" rather than identity rules, but the concept is the same.

productivity of organizations.[8]

Modern markets appear to be impersonal. I can order good a good from China, but the actual connections between me and China exist through a dense network of organizations who build long term relationships. Impersonal exchange is not illusory, but it is far from the dominant form of interaction even in modern markets. Nonetheless, we often think of the growth of markets as the result of lower transaction costs that enable impersonal exchange at a distance with people who are disciplined only by the market.

Rather than expanding the market and enabling people to deal with more people that they do not know, impersonal rules enable us reach better, higher value relationships with people we already know. The importance of impersonal default rules matters crucially here, since the higher level rules work best as coordinating devices if they are not tied explicitly to norms of behavior.

There is no apparent reason to think that the incentives created by relational contracting lead to impersonal rules. Instead, there should be a strong presumption that the incentives created by relational contracting lead to the formation of organizations that jealously create and protect their identities. By doing so the create and enable identity rules to structure organizations and societies. This is one of the basic insights of North, Wallis, and Weingast *Violence and Social Orders*, (2009). In most societies the ability to form an organization that the larger society will support is strictly limited. The economic rents created by limiting access to organizational forms are used to coordinate political coalitions. Those political coalitions, fragile as they are, enable the size of societies to grow and extensive economic growth to occur.

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[8]Moreover, since one of the first credible impersonal rules involved the creation of organizations through an impersonal administrative procedure, a general incorporation act, not only did the productivity of organization increase so did their numbers,

But it not until the power of organizations is unleashed by impersonal rules in the beginning of the early 19th century that intensive economic growth, sustained increases in per capita income, are realized for the first time in human history. The economic history of the world over the last two hundred years shows clearly that access to modern industrial technology without the institutions that make impersonal rules possible, does not produce modern economic growth.

How do we explain why a few socieites moved to impersonal rules after 1800, perhaps 25 or so in the world today? In a societies that limit the ability of people to form organizations, what North, Wallis, and Weingast call natural states, privileged individuals and organizations enjoy rules that are written to benefit them and enforcement of all rules biased in their favor. We have to ask why would those privileged organizations decide that it was in their best interest to abandon some of their privileges and subject themselves to impersonal rules that treated everyone the same? The obvious tautological answer is that powerful elites moved to impersonal rules because it was in their interest. But how did that happen and why was it in their interest?

I have argued that adopting impersonal rules, particularly impersonal default rules raised the productivity of organizations by enabling higher levels of relational contracting. Those gains by themselves, however, are unlikely to explain the movement towards impersonal rules, particularly in the first movers. No one in the United States could have seen the enormous gains that would follow from impersonal rules, why should they believe they will appear?

One unappreciated aspect of identity rules may help is understand why elites support mpersonal rules: the costs of identity rules to powerful individuals and organizations. Here again we can use the logic of relational contracting, where the formal rules organizations (and societies) adopt enable valuable idiosyncratic relationships to thrive by providing the members of the relationship assistance. A classic problem in contract theory is asymmetric information. Two people want to form a business partnership, but some of the terms of their agreement are fundamentally unobservable. One way to solve the contracting problem is for the partner performing the unverifiable task to bond himself. The other partner has the option of dissolving the partnership and redeeming the bond. If the value of the partnership to the other partner exceeds the value of the bond, he continues to coordinate. If the cost of performing the unobservable activity is less than the value of the bond, the bonded partner continues to coordinate. What holds the partnership together is not the bond, it is the value of the relationship to both partners. But in the absence of the a bond or similar arrangement, their partnership fails.

If bonding requires real resources, like sending your oldest son to live with the partner or investing in an unsalvageable asset with no valuable alternative use, then gains from using a contractual promise, like a promissory note, can make both partners better off because their agreement can be made credible at a lower resource cost. But in an identity rule regime, the ability to use contractual promises is asymmetric. If the third party enforcer is biased in favor of the more powerful partner, then the more powerful partner cannot credibly promise to honor the promissory note and the less powerful partner cannot believe that a third party enforcer will enforce the note against the more powerful partner. While the rules and the enforcement of the rules benefit more powerful individuals and organizations, preferential rules and enforcement also carry a cost: the inability of powerful individuals and organizations to bind themselves by third-party enforced rules.

The grant of a corporate charter by the King of England gives us a simple example. If the king grants a corporate charter allowing for limited liability and the transferability of shares, then the market value of the shares is the net present value of the expected income stream plus (or minus) the value of the corporations assets should it be dissolved. If the king is know to be a shareholder and it is common knowledge that in case of a bankruptcy the king will be made whole before any of the other shareholders, then the value of the shares, both to a typical shareholder *and to the king*, is lower than if the king can credibly promise to be treated like every other shareholder. Of course, the king cannot credibly promise that, at least not until sometime in the nineteenth century.[9]

The paradox of privilege works oddly. The people who enjoy privileged positions are able to use contracts and agreements to enforce their claims against weaker individuals and organizations, but are hamstrung by the inability to use the rules to bind themselves. Some of the contractual tools available to support relational contracts are unavailable to the powerful. If the higher order external rules are identity rules, and their enforcement is not only uncertain but depends on the social status of the contracting parties, then ironically more powerful individuals and organizations have less access to the tools that support relational contracts.

In order to enforce contractual provisions against the powerful it cannot be the case that application of the rule can be within the discretion of the third-party charged with enforcing the rule. The only credible impersonal rule must apply equally to everyone in a way that is visible and verifiable. Again, Lisa Bernstein's studies of the grain and cotton trade provide neat examples. What matters for the default rules the association provides is not whether the rules reflect the practice of typical businessmen engaged in the grain trade, but whether the rule provide clear, certain, and *unbiased* defaults rules which members of the association can use to structure their private ordered contracts.

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[9]For neat and clear, although somewhat more complicated, examples see the papers documenting how the charters of the Bank of England (Broz and Grossman,) and the British East India Company (Bogart, 2018) were changed over the 17th, 18th, and 18th centuries.

While Bernstein does not talk about the paradox of privilege, the thrust of both papers is that large shippers, producers, and mills support the impersonal and formalistic enforcement of clear bright line default rules, in large part because it enables the large and powerful shippers to create a legal environment in which they can be credibly disciplined.

> It is also important to note that NGFA's use of bright-line trade rules and a formalistic adjudicative philosophy severely restrict arbitrator discretion and minimize the need for arbitrators both to rely on and assess the credibility of testimony. This is particularly important in the trade-association context, where the adjudicators are themselves market transactors and the risk of adjudicative bias is perceived to be substantial. Combined with the requirement that NGFA opinions state the factual basis for their holdings, this approach makes it easier for market participants to assess whether a given case was correctly decided. This, in turn, makes it easier for a tribunal to establish and maintain a reputation for impartiality and enables more nuanced information about transactors' reputation to be disseminated to the market.
>
> Finally, because the institutional environment created by NGFA operates to strengthen extralegal enforcement mechanisms such as reputation bonds, extralegal agreements are likely to be value creating supplements to many grain and feed contracts, particularly among local or regional merchandisers who trade with one another on a repeat basis. As a consequence, ensuring that extralegal agreements remain extralegal is particularly valuable in grain and feed markets, making NGFA's adjudicative approach particularly well-suited to the private adjudication of grain and feed disputes. (pp. 1819-20)

The existence of a set of clearly defined impersonal rules in the grain trade and cotton trade are not so much valuable in and of themselves. They are valuable because their existence as external rules, accessible to grain traders and cotton traders on an impersonal basis, enhance the value of extralegal and reputational contracting.[10]

What is so neat about Bernstein's examples is that these are privately created and enforced rules, we can abstract from the political process. When the powerful firms find it is in their interest to bind themselves by impersonal rules, they need to establish rules and organizations that can credible rule against them. Impersonal rules are a solution to the paradox

[10]In a phone conversation, Lisa emphasized that the large firms devote substantial resources to these associations and making real the perception that they will be subject to the same rules as smaller firms and traders.

of privilege. Whether we can identify this process historically is a much more difficult problem, but we aren't going to solve it unless we understand how default rules actually work to support relational contracting and why impersonal rules create more value than identity rules.

V. Conclusions

This paper makes one claim: that impersonal rules impersonally enforced support more valuable relational contracts than identity rules. We know both historically and in the contemporary world, that most societies are incapable of creating and enforcing impersonal rules, identity rules are the best they can do.

I have not established empirically in this paper whether the onset of modern sustained economic growth in the early 19th ecntury United States and Britain was the result of those two societies adopting impersonal rules for the formation of organizations and a host of related impersonal rules in expanding circles. Nonetheless, the large and growing literature on the importance of institutions and particularly rule of law institutions as variables capable of explaining modern growth suggests that something about impersonal rules matters.

The paper draws out the logic of how default rules at higher levels of organizations can support relational contracts. Unlike the normal property rights prescription, where the rules are clear and enforced, good default rules are clear, but the form of the rule does not correspond to the behavior of the parties to whom the rule applies. Parties in a relationship use the default rules to structure outside options that make their idiosynratic arrangements more credible and durable.

Until we understand the logic of relational contracting and its interaction with impersonal rules, we are unlikely to unravel the mystery of why elites who enjoyed preferential enforcement of identity rules in the US and Britain shifted their ground in the early 19^{th} century and began agitating for impersonal rules. Until we understand how that happened we are unlikely to understand how to move today's "developing" societies toward sustained development.

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