BOOK REVIEWS

Reputation: Studies in the Voluntary Elicitation of Good Conduct
Daniel B. Klein, ed.
Ann Arbor: University of Michigan Press, 1997, 318 pp.

What do Underwriters' Laboratories, gossip, consumer credit bureaus, brand names, and 11th century Maghribi traders have in common? As Daniel Klein explains in his introduction to the readings he has assembled on those seemingly disparate topics, all foster actions that benefit society. Manufacturers strive to produce products that will win a certificate of safety from Underwriters' Laboratories; residents of farming communities cooperate at harvest time to escape being labeled a shirker by the town gossip; consumers pay their bills to avoid a blot on reports circulated by credit bureaus; and McDonald's, Ford, and others who spend millions promoting their brand name provide quality products to ensure their advertising dollars are not wasted. In each case, concern about reputation—the benefits of a good one and the costs of a bad one—provide an incentive for what the book's subtitle terms "good conduct."

In addition to Klein's own work on credit bureaus, the book contains several articles that are already classics in the burgeoning interdisciplinary field of human cooperation: Bruce Benson's study of the spontaneous evolution of commercial law among medieval European merchants; Sally Engle Merry's analysis of the role of gossip in lubricating social relationships; and Benjamin Klein and Keith Leffler's explanation of why price sometimes signals quality, to name but a few. The book will be welcomed by economists, sociologists, historians, and others seeking to understand what makes people work together to pursue mutually beneficial interests. Besides its value to specialists, it could serve as a supplement for an advanced undergraduate or beginning graduate course on the economics of cooperation.

About the only ones likely to shun this volume are lawyers, for the readings collected here strike at one of the legal profession's principal conceits: that without a legal system backed by the sovereign power of the state, economic activity would be impossible. The articles reprinted here by Benson on the European law merchant, Avner Greif on traders

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in the Maghrib, and Paul Milgrom, Douglass North, and Barry Weingast on decentralized systems of contract enforcement flatly contradict such a claim and together with the other readings show that entrepreneurs can often do quite nicely without the state and its legal apparatus.

The belief that voluntary exchange between consenting adults could not exist without law handed down by a sovereign originates with Thomas Hobbes. He conceived of all trade as involving sequential exchange: one party delivered goods or services and then waited for the other to perform. But as he explained in a memorable passage in *Leviathan*, the party performing first "has no assurance the other will perform after because the bonds of words are too weak to bridle men's ambitions, avarice, anger, and other passions without the fear of some coercive power." Absent the threat of a lawsuit, Hobbes thus saw no reason why the party performing second would ever honor his or her obligation. They had what they wanted and keeping their end of the agreement only made them worse off. In a society with no courts, everyone would recognize the folly of initiating an exchange, and trade would simply not exist.

As always with Hobbes, the logic is impeccable, so impeccable that stated formally, as a one-time prisoner's dilemma game, it remains the point of departure for studying the conditions that give rise to cooperative behavior. Yet five centuries before Hobbes' theory appeared, long-distance trade in North Africa and the Mediterranean was flourishing thanks to an intricate network of contracts which no court had the power to enforce. Why were those traders willing to keep their end of the bargain if they were beyond the reach of any legal system? Where did Hobbes go wrong? Where does the logic behind the prisoner's dilemma break down?

In one of the articles Klein includes here, Greif allows traders who operated in modern-day Morocco, Algeria, Sicily, Israel, and Syria to answer those questions. Citing their letters and other original documents, he shows that they spotted the incentive their overseas agents had to break their promises and devised a way to keep them honest. The Maghribi traders' solution was to offer their agents far greater profits from continued dealings than the agents could earn by cheating once. Those with a reputation for performance were rewarded with repeat business while those with a bad reputation were denied future opportunities. In the jargon of game theory, the Maghribi merchants came up with a way of converting a one-time game into a repeated one.

Does that mean the state is always irrelevant? Not necessarily. As Milgrom, North, and Weingast show in another article in the collection, any system of contract enforcement has its costs. That is as true of the voluntary one devised by the Maghribi traders and the Law Merchant system that emerged in medieval Europe as it is of today's coercive, state-sanctioned method of ensuring performance through the threat of a lawsuit. What differentiates voluntary from coercive systems is how costs change as trade develops.

With a voluntary mechanism, a participant must query a central bureau to determine whether the other party to a potential trade has a history

of cheating or not. If the answer is affirmative, the honest trader refuses to deal with the cheater. The fear of a boycott is what ensures that people perform their current obligations. But traders incur costs in ascertaining the past history of those with whom they contemplate exchanging, costs that increase as the economy grows. The number of potential trading partners on which information must be gathered expands, and the number of queries rises as the number of potential exchanges increases. By contrast, there are economies of scale in operating a contract-enforcement scheme backed by the sovereign power of the state, and as trade increases, those economies become more pronounced. Eventually, according to Milgrom, North, and Weingast, the sum of the costs traders must bear in querying before each trade will exceed the costs of operating a formal judicial system. Indeed, rising transaction costs are how they explain the replacement of the voluntary enforcement mechanisms in use in Europe during the late Middle Ages by national courts.

Does that mean that all voluntary systems of contract enforcement will inevitably be replaced by coercive ones? Are lawyers really needed after all? Again, the answer is not necessarily.

Milgrom, North, and Weingast's main contribution is to put the focus squarely on transaction costs and how changes in those costs dictate the choice between a voluntary and coercive enforcement mechanism. However, it is misleading to think that their work implies that increasing trade always makes voluntary mechanisms more costly than coercive ones. Greater trade lowers at least some of the costs involved in operating a voluntary system. The best example is how the spread of faxes, computers, and other technologies reduces the costs of compiling and disseminating information about the past behavior of consumers and businesses. Hence, while more trade may raise some of the costs associated with a voluntary, reputation-based system, it lowers others. Specifying the different costs, and how they net out as trade expands, should be one of the questions pursued by those picking up where the articles in this volume leave off.

Most of the writings in this book are about institutions that are found in the United States today or were a part of the history of other advanced market economies. Yet their greatest value may be in what they have to say to leaders in developing and former communist countries trying to build market economies. While those involved in the construction have at last realized that the foundation must include a set of institutions that can support market exchanges, there has been a tendency to borrow the most visible institutions that undergird exchange in today's developed economies—courts, commercial legal codes, and the like. But as the several articles Daniel Klein has collected here show, expanded trade need not be a hostage to the development of courts and the lawyers and other trappings that go with them.

There are, to be sure, times when the legal system provides an important lubricant for trade, as Hernando de Soto's writings on the role of government in formalizing property rights show. But not in every case.

When left alone, entrepreneurs can often find their own way around the Hobbesian problem of contract performance. Indeed, perhaps developing countries and their advisers might be well advised to give some thought to how they can smooth the way of those wishing to establish voluntary systems.

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