

Paul R. Milgrom, Douglas C. North, and Barry R. Weingast. "The Role of Institutions in the Revival of Trade: The Law Merchant, Private Judges, and the Champagne Fairs" in *Economics and Politics*, vol. 2: No.1 (March 1990): 1-23.

Reviewed by Martin Dimitrov

Puzzle: How was it possible for long-distance trade to develop during the Middle Ages?

Answer: In a small enough community, where members could be kept informed of each other's behavior, reputation can ensure against the rise of opportunistic behavior. However, as communities grow larger it becomes harder and more costly for individuals to be perfectly informed about the behavior of others. Then the institution of the law merchant arises to protect the community from opportunistic behavior. The institution of the law merchant cannot exist unless it successfully minimizes transaction costs and the law merchant is not corrupt.

As long-distance trade emerges and more complex patterns of exchange start to take place, reliance on reputation alone is not sufficient. Long-distance trade is made possible by visiting merchants who are not part of the local community, which makes it very costly for individuals to gather sufficient information to calculate the reliability of the merchant before engaging in trade. Given the higher transaction costs, and the difficulty of establishing trust, we would expect trade to contract. However, Milgrom, North, and Weingast argued that the institution of the medieval law merchant lowered the transaction costs by providing information on the reliability of traders. Those admitted to trade in the Champagne Fairs had the reputation to be honest traders. Thus, the institution creates a focal point that reinforces the reputation of individual traders. Simultaneously, the law merchant can punish those caught cheating by imprisonment and trial. Given that investigation by the law merchant is time-consuming and costly, however, the institution will be most effective if it discouraged opportunistic behavior by its very existence and the potential repercussions of getting punished, as opposed to actual punishment. Naturally, not all defectors were caught and punished by the law merchant. For punishment to occur, those cheated need to be cognizant of their loss and willing to present a query to the law merchant, who then investigates and punishes the defectors.

The law merchant framework can only operate within the confines of a single medieval trading center. While certainly an improvement over the rudimentary system of barter trade which relied only on reputation, the institution of the law merchant cannot rival the policing powers of the modern state, which provides cheaper, more effective, and more comprehensive protection to those who have suffered a wrong. With the rise of the modern court system, the modern police system, and more advanced notions of contracting, the state can provide a much more credible commitment to enforce contracts than could do the law merchant. Though more limited in scope than the modern state, the institution of the law merchant clearly enabled the important transition from limited-scope local trade to more extensive long-distance trade.