

# PATH DEPENDENCE IN THE DEVELOPMENT OF PRIVATE ORDERING

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## *Abstract*

*Contrary to some idealized notions, Private Legal Systems (PLSs) are not typically locked in Darwinian competition over the efficiency of their norms and do not form autonomously (that is, without reliance on preexisting institutions) upon the identification of an efficient norm. The evolution of PLSs is primarily driven by the PLSs' relative enforcement costs, not by the relative efficiency of the norm they attempt to enforce.*

*Because of enforcement costs, PLSs form in a path dependent manner, beginning by enforcing a collaborative core norm—typically one that provides religious or social identity—then gradually expanding to enforce increasingly adversarial expansion norms. PLSs sometimes attempt to reduce path dependence by “inventing tradition” (creating rituals and symbols that suggest a shared identity)—an activity that has thus far not received much attention in the private ordering scholarship.*

## TABLE OF CONTENTS

INTRODUCTION.....	30
I. WHAT ARE PRIVATE LEGAL SYSTEMS?.....	33
A. Taxonomy of Norm Enforcers Nased on Enforcement Mechanisms.....	33
B. Second-Person Enforcement .....	38
C. Third-Person Enforcement: Private Legal Systems .....	42
II. PATH DEPENDENT FORMATION OF PLSS .....	45

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A. Two Theories on the Evolution of PLSs.....	45
B. Assessing PLS Enforcement Costs .....	47
C. Incumbency and the Paradox of Autonomous Formation.....	48
D. Path Dependent Formation: Core Norms.....	50
E. Path Dependent Formation: Expansion Norms.....	52
III. ON IDENTITY AND NORM ENFORCEMENT.....	54

## INTRODUCTION

Private legal systems (PLSs) are institutions that enforce norms and that are not affiliated with government, that is, with entities that may legitimately use violence to enforce norms. PLSs range from informal institutions that bear little resemblance to the public legal system (the law), such as norms of politeness, to ones that are very similar to the law, such as complex commercial arbitration among diamond dealers.

Scholarship on PLSs tends to focus on two questions, both related to the norms that PLSs enforce: what are the norms that PLSs enforce,<sup>1</sup> and are these norms more or less efficient than those of the law.<sup>2</sup> There is far less concern as to how PLSs develop the ability to enforce norms. Perhaps due to this focus on norms rather than on enforcement, much of the literature assumes that PLSs emerge autonomously in response to governance needs that are unfulfilled by government.

If this assumption were true, one would expect the private ordering landscape to be composed of a very large number of PLSs, each enforcing one (or a very small number) of norms. Identifying an unfulfilled governance need and formulating a norm to address this need are activities that have low barriers to entry, so a newly created PLS can displace an incumbent PLS in identifying the next opportunity to enforce a norm. Indeed, an incumbent PLS may be at a disadvantage, since the member<sup>3</sup> or members that direct the PLS's behavior (the PLS controller) may block the enforcement of norms

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1. *E.g.*, ROBERT C. ELLICKSON, *ORDER WITHOUT LAW: HOW NEIGHBORS SETTLE DISPUTES* (1991).

2. *E.g.*, Lisa Bernstein, *Private Commercial Law in the Cotton Industry: Creating Cooperation Through Rules, Norms, and Institutions*, 99 MICH. L. REV. 1724 (2001); Todd J. Zywicki, *The Rise and Fall of Efficiency in the Common Law: A Supply-Side Analysis*, 97 NW. U. L. REV. 1551 (2003).

3. I use the term "member" to refer to an individual or firm that is subject to the norms enforced by the PLS.

that are efficient but that conflict with the PLS controller's self-interest. In contrast, a newly formed PLS can select its membership so as to exclude members who would object to enforcing the efficient norm.

Yet in reality the private ordering landscape is far less fragmented: a small number of PLSs (e.g., one's peer group, religious community, etc.) each enforces a large number of norms. Though these PLSs typically enforce adversarial<sup>4</sup> norms, they rely on a core collaborative norm—most commonly a norm that provides religious or social identity.

Consider, for example, *Pax Dei* (Peace of God), a movement in tenth and eleventh century Western Europe to protect defenseless peasants, among others, from feuding warlords:

The peace of God was . . . a substitute for the peace of the king. Nothing more. It changed nothing in the framework of peace . . . . The only difference was this: the place formerly occupied by the king was now taken by that which on earth most nearly approached the divine, the holy remains, piled high for the occasion in reliquaries withdrawn from every crypt in the province.<sup>5</sup>

The norm did not change; the enforcement mechanism did. The *Pax Dei* norm was a challenging one to enforce, since it was adversarial in nature—each individual warlord had much to gain by violating it while other warlords abided by it—and applied to a large number of warlords with different preferences, some who may prefer less violence, others who may benefit from more upheaval. When the public legal system—the king—proved ineffective in enforcing the norm, the peasants turned to private enforcement that relied on religion.

An examination of successful PLSs finds that they very frequently rely on religion, kinship, or social ties. Medieval craft guilds provide a second example:

Many craft guilds seem to have originated as religious fraternities whose members were drawn together by ties of common devotion. The starting point of the Mercers' guild at York, for example, was a licence given in

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4. The degree to which a norm is adversarial is the degree to which members have an incentive to violate the norm; in other words, it is the relative cost of compelling compliance with the norm, leaving constant the environmental factors (e.g., the number of members, the homogeneity of their preferences, and the fluctuation in membership). A collaborative norm is on the far non-adversarial end of the spectrum (i.e., has low enforcement costs).

5. GEORGES DUBY, *THE THREE ORDERS: FEUDAL SOCIETY IMAGINED* 135-36 (Arthur Goldhammer trans., Univ. Chi. Press 1980) (1978).

1357 to merchants, mercers, drapers, hosiers and dyers to organize a fraternity for religious and social purposes. In most cases the *fraternity*, that is, the gild in its religious and social aspects, was no doubt merged with the *mystery*, that is, the gild in its industrial aspect . . . Bound together by their common calling in the pursuit of common aims, the mediaeval craftsmen developed an ideal of co-operation and joint effort which gained in intensity what it may seem to have lacked in range of vision.<sup>6</sup>

Other successful PLSs rely on nonreligious social identity. Robert Ellickson describes how ranchers in rural California are deterred by the threat of spreading negative gossip from allowing their cattle to trespass on farmers' lands.<sup>7</sup> Ellickson explains that gossip is an effective deterrent, and one preferable for the injured party to suing the offender, "because only the extreme deviants are immune from the general obsession with neighborliness."<sup>8</sup> Janet Landa examined long-distance trading of rubber in Singapore and West Malaysia in 1969 and concluded that trading was made possible, despite significant information asymmetry and ineffective public enforcement of contracts, because of trust facilitated by ethnic relations between the traders.<sup>9</sup> Similarly, Avner Greif finds that long-distance trading in the Mediterranean in medieval times was facilitated by ethnic and religious ties of Maghribi Jewish traders.<sup>10</sup>

This Article explains why successful PLSs rely on these core, cooperative norms and develops a theory on the development and norm selection of PLSs. In doing so, this Article heavily relies on, revises, and expands my earlier work.<sup>11</sup> In a nutshell, cooperative norms provide PLSs with a competitive advantage, in the form of lower enforcement costs, over rival legal systems, and this advantage is difficult for rival PLSs to imitate. The enforcement costs of a new

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6. EPHRAIM LIPSON, *THE ECONOMIC HISTORY OF ENGLAND, VOLUME I: THE MIDDLE AGES 339-42* (10th ed., 1949).

7. ELICKSON, *supra* note 1, at 57.

8. *Id.*

9. Janet T. Landa, *A Theory of the Ethnically Homogeneous Middleman Group: An Institutional Alternative to Contract Law*, 10 J. LEGAL STUD. 349, 350 (1981).

10. See generally Avner Greif, *Contract Enforceability and Economic Institutions in Early Trade: The Maghribi Traders' Coalition*, 83 AM. ECON. REV. 525 (1993).

11. Amitai Aviram, *Regulation by Networks*, 2003 BYU L. REV. 1179 [hereinafter Aviram, *Networks*]; Amitai Aviram, *A Paradox of Spontaneous Formation: The Evolution of Private Legal Systems*, 22 YALE L. & POL'Y REV. 1 (2004) [hereinafter Aviram, *Paradox*]; Amitai Aviram, *Forces Shaping the Evolution of Private Legal Systems*, in LAW, ECON. & EVOLUTIONARY THEORY 183 (Peer Zumbansen & Graif-Peter Calliess eds., 2011) [hereinafter Aviram, *Forces*].

norm are reduced if the PLS is already enforcing some norm on the same members that are to be subject to the new norm, because the PLS can compel compliance with the new norm by denying a member the benefits of the already-enforced norm.

But how would a PLS enforce the preexisting norm? By beginning with a core norm that has very low enforcement costs, a cooperative norm that provides religious or social identity. Once this core has developed, PLSs may choose expansion norms that can be more expensive to enforce, with each successful expansion increasing the value of membership and therefore reducing enforcement costs, allowing for enforcement of even costlier norms.

The Article will proceed as follows: Part I compares PLSs to other norm enforcing institutions, explains how they enforce norms, and explains what conditions enhance their effectiveness in enforcing norms. Part II considers rival theories on what drives the development of PLSs (autonomous formation vs. path dependent formation) and explains why relative advantage in enforcement costs, rather than in norm efficiency, determines which PLS succeeds in enforcing norms. It then applies this insight to describe the pattern in which PLSs develop: first facilitating a non-adversarial core norm, then gradually adding layers of increasingly adversarial expansion norms, using the value that the core norm and successfully enforced expansion norms provide members to compel members' compliance with new expansion norms. Part III considers the role of shared identity in norm enforcement, highlighting a challenge to path dependent formation from an area that has been ignored by PLS scholars: the "invention of tradition" to artificially produce shared identity.

## I. WHAT ARE PRIVATE LEGAL SYSTEMS?

### A. Taxonomy of norm enforcers based on enforcement mechanisms

This Article examines private ordering through the lens of enforcement mechanisms, and therefore, it distinguishes norm enforcers by the enforcement mechanisms they use. By understanding these mechanisms, we can predict which type of enforcer would most likely enforce a given norm.

Norm enforcers can be distinguished into four categories based on their enforcement mechanisms: public enforcers, first-, second-, and third-person enforcers.<sup>12</sup>

A public enforcer has at its disposal the most effective enforcement mechanism: the legitimate use of violence against a norm enforcer. However, the public legal system that is used by the public enforcer is costly and relatively inflexible in its ability to adjust enforcement costs (and the resulting enforcement effectiveness) to the benefit derived from enforcement. For example, it would be efficient to expend more resources to prevent certain norm violations (e.g., murder) than other, less harmful ones (e.g., possession of small amounts of illegal drugs or violation of immigration laws). But many of the costs of the public legal system are fixed, and there are operational (as well as political) constraints on creating a separate, scaled down system for each norm violation according to its social importance. As a result, with regard to less severe norm violations, the public legal system either over-enforces (spends more on enforcement than the social value from enforcing the particular norm) or it avoids enforcement of the norm entirely (such as through setting police priorities so as to ignore less harmful norm violations; or by leaving an undesirable activity legal and relying on non-public enforcers to discourage it).

First-person enforcement (self-enforcement) relies on an individual to adhere to a norm, even if no one else can observe or punish a violation. Self-enforcement relies on both self-interest (where complying with the norm is directly beneficial to the individual, as in driving on the same side of the road as other cars do to avoid an accident) and on an individual's morality and sense of identity (e.g., an individual rejects an opportunity to have an extramarital affair because that conforms with the kind of person she is). Self-enforcement is the least expensive enforcement mechanism, but it is also the least flexible. One's self-interest and morality do not directly track social benefits, so one may feel morally bound (or find it in one's self-interest) to adhere to socially inefficient norms or feel no moral compulsion to adhere to a particular, socially efficient norm.

Second-person enforcers rely on self-enforcing exchange of bonds (collateral): if a party violates a norm, its counterparty can confiscate the collateral, and knowledge of this deters the party from

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12. This taxonomy is somewhat similar to, and inspired by, ELLICKSON, *supra* note 1, at 126-27.

violating the norm. Collateral exchange is very flexible—each agreement can be specifically tailored to its circumstances and involve as much or as little collateral (and thus as much or as little cost and effectiveness) as would be optimal given the importance of ensuring compliance in the particular transaction. However, second-party enforcement requires negotiation between two particular parties, so it works very poorly when such negotiation is costly or impossible (e.g., in an environment in which transaction parties fluctuate frequently, so one frequently deals with new “strangers”).

Third-person enforcers rely on a private legal system that employs three enforcement mechanisms—exclusion, control, and switching—that rely on network effects for their effectiveness. PLSs are neither the most effective, nor the lowest cost, nor the most flexible enforcers, but they offer a good balance between these three traits.

Figure 1 summarizes the above taxonomy of norm enforcers.

**Figure 1: Distinguishing Norm Enforcers by Their Enforcement Mechanism**

Type	Norm Enforcer	Enf. Mechanism	Relative Advantage
Public enf.	(Public) legal system	Legitimate use of force	Most effective
1P enforcement	Self-enforcement	Self-interest Morality/identity	Lowest cost
2P enforcement	Bilateral contracting	Collateral exchange	Most flexible
3P enforcement	Private legal system	Exclusion Control Switching	Balance between cost, effectiveness & flexibility

I believe this distinction between norm enforcers based on the enforcement mechanism is clearer than other commonly used distinctions. The private ordering literature sometimes creates a dichotomy between public norm enforcers, who are governments, and private norm enforcers, who are not governments. But some PLSs have significant public backing and are very similar to public legal systems,<sup>13</sup> whereas in other cases governments transact and

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13. For example, the King of England enacted in 1353 the “Statute of the Staple,” which prohibited Common Law courts “from hearing disputes arising from contracts made on the staple markets” (markets for important commodities, such as wool). Zywicki, *supra* note 2, at 1598. Instead, the statute created Staple Courts and

enforce norms without the ability to exert violence (e.g., in some international agreements) and must rely on collateral to secure the counterparty's compliance.

Another common distinction between norm enforcers focuses on the degree of competition the enforcer faces in enforcing norms. While this distinction may be important to the content of the norm selected by the norm enforcer, it seems less important in determining the type of enforcement mechanism used and, therefore, the environments in which such an enforcer would thrive. Most disputes can be brought before multiple public legal fora, so these public legal systems face competition. For example, American companies can incorporate in any of the states, and that state's corporate laws will apply to them.<sup>14</sup> Yet the enforcement mechanisms of, say, the Delaware Court of Chancery, bear a lot of resemblance to other, monopolistic public legal systems and very little resemblance to PLSs that also face competition. Thus, a taxonomy of norm enforcers that focuses solely on the degree of competition with other norm enforcers is unhelpful in analyzing the enforcement mechanisms of PLSs.

Distinguishing between norm enforcers based on their enforcement mechanisms enables us to identify the circumstances under which a particular type of enforcer should thrive and displace other types of enforcers. The landscape in which norm enforcers operate can be mapped on two axes representing sources of enforcement costs that are independent from the nature of the norm enforcer. The first axis considers the environment in which the enforcer operates. A harsh environment is characterized by a large number of members, high fluctuation in membership, and heterogeneous member preferences. Conversely, a benign environment involves a small number of members with homogeneous preferences and low turnover in membership.

The second axis considers the nature of the norm that is enforced. A more adversarial norm is one that is more costly to compel compliance, leaving constant the enforcement environment.<sup>15</sup> A norm is more adversarial the greater the conflict between it and an

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instructed them to apply the (privately formed) law merchant. *Id.* at 1598-99. Thus, private law was given exclusive jurisdiction by public decree. *Id.*

14. Much scholarship has examined the competition between states that results. *See, e.g.*, William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 *YALE L.J.* 663 (1974); Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 *J. LEGAL STUD.* 251 (1977).

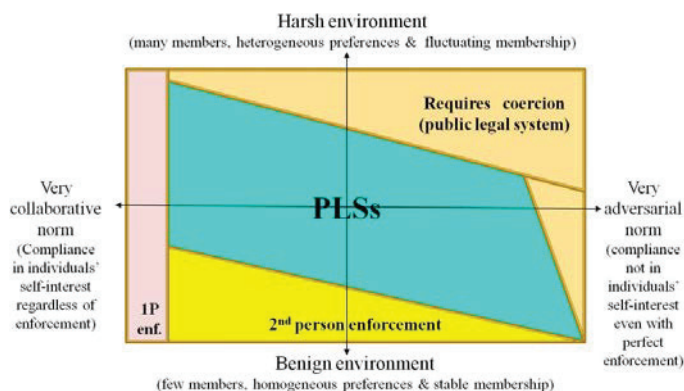
15. *See supra* note 4.



individual's self-interest, and the more the individual benefits from violating it when others comply. For example, if the norm is a prohibition on athletes to use steroids, an individual might be less willing to comply if she knew that all of her rivals were complying, since that would increase her competitive advantage from using steroids. As the enforcer induces more members to comply, resistance from other members will increase, possibly even causing some members who did not find it worthwhile to violate the norm before (e.g., were too concerned about the health effects of steroids) to violate it now (because they would gain a larger advantage now that most athletes don't use steroids).

Mapping the enforcement landscape in this way, the relative advantage of each norm enforcer is shown in Figure 2.<sup>16</sup>

**Figure 2: Relative Advantages of Norm Enforcers**



Public enforcement, being the most effective, has a relative advantage when enforcement costs are so high that nothing short of physical coercion can induce compliance. Therefore, they have a relative advantage in very harsh environments and regarding very adversarial norms.

16. Figure 2 identifies relative advantages, which should be indicative of which norm enforcer would operate in which environment. However, this is not a perfect predictor because it assumes that enforcers are internalizing the benefit they confer from enforcing the norm (as well as the enforcement costs) and that enforcers are interested in maximizing this benefit. This is not always true. For example, the government may be willing to enforce a norm when a less costly enforcer is available because it wants to demonstrate its sovereignty or because the less costly enforcers would select a norm that is undesirable to the government (e.g., a cartel enforcing a norm to maintain prices high or a criminal organization enforcing illegal transactions).

In contrast, first-person enforcement is much less effective, but since it is the least costly enforcer it displaces other norm enforcers in the area in which it is sufficiently effective—enforcing very collaborative norms (the environment does not affect first-person enforcement very much, because compliance depends on self-interest and identity, neither of which is affected by the environment).

Second-person enforcement has a relative advantage as the norm is sufficiently adversarial that first-person enforcement is not sufficiently effective, displacing PLSs and public enforcers because it is more flexible (able to tailor the optimal balance of cost and effectiveness to each set of parties). However, as the norm becomes more adversarial or the environment harsher, the limited effectiveness of second-person enforcement makes it lose ground to PLSs and public enforcement. In particular, second-person enforcement is ineffective in harsh environments: a large number of members increases exponentially the number of bilateral contracts required to have each member have a relationship with all other members, and fluctuating membership requires constant negotiation of new contracts with new members.

Third-person enforcement—PLSs—have a relative advantage in the middle, where the absolute advantage that each of the other enforcers has (in effectiveness, cost or flexibility) does not give it a relative advantage. For example, a highly adversarial norm in a very harsh environment requires the public enforcer's absolute advantage in effectiveness—no other enforcer could induce compliance. But a moderately adversarial norm in a somewhat harsh environment could also be enforced by less effective norm enforcers, so a PLSs lower costs and greater flexibility make it more attractive. Likewise, the absolute cost advantage of first-person enforcement ceases to give it a relative advantage in enforcement when the norm is sufficiently adversarial that self-enforcement is not sufficiently effective to induce compliance.

## B. Second-Person Enforcement

It is usually not difficult to distinguish third-person enforcement (by PLSs) from public enforcement (which can legitimately use violence to enforce norms) and from first-person enforcement (which relies on individuals' self-interest and sense of morality). The difference between third-person enforcement and second-person enforcement merits additional discussion because in both cases norms are enforced on an individual through the response

of another party that has no right compel compliance through violence. The key difference between second- and third-person enforcement is that the former relies on an exchange of bonds, while the latter relies on network effects. In this Subsection I will discuss the second-person enforcement mechanism of collateral exchange. Then, in the Subsection that follows, I will discuss third-person enforcement mechanisms.

Second-person enforcement relies on the exchange of bonds. Bonds are interests of an assuring party that are placed at the mercy of an assured party, such as collateral. The assured party can confiscate or destroy a bond at will, causing harm to the assuring party. The bond should deter the assuring party from defaulting on an obligation, since a default could cause the assured party to confiscate the bond.<sup>17</sup> To mitigate the risk that the assured party would opportunistically confiscate the bond without justification, and to guarantee reciprocal obligations when a transaction involves obligations from both parties, bonds can be exchanged.<sup>18</sup>

Bilateral bonding is an expensive enforcement system, and often a crude one. Nonreciprocal bonding (i.e., providing a bond

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17. The public legal system typically creates such bonds by default through contract law. Each party to an enforceable agreement can petition to use the state's enforcement machinery to enforce the other party's obligations. In some cases, criminal law may also intervene. When bilateral contracts are enforced by courts, they share the traits of public enforcement. For example, they can benefit from government's monopoly on legitimate violence in enforcing a judgment. But they are also limited by government's norm selection and enforcement priorities. For example, a contract may be deemed unenforceable as against public policy, or it may be enforceable in theory but not in practice because the judicial process is slow and expensive. Thus, to the extent that bilateral contracting relies on public enforcement, it is not an alternative to public, but a form of it.

18. Oliver Williamson calls this practice an "exchange of hostages." Oliver E. Williamson, *Credible Commitments: Using Hostages to Support Exchange*, 83 AM. ECON. REV. 519 (1983) (citing Thomas C. Schelling, *An Essay on Bargaining*, 46 AM. ECON. REV. 281, 300 n.17 (1956)).

In fact, a literal exchange of hostages was among the early forms in which this mechanism was used to assure commitment to peace treaties. Gregory of Tours describes the use of this mechanism in the year 511: "But Theoderic and Childebert entered into a treaty and each took an oath that neither would wage war upon the other. They took hostages so that they might the more firmly adhere to what they had promised. Many sons of senatorial families were thus given."

Aviram, *Forces*, *supra* note 11, at 188 n.13 (quoting Gregory of Tours, *Enslaving Noble Families*, in 71 PATROLOGIAE CURSUS COMPLETUS 255 (J.P. Migne ed., 1849), reprinted in A SOURCE BOOK FOR MEDIEVAL ECONOMIC HISTORY 288-89 (Roy C. Cave & Herbert H. Coulson eds., 1965)).

without receiving one) leaves the party offering the bond vulnerable to the other party's ability to confiscate the bond without cause. Reciprocal bonding is subject to reciprocal confiscation, which may leave both parties worse off, but not by enough to deter an opportunist. For example, suppose that Jack agrees to sell to Jill his share of Acme stock for \$10. In order to bond each other into performing their contract, each gives the other \$100 in cash as collateral. When Acme's share price drops to \$5, Jill reneges on the agreement. When Jack retaliates by confiscating Jill's collateral, Jill can confiscate Jack's collateral so that the bonds will offset each other without deterring Jill.

Given this weakness, instead of reciprocal bonding a party can provide asymmetrical collateral: a bond that harms one party without providing the other party with any utility. A hostage exchange is one such example: killing a hostage harms the hostage's kin but does not directly benefit the murderer. Likewise, if person A sullies B's reputation, then B is harmed while A does not receive any benefit. If A were seen to benefit from the harm to B's reputation, the credibility of A's negative information about B would be undermined.

But even with asymmetrical collateral, there is a risk of insufficient deterrence. First, destroying collateral upon suffering a perceived offense may be rational, even when the destruction of the collateral is not profitable, because such destruction enhances deterrence: it indicates that the same action may be taken again in the future if another offense is perceived.<sup>19</sup> But while excessive sensitivity may provide increased deterrence, it also risks undoing a bond. Each party has an incentive to react to minor slights in order to deter the other party from attempting even minor opportunistic behavior at his expense. Therefore, parties may overreact, confiscating the bond at the first perception of an offense in the hope of greater deterrence of the other party in future transactions. But once a bond is confiscated, that other party is likely to retaliate by confiscating the bond it holds, eliminating the assurance mechanism and increasing the likelihood of a cycle of opportunistic—or outright malicious—behavior.

Second, collateral designed to be costly to one party but useless to the other party may be handled in ways that create utility to the latter party. For example, rather than killing a hostage, the hostage

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19. RICHARD A. POSNER, *LAW & LITERATURE* 49-60 (rev. ed. 1998).

may be enslaved, providing the enslaving party with utility.<sup>20</sup> Likewise, collateral useless to the possessing party but useful to a third party may be traded to the third party.

Third, the value of the collateral is often hard to determine. Collateral deters only opportunistic action that is no more profitable than the collateral's value; otherwise, its owner would find it profitable to commit the opportunistic act, pocket the gain, and accept the loss of the collateral. Since gains from opportunistic behavior vary widely, it is hard to anticipate the optimal value of the collateral, and almost any value of collateral would fail to deter some extremely profitable opportunistic behavior. Furthermore, since parties exchanging bonds differ in the degree to which each is vulnerable to the other party's opportunism and in the loss of utility they suffer in providing the bond, parties might disagree on the optimal value of the bond.

Fourth, providing collateral is costly even when it is not confiscated because of its opportunity cost: a work of art given as collateral does not bring joy to its owner while it is held by others; an asset used as collateral for a transaction with one party is unavailable or less valuable to secure obligations with other parties.<sup>21</sup> These costs create an incentive to reduce the size of the collateral as much as possible.

To summarize, bilateral contracting that relies on public enforcement is not second-person enforcement but a form of public enforcement, sharing its advantages and disadvantages. Bilateral contracting that does not rely on public enforcement is costly and therefore, in many environments, is displaced by less costly PLS enforcement.

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20. This is precisely what happened in the hostage exchange between Theoderic and Childebert. See Gregory of Tours, *supra* note 18, at 289. Gregory of Tours describes, "[B]ut when a new quarrel broke out between the kings [the hostages] were reduced to servitude . . . And those who had taken care of them now made slaves of them." Besides deriving utility from the hostages, enslaving them (rather than killing them) may be intended to inflict some harm on the hostage's kin, "while maintaining future deterrence through the ability to inflict additional harm (by killing the hostages)." Aviram, *Paradox*, *supra* note 11, at 18 n.51.

21. Even intangible collateral such as reputation loses its value to one counterparty if another counterparty "confiscates" it. For example, if A's reputation serves as collateral for both A's obligations to B and to C, then C's value from the collateral will diminish if B sullies A's reputation. Therefore, reputation loses value as collateral the more counterparties are able to "confiscate" it.

### C. Third-Person Enforcement: Private Legal Systems

Viewed through the lens of enforcement capabilities, a PLS is a multi-party institution that enforces norms on its members through the use of network effects.<sup>22</sup> Network effects provide three mechanisms to enforce norms on members.<sup>23</sup> The “exclusion mechanism” is the ability to deter norm violations and prevent future violations by expelling a member and prohibiting other members from transacting with the offending former member. Network effects galvanize this mechanism because the larger the number of members and the greater the amount of interaction among members, the greater the value of membership, which is lost upon expulsion.

The “control mechanism” directs transactions through PLS-controlled facilities to force certain desirable behavior, prevent undesirable behavior, or collect information that enables detection of undesirable behavior.<sup>24</sup> For example, a PLS can use its possession and ownership of a shared facility, such as a guildhall or an online social network’s servers, to force members to act in desirable ways or to detect member behavior that violates the PLS’s norms. It may structure a shared physical space or the software used by members to interact so that it forces parties to interact in a way compliant with the PLS norms. Network effects galvanize this mechanism because the greater the amount of business transacted through PLS facilities, the more indispensable those facilities are to members, and therefore the more the members need to transact through these facilities, under the PLS’s watchful eye and subject to facility designs that encourage norm compliant behavior.

Finally, the “switching mechanism” reduces opportunistic behavior by providing access to alternative counterparties. In other words, the switching mechanism shifts relationship-specific investments from the relationship with a particular party to the relationship with the PLS. For example, suppose that Ann agrees to buy from Bob, for \$100, tickets to a Wimbledon tennis match. Relying on the agreement, she purchases plane tickets to London.

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22. Aviram, *Forces*, *supra* note 11, at 183 n.1.

23. Aviram, *Networks*, *supra* note 11, at 1204-11.

24. I distinguished between the control mechanism, which used PLS facilities to encourage or discourage certain behaviors, and the information mechanism, which used PLS facilities to detect norm violations. *Id.* I now believe there is no justification to distinguish these two functions of employing network facilities to enforce norms and therefore consider what I used to call the information mechanism as a subset of the control mechanism.

Bob then demands \$200 for the match tickets, or he will renege on the deal. Ann may well agree, in order to salvage the value of her plane tickets. But if the purchase takes place on an online marketplace, there are likely numerous other match ticket sellers; even if Bob was the cheapest, Ann could probably get a ticket for under \$200. Knowing this, Bob would likely not act opportunistically in the first place.

Most PLSs employ a centralized bonding mechanism that uses as collateral certain intangible assets, such as the right of membership in the PLS, members' reputation, or access to a personally or economically significant location (a holy shrine, the floor of an exchange, etc.). "Confiscating" this collateral means expulsion from the PLS, tarnishing a member's reputation or denying access to locations significant to the member.

To overcome the problems of bilateral bonding, a PLS ideally forms "a centralized bonding mechanism [with the following features]: (1) an independent party (the PLS) holds the collateral of all members and has control over its confiscation; (2) the collateral . . . does not lose utility by being controlled by the independent party; (3) the independent party does not profit from [opportunistically] confiscating the collateral;"<sup>25</sup> and (4) the expected cost to a member from the confiscation of the collateral is greater than the expected profits from defaulting on the norm.

Element (1) eliminates the risk of retaliation confiscations, such as between Jack and Jill in the above example, and also places the confiscation decision at the hands of a repeat player—the PLS—who may suffer if its decisions are arbitrary. "Some PLSs (e.g., common social courtesy) are decentralized, lacking a [controller who] decides whether to confiscate the collateral."<sup>26</sup> When PLSs expand to enforce more adversarial norms, they are likely to develop a centralized body of officials who investigate suspected norm violations and are authorized to exclude offending members, with their decision binding on all members. Another structural development is a secondary boycott norm that excludes members who continue to interact with the excluded member. Finally, the greatest control over confiscating the collateral is obtained if the PLS can direct all PLS transactions through a common essential facility that is managed by the PLS, such as a common room, trading floor or

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25. This feature requires that "remaining members do not profit from excluding the expelled member." Aviram, *Forces*, *supra* note 11, at 190.

26. *Id.*

computer system used by the members to transact their common business. This allows the PLS to affect an expulsion by denying a member access to the facility, without having to rely on members' adherence to its decision.

Element (2) reduces the costs of providing the collateral. Unlike many physical assets, the common collateral used in PLSs—a right of membership in a PLS, one's reputation among members, access to a personally or economically significant location—does not lose value from being controlled by the PLS.

Element (3) addresses the risk of opportunistic confiscation of the collateral. The collateral in a PLS is usually asymmetrical (a member gains from having it, the PLS does not gain from taking it) because a PLS would lose some network effects by excluding a member. However, because members often compete in certain spheres, occasionally some members would gain more from eliminating another member than they would suffer from the reduction in PLS network effects if that member were eliminated—a strategy called “degradation.”<sup>27</sup> This would typically occur when there are few members, and thus the weakening or elimination of one gives others a significant advantage, and when the PLS provides sufficiently significant benefits, so that the expelling a member would significantly weaken it. When members benefit from an opportunistic expulsion of another member, the PLS is less effective in enforcing norms.

Element (4)—that a member's loss from expulsion is greater than the benefit from violating the norm—is required for the threat of confiscation to deter a potential norm violator. This depends on the benefit from violating the norm (i.e., how adversarial the norm is) and on the benefit a member derives from association with the PLS. Newly formed PLSs have yet to provide utility, and therefore expulsion from the newly formed PLS is not costly. Some incumbent PLSs also provide low utility to members, either because the benefits they already provide are not sufficiently great to surpass the benefits of violating an adversarial norm or because they cannot effectively exclude a member.<sup>28</sup>

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27. Aviram, *Networks*, *supra* note 11, at 1212-17.

28. The inability to exclude a member may either be due to the PLS needing the member more than the member needs the PLS, or due to structural limitations of the PLS in ensuring all members complied with the decision to exclude a particular member. A social group, for example, may rely on negative gossip to ostracize a member. However, the PLS can only disseminate the negative gossip; the decision to ostracize is taken by each member individually.



The first three elements are a matter of PLS design. A PLS could fulfill them from the moment it was created. The fourth element, however, distinguishes incumbent PLSs from new ones: the expected cost to a member from being punished by the PLS depends on the effectiveness of the three enforcement mechanisms that were described in Part I.A. The effectiveness of these mechanisms depends, in turn, on the network effects produced by interactions within the PLS. Thus, incumbent PLSs can be expected to have lower norm enforcement costs than newly formed ones. Part II explains how this characteristic leads to a particular pattern of PLS development: path dependent formation.

## II. PATH DEPENDENT FORMATION OF PLSs

### A. Two Theories on the Evolution of PLSs

At a high level of abstraction, there are two alternative theories for the evolution of PLSs that differ over the main factor over which potential PLSs compete, success in which allows the PLS to survive. One might view them as a demand-side theory, which focuses on the norm's efficiency (i.e., the benefit to members from the enforced norm that indicates members' demand for enforcing the norm), and a supply-side theory, which focuses on the PLS's efficiency in enforcing (supplying) the norm.

The first theory, which I call autonomous formation,<sup>29</sup> views PLS evolution as competition between potential PLSs over the *efficiency of the norm they enforce*. Potential PLSs experiment with various norms, and the surviving PLSs are the ones that successfully identify "efficient" norms—in the sense of maximizing the welfare of the PLS's members—and demonstrate this efficiency to the members. In this world, incumbent PLSs do not have a significant advantage over newly formed PLSs because incumbency does not

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29. By "autonomous formation," I mean the creation of a PLS without reliance on a preexisting norm enforcing institution. I claim that a PLS rarely forms without reliance on a preexisting foundation and that this preexisting foundation is almost ubiquitously a collaborative norm—typically one that provides religious or social identity. Because much of the private ordering literature focuses on the lack of reliance on government, one may mistakenly interpret autonomous as "independent from government," but this is not the meaning I intend. In challenging the notion of autonomous formation, I do not dispute that PLSs can, and frequently do, form and evolve without relying on government actions, but they very rarely form and evolve without relying on some preexisting norm enforcing institution, be it government or a preexisting PLS.

typically increase the ability to devise more efficient norms. Indeed, incumbent PLSs are likely disadvantaged relative to newcomers if either: (1) norms they already enforce are at odds with a newly devised efficient norm, and thus the incumbent would not want to enforce the new norm; or (2) the efficient scope of the new norm does not overlap with an incumbent PLS's membership.<sup>30</sup> Thus, if PLSs live and die by the efficiency of the norms they devise, then we should expect an almost random pattern of PLS development, in which new PLSs autonomously form as they identify an efficient norm. In this world, a new norm is likely to be enforced by a new PLS.

The second theory, which I call the path dependent formation, views PLS evolution as competition between potential PLSs over the *cost of enforcing the norm*. Under this theory, PLSs with high enforcement costs cannot credibly assure potential members that they will be able to enforce the norms they espouse, but PLSs with lower enforcement costs can. Faced with a choice between a low probability of enforcing the most desirable norm and a high probability of enforcing a less desirable, but still somewhat beneficial, norm, potential members are likely to grudgingly throw their lots with the latter PLS.

As explained below, a PLS's incumbency significantly reduces its enforcement costs. As a result, and contrary to the autonomous formation theory, a new norm is likely to be enforced by an incumbent PLS, and a small number of PLSs expand and control most private norm enforcement over a given group of members. The main check on the growth of PLSs, which prevents a single PLS from enforcing all norms, is that a PLS's enforcement mechanisms are effective against only its members. To enforce norms that require the cooperation of a different set of actors, the PLS must expand its membership. This expansion in turn increases the heterogeneity of member preferences, which increases the costs of enforcing all PLS norms, including ones already enforced. To avoid diminishing the effectiveness of its norm enforcement, which might open the door for a competing PLS to step in, an incumbent PLS will likely forego enforcing norms that require significant membership expansion.

Since the enforcement of a new norm is likely to be in the hands of an incumbent PLS, and since the PLS has some discretion

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30. A new PLS could select its members so as to fit the efficient scope of the new norm, while an incumbent PLS would be forced to modify its membership if it wishes to also enforce the new norm.

over the content of the norm it enforces, the norms enforced today depend on the PLSs that existed yesterday—hence a path dependent formation.<sup>31</sup>

## B. Assessing PLS Enforcement Costs

While the literature on PLSs has not developed a framework for assessing norm enforcement costs, another body of legal and economic scholarship has addressed this issue in great depth: the antitrust literature addressing cartel sustainability.<sup>32</sup> Cartels are norm enforcers that enforce a particular, highly adversarial norm: the maintenance of above-market prices or the delineation of markets between cartel members. Since George Stigler's seminal article,<sup>33</sup> the literature on cartel sustainability has focused on the cartel's enforcement costs. Sustainable cartels have lower enforcement costs due in large part to homogenous preferences of members (which results from homogeneous products and stable market demand), a small number of members with a high aggregate market share, and a stable membership (facilitated by high barriers to entry and little or no competition with rival cartels over the members). These factors affect enforcement costs of other PLSs.

However, the utility to PLS scholars from the literature on cartels is limited because the cartel norm is so adversarial. The benefit from defecting from a cartel is so great that, in most circumstances, cartels can be enforced only in extremely benign environments, involving a small number of members with homogenous preferences and stable membership. When this benign environment deteriorates, cartels tend to collapse.

In contrast, the PLSs that most resemble the public legal system have a large number of members with heterogeneous preferences, and barriers to entry are low (in the sense that many individuals may migrate into the geographical or social sphere in which the PLS operates). PLSs are able to enforce norms in such harsh environments because of their ability to rely on government

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31. On the definition and nature of path dependence, see Paul A. David, *Path Dependence: A Foundational Concept for Historical Social Science*, in *LAW, ECON. & EVOLUTIONARY THEORY*, *supra* note 11, at 88.

32. See generally Andrew R. Dick, *When Are Cartels Stable Contracts?*, 39 *J.L. & ECON.* 241 (1996); George J. Stigler, *A Theory of Oligopoly*, 72 *J. POL. ECON.* 44 (1964).

33. Stigler, *supra* note 32.

institutions and particularly on government's monopoly on legitimate force.

The cartel literature would predict that in this harsh environment private enforcement is unsustainable, yet this prediction conflicts with the existence of PLSs such as the medieval craft guild (which enforced, among other things, a cartel norm) or *Pax Dei* (which enforced limits on warfare—an even more adversarial norm than a cartel). PLSs are able to enforce such adversarial norms in harsh environments because they begin by enforcing less adversarial norms and only later expand into more adversarial norms. As a result, many PLSs become more sustainable over time as they expand to enforce more norms, in contrast to narrow cartels, which tend to become less sustainable over time.<sup>34</sup>

To the main factors mentioned in the antitrust literature as determining enforcement costs—homogeneity of member preferences, number and aggregate power of members relative to potential members (market share, in the antitrust context), and degree of fluctuation in membership—we should add an additional factor: how adversarial the norm is. The degree to which a norm is adversarial is not a factor explored in cartel literature because that literature focuses on just two adversarial norms: price fixing and market allocation.<sup>35</sup> The broader world of PLSs ranges from nonadversarial norms to highly adversarial ones. The enforcement of less adversarial norms can succeed in harsh environments in which autonomous enforcement of cartels would be impossible.

### C. Incumbency and the Paradox of Autonomous Formation

As the literature on cartels predicts, the fact that a highly adversarial norm is efficient for its members is not sufficient to sustainably enforce the norm in harsh environments characterized by a large number of members, high fluctuation in membership, and heterogeneous member preferences. This is due to a “chicken and egg” paradox, which I call the autonomous formation paradox: “to enforce a norm efficiently, a PLS must ensure the cooperation of its members. But the effectiveness of the mechanisms used to secure

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34. Dick, *supra* note 32, at 268-69.

35. Dick does find that cartels that are created to share costs are more sustainable than those created to fix prices, a finding that suggests that the price fixing norm is more adversarial than the cost-sharing norm. *Id.* at 275. For the most part, however, cartel scholarship analyzes adversarial price fixing and market allocating arrangements, rather than other, less adversarial ones.

this cooperation depends on a PLS's ability to confer benefits to its members—primarily the ability, not yet existing in a newly formed PLS, to efficiently enforce norms.”<sup>36</sup>

Consider an alternative history replacing *Pax Dei*: the peasants in a region could have convened and agreed to pool their resources, without relying on religion, to intimidate the warlords into undertaking peace oaths. If all peasants followed through with their promise, this norm would benefit them. However, enforcing this norm—like other norms providing public goods—requires addressing a collective action problem: the peasant coalition would deter warlords even if an individual peasant defected, and the resulting peace would benefit all, including those who defected. Furthermore, if a single peasant supported the movement while others defected, the movement would fail, and the individual peasant would be punished for his participation. A peasant's incentives, structured here as a prisoner's dilemma, clearly favored defection.

The PLS literature suggests that reputation facilitates cooperation. But reputation in itself cannot enforce norms. Reputation facilitates norm enforcement only by affecting interactions in a vibrant network that provides important benefits to the party carrying the reputation. When a PLS is in its infancy and does not yet confer significant benefits to its members, one's reputation among the PLS's members does not have a significant effect. Stated differently: bad reputation is shorthand for the threat to deploy the three enforcement mechanisms that PLSs use (Section I.A). These mechanisms are only as effective as the network effects from members' interactions within the PLS. A newly formed PLS has no network effects and therefore very weak enforcement mechanisms, so having a bad reputation within the PLS is not much of a threat.

The paradox of autonomous formation is a problem of assurance: if all members of a newly formed PLS could be assured that all other members would comply with a norm, the newly formed PLS would be as effective as a similarly sized incumbent. However, bilateral bonding is very expensive (Section I.B) and multi-lateral, centralized bonding (Section I.C) relies on network effects that are not yet realized in the newly formed PLS. If no other PLS or government enforcer can step in to enforce the norm, and if the norm is sufficiently beneficial to justify the large expense, then perhaps the newly formed PLS would use costly bilateral bonding to bootstrap

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36. Aviram, *Forces*, *supra* note 11, at 187.

the PLS until it developed the network effects that would facilitate effective centralized bonding.<sup>37</sup> But in most cases, an incumbent PLS would expand to enforce the new norm, displacing the newly formed PLS that suffers from higher enforcement costs.

This occurred in the case of *Pax Dei*. Rather than a new PLS relying on exchanges of collateral between peasants, the peace movement relied on the Christian social network that provided its members with significant spiritual benefits, including a sense of belonging to a community and a sense of security derived from belief in divine oversight. Reneging on what was perceived to be a covenant with God would result in excommunication and the loss of benefits religion provided. While religious faith could aid the success of *Pax Dei*, it was not necessary for the peace movement's success, as even those members who believed that breaking the peace oaths would not invite divine wrath feared the effects of exclusion from the Christian community.

#### D. Path Dependent Formation: Core Norms

To avoid the paradox of autonomous formation, PLSs that (ultimately) successfully enforce highly adversarial norms begin by enforcing core norms: non-adversarial norms that members are inclined to comply with even when it is not certain that all members will comply. The most common core norms affect members' shared identity, and are social, religious, or both. Such norms provide members with a sense of community, social interaction, and spiritual guidance. These norms are not very adversarial; people are more

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37. The existence of cartels provides examples of adversarial norms that are enforced without reliance on preexisting nonadversarial core norms. Cartels' fragility and their near absence in all but the most accommodating environments demonstrates, however, that this is a suboptimal enforcement method that survives, with moderate effectiveness, only because no superior enforcer displaced it. Another example of private norm enforcement that does not rely on nonadversarial core norms is provided by Karen Clay, who describes trade in Mexican California in the 1830s. Karen Clay, *Trade Without Law: Private-Order Institutions in Mexican California*, 13 J.L. ECON. & ORG. 202, 202 (1997). Unlike the traders described by Landa, *supra* note 9, at 361, and Greif, *supra* note 10, those described by Clay did not share a common ethnicity or religion. Some collaboration between merchants developed, though it was very limited in comparison to that among the Maghribi traders described by Greif, *supra* note 10. While the traders in Mexican California exchanged information on dishonest colleagues, they rarely succeeded in imposing collective punishment. In contrast, the Maghribi traders frequently imposed collective punishment—a more adversarial and more effective norm than information sharing.

willing to interact socially with a group of strangers than to make binding promises to the same strangers, especially when they are not sure how many of these people would reciprocate.

Norms that shape a shared identity, such as religious, nationalist, tribal, and other norms, tend not to be adversarial because they create a desire in members to enforce the norms and punish violators, as a vindication of the identity. Allowing someone to violate ideological norms and go unpunished questions the validity of the ideology, or at least the importance of the ideology to the identity of members who acquiesce to the violation. In contrast, by punishing the violator, a member reaffirms the centrality of the ideology to her identity. Potential norm violators are less likely to violate norms when the violation questions their identity. No less important, members who do not share the identity, such as a nonbeliever who is a member of a religious community, would still be hesitant to violate an identity-based norm if they expect that most other members do share the identity and would therefore receive psychic benefit from seeing the norm offender punished.

Another enforcement advantage of core norms that shape a shared identity is that they reduce competition between PLSs by increasing the cost of switching to another PLS. Learning the nuances of a shared identity is time consuming, and the lack of familiarity in them is easy to detect. Thus, they present a relationship-specific investment in a PLS that shares the identity. A member contemplating violating norms enforced by the PLS will lose the investment he made in learning the network's culture and will have to make a new investment in learning the identity of the new PLS he joins. In the meantime, he will be identified by the new network as an outsider, possibly for quite a while.<sup>38</sup> Some identities, such as ethnicity and religions that do not allow members to convert to another religion, make switching PLSs nearly impossible.

The ability of PLSs based on religious identity to regulate believers is enhanced by two additional benefits.<sup>39</sup> First, a religious belief in an afterlife or reincarnation facilitates rewards and punishments that come after death.<sup>40</sup> Such incentives are powerful in

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38. As Ellickson reports, people who resided in Shasta County for a decade were still viewed by most locals as newcomers and outsiders. ELLICKSON, *supra* note 1, at 38 n.14.

39. Aviram, *Forces*, *supra* note 11, at 192.

40. *Id.*; Gary Richardson & Michael McBride, *Religion, Longevity, and Cooperation: The Case of the Craft Guild*, 71 J. ECON. BEHAV. & ORG. 172, 172-73 (2009).

environments of high mortality,<sup>41</sup> or when being taken advantage of may lead to death.<sup>42</sup> Second, a religious belief in an omniscient and omnipotent god assures believers that all violations would be detected and punished.<sup>43</sup>

#### E. Path Dependent Formation: Expansion Norms

Once a PLS is successfully enforcing a core norm, it can choose to enforce expansion norms that are more adversarial, using the threat of denying violators access to the benefits of the core norm (e.g., with a religious norm, the threat of excommunication). Expansion norms need to satisfy the following conditions:

(1) PLS has an incentive to enforce: The PLS controller must find it attractive to enforce the norm.

(2) PLS is able to secure member compliance: Member benefits, prior to expansion, from PLS membership must exceed the expected benefit to a member from violating the norm.<sup>44</sup> Otherwise, expulsion from the PLS would not deter potential norm violators. Early in the life of a PLS, while it enforces relatively few or less beneficial norms, it can expand only to slightly more adversarial

41. Aviram, *Forces*, *supra* note 11, at 192. Consider the *Pax Dei* prohibition on warfare during holy days:

If person A abides by the norm, [say by refraining from attacking on a holy day,] while person B violates the norm and surprises A, then A may die. If punishment and rewards are limited to one's lifetime, then the risk of being taken advantage of may make this norm unenforceable, since A cannot be rewarded posthumously for complying with the norm. However, a reward in one's afterlife may be sufficient incentive for a believer to abide by the norm.

*Id.* at 193.

42. *Id.* at 192.

[C]onsider a norm of honoring one's promises, enforced at a time of very high mortality[, such as] during a plague. If A is to honor her promise, she foregoes the option of opportunistically renegeing on a now unprofitable promise. In return, she may expect others to honor their promises in the future. But if A believes she may die soon, before others honor their promises to her, she may renege now. [Yet] if A believes that she would be rewarded in her afterlife (or be reincarnated in a manner that rewards her for her good deeds in her current life), then her death does not constrain the ability to incentivize her.

*Id.* at 193.

43. *Id.* at 192.

44. The expected benefit to a member from violating a norm is a significant factor affecting how adversary the norm is (together with the degree to which a member is vulnerable if she complies with the norm while others violate it).



norms. However, the benefit from membership increases with each successful enforcement of an expansion norm that is advantageous to the members, allowing the PLS to then select expansion norms that were too adversarial to enforce earlier.

(3) Member compliance is sufficient: Securing the compliance of the PLS's current (pre-expansion) members must be sufficient for the expansion norm to yield a net benefit to the members without requiring compliance of other parties. A PLS's enforcement mechanisms are effective against only its members. If a potential expansion norm requires the cooperation of a different set of actors, then the PLS would not have a particular advantage in enforcing that norm.

The PLS literature on the enforcement of adversarial expansion norms is much richer than on core norms.<sup>45</sup> Adversarial expansion norms attract the attention of legal scholars and economists because they are more similar to the norms enforced by the public legal system—they look more like “law.” The literature's focus on the content and efficiency of the norm rather than on a norm's enforcement costs places the spotlight on the more complex—and adversarial—expansion norms. While these expansion norms attract much attention, the core norms that support them are often ignored or treated as curious details rather than essential elements.

Notable exceptions are Landa, who highlighted the role of ethnic ties in facilitating long-distance trading of rubber in Singapore and West Malaysia,<sup>46</sup> and Greif, who highlighted the role of ethnic and religious ties in long-distance trading in the Mediterranean during medieval times.<sup>47</sup> Both articles emphasize the importance of the ethnic/religious core norm in supporting an adversarial expansion norm (in these cases, honoring one's contracts). Lisa Bernstein<sup>48</sup> and Barak Richman<sup>49</sup> likewise highlight the role of religion in enforcing informal contracts among diamond dealers.<sup>50</sup>

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45. For an analysis of case studies from the PLS literature reinterpreted through the lens of core norms supporting expansion norms, see Aviram, *Paradox*, *supra* note 11, at 46-58.

46. Landa, *supra* note 9, at 350.

47. Greif, *supra* note 10, at 525-27.

48. Lisa Bernstein, *Opting Out of the Legal System: Extralegal Contractual Relations in the Diamond Industry*, 21 J. LEGAL STUD. 115, 140-41 (1992).

49. Barak D. Richman, *Firms, Courts, and Reputation Mechanisms: Towards a Positive Theory of Private Ordering*, 104 COLUM. L. REV. 2328, 2351-52 (2004).

50. Ellickson also connected a core norm to an expansion norm by highlighting the importance of social identity (neighborliness) in the PLS that

These articles, however, confine themselves to a particular adversarial norm: the enforcement of informal contracts. They also focus almost exclusively on the particular core norm that appears in the case study each article considers—an ethnic norm in the case of Landa<sup>51</sup> and an overlapping ethnic and religious norm in the cases of Greif, Bernstein, and Richman.<sup>52</sup> This Article presents a broader theory that attempts to unify common traits of these seemingly disparate norms, distinguishing norms by the degree they are adversarial and demonstrating how that difference determines which norm gets enforced first and by whom.

Furthermore, most PLS scholarship treats PLSs as static, endeavoring to explain why an existing PLS is effective but not how it came to be effective. In contrast, this Article considers the dynamic process of PLS development and suggests how it is that a PLS comes to bundle the enforcement of particular norms, and in what order.

### III. ON IDENTITY AND NORM ENFORCEMENT

This Article argues that the development of PLSs is path dependent because in most environments highly adversarial norms will be enforced by incumbent PLSs that began by enforcing non-adversarial core norms—mainly norms that create a shared identity among members. Since the content of a norm depends on the preferences of the enforcing PLS, the content of new, highly adversarial norms will depend on which PLSs already exist and enforce less adversarial norms on the same group of members whose behavior needs to be regulated to ensure the success of the new norm.

The economics of identity have received increased attention from scholars in recent years. In the context of the group norms, some scholars called to replace traditional, incentive-based models (in which an actor follows norms because of fear of punishment for others if she deviates) with identity-based models (in which an actor

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addresses cattle trespassing on farmland. ELLICKSON, *supra* note 1, at 56-58. Ellickson's focus, however, was on the content of the expansion norm—how were trespasses addressed and how does it compare to the legal rule—rather than on the PLS's enforcement costs. *Id.*

51. See generally Landa, *supra* note 9 (examining ethnic Chinese traders in Malaysia).

52. See generally Greif, *supra* note 10; Bernstein, *supra* note 48; Richman, *supra* note 49. Each of the three articles examines Jewish traders.

follows norms because it fits with his or her identity).<sup>53</sup> While identity no doubt plays a role in human behavior, identity-based models may underemphasize the role that incentives, including fear of punishment by others, play in human behavior, particularly when stakes are high. They also underemphasize cognitive biases that allow individuals to subconsciously interpret their environment and actions in a self-serving way, thus allowing an actor to act in a self-serving way while sincerely believing that he is acting in accordance with an altruistic identity.

In this Article, I suggest an alternative way to incorporate identity into models of group norms and norm enforcement without abandoning incentives. The ultimate motivator for compliance with norms is an actor's incentives, particularly fear of punishment by others. But, in all but the most benign environments, highly adversarial norms cannot be sustainably enforced without the support of an incumbent institution that enforces a preexisting core norm—one that facilitates a shared identity.

In conclusion to this Article, I would like to discuss a potential bypass to the path dependent formation of PLSs and at the same time introduce into the PLS literature a body of historical scholarship that has thus far not been considered: work on the “invention of tradition.”

The “invention of tradition,” a term coined by Eric Hobsbawm & Terence Ranger,<sup>54</sup> is a (surprisingly common) phenomenon of artificially creating a shared identity through “a set of practices . . . of a ritual or symbolic nature, which seek to inculcate certain values and norms of behaviour by repetition . . . [and] attempt to establish continuity with a suitable historical past.”<sup>55</sup>

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53. GEORGE A. AKERLOF & RACHEL E. KRANTON, *IDENTITY ECONOMICS: HOW OUR IDENTITIES SHAPE OUR WORK, WAGES, AND WELL-BEING* 57-58 (2010).

54. Eric Hobsbawm, *Introduction: Inventing Traditions*, in *THE INVENTION OF TRADITION* 1, 1 (Eric Hobsbawm & Terence Ranger eds., 1983).

55. *Id.* While many invented traditions are orchestrated by governments, they can be and are occasionally orchestrated by private parties. Private parties invent tradition in a variety of ways, including barter friendships, which oblige the parties to similar standards of loyalty to those they owe their kinsmen, see Richard A. Posner, *A Theory of Primitive Society, with Special Reference to Primitive Law*, 23 J.L. & ECON. 1, 26 (1980), and political adoption, in which two individuals (frequently, both adults) accept the status of parent and child, respectively, motivated by political reasons such as unifying or strengthening a dynasty, see HUGH LINDSAY, *ADOPTION IN THE ROMAN WORLD* 169-73 (2009). Dynastically motivated adult adoption is practiced today in Japan. See Vikas Mehrotra et al., *Adoptive Expectations: Rising Sons in Japanese Family Firms*, 108 J. FIN. ECON. 840 (2013); *Adult Adoption in Japan: Keeping It in the Family*, *ECONOMIST*, Dec. 1,

Invented tradition can be false, and some traditions have been alleged to be false. One example is the Scottish Highlander “traditional” garb, which Hugh Trevor-Roper claimed had developed after the union with England.<sup>56</sup> Another example is the biblical stories of a unified Israelite-Judean kingdom ruled by the House of David from Jerusalem, which, Israel Finkelstein and Neil Silberman speculate, is a fiction created by Hezekiah, an eighth century BC Judean king, in an attempt to unify a mixed population of native Judeans and refugee Israelites in preparation for rebellion against the Assyrian Empire.<sup>57</sup>

Other invented traditions may be historically true, but are emphasized and ritualized in a context that channels historical identity into a contemporary target. An example, described by Yael Zerubavel, is the veneration of Yoseph Trumpeldor in Israel during the decades just prior and just following Israeli independence.<sup>58</sup> Trumpeldor, a former officer in the Czarist army, was in 1920 among the residents of the Jewish village of Tel Hai, then on the border between French and British zones of control in territory captured from the Ottoman Empire in the First World War. Tel Hai was attacked by an Arab militia and Trumpeldor died in the attack. Almost immediately Trumpeldor became a role model—a fighter and a farmer who died heroically in the defense of Tel Hai. He was portrayed as a continuation of a line of Jewish heroes going back to biblical times. With the possible exception of Trumpeldor’s dying words—“it is good to die for our country”<sup>59</sup>—the facts surrounding Trumpeldor’s life and death are seen as historically accurate.

Yet as Zerubavel points out, his elevation to a status of hero, the emphasis on his dedication to the greater good and on his military prowess, and the association between him and ancient Jewish military leaders all seem calculated to develop a shared image of the Jewish population in British Palestine as heroic, community-minded, tied to the land, and able to defend itself. This image was

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2012, <http://www.economist.com/news/asia/21567419-family-firms-adopt-unusual-approach-remain-competitive-keeping-it-family>.

56. Hugh Trevor-Roper, *The Invention of Tradition: The Highland Tradition of Scotland*, in *THE INVENTION OF TRADITION*, *supra* note 54, at 15.

57. ISRAEL FINKELSTEIN & NEIL ASHER SILBERMAN, DAVID AND SOLOMON: IN SEARCH OF THE BIBLE’S SACRED KINGS AND THE ROOTS OF THE WESTERN TRADITION 121-49 (2006).

58. Yael Zerubavel, *The Historic, the Legendary, and the Incredible: Invented Tradition and Collective Memory in Israel*, in *COMMEMORATIONS: THE POLITICS OF NATIONAL IDENTITY* 105, 105-23 (John R. Gillis ed., 1994).

59. *Id.* at 108.

designed to suggest continuity with the image of the Jewish community of ancient times, while contrasting with an image of Jewish Diaspora communities as helpless, nomadic, and lacking military and agricultural proficiency. This image helped mobilize the community as it engaged in an increasingly bloody struggle leading to, and then following, the creation of the state of Israel.

If tradition can easily be invented, then path dependent formation of PLSs is not necessary. A collaborative core norm can be instantaneously invented when a more adversarial norm needs to be enforced, rather than relying on an incumbent PLS. For example, if Finkelstein & Silberman's speculation on the unified kingdom is correct, then native Judeans and refugee Israelites may not have seen each other as kin before Hezekiah's invented tradition of a unified kingdom, but upon accepting that tradition, Hezekiah could instantaneously enforce more adversarial norms, such as paying taxes to support a fortification effort or willingness to serve in the military in the defense of both ethnic groups.

However, the impact of invented traditions on PLS enforcement may not be so dramatic. Even an anecdotal observation of PLSs (as done, for example, in the introduction to this Article) demonstrates that the enforcement of highly adversarial norms does tend to rely on incumbent PLSs that enforced less adversarial core norms. If inventing tradition were easy and effective, one would expect an autonomous formation world in which numerous PLSs enforce highly adversarial norms without a history of enforcing core norms, but rather supported by instantaneously invented traditions. Instead, invented traditions that are not supported by incumbent PLSs seem to appear in the public legal and political systems, where enforcement utilizes government's monopoly on legitimate violence and thus does not need to rely on tradition to the same degree as PLSs. Invented tradition, if it matters at all in those contexts, increases government legitimacy on the margin, but public enforcement still relies on the police or military rather than on voluntary compliance due to a shared identity formed by a newly invented tradition.

Zerubavel may have identified a key limitation on the invention of tradition in her observation that belief in invented tradition tends to rely more on credibility (assessed according to the fit between the tradition and the individual's existing identity) than on historical validity.<sup>60</sup> She considers a controversy as to Trumpeldor's dying

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60. *Id.* at 117.

words, which the original tradition claimed were, in Hebrew, “it is good to die for our country,”<sup>61</sup> but which a later tradition claimed were a crude Russian curse. The former interpretation fit a community in the midst of a military struggle, which needed military heroes and a willingness of individuals to sacrifice for the good of the community. The latter interpretation fit a community that gave more emphasis to individual needs and aspirations and was wary of heroes and demands for sacrifice. Zerubavel points out that, while historical evidence is, on balance, more supportive of the original tradition of Trumpeldor’s dying words, the later tradition had become more accepted. Historical truth was secondary to coherence with one’s values and identity.

Here, again, identity plays a role in norm enforcement. If invented tradition succeeds when it conforms to preexisting values and identity, then it is endogenous to the development of PLS because an invented tradition will enhance an existing core norm of a shared identity, but will fail when it conflicts with the existing core norm. Incumbent PLSs that are enforcing core norms can be expected to enhance their enforcement power not only by adding expansion norms, but also by maintaining and buttressing the core norm through invented tradition. This interpretation explains why, despite the prevalence of invented tradition, successful PLSs enforcing highly adversarial norms rely on long-established core norms rather than on invented tradition.

Further inquiry into the role of invented tradition, and particularly the limits on effective invention of tradition, is beyond the scope of the present Article. Looking ahead, this line of scholarship has great promise in enriching the literature on private ordering and particularly in allowing scholars of PLSs to better incorporate the dynamic role of shared identity on norm enforcement.

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61. *Id.* at 108.