

*Forum Series on the Role of Institutions in Promoting Economic Growth*

**Why the Middle East Is Economically Underdeveloped:  
Historical Mechanisms of Institutional Stagnation**

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**Executive Summary**

A millennium ago the Middle East was not an economic laggard. By the 18<sup>th</sup> century it was exhibiting clear signs of economic backwardness. The reason is that certain components of the region's legal infrastructure stagnated during a long period when their Western counterparts were giving way to the modern economy. Among the institutions that generated evolutionary bottlenecks are the Islamic law of inheritance (which inhibited capital accumulation), the absence in Islamic law of the concept of a corporation (which kept civil society weak), and the waqf (which locked vast resources into unproductive organizations for the delivery of social services). All of these obstacles to economic development were largely overcome through radical reforms initiated in the nineteenth century. Nevertheless, traditional Islamic law remains a factor in the Middle East's ongoing economic disappointments. The weaknesses of the region's private economic sectors and its deficiencies of human capital are among the lasting consequences of traditional Islamic law.

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**Introduction**

If one of the most significant questions of economic history concerns the rise of the West, another is the slip of the Middle East into a state of underdevelopment.<sup>1</sup> A millennium ago, around roughly the tenth century, the Middle East was not an economic laggard. On the contrary, it was economically advanced, as measured by standard of living, technology, agricultural productivity, literacy, or institutional creativity. The one region of the world that might have been even more developed was China. By the 18<sup>th</sup> century, however, the Middle East, like China, was exhibiting signs of

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<sup>1</sup> The term “Middle East” admits many definitions. Here I am using it in a broad and elastic sense. In particular, it includes not only the entire Arab world and Iran, but also Turkey, including its segment in Europe, along with the rest of the Balkan peninsula, which was under Turkish rule during much of the period of interest. Spain belongs to the region up to the Reconquista—its reversion from Muslim to Christian control.

backwardness. Before long the Middle East began to be viewed as “underdeveloped” in relation to Western Europe and its offshoots in the New World; and, by the late 20<sup>th</sup> century, it was considered markedly behind parts of East Asia as well. The peoples of the region have shared, and continue to share, these perceptions, as evinced by the history of Middle Eastern reforms aimed at catching up with economically advanced countries.

For the past two centuries, two classes of explanations for the Middle East’s loss of global economic standing have enjoyed great popularity. One treats Islam as incompatible with economic efficiency, innovation, and progress; the other points the finger at Western belligerence and exploitation. As discussed elsewhere (Kuran, 1997), the former class of explanations collides with the incontrovertible fact that under Islamic rule the Middle East initially experienced remarkable economic advances. As a case in point, the first few Islamic centuries saw the development of financial and commercial institutions that were advanced for the time, and these allowed Middle Easterners, including *Muslim* Middle Easterners, to play leading roles in long-distance trade emporia stretching from Spain and Morocco to China and the East Indies. As for the latter class of explanations, they fail to make sense of why European imperialism triumphed when it did. After all, the region’s riches whetted European appetites long before the eighteenth century, and there had been earlier campaigns to bring it under foreign control; the Crusades, which ended in failure, offer a poignant example. What exactly changed to make the Middle East economically dependent on the West, too weak to resist Western colonization, and in need of Western-inspired structural reforms?

The critical transformation did not occur in the Middle East itself. Rather, from about the 10<sup>th</sup> century onward, Western Europe experienced institutional advances that vastly increased its capacities to pool resources, coordinate productive activities, and conduct exchanges. In the course

of this evolution, the Middle East hardly experienced an absolute decline in economic performance. Nor did it stop experiencing institutional change; its fiscal systems, for example, underwent repeated overhauls. By the same token, certain institutions changed minimally as compared with the ongoing structural transformation of the West or, for that matter, with the Middle East's own evolution during the early Islamic centuries. In 18<sup>th</sup>-century Cairo, credit institutions did not differ fundamentally from those that served Cairenes of the 10<sup>th</sup> century. Likewise, investors and traders were using enterprise forms essentially identical to those prevalent eight centuries earlier.

The task of explaining the Middle East's relative economic decline presents, then, two sets of challenges. The first is to account for the spectacular West European transformation that ushered in the modern economy; the second, to identify why the Middle East failed to keep pace with the modernization process under way across the Mediterranean. Focusing on the second challenge, this essay outlines the social mechanisms responsible for the stagnation of key Middle Eastern institutions. Nothing in the analysis requires presuming a unique path to increasing economic productivity or a single way to mobilize the resources of the masses. Plainly, however, certain elements of the region's old economic infrastructure had to change for living standards to register the improvements associated with modern economic growth. If the pre-modern economic institutions of the West were incompatible with modern levels of prosperity, the same was true of the pre-modern institutions of the Middle East. The choice of using the Western experience as a benchmark is deliberate. It is in relation to the West that the Middle East became underdeveloped. Accordingly, familiarity with the metamorphosis of the West can assist in the identification of critical cases of institutional immobility.

## **Methodology**

To explain the stagnation of a certain institution, or the slowness of its change relative to some standard, one must identify a causal mechanism responsible for the observed outcome. A causal mechanism, *M*, is an account of how a given set of inputs, *I*, and a corresponding set of outputs, *O*, relate to one another over a particular time span. In searching for a mechanism, one is not satisfied with identifying covariation. One looks for a sequence of reactions, such that *I* generates *O*. If our topic were medicine, we would not be satisfied with noting merely that when patients with certain symptoms are treated with penicillin (*I*) they get well (*O*).

In addition, we would want to specify the biochemical processes through which patients' respiratory systems return to normal (*M*). With respect to development, we might want to identify, for instance, the mechanism through which a given set of institutions (*I*) induces a community's members to keep their commercial enterprises small (*O*).<sup>2</sup>

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<sup>2</sup> On the study of social mechanisms in general, see Hedström and Swedberg, eds. (1998). Many examples, along with analytical commentary, may be found in Kuran (1995). North (1990) and Greif (2000) offer pertinent analytical frameworks as well as applications to economic development.

A quest for causal mechanisms may uncover complex relationships. It could yield a multiplicity of distinct mechanisms linking I and O. The mechanisms in question could be additive in their effects, or they could counteract one another. Any given mechanism could generate adjustments that strengthen an already existing tendency. For an example of such adjustments, known generically as *positive feedback*, imagine that a certain institutional endowment ( $I_1$ ) induces merchants to form small partnerships ( $O_1$ ). Those partnerships then alter the relevant institutional endowment:  $I_1$  gives way to  $I_2$ . And, as a consequence, the initial mechanism is strengthened:  $I_2$  leads to even smaller partnerships ( $O_2$ ). There is not positive but *negative feedback* when the adjustments weaken an existing tendency. To modify the stylized example at hand, suppose that when  $O_1$  transforms  $I_1$  into  $I_2$ , the mechanism responsible for  $O_1$  weakens. In concrete terms, the incentives making merchants keep their partnerships small diminish, and the average partnership size grows ( $O_2$ ). Here the feedback is negative, for it undermines the mechanism keeping partnerships small. With *neutral feedback*, or the absence of feedback, the initial mechanism would be self-perpetuating and the relationship between I and O self-enforcing. Accordingly, the institutional endowment and its observed outcomes would remain intact indefinitely. Mechanisms need not be intentional, and their effects need not have been anticipated. Social leaders who develop institutions to govern inheritance practices, commercial cooperation, and property rights need not be conscious of all the incentives these create jointly.

Identifying the mechanisms that kept a society economically backward may have immediate practical returns insofar as one discovers ways to short-circuit the harmful processes. As such, it can steer attention away from interpretations that call for either resignation or blaming outsiders. Without an understanding of mechanisms internal to the society in question, one might draw

conclusions that invoke fatalism, irrationality, economic ineptitude, or indifference to enrichment—factors of the sort advanced by the first of the problematic explanatory frameworks discredited above. Insofar as such factors are operative, there is little ground for expecting to overcome the state of backwardness. Alternatively, one might conclude that the underdeveloped society was pushed into impoverishment by militarily or politically more powerful outsiders, thus endorsing the second of our flawed classes of explanations. Such a conclusion is a recipe, of course, for conservatism. It treats the economically backward society as a puppet whose strings are controlled entirely by wealthier, more productive societies. It also implies that nothing in the backward society needs to be reformed; rather, it is the outside world that ought to change.

The present approach does not let the Middle East off the hook. On the contrary, it points to specific Middle Eastern institutions, including ones rooted directly in the region's dominant religion, as past, or even continuing, obstacles to economic development. The paper thus claims a middle ground between the polar approaches of blaming Islam categorically and absolving the Middle East of all responsibility for its own fate. It also lays the historical groundwork for comprehensive reforms to restore the region's creativity, productivity, and prosperity. These reforms do not entail rejecting Islam as incompatible with economic development. They do call, however, for serious rethinking about what is central to the religion and what belongs to its modifiable superstructure.

The paper's organization is dictated by its mechanism-based methodology. I start by identifying relevant elements of the Middle East's institutional endowment at a time well before it became underdeveloped. Then I identify signs of relatively poor economic performance, in other words, the outcomes requiring explanation. The mechanisms linking the institutional endowment and the eventual economic failures are taken up next. The final section of the paper inquires into the

prevailing residues of the identified historical mechanisms. It also draws some implications for structural reforms.

### **The Middle Eastern Economy, c. 1000**

Islam's economic institutions did not emerge all at once, in the time of Prophet Muhammad. Key elements were not present in 661, the end of Islam's canonical Golden Age, which spanned the helmsmanships of Muhammad and his first four successors. Few economic institutions are even mentioned in the Qur'an, let alone specified in concrete terms. The distinguishing economic features of classical Islamic civilization evolved over the next three centuries or so, roughly through the 9<sup>th</sup> century. Key institutions were not created from scratch; each drew on pre-Islamic precedents of one sort or another. Nevertheless, this period stands out as a time of remarkable creativity.

By around 1000, then, the central economic institutions of the Islamic Middle East were in place. These were to remain critical to the region's economy until the modernization campaigns of the 19<sup>th</sup> century, launched under duress. What follows is not an exhaustive account of the region's pre-modern economic institutions. It is deliberately selective in order to put in relief the social mechanisms that kept the region from achieving economic modernization through indigenous means, without institutional transplants from the West. Like theorizing in general, a mechanism-based explanation requires the suppression of factors irrelevant to the task at hand. What, then, were the early institutions that account for the region's subsequent institutional evolution?

#### *A. Advanced contract law*

During the first few centuries following the rise of Islam, Islamic law had produced a rich set of principles, regulations, and procedures to govern contractual relationships. There were rules to support the joint ownership of property. There were also rules to support the pooling of resources for

commercial missions. Commercial partnerships established under Islamic law typically involved one sedentary investor who financed a trading mission run by a single traveling merchant. In principle, there could be more partners, but the number rarely exceeded six. In any case, the cooperative enterprise was limited to a single mission. Unlike a modern firm, it could not outlast its founders, and it had no juridical personality of its own. Nevertheless, it was well suited to the prevailing global economy. Compared to other legal systems of the time, it allowed traders and investors abundant flexibility in circumscribing the mission and setting profit shares (Udovitch, 1970).

#### *B. Finance without banks*

At the time that Islam emerged, money lending was a flourishing pursuit in the Middle East. By one interpretation of the Qur'an, Islam banned the use of interest in loan contracts. In reality, early Muslims did not agree among themselves that Islam prohibits interest in all its forms. Nor did they achieve a consensus on what constitutes interest. Notwithstanding these controversies, money lending continued, and it often involved transfers recognizable as interest. The jurists of Islam saw to it that people could borrow and lend at interest by devising, as in European territories under Christian rule, stratagems that allowed Muslims to circumvent Islam's presumed interest ban without violating its letter (Rodinson, 1966/1973). Lenders and borrowers of funds were usually individuals, although small partnerships were sometimes constituted to supply loans. There were no banks that pooled the resources of multitudes could outlive their shareholders and employees (Udovitch, 1979).

#### *C. Legal personality limited to individuals*

A striking aspect of classical Islamic law is the absence of corporate structures—collective enterprises possessing legal rights distinct from those of the individuals who finance or serve it. A corporation can make and remake its own internal rules, possess property, make contracts, and file

legal claims. Its debts are not owed by its members as individuals. Its decisions do not require the approval of each of its members. It can live on after its founders die or retire. In the absence of corporate structures, Islamic law recognized only individuals. Partners could sue one another, of course, as parties to a contract. But a partnership had no legal standing as a distinct entity. A third party could sue one or more partners, never the partnership itself.

#### *D. Shallow economic governance*

The state sought practically no role in such areas as productivity, sanitation, health, welfare, and or mass education. By modern standards, it was strikingly disinclined to serve as a provider of public or semi-public goods. Few of the great mosques, libraries, caravanserais, and charitable complexes of the time were financed or built directly by the state. Nor did the state seek to micro-manage the economy, intervening only to pursue limited ends. Muslim-ruled states of the Middle Ages followed two basic principles of governance: provisionism and fiscalism. Provisionism refers to the emphasis given to securing steady supplies of critical commodities, usually to keep urban populations content. Often it required the encouragement of imports and the discouragement of exports. Fiscalism signifies the relentless drive to raise revenue from an economy considered subservient to the treasury.<sup>3</sup>

#### *E. Arbitrary taxation and weak private property rights*

The earliest Muslim statesmen, starting with Muhammad, imposed concrete tax policies, defined in relation to commodities known in the economy of Arabia. These policies became obsolete within the

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<sup>3</sup> These are two of the three principles that Genç (2000), chaps. 1-4 identifies as the pillars of economic governance in the Ottoman Empire after it reached maturity. They apply with equal force to earlier and coeval Muslim-governed states. The last of his three principles, conservatism, was not yet an identifiable principle around 1000, which followed a period of sustained institutional innovation and development.

span of a generation, as Islam spread to areas that had spawned relatively more complex pre-Islamic civilizations—Palestine, Syria, Iraq, Iran, and beyond. Accordingly, precedents emerged quickly for adjusting tax rates and forms arbitrarily. A by-product of this situation was material insecurity, at the time a condition also common in Europe. As in other coeval civilizations, discrimination in taxation was common. In principle, Muslims paid lower taxes than non-Muslims. In practice, since rulers grabbed revenue where they saw it, applying new taxes and fees wherever possible, religious discrimination in taxation was unsystematic, and Muslims did not necessarily receive more lenient treatment. All communities also endured expropriation and the *corvée*. In times of crisis rulers might resort to confiscation or impose new taxes.

#### *F. Egalitarian inheritance system*

There are not many economic rules in the Qur'an, which is not, after all, a manual for economic management. Of the few exceptions, the most detailed and most explicit pertain to inheritance. Two-thirds of any estate are reserved according to complex rules for a list of extended relatives, including sons and daughters, parents, brothers and sisters, and often also more distant relatives of both sexes. Thus, the number of legal heirs can be large in relation to those mandated by a wide array of other inheritance practices. The individual's testamentary powers are limited to one-third of the estate. In addition, at least in the Sunni interpretation, none of the legal heirs may be included in the will (Fysee, 1964, chaps. 11-13; Mundy, 1988).

This system had a visible distributional effect: limiting the concentration of wealth. By the same token, it made it difficult to keep successful enterprises, or other property, intact over generations. True, one could hold a property undivided by forming a proprietary partnership or by having a single heir buy out the rest. Nevertheless, the system's net effect was to fragment property,

especially financial wealth. Moreover, the explicitness of the Qur'anic commandments made it unlikely that they would be challenged by wealth holders concerned about fragmentation.

### *G. Private provision of public goods through the waqf system*

A vast array of social services, including public and semi-public goods, were supplied through an institution called the waqf, known also as a pious foundation or an Islamic trust. A waqf is an unincorporated trust established under Islamic law by a person for the provision of a designated service in perpetuity (Çizakca, 2000; Kuran, 2001). One establishes a waqf by turning immoveable private property into an endowment to support any social service permissible under Islamic law: a mosque, a school, a lighthouse, an orphanage, a neighborhood's water supply, among innumerable other possibilities. The beneficiaries do not have to be Muslims.

The waqf came to play an increasingly important role in Muslim-governed states. In the memorable words of Marshall Hodgson (1974, p. 124), it became the primary "vehicle for financing Islam as a society." Hence, it is essential to review certain details about the motivations underlying its success. These were intimately related to certain institutions already discussed.

Islam's original institutions did not include the waqf, which the Qur'an does not even mention. It was incorporated into Islamic culture a century after the rise of Islam, almost certainly as a creative response to the precariousness of private property rights. The lack of safeguards against opportunistic taxation and expropriation was an enormous source of concern to high officials, many of whom were major landowners. They obviously stood to gain from a device to shelter personal assets and enhance the material security of their families. Older civilizations of the Eastern Mediterranean had developed various trust-like institutions. From these prototypes, Muslim officials of the 8<sup>th</sup> and later centuries developed a form of trust suited to their own needs.

The waqf came to be viewed as sacred on the ground that it served charitable purposes. How, then, did it serve as a wealth shelter? It protected property by constraining the actions rulers might take with respect to its assets. Precisely because waqf-owned assets were considered sacred, rulers were reluctant to confiscate them, lest they develop a reputation for impiety. Therefore, endowing property as waqf gave it substantial immunity against expropriation. But if the founder's goal was to shelter private assets for his own use (or, less commonly, *her* own use), what was gained by converting them into an endowment to finance, say, a soup kitchen? Endowing property brought the endower the privilege of appointing himself as the consequent waqf's mutawalli, or trustee and manager. The mutawalli of a waqf could pay himself a handsome salary, appoint his family members to salaried positions, and designate a single child as his successor.

In effect, the founder of a waqf could circumvent Islam's inheritance regulations. For instance, he could disinherit heirs of his choice. That was another material advantage of establishing a waqf. In so doing, then, a property owner did not simply provide charity. Solidifying his control over the disposition of his wealth, he also ensured that some of the waqf's income would accrue to himself personally, with greatly diminished risk of confiscation. Could a person found a waqf to support a soup kitchen, and then, having secured his assets, reserve 99 percent of the income for his personal pleasure? There was no formal ceiling. Yet, at most times and in most places, the prevailing norms required waqf founders to provide some meaningful service. In practice, therefore, there was a quid pro quo. In return for enhanced material security, the founder supplied social services. In the process, he unburdened the state of potential responsibilities.

The waqf system represented, in effect, an implicit bargain between rulers and their wealthy subjects. Through it rulers made a credible commitment to leave certain property effectively in

private hands; in return, waqf founders agreed to deliver meaningful social services. The system was basically decentralized; wealthy individuals provided whatever services they wanted. But rulers used moral suasion to encourage their close relatives and highest officials—groups that founded most of the largest waqfs—to make choices compatible with the state’s strategic objectives.

#### *H. Restricted legal pluralism*

From the early days of Islam in the seventh century, Muslims were required to abide by Islamic law in all spheres of life, including business. On commercial and financial matters they had no say over the legal system within which they would operate, except insofar as opportunities existed to switch allegiance from one of Islam’s four major schools of law to another. By contrast, at least in contexts free of Muslim involvement, Christian and Jewish subjects could choose among a menu of co-existing legal systems; as a practical matter, they thus possessed “choice of law.” Mixed cases—ones involving both Muslims and non-Muslims—were under the sole jurisdiction of Islamic courts.

Islamic judges, or kadis, were obligated to accept every case brought before them, even those strictly among non-Muslims. So consider an investor and a merchant, both of the Greek Orthodox faith. Like Muslims, they were free to form partnerships under Islamic law and to have their disputes resolved in Islamic courts. But unlike Muslims, they could opt to use contractual forms prevalent in their own community and have their disputes litigated in ecclesiastical courts. For reasons to be given later, it is significant that they could exercise choice of law both *ex ante* (before the stage of contract choice) and *ex post* (after agreeing to conduct the transaction under one particular law).

#### *I. Special economic privileges for Westerners*

Merchants belonging to selected Western nations, for example Venice, enjoyed extraterritorial legal privileges, which enhanced their incentives to do business in the Eastern Mediterranean. These

privileges included security of life and property, tax breaks, exemptions from various tolls and fees, and the right to operate courts of their own to handle cases among themselves. Initially such privileges came with reciprocal entitlements for Muslims.

#### **Four Puzzles**

These institutions helped to determine not only the Middle East's economic performance around the 10<sup>th</sup> century but also its possibilities for institutional development. Meanwhile, in the West an overlapping, yet not identical, institutional endowment was galvanizing an extended transformation that was to culminate, a millennium later, in the modern economy. Toward the end of this process, in the 19<sup>th</sup> century, the West used its by-then enormous institutional advantages to establish domination over the rest of the world, including the Middle East. In the course of the colonization process, as the limitations of the Middle Eastern economy gained increasing exposure and recognition, changes occurred also in the balance of economic power between the region's principal religious communities. In particular, Christians and Jews pulled ahead of Muslims, as groups. The rise of the religious minorities was especially clear in commerce and finance—sectors in which, prior to the 18<sup>th</sup> century, no major community enjoyed clear dominance. As the West became an economic powerhouse, Middle Eastern minorities came to play highly disproportionate roles in various lucrative areas, including trade with the West, local commerce in the largest cities, banking, and insurance.

What elements of the Middle East's initial economic infrastructure differed from their counterparts in the West? Which ones were functionally similar? Answering these questions will provide vital clues as to why the Middle East lagged in economic modernization.

To start with the similarities, and following the previous section's order, contract law was essentially identical, and in neither region did the financial sector include banks. In both the Middle East and Western Europe governments provided few social services, and all were prone to arbitrary taxation and expropriations. Legal pluralism was the norm in both regions, in each of which courts competed over the supply of legal services. Also shared was the practice of allowing selected foreigners their own legal jurisdictions.

Against such similarities, there were striking differences. Whereas Islamic law made no allowance for corporate structures, Western cities, religious orders, and universities were getting organized as corporations (Berman, 1983, 214-21 and 239-40). If only because the Bible does not specify a system for disposing of estates, inheritance practices were far more diverse and variable in the West than in the Middle East. The Western trust developed later than the Islamic waqf, and the incentives for establishing a trust were relatively more limited (Kuran, 2001, 876-83). Our challenge now is to show how distinguishing elements of the Middle Eastern economic infrastructure, combined with elements shared with the West, kept the Middle East from achieving economic modernization on its own, without depending on innovations generated elsewhere. As a prelude to identifying distinct mechanisms that contributed to the Middle East's institutional stagnation, I identify four puzzling contrasts of the 19<sup>th</sup> century. The rest of the article explores the mechanisms responsible for the intriguing differences.

First of all, by the 19<sup>th</sup> century French, English, and other Western enterprises established to pursue production or trade were much larger in size and far more durable than those of the Middle East. Joint-stock companies and corporations were being formed through the mobilization of vast resources. These enterprises had long time horizons conducive to projects with long gestation

periods. Durable financial organizations identifiable as banks were in operation. Stock markets had been formed, allowing co-owners opportunities for convenient liquidation. As for the Middle East, it had not undergone such organizational developments. Although wealthy people invested in production and consumption, there were no examples of resource pooling involving mass participation. Pooling on a small scale took place through ephemeral partnerships of the sort known already a millennium earlier. There were no stock markets, no banks, and not even resource-pooling instruments we would now, with the benefit of hindsight, characterize as fundamental innovations. Here, then, is the first puzzle demanding a solution. *If institutions to support private contracts and resource pooling were once essentially the same in our two regions, why did the Middle East not undergo an organizational revolution?* The observed differences in evolutionary paths must have been due to something distinct from contract law, yet affecting its use.

In the 19<sup>th</sup> century another striking characteristic of the Middle East concerned the delivery of modern social services. The waqf system failed to supply new services being provided in the West on a large scale, for instance, street lighting, piped water, modern sanitation, and mass education. Unlike Western municipalities and other governmental agencies, which were authorized to tax constituents, change their own budgets, and impose ordinances, the waqf system did not make the necessary adaptations. The reason was not a lack of resources. Rather, existing resources were not being reallocated properly. *Why did Islam's once spectacular system for delivering social services become dysfunctional?*

The third puzzle is that, at the dawn of the modern global economy, there was less material security in the Middle East than in the West. This was not simply a matter of disorder on trade routes. Arbitrary taxation was more common in the Middle East, and so were expropriations. Bribery

was also endemic. In the West, there had been successful efforts to make governments respect private property rights and to limit taxation. Corruption was less common. Democratic rights had emerged, making governance less arbitrary. *What explains why efforts to bind the hands of the state far less organized in the Islamic world and much less successful? And why did the rule of law remain limited?*

As the Middle East fell into a state of underdevelopment, foreign merchants and financiers came to play a growing role in its economy. This was a reflection of Western institutional advances in the face of the stagnation of economically critical Middle Eastern institutions. Meanwhile, local religious minorities began to register economic advances relative to the Muslim majority. *Was it a coincidence that local Christians and Jews advanced as groups just as the West was establishing domination over the region? Was it a matter of religious favoritism?*

Resolving our first two puzzles will contribute also to resolving the third and fourth. It is worth noting in advance that the arguments in store do not presuppose that Islam retarded the Middle East's institutional evolution directly or intentionally. None stems from a premise that Islam, or "Islamic culture," was incompatible with innovation and enterprise. In any case, such an assumption would conflict with the dynamism of Islam's first few centuries. Nor will the approach imply that the impasses reached as a result of the West's evolution could have been foreseen at the beginning of our period, the year 1000. Certain economic institutions of classical Islamic civilization, I will show, interacted in ways that blocked adaptations that we now recognize as critical to economic modernization in the West.

### **Stagnation of Islamic Contract Law**

The main form of commercial partnership used in the Middle East around 1000, the *mudāraba*, served to pool the capital of one or more investors with the labor of one or more traveling merchants. According to the Islamic law of partnerships, it became null and void if any partner died before completion of the contracted mission. The assets of the partnership then had to be divided among the surviving partners and the heirs of the decedent. In principle, the living ex-partners and the heirs of the deceased partner could complete the interrupted mission under a new partnership. The renegotiation costs in question depended on the number of heirs. If the dissolved partnership had two members, and the deceased partner had six heirs, seven people would have to agree to continue the enterprise and to a new division of profits. If instead the decedent had a single heir, the renegotiation would take place between just two people. Holding all else fixed, two people will reach an agreement more easily than seven. By implication, the fewer the number of heirs the greater the chances of completing the initially chosen mission.

The prevailing inheritance system will matter, then, to contractual practices. The higher the number of potential heirs, the greater the threat of early termination; partners will recognize that if lots of people have claims on their partnership's assets, the resolution will get complicated, imposing high costs on all involved parties. They will recognize also that the larger the partnership, the greater the likelihood of a premature death within their ranks and, hence, the more likely the mission's early termination. Thus, where heirs are likely to be numerous, there are incentives to keep partnerships small as a means of limiting the risk of early termination. In mandating the division of estates among a potentially very long list of relatives, the Islamic inheritance system thus created a basis for keeping partnerships small.

More important in the long run than this static consequence were a host of dynamic

consequences. The prevalence of small partnerships kept the Middle East free of the challenges of organizational development. In the absence of expanding partnership size, no need arose, for instance, to develop standardized accounting techniques, create hierarchical management practices, or address problems of multi-polar communication. In other words, it was unnecessary to search for increasingly sophisticated organizational forms. Well-adapted to the environment in which it achieved its classical form, Islamic contract law thus stagnated over the subsequent millennium. The roots of this stagnation lay, as we have seen, in the Islamic inheritance system. Designed to fragment wealth, it had the unintended effect of squelching organizational innovation.

As Islamic contract law stagnated, Western Europe experienced a long string of innovations that were to result in new partnership forms designed to accommodate more members; joint-stock companies that effectively allowed partners to withdraw without requiring the remaining partners to re-organize; and, eventually, business corporations with lives of their own. What caused the Western and the Middle Eastern organizational trajectories to differ so strikingly is not that the essence of contract law was initially different. Around 1000, in Western Europe, as in the Middle East, a partnership became null and void with the death of a partner. The roots of the observed divergence lie in differences between inheritance systems. Unlike the Middle East, Medieval Europe had a huge variety of inheritance laws, none clearly anchored in the Bible. It was possible to vary inheritance practices to meet perceived needs. Accordingly, Western Europe saw the development of diverse inheritance regimes conducive to large partnerships. Certain regions adopted primogeniture—the practice of leaving all income-producing wealth, if not the entire estate, to the oldest son. When a partnership had to be dissolved due to a death, primogeniture allowed the deceased partner's share to pass to a single heir, thus facilitating the mission's continuation. It also made large enterprises more

reliable relative to those in the Middle East, so people were less reluctant to form them.

It is the dynamic consequences of the growth in enterprise size that account for the Western lead in developing modern forms of organization. As Western commercial and financial enterprises expanded in size, new communication problems called for creative solutions, such as multi-divisional management. Another new need was the simplification of the process for share transfers. Court systems thus came under pressure to recognize rules suitable to business enterprises much larger and much more complex than a simple partnership established to pool resources on a temporary basis. In sum, Western Europe experienced chains of organizational advances that were absent from Middle East.

Although the starting points of contractual law were similar, because of different inheritance regimes they followed very different evolutionary paths. Neither these paths nor the consequent cross-regional divergence in commercial and financial performance was predictable in 1000. Although the architects of the inheritance systems practiced in Europe and West Asia must have been aware of the consequences for enterprise size and longevity, they could not have anticipated the dynamic processes in store. Just as Western designers of primogeniture could not even have envisaged the institutions of the modern economy, the interpreters and enforcers of the Islamic inheritance rules could not have imagined that they would leave future merchants and financiers seriously handicapped in their dealings with Westerners. The grand mechanisms responsible for the organizational divergence between the two regions were neither intended, then, nor designed. Though intelligible with the benefit of hindsight, they are largely by-products of numerous and mostly disconnected adaptations spread across many centuries.

## **Dysfunctional Waqfs**

The vast waqf system of the Middle East produced adverse organizational consequences of its own. Remember that this system, which came to control vast resources, entailed an implicit bargain between rulers and the rich. In particular, wealthy people delivered social services, thereby enhancing the regime's security; in return, they themselves gained property rights, including the right to make bequests to people of their own choosing.

If the waqf's functions were fixed in perpetuity, the goal was to help solve a vexing principal-agent problem. The state ensured that the founder, upon taking over as mutawalli, did not violate his side of the implicit deal by diverting resources away from the uses stipulated in the waqf deed. And the founder himself ensured that his successors, serving as his agents, remained faithful to his initial intentions. In principle, therefore, neither the founder nor any mutawalli could alter the waqf's mission or its management. If the founder had specified the workforce, one could not add a new employee to meet a new need; and if new technologies made it optimal to operate on a large scale, small waqfs could not merge to pool their resources. The founder's stipulations had to be followed to the letter. An added difficulty lay in the lack of corporate status in Islamic law. The traditional waqf was a partial exception, for it could outlive its founder. Unlike a genuine corporation, however, it lacked legal status as an organization. Possessing no power to make or remake its rules of operation, it could not redefine its mission to exploit new opportunities.

In a fixed economic environment—one with unchanging technologies, demand patterns, and supply conditions—this limitation may not have mattered much to economic performance. Under the rapidly changing economic conditions of the 18<sup>th</sup> and 19<sup>th</sup> centuries, it proved disastrous. Indeed, the system locked resources into uses decided centuries earlier, and many once-beneficial waqfs became

dysfunctional. A glaring manifestation of this inflexibility is the waqf system's slowness in providing new urban services; neighborhoods opted to establish Western-style municipalities precisely because of difficulties in getting existing waqfs to modify their services and procedures.

In practice, of course, the system was not totally rigid. For one thing, waqf deeds contained ambiguities that allowed mutawallis some discretion. For another, the judges empowered to oversee waqfs sometimes looked the other way as mutawallis made modifications. But these methods of legally contestable change imposed costs on waqfs. Exploiting their authority to veto waqf decisions, judges could demand bribes. In the West, one might observe, there were similar obstacles to resource reallocation. The rigidity of trusts is an often repeated theme in European economic history. Even today, university endowments contain restricted accounts to support awards for students in disciplines whose popularity has shrunk enormously. The difference is that in the Islamic world the waqf absorbed a much greater share of society's resources. In the West, as the second millennium progressed, many social services were provided by self-governing organizations. So fewer resources were tied up in inflexible trusts. Also, the greater variety of organizational forms allowed more experimentation in the delivery of services.

By the 19<sup>th</sup> century the weight and rigidities of the waqf system were well understood among Middle Eastern policy makers as well as foreigners who carried influence over them. This is why powerful constituencies developed for supplying new services through alternative organizational forms financed partly by dismantling the waqf system. The weight of the system was a long-term consequence, of course, economic behaviors induced by weak private property rights and sharply restricted testamentary freedoms. Enormous resources flowed into waqf formation to achieve greater material security and circumvent inheritance regulations. The economic environment in which the

waqf system emerged was, of course, slow-changing. This system became a serious obstacle to development only when the pace of economic change reached levels scarcely imaginable a millennium earlier, at its inception.

Why did the Islamic waqf not evolve into a genuine corporation able to make and remake its own rules, change its mission, and reallocate resources of its own will? The most obvious factor is that there were no corporate models to imitate, which meant that the required institutional leap was enormous. Precisely because the concept was alien to the social system, to demand structural reforms was to risk being accused of irreligiosity. In the West, by contrast, as early as the 10<sup>th</sup> century there were organizations chartered as corporations. More important, perhaps, is that the most common responses to waqf rigidities—exploiting ambiguities in the founder’s stipulations, waiting for a sympathetic judge, making modifications surreptitiously—dampened pressures for fundamental institutional reform. These more or less illegal practices also generated a vast group with a vested interest in preserving the existing system. They fought ferociously when their privileges came under challenge. In sum, the quick fix of corruption inhibited efforts to find a low-cost solution to the problem of achieving flexibility.

### **The Retardation of Modern Rule of Law**

The rigidities of the waqf system had some additional lasting consequences, also unintended and unanticipated. The observed administrative pragmatism often came about through illicit acts. These contributed to a culture of corruption, which, especially after the 16<sup>th</sup> century, local and foreign observers stressed *ad nauseum*. A culture of corruption raises the costs of making and enforcing laws. Since laws are commonly evaded, law-breaking brings no major stigma. Consequently, it is

relatively hard to get people to obey new laws; rules and regulations enforced at low cost elsewhere remain only on the books. Middle Eastern regimes adopted new legal codes in the 19<sup>th</sup> century, but practices changed slowly. Laws transplanted from Western Europe did not alter legal procedures overnight.

Nor was this all. Given the waqf's enormous economic significance, its failure to become a self-governing unit left the Islamic world without a strong "civil society." In its most common usage, civil society consists of social organizations outside of direct state control. Forming an extended network of free associations, it serves two functions simultaneously. Meeting the fine-grained needs of diverse and possibly overlapping sub-communities, it also serves as a bulwark against despotism (Tocqueville, 1840/1945, 94-110.). Very early in Islamic history, in the 8<sup>th</sup> century, the waqf system had put in place one element of a strong civil society: the freedom to found non-governmental organizations of one's choice. At the same time, it inhibited organizational autonomy, keeping established waqfs from remaining socially efficient. In addition, it kept waqfs from becoming a political force for democratization. During the European Middle Ages, civil society would not have appeared appreciably weaker in the Middle East. Over the long run, however, even small social differences can be enormously consequential by affecting the path of institutional development.

The mechanisms discussed thus far shed light on yet another difference between the trajectories of our two regions. It is that limits on the powers of rulers developed more slowly in the Middle East than in Western Europe. This is not the place to review the transformation of the West, on which a vast literature exists. Three observations are uncontroversial. First, economic security and democratic rights emerged gradually, over many centuries. Second, they required epic struggles between rulers and the ruled. The peoples of England, France, and their neighbors fought hard and

long for democratic rights. In particular, they struggled for judicial independence and for the right to sue royalty in independent courts. They strove also to prevent arbitrary government through institutional checks and balances. Finally, many land owners and merchants stood at the forefront of these struggles. They financed and led campaigns to de-legitimize, undermine, and constrain capricious rule.

Why did analogous developments not take place in the Islamic world? Why was the first parliament of the Middle East—the Ottoman parliament in Istanbul—established only in 1876, and under Western influences? Why, at the start of the 19<sup>th</sup> century, did taxation remain relatively arbitrary? Critical components of the answers lie in the evolutionary mechanisms already described.

Because Islamic contracts represented ephemeral agreements, the Middle East did not generate commercial or financial enterprises capable of indefinite survival. This hindered the formation of lasting political coalitions outside of state control. A difficulty is that there existed few wealthy merchants with enough of a personal stake in democratization or in the strengthening of property rights to lead and finance political struggles toward these ends. By the logic of collective action, the public goods produced by such struggles create incentives to engage in free riding, except in players with an enormous stake in the outcome (Olson, 1971). Insofar as Islamic law prevented the emergence of large and durable enterprises, it also hindered, then, the advancement of individual rights, both political and economic.

As we have seen, the Islamic inheritance system played a key role in keeping Islamic partnerships small. Indirectly, we now see, it blocked paths to stronger individual rights. The Islamic inheritance system caused this blockage also by fragmenting any private fortunes achieved against all odds. Though difficult, it was possible for a merchant to amass a fortune through hundreds of

concurrent and consecutive partnerships. The resulting fortune could not last, however, because upon his death the merchant's wealth got divided among many heirs. Typically a successful merchant had many children, often from multiple wives, which increased the likelihood of fragmentation.

The waqf system compounded the obstacles to advancing democratic rights and strengthening private property rights. In the pre-modern Middle East, the waqf was used on a very large scale to shelter private wealth, especially privately owned real estate. Unlike commercial wealth, real estate could be preserved intact within waqfs. So the waqf could have provided the economic basis for a private coalition to check the power of rulers. Alas, the waqf lacked the necessary flexibility. The requirement to follow the founder's wishes to the letter would have limited opportunities to channel resources into political causes.

In any case, by its very nature the waqf weakened individual incentives to struggle for private property rights. After all, the mutawallis and beneficiaries of waqfs included people who had no pressing need for private property rights because their resources were sheltered within a waqf. From the perspective of an individual wealth holder, using the waqf as a wealth shelter was a rational response to the prevalence of material insecurity. From a social standpoint, however, this opportunity blocked a better solution to the problem, which was to institutionalize private property rights for all. Thus, the waqf became an institutional trap. By drawing people into structures that preserved some of their wealth, it weakened their need for constitutionally enforced private property rights. In turn, weak property rights dampened the incentive to invest in industry or new technology.

Recall that the waqf served also as a vehicle to circumvent the Islamic inheritance system without violating the letter of the inheritance rules. Herein lies a second channel through which the

inheritance system blocked the advancement of private property rights. Had the Islamic inheritance system been more malleable, or more conducive to wealth preservation, the waqf system may not have been so popular, and vested interests protecting the system may not have been so strong. Wealthy people might have chosen to pass on their wealth through wills that gave their inheritors flexibility as opposed to setting up trusts that constrained the management of resources. Moreover, with larger numbers of private property owners, pressures to strengthen private property rights would have been greater.

### **Rise of the Minorities**

The foregoing interpretations shed light on why, as the West developed the infrastructure of the modern economy, the Middle East fell under its domination. By the 18<sup>th</sup> century, the West was overwhelmingly better at mobilizing and accumulating capital; its commercial and financial enterprises were much larger and more durable; and its courts were far better suited to handling disputes of the sort that arose in interactions among modern enterprises. However, nothing thus far explains why the Middle East's slip into a state of underdevelopment was accompanied by the economic advancement of its major religious minorities, including Greeks, Armenians, and Jews. Making sense of this transformation within the local population requires attention to the last two elements of the region's legal infrastructure, as sketched at the outset.

Under Islam's characteristic form of legal pluralism, both Muslims and non-Muslims could do business under Islamic law and have disputes adjudicated before a kadi. However, only the latter were authorized to have cases decided in a non-Islamic court, by non-Muslim judges. Prior to the 18<sup>th</sup> century, on matters of interest here all minorities tended to exercise their choice of law in favor

of Islamic law. Three factors account for this pattern. First of all, relative to the decisions of non-Islamic courts, those of Islamic courts were enforced more reliably. Accordingly, Christian and Jewish subjects usually registered property claims and loan agreements in Islamic courts, which required them to abide by Islamic legal norms. Second, in certain contexts Islamic law offered at least some parties advantages lacking in its alternatives. For example, in setting profit shares the Islamic law of partnerships gives partners much greater freedom than its Jewish counterpart does. Not surprisingly, a steady theme in the pre-modern economic history of Jews living under Islamic rule is that of rabbis complaining about merchants doing business “in the manner of Muslims” (Goitein, 1999, chap. 6; Shmuelevitz, 1984, chap. 2). For another example, Jewish and Christian wives found the Islamic inheritance system appealing inasmuch as it grants daughters and wives mandatory shares in any estate. Third, and perhaps most important, the choice of law of non-Muslims did not end with the conclusion of an agreement under some other law. Because they enjoyed options both *ex ante* and *ex post*, contracts negotiated outside of the Islamic legal system lacked credibility. True, Christian and Jewish communities managed to limit opportunistic *ex post* switches through social pressures. But the threat of *ex post* switches could not be eliminated, which is why individual non-Muslims took pains to anticipate challenges under Islamic law. Thus, in dividing estates families usually took care to give women shares sufficiently large to keep them from appealing for an Islamic settlement. The courts of the minorities tended to accept such adaptations, if only because the alternative was to compound the use of Islamic courts.

Middle Eastern Christians and Jews had several complementary reasons, then, to take financial and commercial matters to Islamic courts, even when free to use the courts of their own communities. As a matter of practice, this meant that the region’s religious minorities pursued

financial affairs and did business under the legal system of the Muslim majority. They thus enjoyed the advantages of Islamic law, and endured its disadvantages, along with Muslims—an observation consistent with the lack of major gaps in economic achievement, prior to the 18<sup>th</sup> century, among the various religious communities. The sharing of legal practices also had a far-reaching dynamic implication. It meant that the minorities faced the same obstacles to indigenous economic modernization as the Muslim majority. In particular, they found it difficult to accumulate wealth and to keep successful commercial and financial enterprises going across generations. Moreover, like Muslims, they remained unmotivated to develop larger and more complex forms of pooling resources. Although Islamic legal pluralism certainly allowed the minorities to escape the dynamic limitations of Islamic law, as a matter of practice it restricted their institutional creativity as surely as it squelched the innovativeness of the majority. Under the conditions of the pre-modern Middle East, Islamic legal pluralism thus turned out to be self-destroying. Instead of stimulating legal diversity and experimentation, it reduced options and inhibited innovation by driving legal systems to become increasingly similar.

However, Islamic legal pluralism turned into an enormous advantage for minorities with the economic rise of the West (Kuran 2003b). Jewish and Christian Middle Easterners found it a simple matter to extend their customary choice of law to cover Western legal systems, especially because economic rights long enjoyed by Western traders included the privilege to settle their internal disputes in local consular courts. From the late 18<sup>th</sup> century onward, hundreds of thousands of non-Muslims, including merchants and financiers, thus switched jurisdiction by obtaining, for a fee, the protection of a European power. In the process, they became entitled to tax reductions enjoyed by foreigners. More importantly, they gained access to consular courts. Initially the latter privilege was

limited, as with the right to use indigenous non-Muslim courts, to cases involving no Muslims. Eventually, with the balance of military power between the Middle East and the West shifting steadily in favor of the latter, West Europeans managed to loosen the age-old ban against trying Muslims in non-Islamic courts. The norm came to be for all cases involving even one Westerner or Western protégé to be tried in a consular court. The jurisdiction of the Islamic courts came to be limited, therefore, to cases involving only Muslims.

What motivated local Christians and Jews to obtain Western protection was not that they felt an affinity for European culture. Rather, such protection gave them competitive advantages that enabled them to pull way ahead economically. First of all, they gained the ability to make agreements involving various new organizational forms, including complex partnerships and corporations. Second, they were able to do business with modern banks, knowing that in case of a problem they could sue in a court accustomed to treating banks as juristic persons. Third, they could purchase insurance without the danger that a judge would reject the contract as morally repugnant and legally invalid. In view of these observations, it is unsurprising that in the late 19<sup>th</sup> century practically all bankers and insurance agents in the Middle East were either Western expatriates or local non-Muslims operating under Western protection; that local representatives of Western companies were drawn almost exclusively from these two groups; that the largest and most lucrative businesses in major commercial centers such as Istanbul, Izmir, Salonika, Beirut, and Alexandria were disproportionately owned and operated by minorities; and that the advances of the minorities were particularly salient in cities that participated most heavily in commerce with the West. Not only had the minorities become measurably more productive than their Muslim competitors, actual or potential. West European banks, shipping companies, and merchants had come to prefer dealing with

them over Muslims, largely to minimize the chances of lawsuits in non-Western courts.

By the late 19<sup>th</sup> century, Muslim merchants and financiers were acutely aware of the immense handicaps they faced on account of Islamic law. They realized that the region's age-old legal infrastructure required the use of inadequate organizational forms and hindered capital accumulation. They saw, too, that existing Islamic courts were poorly equipped to litigate court cases involving recently developed business techniques or organizational forms. Accordingly, many Arabs, Turks, and other Muslims would have accepted European protection for exactly the same reasons that motivated their non-Muslim competitors: superior productivity and profitability. Alas, such a move would have entailed a huge break with a legal tradition dating back to Islam's earliest period. In any case, foreign consuls were hardly eager to sell Muslims protection, for this could get them embroiled, at the very least, in a diplomatic tug-of-war. Under the circumstances, for Muslims the only way out was to broaden the available indigenous legal systems. The first major reforms came in the mid-19<sup>th</sup> century, with the establishment of new commercial courts in Istanbul, Cairo, and Alexandria. Authorized to try cases according to a commercial code largely transplanted from France and without regard to the religious affiliations of litigants, these new courts effectively narrowed the jurisdiction of the traditional Islamic courts, setting a precedent for later curtailments. In some places, beginning with Republic of Turkey in the 1920s, Islamic law was ultimately abrogated. Where it has survived, as in the Arabian monarchies, it has been modified beyond recognition in areas of relevance here (Comair-Obeid, 1996; Wilson, 1983). The corporation is now an acceptable and popular organizational form. Insurance contracts are legally enforceable. Banks are integral components of every economy. And contracts involving interest payments are commonplace, although in certain contexts and places such payments are disguised as

“commissions” or “fees.”<sup>4</sup>

Nothing in the foregoing account presupposes, as disturbingly many contemporary writings on the plight of the Middle East do, that Islam is hostile to commerce, or that it discourages wealth creation, or that it promotes irrationality. To be sure, Islam, like other religions, harbors elements inimical to economic productivity and efficiency. But these have not formed an absolute barrier to economic growth or creativity. This is easily seen by examining the whole of the Middle East’s economic history since the rise of Islam, as opposed to the last quarter-millennium in isolation. Only recently has this region qualified for the characterization of “underdeveloped.” What made the Middle East fall economically behind is not only that its own legal infrastructure essentially stagnated but that in another part of the world—the West—a similar, but not identical, institutional endowment carried within it the seeds of economic modernization. For the Middle East, as for the rest of the non-Western world, the West’s transformation presented at once an immense problem and a golden opportunity. It became a problem, because *relative* economic weaknesses set the stage for a host of military, political, and cultural challenges from the West. And it created a fantastic opportunity for modernizing in a hurry, simply by borrowing modern institutions that in the West developed slowly, over many centuries. In principle, the Middle East’s underdevelopment could have been short-lived. It could have been overcome soon after it caught local attention, simply through institutional transplants.

### **The Persistence of Middle Eastern Underdevelopment**

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<sup>4</sup> For an overview of the region’s economic transformation that began in the 19<sup>th</sup> century, see Owen (1993).

If the Western legal infrastructure has already been transplanted to the Middle East, why does the region *remain* underdeveloped? Why is the process of catching up proving so arduous?

First of all, to transplant a legal code is not the same thing as appropriating the entire social system to which it belongs. Just as the performance of a computer depends on the software loaded into it, that of a given legal code depends on the norms, or shared understandings, of the community putting it to use (North, 1990, chap. 5; Platteau, 2000, chaps. 5-7). Thus, the availability of modern organizational forms is a necessary, but not sufficient, condition for having a vibrant civil society capable of monitoring and reining in the state. Precisely because the Middle East began to modernize without a strong civil society, states took the lead in many economic sectors that, in the West, had developed outside the state's direct purview. Whatever the immediate benefits, the consequent extension of governments' economic reach delayed the growth of civil society. Equally critical, it fostered suspicion of privately organized social movements, criticism of the state, and political decentralization—all factors that contribute to self-correction and innovation. The commonness of autocracies in the Middle East stands then, among the continuing legacies of traditional Islamic law. The same can be said about the fragility of its few existing democracies.

For another example of how local norms may diminish the performance of a transplanted institution, consider the establishment, in the mid-1800s, of Turkish and Egyptian commercial courts modeled after those of France. The judges appointed to serve on these courts did not become proficient at applying the new commercial code overnight. More critical, local norms of fairness, responsibility, and procedural correctness did not change immediately. The notion of holding a judicial person responsible for an adverse externality, as opposed to a natural individual or group, has taken time to take root in the region's legal culture. Likewise, the acceptability of nepotism has

proven resilient, all the more so in small towns and villages. And judicial corruption remains rampant, partly because both state employees and their constituents find it relatively easy to personalize exchanges involving judicial persons. The prevalence of corruption in the Middle East shows up in the “Corruption Perceptions Index” of Transparency International, an organization that monitors the business climate in most major countries. According to this index, businessmen consider corruption a significantly greater problem in the Middle East than in Western Europe. On a zero to ten scale running from most to least corrupt, the surveyed countries of Western Europe received an average score of 7.7 in 2000, as against 4.3 for the five predominantly Muslim countries of the Middle East (Transparency International, 2000). Evidently the culture of corruption fueled, over many centuries, by the rigidity of the waqf system lives on, many generations after that system was largely dismantled in the course of successive institutional reforms. Modifying the region’s cultures has proven more difficult than rewriting formal laws.

The very condition of economic underdevelopment has created problems that have discouraged reforms. Making the region chronically vulnerable to outside interference, and many individual countries ever dependent on outside protection, it has bred complacency toward autocratic rule. The underlying logic is that democracy, by exposing political cleavages, may breed instability, becoming itself an obstacle to growth. The current predicament of Iraq offers a case in point. Together with perceived American designs concerning Syria and Iran, the ongoing occupation of Iraq has sown massive fears of broader American occupation (*Economist*, June 7-13, 2003, pp. 26-27). And this has compounded the task of instituting fundamental reforms. Ambitious reformers risk being accused of undermining unity and exposing the region to more external meddling.

The region’s economic failures, combined with associated political insecurities, have also

contributed to the rise of Islamism—a now-global movement that aims to restore the primacy of traditional Islam in everyday life by shielding Muslims from the transformative influences of globalization and regulating interactions with non-Muslims. In view of the Islamist conception of an unchanging religion, one might think that Islamists are eager to restore pre-modern economic relations. In fact, they have no problems with corporations, joint-stock companies, stock markets, or modern accounting systems, among many other novelties of the past two centuries. Their opposition to the modern economy is heavily concentrated on a few pet issues: the immorality of interest and insurance, the unacceptability of prevailing inequalities of wealth, and the destructiveness of unregulated advertising and consumerism. Even on these issues, however, Islamists are divided among themselves, with some displaying acceptance of modern practices that others condemn as un-Islamic (Haneef, 1995; Kuran, in press). And even the more militantly anti-modern Islamists have generally failed to reverse past economic reforms. Islamism has harmed development primarily by inducing policy makers, including secularists, to shy away from reforms that might subject them to charges of impiety. It has thus reduced experimentation and discouraged creativity.

Of the institutions identified as obstacles to indigenous economic modernization in the Middle East, one that remains largely in place is the Islamic inheritance system. Even in countries that have repudiated Islamic law to one degree or another, the prevailing inheritance system shares basic features with the traditional Islamic system, including rules against disinheriting family members. Does this mean that inheritance practices are a continuing cause of economic backwardness? Such an inference would be unjustified, for the argument developed earlier in the paper pertained to the *emergence* of more advanced organizational forms. Once the corporation and the joint-stock company have entered the menu of available organizational options, the Islamic

inheritance system need not remain a problem in regard to enterprise continuity or longevity. After all, share ownership in corporations and joint-stock companies tends to be very fragmented anyway; it does not depend on cross-generational share transfers. If a wealthy decedent's shares in a corporation get divided among his ten heirs, that corporation's management need not become more difficult; the fall in ownership concentration may even simplify it by enhancing the ability of to resist pressures from shareholders. Where the Islamic inheritance system remains a salient problem is in the fragmentation of agricultural land into uneconomical plots. The resulting inefficiencies are dampened, however, through land markets that serve to reconsolidate fragmented land.

The fact that the Islamic inheritance system is no longer an obstacle to forming large, complex, and durable commercial enterprises does not mean, however, that its effects on the region's commercial life have been overcome. One of its major consequences had been to hinder the accumulation of private capital, especially by Muslims. At the start of the 20<sup>th</sup> century, an overwhelming preponderance of the large commercial enterprises in the Middle East was owned either by foreigners or by local religious minorities. With the departure of huge numbers of these entrepreneurs through population exchanges (most importantly, the Turkish-Greek population exchange of 1922-23), the spread of diverse nationalisms partial to Muslim nationals, and emigrations associated with the creation and Arab rejection of Israel, the region's private sectors have been accumulating capital from a low base. The state-centered development programs of many countries, it might be said, hindered the growth of private sectors. True enough, but state-centrism went as far as it did, and numerous economies of the region continue to be state-dominated, because the states formed after World War I had weak private sectors to start with. And that weakness was a legacy of the region's age-old inheritance practices.

The weakness of the region's private sectors was not just a matter of low physical or monetary capital. Human capital, too, was low by the standards of the developed world, including skills essential for success in modern global markets. Partly because of past passivity in international markets, knowledge of foreign languages and of the outside world was limited, making it difficult for local merchants to secure footholds in external markets. Compounding the problem is that they lacked a major presence in established global networks. In spite of a few bright spots, one of which is the Middle East's heavy share of the global oil market, most of the region's private sectors thus remain conspicuously isolated from the global economy. Developing the required skills has been hampered also, of course, by poor incentives caused by state-centered development policies.

The foregoing interpretations carry both an optimistic message and a pessimistic one. To start with the bad news, lifting the region from its state of underdevelopment is not a task achievable in the near term. Even if all the bad government policies in the region were to disappear today, strong private sectors and civil societies could take decades to develop. The good news is that the necessary economic policy reforms can be accomplished without having to take on Islam as a religion. Whatever the outcome of ongoing struggles to define what Islam stands for in other areas—education, women's rights, expressive freedom—key economic institutions were borrowed sufficiently long ago to make them seem un-foreign. Equally significant, given Islam's long tradition of leaving the economy largely unregulated by the state, it is hard to make a case that promoting private enterprise conflicts with basic Islamic principles.

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