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Institutional Causes of Economic Underdevelopment in the Middle East: a Historical Perspective*

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1 The puzzle of Middle Eastern economic underdevelopment

To anyone who knows the Middle East, broadly defined to include North Africa and the Balkans, it is a puzzle that the region became and remains economically underdeveloped. Visit any major city in the region – Cairo, Aleppo, Istanbul – and you will encounter big covered bazaars, centuries old. Istanbul's stunning Grand Bazaar, whose core was built in the 1460s, boasts more than 4000 shops. Wandering in its vaulted streets, you appreciate the major commercial centres that the region has had. Travellers and resident foreigners of the sixteenth century marvelled at the size of the markets and at the variety of commodities traded. They were also impressed by the prevailing living standards. None considered the region economically backward. Admittedly, some foreigners were critical of Islam, or of 'the Turk' who by then ruled much of the region, or of handicaps endured by visiting merchants. However, informed foreigners did not consider Islam inimical to wealth creation or the region's institutions harmful to economic activity.

Yet, subsequently the region's economic output per person failed to keep up with that of countries now categorized as 'developed'. It fell behind Western Europe, and in the late twentieth century behind parts of East Asia as well. Except for a few sparsely populated oil exporters, no predominantly Muslim country, in the Middle East or elsewhere, currently ranks among the countries generally considered developed.

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2 Searching for historical causes

To identify the sources of the Middle East's decline in economic standing, it helps to know when the slippage began. It was in the late eighteenth century that outsiders began to hint in unison that the region was relatively poor. Impressions can mislead, but work by economic historians confirms that in this case they were empirically sound. Modern economic growth had already taken off; in the nineteenth century Western Europe grew steadily faster than the Middle East and the divergence continued into the twentieth century (Özmucur and Pamuk, 2000; Easterlin, 1996). In the late eighteenth century, as various data show, certain developments came together to make Western Europe more hospitable to growth than elsewhere.

What is unique about this period of divergence in living standards? The eighteenth and nineteenth centuries mark the Industrial Revolution, whose hallmark was mass production based on new technologies. The new technologies emerged in Western Europe, which by then had the organizational means to exploit them. England, the Low Countries, and the rest of the region could finance mass production. They could mobilize the savings of large numbers and channel them into large projects. And they could pool the labour and capital of large numbers within indefinitely living companies (North, 2005; Lal, 1998; Mokyr, 1990; Jones, 1987).

These are capabilities now taken for granted, but they posed immense challenges in some parts of the world, including the Middle East. The new physical technologies were easily transferable. One can transport a steam engine on a ship, along with the technicians and raw materials needed to make the engine productive. By contrast, the organizational vehicles of economic advancement – the institutions that enabled the West to exploit the new physical technologies – cannot be readily transferred. A viable stock market cannot be established overnight, for it requires an intricate legal system; also a range of specialized professions, including schools to train them, must support its operation.

As growth took off in the West, the Middle East lacked the organizational capabilities to use the technologies of modern industry. To make matters worse, these could not be borrowed at will. Thus the Middle East was an economic laggard during the Industrial Revolution.

Two critical institutions blocked adaptations during the Industrial Revolution: the region's law of commercial contracts and its distinct form of trust, the *waqf*. Both institutions were elements of Islamic law, the region's dominant legal system after the rise the Islam. Neither had changed significantly over the previous millennium, and in the nineteenth century both became the focus of legal reforms aimed at stimulating economic development through secularization. Accelerating the growth process required, reformers of the period thought, modifying these Islamic institutions in the light of new global realities. Indeed, to understand why the Middle East fell

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behind during the Industrial Revolution we must identify the static and dynamic consequences of these two institutions. We must set out, that is, the short-term outcomes they enabled and blocked, and also their long-term effects on economic modernization.

3 Commercial contract law

By the start of the second millennium, Islam had generated a law of contract that enabled the pooling of labour and capital through partnerships. Under the system enforced through Islamic courts, investors who could not, or did not want to, exert physical effort financed merchants and producers lacking the capital to undertake profit-oriented ventures (Udovitch, 1970). What is striking about the consequent partnerships is their small scale and short duration. Known as *mudaraba*, the typical partnership involved two people: a sedentary and passive investor, along with an active labourer. Their profit shares, which could be unequal or contingent, were set in advance and losses were shared up to a point. Whereas the active partner carried unlimited personal liability, the liability of the passive partner was limited. In particular, the latter risked only the capital that he placed at the partnership's disposal.

Islamic partnership contracts were enforceable over a vast area. As merchants and producers moved, they carried their law with them, helping to spread Islam. In time, it would become possible to conduct commerce under a more or less uniform legal system over a vast area stretching from Morocco and Spain to India and Indonesia. Initially at least, Islamic partnerships did not hinder Middle Eastern capabilities in exchanges with Westerners. Around the start of the second millennium, essentially the same partnerships were used throughout the Mediterranean basin. In twelfth-century Venice the institutions governing resource pooling did not differ fundamentally from those of Baghdad (Pryor, 1977; Çizakça, 1996).

Islamic law did not put any limits on the number of people who could contribute labour or capital to a commercial partnership nor restrict how long the partnership would last. It was legal for 50 people to pool labour and capital for a trading mission expected to last three years. As a matter of practice, however, the number of partners was usually two; in historical records, rarely do we encounter partnerships with more than five members. Moreover, the typical partnership was established to pursue a mission with an expected duration of at most a few months, such as a trading venture between Cairo and Aleppo.

At the end of an Islamic partnership its members could form a new partnership. In the medieval Middle East recontracting was possible and did occur. Yet, a medieval partnership was not what we now call a firm. Lacking legal standing, it had no life of its own. If a partner died before the contract had been fulfilled, the partnership ended, the assets were divided,

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and the deceased's share was distributed among his or her heirs. Whether the interrupted business activity was restarted depended on the prevailing inheritance system.

4 The Islamic inheritance system and its impact on modernization

After the rise of Islam, the dominant inheritance system in the region was the Islamic inheritance system. According to rules outlined in the Qur'an, two-thirds of any estate is reserved for children, parents, spouse(s), and possibly other relatives. For any category of relatives, the share of a female equals half that of a male. Thus, a daughter gets half as much as a son, and a sister half as much as a brother.

By medieval standards, this system was remarkably egalitarian. It did not allow a parent to favour one child over others. No relative entitled to a share could be disinherited (Powers, 1999). On the downside, the system made it difficult to keep property intact from one generation to the next. Although ways existed to circumvent the egalitarian provisions of the inheritance regulations (e.g. *inter vivos* gifts to minor grandchildren), they all had serious drawbacks of their own. Consequently, successful businesses tended to fragment after their founder's death.

In principle, the heirs of a successful producer or merchant could reconstitute his liquidated business. But the larger the number of heirs, the higher the reconstitution costs were. Successful businessmen – those who commanded abundant capital – were most likely to have many heirs, if only because they tended to have multiple wives. So the death of a partner was especially problematic if he was a successful businessman, in that untimely termination was especially likely to impose substantial reconstitution costs (Kuran, 2003).

If premature dissolution of partnerships was costly, their members would have tried to reduce the risks involved. These risks rose with partnership size, in that the probability of at least one death increased. The risks increased also with the duration of the partnership's business agenda. Thus, merchants, producers and investors could all minimize their risks by keeping their partnerships small and limiting their duration.

In the Middle Ages, premature dissolution could pose problems in Western Europe as well. Italian partnerships known as *commenda* became null and void if a partner died. However, inheritance practices differed between the Christian- and Muslim-dominated shores of the Mediterranean. Because the Bible does not explicitly specify an inheritance system, on matters of inheritance there was much more experimentation in Western Europe. Accordingly, inheritance practices in France, England, the Netherlands, Germany and elsewhere varied greatly over both space and time. In some places, including those that led the Industrial Revolution, a common practice

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was primogeniture, under which a deceased's business could fall in its entirety to his oldest son. Primogeniture greatly reduced the risks of premature partnership termination. It allowed a partner to pre-commit credibly to having a son take over in the event that he himself could not continue. It made it profitable, therefore, to form large business enterprises expected to last for years, as opposed to mere months.

Over many centuries, the consequent interregional difference in the scale and duration of business activity had a huge impact on business practices. In the West, precisely because businesses expanded and gained longevity, pressures arose to develop more advanced commercial institutions (Hunt and Murray, 1999). Thus, standardized accounting methods were developed to facilitate communication among growing numbers of business partners and changes in their ranks. Likewise, stock markets developed to provide liquidity to people who invested in long-lived enterprises. In the Middle East, such innovations did not occur until the nineteenth century, essentially because the demand for organizational change was absent. Where partnerships are ephemeral and limited to at most a few people, no pressing need arises for double-entry bookkeeping because it is relatively easy for partners to agree to a simple accounting system of their own. Likewise, there is no need to establish formal equity markets as an instrument of liquidity because shares in ephemeral enterprises are already liquid.

The persistent smallness of traditional Middle Eastern enterprises also limited the division of labour. This is evident in the stagnation of the number of distinct commercial occupations. Lists of commercial occupations compiled from court transcripts, palace records, travel accounts, advice to sultans, and other written documents show that in the Arab Middle East their number stayed statistically constant between four early Islamic centuries (8th to 11th centuries) and the subsequent four-century period (12th to 15th centuries). During the same interval, the number of occupations in the state bureaucracy and the military tripled, and the number in education, law, and religion more than quadrupled (Shatzmiller, 1994). Given that division of labour is a correlate of economic dynamism, we may infer that there was enormous dynamism in certain sectors, but also that commerce was relatively stagnant.

We can hence identify a major reason why the Middle East fell behind the West. In the course of the second millennium, the West developed the capacity to form enterprises with hundreds, eventually even thousands, of employees and shareholders. Some of these enterprises lasted for many generations and by virtue of their long histories, they came to be very widely known. Because few Middle Eastern enterprises could compete with such enterprises, commerce between the Middle East and Western Europe fell increasingly under the control of Westerners (Kuran, 2003, 2005). Moreover, as the West industrialized, the Middle East could not exploit the technologies of mass production to form modern industries.

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The Middle East could not easily borrow the organizational forms that gave the West an advantage because, due to a millennium of organizational stagnation, the preconditions were lacking. Standardized bookkeeping and stock markets offer examples. Modern firms require double-entry accounting. In case of disputes, they need judges familiar with modern accounting conventions. If for no other reason, the indigenous courts were unequipped to handle financial cases involving modern firms. Likewise, the absence of stock markets made it difficult to raise the capital needed to start industrial enterprises. In sum, institutional borrowing was hindered by the lack of complementary institutions.

To sum up thus far, the Islamic inheritance system, by creating incentives to keep commercial enterprises small and short-lived, prevented the emergence of modern commercial institutions from within Islamic law. These institutions emerged initially in Western Europe, helping to make it the first region to experience modern economic growth. The Middle East could not borrow the winning institutions in piecemeal fashion. Their complementarities meant that reforms, whenever launched, would have to be wide-ranging. Hence no major reforms of direct relevance to the private economic sector were initiated until the mid-nineteenth century, by which time the Middle East was already far behind the West, as a range of economic indices demonstrated.

5 The role of attitudes

Insofar as inheritance practices mattered, the West did not leap ahead by knowingly adopting the right regime. The people who adopted inegalitarian inheritance practices such as primogeniture could not have known the institutional dynamics that would be unleashed, or the global advantages that would eventually emerge. Rather, it was greater experimentation that generated the winning combination in the West.

Nothing in the foregoing argument relies on the common claim that Islam discourages commerce. In the medieval era the Middle East was as friendly to merchants as anywhere (Rodinson, 1966/1973). Its businessmen participated heavily in, if not dominated, several of the world's major long-distance trade emporia, including the Middle East itself, and also East Africa, Central Asia, and the Indian Ocean (Ensminger, 1997; Chaudhuri, 1985). Middle Easterners were commercially so successful, in fact, that where they went in large numbers, their commercial institutions, including Islam's law of commercial contracts, went with them. Islam spread to the Far East and Africa not through the sword but primarily through trade. Vast numbers of conversions to Islam were motivated by the lure of joining Middle Eastern trade networks.

Notice also that the argument does not invoke attitudes toward innovation. The Middle East has never been opposed to innovation *per se* as a matter of general policy. Adaptations did occur as exemplified by the repeated

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adjustment of tax systems for reasons explicable through economic logic (Coşgel and Miceli, 2005; İnalcık, 1994). However, during the second millennium institutional changes occurred mostly outside the profit-driven private economic sector as evidenced by our data on the division of labour. The division of labour increased in state-controlled sectors, which points to their dynamism. By and large Muslim clerics went along with the state-introduced modifications – evidence that Islamic institutions are not inherently static and Muslim clerics not inherently conservative. If commercial laws and techniques remained stagnant, this is because, until quite late, private merchants, producers, and investors were unmotivated to demand fundamental changes.

In what ways has this history left its mark on the present? At the start of the twentieth century, native Middle Easterners, with the telling exception of religious minorities who purchased foreign legal protection, were unable to found or operate large companies (Kuran, 2004; Toprak, 1995). For this reason alone, domestic private capital accumulation was limited. Subsequently, modern economic institutions have taken root in the region; every major country now has growing stock markets, and each benefits from modern accounting systems. But adapting such transplanted institutions to local circumstances is taking time. It took centuries for the modern economy to develop in Western Europe. Given the recency of the first Middle Eastern steps toward economic modernization, it is not surprising that businessmen find the business climate less hospitable in, say, Egypt, than in developed countries.

There is, however, another channel by which the foregoing history has had an enduring effect. At the start of the twentieth century, partly because private capital accumulation was limited, civil society – the part of the social system outside direct state control – was weak. The resulting political vacuum allowed, even compelled, states to take the lead in economic development. State-centred development programmes have resulted in large bureaucracies and sharp limits on private economic freedoms. Even today, adaptations to global economic realities are slowed and hindered by the political weaknesses of civil society.

6 The *waqf*

The other Islamic institution that played an enormous role in the Middle East's economic evolution, accounting for stunning successes but also for some of the shortcomings of recent centuries, is the *waqf*, which is an unincorporated trust established under Islamic law and overseen by Islamic courts. The founder of a *waqf*, man or woman, is an owner of private immovable property – land or buildings. The purpose is to provide a service allowed under Islamic law. A *waqf* may be established to support a mosque, a school, an orphanage, a

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park, a lighthouse, a region's water supply, or a road, among other possibilities. Whatever the nature of the service, it must be provided in perpetuity.

In the pre-modern Middle East, the *waqf* permitted individuals to supply in a decentralized manner a wide variety of public goods now commonly supplied by governments. In some respects it formed an admirable system: precisely because of its lack of centralized control, it was responsive to local needs.

Over many centuries, vast resources flowed into what became the *waqf* sector. The figures are staggering. By 1700, depending on the region, *waqfs* controlled between a quarter and half of all real estate. Their income was used partly to provide social services. In 1700, when Istanbul had a population of around 700,000, 30,000 people were fed each day through *waqf*-financed soup-kitchens. Most of the centuries-old structures that tourists now admire – fountains, inns, mosques, schools, bathhouses, hospitals, even certain markets – are structures built and then operated for centuries through *waqfs*.

The *waqf* is not among Islam's original institutions. It is not mentioned in the Qur'an. The earliest evidence of its existence belongs to a century after the rise of Islam. Although the evidence is largely circumstantial, a key motivation appears to have been the quest for economic security. In the eighth and ninth centuries, when the *waqf* system took shape, private property was insecure throughout the Middle East, as elsewhere. Arbitrary taxation and outright expropriation threatened high officials, who were major landowners. These officials did what wealthy people still do: they looked creatively for a wealth shelter. The region's older civilizations, including Roman civilization from which Islam borrowed widely, had developed various forms of trust – endowments whereby a trustor set aside assets to be managed by a trustee according to his or her wishes. Early Muslims took the basic idea and developed it into a distinct and ingenious institution that achieved massive economic significance.

Why did assets become more secure when converted into the corpus of a *waqf*? Regardless of the service it provided, a *waqf* was considered sacred. Given this belief, which took root in its formative centuries, rulers were hence reluctant to tamper with *waqf* assets, lest they develop a reputation for impiety, lose legitimacy, and embolden political opposition. People endowed *waqfs* to protect their assets; in other words, to lower the probability of becoming a victim of expropriation or arbitrary taxation.

If a founder's goal was to shelter assets for his own use, what would he have gained by setting up a trust to provide a public good? Just as a *waqf* was considered sacred, so establishing a *waqf* was considered an act of piety. The founder thus obtained, in addition to inner satisfaction, social prestige. But he also achieved significant material returns (Kuran, 2001; Çizakça, 2000). The founder could appoint himself as the *mutawalli* (trustee and manager) of the *waqf* for life. In this capacity, he could set his own remuneration, appoint

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relatives and friends to salaried positions, and designate his successor. The last privilege allowed him to circumvent Islam's inheritance rules. In setting up a *waqf*, then, a property owner did not simply engage in charity, which is the impression one might derive from the historical literature. A portion of the secured income accrued to him and his family. The *quid pro quo* for the privilege of sheltering some wealth for personal use is that ordinarily he accepted certain social responsibilities.

There was no hard rule regarding the share of the *waqf* income that the *mutawalli* could reserve for personal use. Local social norms determined the limit. If he went beyond the customary level, he could draw objections, prompting the courts to intervene. This institution provided identifiable benefits to diverse political players, which is one reason it lasted so long. The wealthy obtained from the state a credible promise of material security. For its part, the state could collect taxes without providing much in return, other than law and order; cities would run on services provided by the wealthy. Finally, the average person benefited from various subsidized services. From his standpoint, this was a system that encouraged philanthropy and responded to local conditions. The system was bound, therefore, to generate coalitions with a stake in its continuation. Once in place, it would be preserved.

7 Static perpetuity

For all its strengths, this system had economic drawbacks, which became increasingly serious over time. The functions of a *waqf* had to be fixed in perpetuity, presumably to give credibility to the implicit deal between the state and the *waqf* founder. The static perpetuity rule kept a property owner from founding a *waqf* to provide a particular service and then, once the property had been secured, make self-serving changes to the *waqf* mission. Thus, the *waqf* was meant to be a rigid organization (Kuran, 2001; Schoenblum, 1999).

The consequent costs would have been limited in the Middle Ages, when demand patterns and opportunities were very slow to alter. As physical technologies and patterns of global comparative advantage started changing rapidly, the static perpetuity rule might have been expected to lock capital into seriously inefficient uses. Indeed, in the eighteenth and nineteenth centuries, when around the world resources were being reallocated to exploit new technologies of production, in the Middle East major *waqfs* became conspicuously dysfunctional. Their vast resources could not be transferred – at least not quickly – to new *waqfs*, or moved outside the *waqf* sector, in order to provide new public goods, or supply old ones more efficiently. Nor could existing *waqfs* be reinvented. Thus, *waqf*-funded schools generally did not modernize their curriculum, and *waqfs* meant to finance public water fountains were not merged to form a modern water system. Modern schools and water delivery systems emerged outside the *waqf* sector.

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In practice, of course, the *waqf* was not totally rigid. The law allowed operational changes and asset swaps in times of dire necessity. *Waqf* deeds contained ambiguities that *mutawallis* might exploit. The judges (*kadis*) empowered to stop modifications could look the other way as rules of operation and objectives underwent modification. Nevertheless, the costs of adaptation were high. Conscious of the returns to flexibility, judges often made their approval conditional on payment of a bribe. Therefore, a school established as a *waqf* exhibited greater inertia than if it had been founded as a corporation, that is, as a self-governing organization enjoying legal personhood.

8 Absence of the corporation

To put the last observation in comparative perspective, note that *waqfs* supplied services delivered in the West largely through corporations. Whereas Islamic colleges (*madrasas*) were financed by *waqfs*, the early European universities were founded as, or quickly became, corporations. In a major Middle Eastern city urban services were supplied by thousands of *waqfs*. In a Western city, similar services were provided by a municipality that enjoyed corporate powers. Mosque complexes, which delivered a huge array of services ranging from education to charity, were organized as *waqfs*. Churches performed analogous functions under corporate structures.

Forerunners of both the *waqf* and the corporation were present in Roman law. The famous law code completed during the reign of the Byzantine emperor Justinian (r. 527–65) recognizes various forms of trust as well as rudimentary corporations. Starting in the eighth century, as the Middle East was developing the *waqf* as an antidote to predatory states and unreliable property rights, central authority was relatively weak in the West. Under the circumstances, corporations emerged to supply enforceable legal systems for associations seeking to differentiate themselves from the outside world, overcome anarchy, and exercise a measure of self-governance. Two separate institutional choices, made in response to distinct local conditions, thus set the two regions on divergent organizational paths.

The divergence continued until the nineteenth century, when corporations, including the Middle East's first municipalities, began to take over the delivery of public goods once supplied exclusively by *waqfs*. This organizational transformation occurred largely because a municipality offers dynamic advantages over a *waqf* system. As a corporation, a municipality is self-governing, so it is able to make changes denied to a traditional *waqf*. A municipality can reallocate resources quickly in response to evolving demand patterns. In contrast to a *waqf*, whose expenditure patterns must conform to the founder's stipulations, it can make its own budgets. It can also impose new fees on users, or modify existing ones. Finally, it can impose ordinances, such as building codes and rules for using public goods.

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The unintended costs of the *waqf* system were not limited to rigidities in the supply of social services. If most countries of the Middle East currently have non-democratic governance systems that inhibit individual initiative and limit material security (Yousef, 2004; Arab Human Development Programme, 2002), a basic reason is that the *waqf* system hindered the development of civil society – the backbone of stable democracy. The ingredients of a strong civil society are freedom of association and organizational autonomy. In allowing property owners to choose with whom they would associate and to what ends, the *waqf* system provided a form of associational freedom. At the same time, it sharply restricted self-governance in comparison to a municipality. For one thing, the discretion of a *mutawalli* was substantially more limited than that of a mayor. For another, whereas a mayor's constituents could remove him from office, the beneficiaries of a *waqf* had no say over who would serve as *mutawalli*.

In the nineteenth and early twentieth centuries diverse reformers worked to dismantle the *waqf* system. They were motivated partly by a quest for resources to finance their modernization projects, which the *waqf* system offered in abundance. A complementary motivation was to reduce the weight of the *waqf* system, both because of its rigidities and because it was controlled largely by conservatives. In the light of this history, it may come as a surprise that the *waqf* is regaining significance in certain countries, including Turkey and Egypt. Ironically, an assorted mix of civil rights advocates and economic reformers – groups whose precursors once considered the *waqf* a source of backwardness – are behind movements to re-energize the *waqf* sector. But the contemporary *waqf* differs substantially from the traditional Islamic *waqf* (Çizakça, 2000). Whereas the founder of a traditional *waqf* had to be an individual, its modernized namesake may be formed by a consortium of natural or legal persons. A modern *waqf* is overseen by a *mutawalli* board, which delegates managerial responsibility to professionals. Most important, it is a corporation – a self-governing entity enjoying legal personality. The spread of modern *waqfs* may be expected to strengthen civil society and improve the quality of governance.

9 Implications for future reforms

Like the corporation, various other elements of a modern economy, including stock markets, double-entry bookkeeping, and courts familiar with advanced economic institutions, were transplanted to the Middle East in the nineteenth century. The fact that such institutions were borrowed almost two centuries ago now hides their foreign origins from the masses even where, as in Saudi Arabia, Islamic law remains the law of the land (Vogel, 2000). As such, these institutions are culturally acceptable even to Islamists committed to preserving or reviving structures associated with traditional Islam. Reforms to improve the transplanted institutions can

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proceed, therefore, without appearing to be promoting cultural alienation or opposing Islam as a religion.

If the historically problematic institutions associated with Islamic law no longer hinder development directly, does it follow that the institutional history just interpreted has lost its relevance to economic performance? The persistent weaknesses of civil society in countries of the region, and thus the enduring obstacles to reforms beneficial to economic sectors beyond the control of Middle Eastern states, are rooted in the two historical patterns discussed above: rigidities of the traditional *waqf* and the protracted stagnation of Islamic contract law. Weaknesses of civil society in the region hindered collective action to institute political checks and balances. In the process, they left political vacuums filled as the twentieth century unfolded by economically interventionist states uncommitted to the rule of law and generally fearful of political and economic liberalization.

The very logic of the foregoing historical argument provides, however, a reason for some optimism about the future. Largely through reforms that began in the nineteenth century, the factors responsible for the weaknesses of Middle Eastern civil society have been overcome. Consequently, the institutional means of a much stronger civil society are now available. Although groups with a stake in the political *status quo* will put up resistance, sooner or later, one can expect on that basis, organized private groups will voice demands for more extensive economic and political rights. In relation to even a half-century ago civil society has already made remarkable strides in Turkey and, to a lesser extent, also in Iran and in some parts of the Arab world. Should the pattern continue, the twenty-first century may become what the late twentieth century was for East Asia: a period of renewed economic vigour and leadership.

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