Institutional Roots of Economic Underdevelopment in the Middle East[1]

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The Middle East has had a poor economic record over the past two centuries. This is evident in international statistical comparisons. The region's per capita income is less than a third of per capita income in advanced industrial countries. Life expectancy is eight years less. Within the region, there are variations, but all its major components stand out as poor performers.

This is a puzzle, because in the Middle Ages the region was advanced by standards of the day. Only China might have been richer. Evidence can be seen in the old bazaars of the region. Istanbul's Grand Bazaar was once the world's largest shopping mall. Travelers marveled at the variety of goods traded and at the volume of commerce.

Something must have happened that kept the Middle East from remaining advanced economically. Something must have kept it from generating the transformations that made Europe get ahead.

Causes of Underdevelopment

I'm going to suggest an explanation for this reversal of fortune. Of course, I am not the first to do so. Most existing explanations center on misguided state policies: bad priorities, lack of vision, regulations that kept the private sector from developing.

It has been convenient to focus on the state, because public archives in the Middle East are very rich and private archives almost nonexistent. But it makes less sense to focus on the state in regard to Middle Eastern history—less than in does in the case of Europe—because historically Middle Eastern states were shallow states. They provided law and order and collected taxes, and not

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much else. Public services were provided privately, through trusts waqfs, not by local governments, as was the case in Europe.

An alternative starting point, which is the one I am going to pick, is the trajectory of the private sector. The private sector essentially stagnated during the second millennium. Its institutions remained more or less fixed. I will try to show that this institutional stagnation gradually made the Middle East uncompetitive in global markets, as western competitors started benefiting from progressively advanced institutions. It also weakened states of the region vis-à-vis European states. Private sectors of the Middle East could not finance local governments, who then turned abroad for loans.

Timing of Underdevelopment

So my agenda is to explain why the private sector stagnated institutionally. What do we know about the timing of underdevelopment? The 18th and 19th centuries were a time of crisis. Economic weaknesses brought political weakness: there were territorial losses, the Ottoman Empire went bankrupt, Egypt went bankrupt, and massive reforms were undertaken to jump-start a catch-up process. Of course, the Middle East was visibly poorer that Europe then, so it is not controversial that at that time the region was underdeveloped. This perception was shared by peoples of the region, including local leaders.

Did the region fall behind all of a sudden? Analysts have gone back a few centuries to the era when Mamluk Egypt, and then the Ottomans, gave one-sided trade privileges to the Italians, the French, the English, and others. But if we ask why the capitulations were given, and look at their content, we see that they were meant to get around institutional features of the region.

So we need to go further back still, all the way to the 9th-10th centuries. That is when the institutional framework for commerce and finance in the region fell into place. Distinct institutions emerged by then for pooling resources and for providing public goods such as schools and water fountains.

These institutions, which I'll identify, were all components of the sharia or Islamic law, the law of the land. In the pre-modern Middle East not every aspect of daily life was governed by Islamic law. But critical aspects of the economy were, and that made a huge difference to the region's economic trajectory.

I will suggest, then, that the roots of underdevelopment go back to the Middle Ages. The capitulations were not causes of underdevelopment. They were early symptoms.

Industrial Revolution

Let us return to the 19th. century—the period of deep crisis—when the Middle East started looking obviously underdeveloped. This period coincides with the Industrial Revolution.

The new industries of the period involved mass production, using new technologies. These technologies emerged in Western Europe. That part of the story is well known. Also critical, however, is that Western Europe took the lead in developing institutions that enable the exploitation of the technologies of mass production.

By the late 18^{th} c., through stock markets, banks, and corporations, Western Europe was mobilizing the savings of large numbers and channeling them into mass production. Western entrepreneurs were pooling the labor and capital of large numbers within indefinitely living companies. These are capabilities we now take for granted. But they posed immense organizational challenges in some parts of the world, including China, India, and of course the Middle East.

The new physical technologies were easily. However, the institutions that enabled the West to exploit the new physical technologies were not so easily transferable. One cannot set up a stock market overnight. It requires an intricate legal system and various professions to support it and schools to train the professionals.

Lack of Industrialization in Middle East

As growth took off in the West, the Middle East could import the technologies of industrialization. But it lacked the organizational capabilities to use them. And these could not be borrowed at will or quickly. That is a key reason why the gap in living standards widened, and why the Middle East remains economically underdeveloped in 2010.

First Modern Ottoman Company

That organizational limitations posed a huge handicap was noticed by Middle Eastern leaders in the mid-19th century. Turkish, Iranian, and Arab leaders recognized that overcoming these limitations were critical to catching up with the West, which by then was dominating the world economy.

At the time, much of the region was within the Ottoman Empire. An early Ottoman response was the founding of the first completely indigenous modern company---modern, in the sense that it would have an indefinite existence and have publicly traded shares. This was the Şirket-i Hayriye maritime transportation company.

This transportation company was not set up merely to make money. It was intended to serve as the prototype of a completely new type of company, with respect to the traditional legal system of the Ottoman Empire. So a neologism was created to describe it. It was called a kumpaniye—in other words, what the English called a company and the French *compagnie*. Şirket-i Hayriye issued 1500 tradable shares, and most were bought by dignitaries. Sultan Abdülmecit served as the main shareholder, and the company’s patron.

Abdülmecit’s Motive

Why did the Sultan get involved? By the 1850s the most dynamic sectors of the Ottoman economy were dominated by permanent and large enterprises. These were *all* owned by foreigners or minorities. Sultan Abdülmecit felt that it was time for Muslim Turks, the politically dominant nation in the empire, to begin pooling capital within large and durable companies capable of exploiting modern technologies. The political leadership was to set an example for the rest of society to follow.

Evidently, Ottoman elites were coming to grips with limitations of traditional economic institutions grounded in Islamic law. They recognized by then that traditional means of pooling capital and labor were ill-suited to forming the sort of enterprise that prevailed in new sectors, such as banking, mass transport, and manufacturing. What were these? They were simple partnerships formed under Islamic law.

My point now is that in modern sectors such as mass manufacturing and mass transportation, successful enterprises did not consist of partnerships. It was not possible to compete in modern sectors through Islamic partnerships that had not changed form in 1000 years. In fact, the Ottoman Empire's Muslims were having trouble competing through traditional institutions with the local minorities (principally, Greeks, Armenians, and Jews) who were forming alliances with Europeans and benefiting from European institutions.

Basic Organizational Forms

Let me relate the leap that Abdülmecit tried to make to the three basic organizational forms used in commercial life. In the 1850s, the organizational menu in the commerce of Ottoman Empire and the rest of the ME was limited to various types of partnerships. These are enterprises established for specific purposes; every member has veto power over decisions; and shares are not tradable.

Abdülmecit tried to broaden the menu of options by establishing Şirket-i Hayriye a joint-stock company. The ownership was to be divided into shares. The shares would be tradable, so the enterprise would have a life independent of the lives of individual founders and employees.

Most of the world's largest companies, even in the 1850s and certainly now, are corporations. Unlike a standard joint-stock company, a corporation has standing in court. It can sue and be sued as an organization.

Şirket-i Hayriye was not a corporation. It has one feature of a corporation, but not all. Incorporation under Ottoman law (establishing a corporation) became possible only in the early 20th century. That is when the first laws of corporations were passed, in 1908. Egypt followed the same pattern.

Publicly Traded Ottoman Companies

How successful was Abdülmecit's plan to trigger an explosion in large companies owned by Ottoman Muslims? In the short term, not at all. It took 60 years for the initiative to bear fruit. Up to the early 20th century almost all new publicly traded companies were formed by foreigners and minorities. Only after 1908, when the Ottoman Empire instituted its first Law of Corporations, did the empire's Muslims start forming publicly traded, large, and durable companies.

Why did it take so long? Why did the Middle East not develop the corporation from within? In the 19th century, critical complementary institutions were still missing. Hence, a law of corporations would have been meaningless.

To explain why, I have to take you way back to around the year 1000, and tell you about the legal system under which the private economy traditionally operated—and still operated at the time of Abdülmecit's intervention. Then I'll explain why that legal system stagnated for a millennium.

Commercial Partnerships, c. 1000

In the Middle East, 1000 years ago, commercial enterprises were formed under Islamic partnership law. This law enabled people to pool labor and capital in commercial enterprises. The emergence of this law was a very important development. People could always do business using their own capital, through a proprietary business. To do business on a larger scale, they needed to pool resources with others within a partnership. The first place they looked was of course the family, because family members tend to trust each other.

But not everyone has a family able to supply capital. So every civilization has faced the challenge of promoting trust among non-relatives who stand to gain by pooling capital and labor.

Specifically, you have merchants and producers who need capital to finance their ventures. And you have potential investors who cannot or don't want to do physical work, like carrying goods to a distant land in a caravan. The challenge is to devise institutions that allow these demanders and suppliers of capital to pool resources.

Islam produced an impressive contract law for the period to regulate partnerships among these groups. The typical partnership, known as mudāraba (or mudârebe in Turkish), combined the labor of a producer or trav. merchant with capital of a passive investor. In a commercial partnership profit shares set in advance. The shares could be 50-50, but this was not required.

Suppose the venture involves long-distance trade. The merchant goes off, trades, then profits are shared. If disaster strikes, and goods are lost (say, the caravan is sacked by brigands) the active worker will get nothing for labor. The passive investor will lose his capital, but he cannot lose anything more. He has limited liability

Islamic partnerships like the one I have described were enforceable over vast area. Merchants who used them were active in most of the major trading circuits of the Middle Ages. As Middle Eastern merchants moved, they took their law with them, including their partnership law, helping to spread Islam. Consequently, over a huge area stretching from Morocco and Spain, ultimately to Indonesia, people could conduct commerce, and adjudicate commercial disputes, under a more or less uniform legal system.

Around the start of second millennium, essentially the same partnerships were used throughout Mediterranean basin. Italians used a limited partnership form known as commenda. The commenda was more or less the same as the mudaraba. Around that time, I should note again, the Middle East was not poorer than Europe. This is consistent with the fact that Europe did not have superior commercial institutions.

This is why, by the way, I started the story around the year 1000. At that time, the organizational abilities were not significantly different. We know that the subsequent trajectory *was* different. So something else must have differed around 1000 between the Middle East and Western Europe.

Enterprise Scale and Longevity

What do we know about the size and longevity of Islamic partnerships? Islamic law put no limit on number of people contributing labor or capital to a partnership. Nor did it restrict how long the partnership would last. In principle, 50 people could pool labor and capital for a trading mission expected to last 3 years.

However, in practice number of partners usually two. Islamic partnerships were minuscule by the standards of modern enterprise. Also, the enterprise was typically limited to single mission.

Partnerships in Istanbul, 17th century

The pattern that I'm describing endured right up to the 19th century. In seventeenth-century Istanbul large partnerships, defined as having five or more partners, were rare. And there was no trend toward larger sizes during the century. This is the pattern that Abdülmecit painfully identified, two centuries later, as a factor keeping Ottomans uncompetitive.

Recontracting

At the end of a partnership, partners can of course enter into a new partnership. But note this: a traditional Islamic partnership is not what we call a firm or a corporation. It has no legal standing of its own and no life of its own. In a modern firm, if an employee or shareholder dies, the enterprise continues. By contrast, if the member of an Islamic partnership dies, the partnership ends, its assets are liquidated, and the deceased partner's assets are distributed to his heirs. Whether the interrupted business activity resumes will depend on the inheritance system in place. So let us take a look at the Islamic inheritance system.

Islamic Inheritance System

After rise of Islam, this was the dominant inheritance system in the region. According to rules laid out in Quran, 2/3 of any estate is reserved for extended relatives. A daughter gets half the share of son, an aunt half the share of uncle, and so on for each category of relatives. The female share was half the share of a male in the same class of relatives.

By medieval standards, this system was remarkably egalitarian. One could not disinherit a child or a relative entitled to a share. On the downside, the system made it difficult to keep property intact from one generation to next. Successful businesses got fragmented after the founder. Children and other heirs had a tendency to go off with their shares.

In principle, the heirs of a decedent could reconstitute a liquidated business. But there is a catch: the more heirs, the higher the cost of reconstituting the business and, hence, the greater the cost of untimely termination. Successful merchants, those with large commercial operations, were most likely to have large numbers of heirs. This is because they tended to have multiple wives, which meant that they had more children, and thus more heirs. So the death of a partner was especially problematic if he was a successful businessman.

Choice of Size and Longevity

If premature dissolution was costly, members of partnerships would have tried to reduce the risk. How? This risk rises with partnership size. The larger the partnership, the greater the probability of one partner dying during the contract period. So merchants and investors would have minimized the risk of premature dissolution by keeping their partnerships small. The risk of premature dissolution also rises with the anticipated duration of partnership mission. So merchants and investors would have minimized risk also by limiting the duration of their partnerships. In brief, they would have formed small and simple and ephemeral companies.

What Was Different in Europe

The same risk existed in Western Europe. Medieval Italian partnerships became null and void if a partner died. But the inheritance system was different and that had major consequences over the long run. The Bible does not explicitly specify an inheritance system, so there was vast experimentation in this area. Inheritance laws varied across space, across time. One of these is of interest here: under primogeniture, the business falls to oldest son. In places where primogeniture was practiced (mainly the northern countries), merchants knew that if one died, his son would take over. They pre-arranged to have the decedent's son step in. This arrangement was not necessarily. good for later sons, to say nothing of daughters, but it had a huge advantage. It reduced risk of terminating a business early. In other words, it facilitated continuity over time.

Effects on Organizational Development

Why is this difference between the regions significant for long-term economic development? Why are partnership size & longevity so important historically? Why are they so relevant to why the ME fell behind? Advances in the scale and longevity of business are needed to stimulate the development of more advanced business techniques.

If businesses remain small and short-lived, no need arises for developing advanced forms of business. Consider accounting. If partnerships are limited to two people, and expected to last three months, there is no need for standardized accounting. Accounts are simple. But if partnerships have ten people at any one time, and memberships change over time (shares are transferable from father to son, or to strangers), standardized bookkeeping becomes a necessity.

In West, as business forms evolved, modern accounting developed. In the Middle East, accounting practices did not change before 19th c. The reason is that the need did not arise.

Likewise, pressures to make shares tradable and to establish stock markets develop only where enterprises become long lived. People want tradability to make shares liquid. No secondary markets for enterprise shares arose in Middle East until the 19th c. People's capital was never tied up for long in firm shares, so the need did not arise to sell them.

In short, in Europe institutional innovations fed on themselves. In the Middle East commercial institutions stagnated.

This was reflected in the enterprises in the bazaars. Most of them were like a hole in the wall. They used simple accounting systems and their shares were not tradable.

Distinct occupations in Arab Middle East

The persistent smallness of enterprises also limited the division of labor in private commerce and finance. According to data collected by Maya Shazmiller, the number of distinct occupations in the Arab Middle east more than tripled in the public sector, including the military and the state bureaucracy, between the 8th-11th centuries and the 12th-15th centuries. Evidently, there was enormous dynamism in the public sector.

Between the same two periods the number of distinct occupations in commerce stagnated. Economies become more productive through specialization, and that comes from division of labor. In the Middle east the private commercial sector was not becoming gaining productivity. The lag of the private sector is apparent also in the numbers of new occupations. Far fewer new occupations emerged in commerce than in the public sector.

The Onset of Economic Underdevelopment

Now we can see one reason why the Middle East could not exploit technologies of Industrial Revolution using indigenous institutions. The West formed enterprises with hundreds, thousands of employees, shareholders. These were durable enterprises; some lasted generations. Accordingly, they established lasting reputations. The Middle East could not compete with these huge enterprises.

Consequently, commerce between Middle East and Europe fell under control of Westerners. Also, as the West industrialized, the Middle East could not follow suit. In short, the ME fell behind the West.

Why couldn't the Middle East simply transplant the organizational forms that gave the West an advantage? Why could it not catch up quickly? Why did Abdülmecit's initiative largely fail, for 60 years? Precisely because of a millennium of organizational stagnation, the preconditions were lacking, complementary institutions were absent.

Here are examples with which we are now familiar: (1) Modern firms require standardized bookkeeping. In case of disputes, judges familiar with accounting conventions are needed. Alas, the Islamic courts were unequipped to handle financial cases involving modern firms. (2) In the absence of stock markets, not to mention banks, it is difficult to raise the capital needed to found an industrial company. These examples demonstrate the difficulties of jumping from the Islamic partnership to the corporation if all the institutions that would have to be generated along the way are absent.

Alternative Paths to Organizational Development

To sum up the argument thus far, differences in inheritance systems (the Islamic system was more egalitarian) placed the commercial institutions of the two regions on divergent paths, which, in turn, led to a divergence of economic performance. I should point out that the West did not do better because it consciously adopted the right inheritance regime. There was more experimentation, and this generated the winning combination.

Rise of the Waqf and the Corporation

Let me now turn to the second of the institutions that became a handicap. I said at the outset that in the 19th century the Middle East was failing also at providing public goods efficiently. Economically the most important supplier of public goods was a non-state organization known the waqf (in Turkish, *vakıf*). It is a form of trust. One might expect it to have provided an alternative starting point for organizational modernization. I'll start byproviding a broad historical perspective that relates the rise of the waqf in Middle East to the rise of the corporation in Europe.

The waqf emerged in the 8th century, about a century after the emergence of Islam. Around the same time European cities, monasteries, guilds, were declaring themselves corporations. In Europe, the corporate form was not applied to business until the 1600s, but when the need arose, it already had centuries of experience with the basic form.

In the Middle Ages, both Europe and the Middle East were highly innovative from an institutional standpoint. But they made choices that contributed over the long run to an economic divergence that that left the Middle East behind.

So what is a waqf?_It is a trust founded under Islamic law, which is managed by a trustee (mutawalli or *mütevelli*), who must follow the stipulations laid down by the founder. It is unincorporated, in the sense that it is neither a legal person nor self-governing. The endowment of a waqf is used to provide a service in perpetuity.

This organization served as the delivery vehicle for functions met in the West through corporations. It was the Middle East's alternative to the corporation. Thus, practically all urban services in the Middle East were provided by waqfs, rather than self-governing municipalities. Madrasas were financed by waqfs, whereas the universities established in the West were corporations.

Possible Services

In the premodern Middle East, a huge variety of services were provided by waqfs. This institution permitted individuals to supply, in a decentralized manner, public goods now commonly supplied by governments. In some respects it was a magnificent system; precisely because of its lack of centralized control, it was responsive to local needs.

Except for palaces and fortresses, almost all surviving old buildings in the region were built and maintained through waqfs. Turkey contains thousands of examples. They include the Çoban Mustafa Paşa medrese in Gebze, the Zazadin Kervansaray ourtside of Konya, the chariable complex (külliye) of Seyyit Battal Gazi near Eskişehir, and the Blue Mosque (Sultan Ahmet Camii) in Istanbul.

Origins of the Waqf

Such examples demonstrate that the waqf was an immensely important institution economically. It so happens that it is not among Islam's original institutions. There is no mention of the waqf in the Qur'an. The earliest evidence of its existence is from a century after birth of Islam. What prompted this innovation?

Around the 8th century, private property was quite insecure. Arbitrary taxation and expropriation threatened high officials, who tended to be major landowners. These high officials did what wealthy people do everywhere: they looked creatively for an institution to serve as a wealth shelter. Older civilizations in the region, including Roman civilization on which Islam built, had developed various forms of trust. Early Muslims used the basic idea to develop an ingenious institution that achieved massive significance over time.

Sacredness of the Waqf

Why did assets become more secure (in other words, why did they get sheltered, when endowed as waqf? Regardless of the service it provided, the waqf was considered sacred, and it was common knowledge that this was widely believed. Consequently, rulers were reluctant to expropriate waqf assets, lest they develop a reputation for impiety. So property owners endowed waqfs to protect their assets—to lower the probability of losing property through confiscation or arbitrary taxation.

Material Advantages

You are probably wondering, if a founder's goal was to shelter assets for his own use, what did he gain by setting up a waqf that would, say, provide the upkeep of an inn or school? What was in the deal for him? It was a considered pious act, so be obtained inner satisfaction, but also social prestige. There were also significant material returns. The founder of a waqf could appoint himself as its mütevelli (trustee / manager) for life. In that capacity, he enjoyed various benefits. Specifically, he could set his own salary, place friends and relatives in various positions, and designate his successor (often he chose a child). The last privilege meant that he could circumvent inheritance law.

So in setting up a waqf a founder didn't simply engage in charity. Some of the secured income accrued to him, his family, and his descendants. But there was a quid pro quo. In return, he accepted certain social responsibilities.

Organizational Consequences Over the Long Run

Why have I taken you through these details? We are trying to understand why traditional institutions of the Middle East did not give rise to modern institutions. The waqfs held massive amounts of property, so any explanation of what went wrong must address the role of waqfs.

The waqf has one key property of the corporation. It has an existence apart from its individual trustees, employees and beneficiaries. So it might have provided the starting point for corporate life. However, unlike a corporation it is not meant to be self-governing. Legally, its deed is viewed as a contract between founder and Muslim society. The waqf's objectives and rules of operation are set by the founder, and they cannot be changed. Due to lack of self-governance, waqfs tended to become dysfunctional. A waqf set up to provide lodging for merchants could not adjust—at least not quickly—if trade routes changed, and the inns were no longer needed.

The waqf system delayed the emergence of the corporation through one other channel. Because of its wealth sheltering function, it sucked capital out of the commercial sector. Successful merchants invariably set up waqfs to give their families security. In the process, they moved capital into a relatively inflexible sector from a sector where growing enterprises might have looked for organizational innovations.

Lack of Demand for Business Corporation (c. 1000-1850)

So far we have considered why the corporation didn't emerge in the Middle East (the initial conditions different), and why its alternative, the waqf, proved to be an inferior substitute in the long run. But identifying why a given institution was not selected in the 8th century doesn't explain, by itself, why it was not adopted later, especially if the choice created problems over long run.

Indeed, the corporation could have been borrowed from abroad. It could have been invented by people conscious of the limitation of the waqf sector. However, critical ingredients were lacking because Islamic partnership law, in combination with the prevailing inheritance law, led, as I explained earlier, to conditions that made their development unnecessary.

Members of small and short-lived partnerships do not feel a need to develop sophisticated accounting methods. That matters because difficult to raise capital for a corporation without standardized bookkeeping. Likewise, short-lived partnerships have no use for tradable shares (tradability serves to increase liquidity; a partner whose capital is tied up for only a short period already has liquidity).

People will not invest in a corporation without a way to give shares liquidity. But the appropriate market not there. On top of these missing ingredients in the commercial sector, the legal system was unfamiliar with the concept of legal personhood.

For many centuries, the absence of such organizational advances blocked one possible path to the corporation: borrowing from abroad. The organizational challenges were too numerous.

Beginnings of the Divergence

Let us go back, one last time, to the origins and the divergence from the Western organizational pattern. In Middle East the waqf and in the West the corporation emerged around the same time. Both solutions grew out of Roman law.

During the 8^{th} to 10^{th} centuries, the Middle East had strong states, such as the Umayyad, Abbasid, and Fatimid empires. In the aftermath of the demise of the Western Roman Empire, Western Europe had weak states which were unable to enforce law and order. So the Middle East saw the emergence of an organization to respond to a problem present in a society with a strong state capable of enforcing a far-reaching legal system and also of predation. The waqf provided material security to its founder from a strong state. By contrast, the West saw the emergence of an organization meant to compensate for weak states and, hence, the absence of enforceable law. The corporation supplied the means for self-governance.

By the way, although the West also borrowed the trust from Roman law, it played a far less important role than the waqf did in the Middle East.

Attitudes toward Innovation

I’ve offered an organizational argument for why the Middle East fell behind. Notice that I have not invoked attitudes toward innovation. I have not suggested that the modern Middle East is underdeveloped because Islam is a conservative religion.

The region was not opposed to innovation per se. Adaptations did occur. However, during the second millennium they occurred mostly outside private economic sector. Government organization went through many changes and the tax system evolved. Muslim clerics (*ulema*) went along with some of these changes—evidence that Islamic institutions are not inherently static and that clerics not consistently conservative.

Commercial laws and techniques remained stagnant because private merchants and investors, until quite late, lacked reasons to demand the sorts changes that led to modern economic organizational forms.

Summary

To recapitulate, the question has been why, as late as the 19th century, the Middle East had no long-lasting and self-governing private organizations. This had become a cause of economic underdevelopment. It set the pattern we observe today. Sultan Abdülmecit tried to break a vicious cycle.

My explanation has had three key components.

1. The Islamic inheritance law, along with its marriage laws, helped to keep partnerships small, and therefore to limit pressures for organizational innovation.

2. The waqfs served the institutional role that in the West corporations served. Many people had a vested interest in the continuation of the waqf system. Waqfs sucked capital out of the commercial sector.

3. When large and durable organizations became essential, the corporation could not be transplanted from abroad, because the institutional preconditions were lacking, and that was a consequence of the inheritance system.