THE MILKEN INSTITUTE
Review
A JOURNAL OF ECONOMIC POLICY
First Quarter 2011

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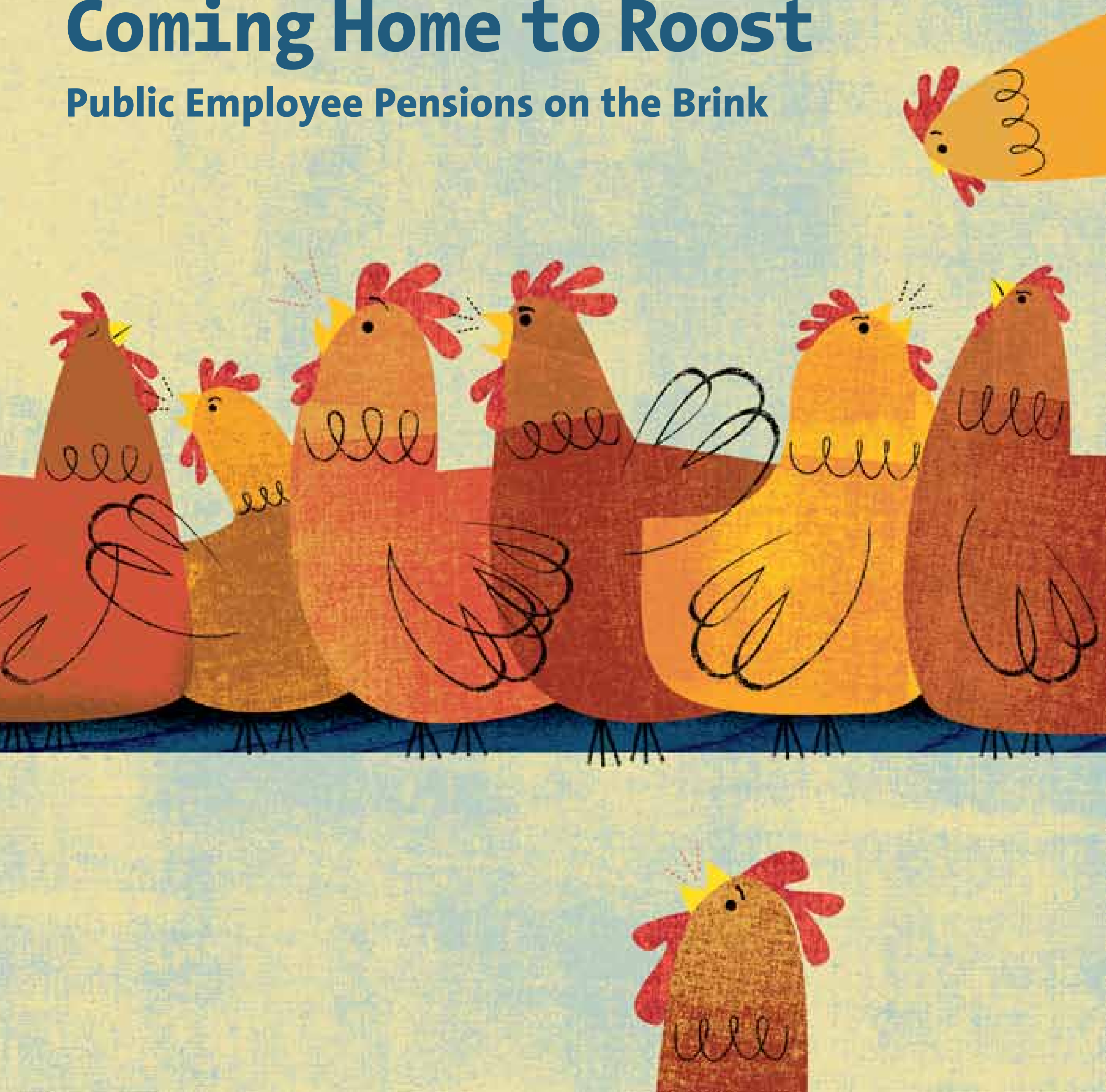
Public Employee Pensions on the Brink



Review

The Milken Institute Review • First Quarter 2011

VOLUME 13, NUMBER 1

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ISSN 1523-4282
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The Milken Institute
Santa Monica, California

The Milken Institute Review is published quarterly by the Milken Institute to encourage discussion of current issues of public policy relating to economic growth, job creation and capital formation. Topics and authors are selected to represent a diversity of views. The opinions expressed are solely those of the authors and do not necessarily represent the views of the Institute.

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The Long Divergence

How Islamic Law Held Back the Middle East

BY TIMUR KURAN

Timur Kuran, a professor of economics, political science and Islamic studies at Duke University, is unique among academic economists: he is as comfortable mining the archives of the Ottoman Empire for insights on the evolution of *Shariah* as he is teaching economic theory to elite grad students. Much of his own research focuses on the nexus between religion, culture and economics. (Reportedly coming soon: work on the link between Hinduism and India's born-again economy.) His latest book, *The Long Divergence: How Islamic Law Held Back the Middle East*,* offers a pathbreaking analysis of why the flourishing premodern economies of the Islamic world fell into relative decline as Western Europe rose. And it explores the issue of whether conservative Islam is compatible with modern economic institutions. You'll be surprised by many of his conclusions. — *Peter Passell*

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At the start of the second millennium, around the year 1000, a visitor from Italy or China would not have viewed the Middle East as impoverished, commercially deficient or organizationally primitive. Although the region might have seemed enigmatic, its oddities would not have painted a picture of general economic inferiority. Now, at the start of the third millennium, it is widely considered an economic laggard, and numerous statistics support this consensus.

Life expectancy in the Middle East is 8.5 years shorter than in high-income countries of North America, Western Europe and East Asia. The region's per capita income is just 28 percent that of the high-income countries. And one-quarter of adults are illiterate.

In 1750, the region was already far behind. The purchasing power of the average worker in London or Amsterdam was twice that of the average worker in Istanbul, the largest metropolis and leading commercial hub of the eastern Mediterranean. The gap subsequently widened. But since World War I, growth rates have been roughly equal: Measured as a ratio, the current income gap between the West and the Middle East remains what it was a century before.

The Middle East's economic decline was thus relative over the last century, not absolute. Indeed, the region does not offer a picture of stagnation in the very long term: the current standard of living far exceeds that of a millennium earlier. From 1820 to 1913, per capita income grew by about two-thirds. And after a period of modest growth between the two world wars, it tripled between 1950 and 1990.

In seeking to explain why the Middle East – defined to include the Arab countries, Iran, Turkey and the Balkans – entered the 19th century as an underdeveloped region, I've focused on institutions that contributed to critical deficiencies. Until the 18th century, neither the people who lived under those institutions nor outside observers viewed them as problematic. Indeed, in the 17th century, not even foreigners whose organizational innovations were transforming Western Europe into an economic superpower understood that the Middle East's economic infrastructure would become dysfunctional.

Although some statesmen and business leaders may have been aware of specific inefficiencies – inflexible *waqfs* [Islamic financial trusts]; small, illiquid financial markets; courts unsuited to adjudicating commercial disputes – none comprehended how such institutions were mutually reinforcing, or how they were blocking changes essential to the region's competitiveness.

Part of the problem is that, along with inefficient institutions, observers also noticed institutions that were working admirably well. The region's bazaars carried a wide assortment of luxuries. Its commercial centers attracted fortune seekers speaking a babel of languages, much as Los Angeles and Paris do today. Capitulations [treaties granting special privileges] allowed ambitious foreigners to operate in the region with increasing ease. *Waqfs* subsidized social services to the masses.

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Economic disputes were settled informally through arbitration, or formally through courts that rendered judgments quickly. By the same token, Islamic law was not considered harmful to economic progress. While certain Islamic institutions bothered local residents and foreigners alike, observers of Islamic law also saw evidence of healthy pragmatism. The acceptance of contracts requiring payments of interest (nominally barred by Islamic law) and interfaith cooperation were just the most obvious examples of business-friendly accommodations. Hence, had this book been written from the perspective of a premodern observer, Islam's economic infrastructure would have seemed largely unproblematic and the reasons the Middle East would eventually fall behind would have been a mystery.

To explain the lag in the region's modernization and Islam's role in this delay, I had to focus on aspects of the Middle East's organizational heritage that became problematic only because the European economy was evolving. I also had to recognize that locally optimal solutions need not have been globally optimal, just as the highest peak in sight might be dwarfed by mountains beyond the horizon.

To identify Islam's weaknesses in supporting growth and to explain their persistence, I needed to keep track of the mechanisms that fueled the ascent of the West. And this comparative analysis led me to conclusions that may rattle Middle Eastern specialists on the premodern period.

HOW ISLAM DELAYED ECONOMIC MODERNIZATION

In its early centuries, Islam developed a law of contracts that was sophisticated for the time. Islamic partnerships stimulated commerce and helped merchants carry Islam to far corners of the globe by facilitating the pooling of resources across family lines. Islamic contract law allowed passive investors to shield their personal assets against liabilities incurred by the partnership.

But the Islamic partnership form had weaknesses. Active partners carried full liability. Also, an Islamic partnership lacked entity shielding: any partner could force its dissolution unilaterally, and its assets were exposed to demands from third parties. The death of a partner terminated the partnership automatically, giving heirs an immediate claim on a share of the assets; all surviving members incurred costs in the process of settlements. Moreover, the number of heirs could be large, because Islam's inheritance law assigns mandatory shares to designated relatives of the decedent.

The partnership termination rule, like the lack of entity shielding, discouraged the formation of large and long-lived partnerships. Moreover, in allowing polygyny [multiple wives], Islam compounded the incentives to keep partnerships atomistic and ephemeral because merchants with more than one wife tended to have more heirs. The business empires of the most successful merchants rarely survived them because their estates were divided into too many pieces to make recombination practical.

Stagnation in the size and longevity of Middle Eastern partnerships had long-term dynamic consequences. Exchange largely remained personal, removing the need for institutional transformations essential to the modern economy. No demand, for example, arose for standardized accounting or a business press. Incentives to trade shares were dampened. Finally, before the 19th century, oral rather than written contracts were the norm, and adjudication relied mostly on oral testimony. From around the 10th century to the industrial era, commercial enterprises did not gain in complexity, as they did in Western Europe.

In the 19th century, the most heavily capitalized commercial enterprises of the global economy tended to be organized as corporations rather than partnerships. Meant to last indefinitely, they enjoyed legal personhood. The stagnation of the Middle East's commercial infrastructure could have been overcome through the formation of corporations. But two factors precluded this option. For one thing, precisely because of the delay in economic modernization, the preconditions for making business corporations viable were lacking. In the absence of stock markets, standardized bookkeeping and courts accustomed to adjudicating disputes involving large organizations, people would not invest in corporations. For another, the concept of a corporation was alien to Islamic law in general.

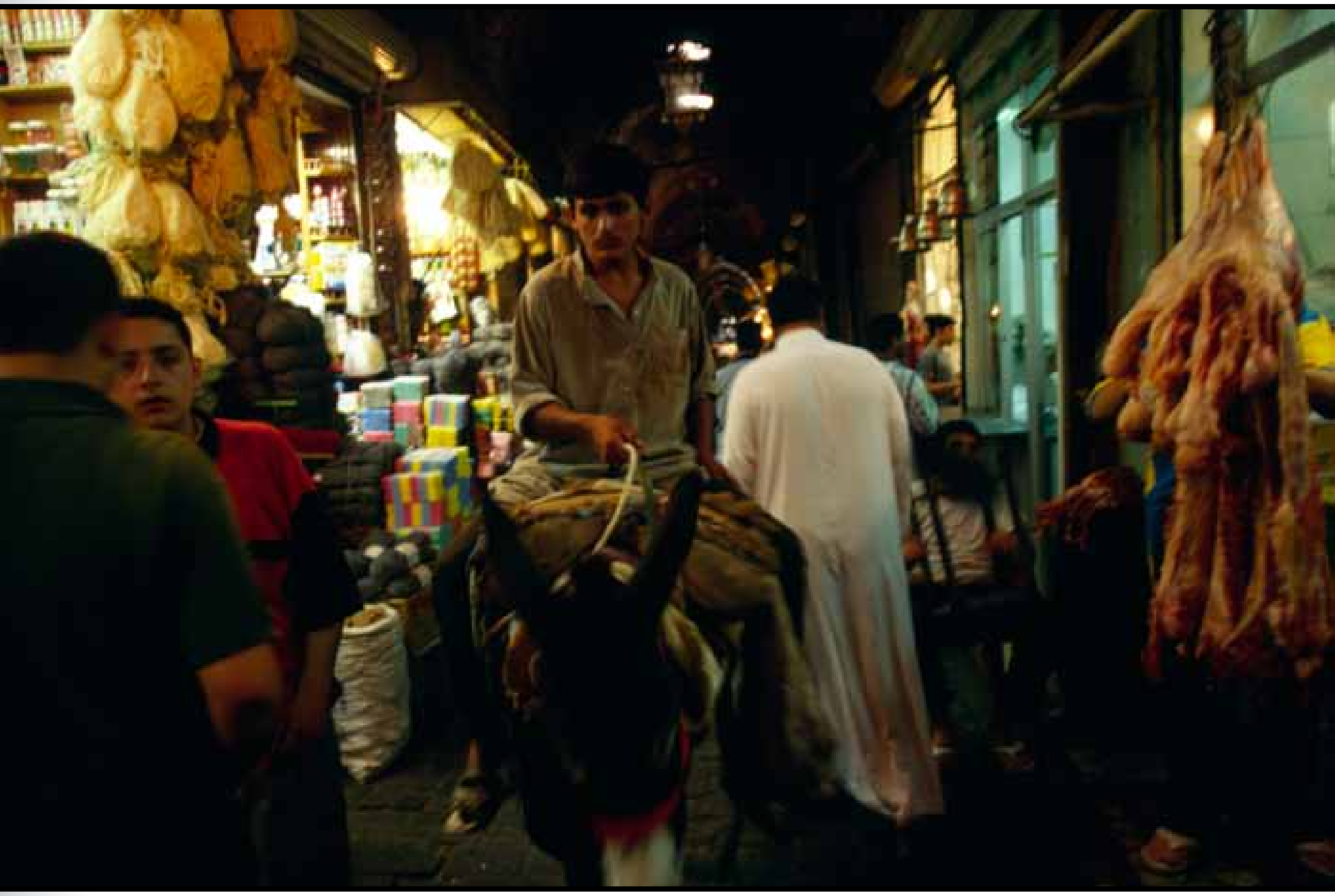
Although the corporation was known to Middle Easterners even before the seventh century, early Muslims limited legal standing to persons. Hence, until well into the 19th century, the corporate form was also absent from other enterprises, including urban government, education and charitable services. The resulting lack of experience made it impossible to introduce the corporation into commerce when the need presented itself. Thus, when technologies of mass production raised the demand for large-scale financing, banks could not be established under Islamic law to mobilize the required resources. Nor could the new technologies be exploited through appropriately capitalized manufacturing enterprises.

In the premodern Middle East, many services now generally provided through corporations were delivered through the *waqf*, a form of trust. A *waqf* was established by endowing income-producing property to provide a service – private or charitable – in perpetuity. Like a corporation, it could outlive its founder and employees. However, the *waqf* was not self-governing. Since trustees were required to abide by its founder's wishes as recorded in the deed, a *waqf* could not easily remake its internal rules or modify its objectives. This rigidity reduced its usefulness in the face of structural economic changes.

When technologies of mass production raised the demand for large- scale financing, banks could not be established under Islamic law to mobilize the required resources.

Moreover, the resulting resource misallocations became increasingly costly over time because individuals continued to have strong motives to establish *waqfs*. First, a founder could appoint himself as the caretaker of his *waqf*. Second, he could draw a salary for his services and appoint its staff as well as his own successor. Finally, a widely held belief in the sacredness of its assets made the *waqf* a credible vehicle for sheltering wealth against arbitrary taxation and expropriation. Not surprisingly, vast resources flowed into *waqfs*. In establishing them, successful merchants transferred wealth from a sector in which resources could be deployed flexibly to one in which uses were essentially fixed, depressing the already low demand for more advanced forms of commercial organization.

It is important to understand that none of the institutions that hindered the development of modern organizational forms were deliberately advanced to impair the evolution



of commercial life. Each emerged for other reasons. Thus, the provision that an Islamic partnership ended with the death of a partner protected the deceased partner's heirs. Egalitarian rules of the Islamic inheritance system dampened wealth disparities and gave women financial security. Limits on the freedoms of *waqf* caretakers addressed a principal-agent problem by making it difficult to depart from the founder's wishes. The absence of the corporate form limited the destructiveness of tribalism by denying tribes the ability to form legally recognized organizations.

As these Islamic provisions took shape more than a millennium ago, no one could have anticipated the paths they would foreclose. Indeed, no one foresaw that institutional changes in a neighboring region (Europe) would make it increasingly disadvantageous to conduct business under Islamic law.

LOSING GROUND

Organizational stagnation turned the Middle East into an underdeveloped region as modern forms of commercial organization emerged elsewhere along with the business practices essential to their viability. Precisely because it spearheaded this process of economic modernization, Western Europe came to dominate the global economy. The global explorations that fostered Western control over the New World, the explosion in international trade, and the formation of colonial empires all depended for financing and execution on organizational innovations not available in the Muslim world.

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Thus, the expansion of commerce between Western Europe and the Middle East occurred largely at the initiative of Western merchants, who established trading colonies in the eastern Mediterranean. These expatriate merchants did business under treaties known as "capitulations." The agreements allowed them to have law courts of their own, to use innovative financing methods and organizational forms, and to settle estates according to European laws.

The advantages of operating outside of Islamic law grew in concert with Europe's institutional transformation. Modern banking arrived in the region through consortia headquartered in Europe. Middle Eastern cities started supplying utility services through Western-style municipalities rather than through *waqfs*, with the process beginning in neighborhoods favored by foreigners.

The rise in the advantages of trading and producing under Western institutions coincided with striking economic advances by the region's indigenous Christians and Jews over the Muslim majority. Most notably, non-Muslims leapt ahead of Muslims in economic sectors requiring major capital outlays: banking, communications, transport and manufacturing. And they usually did so under Western legal protection.

As the modern economy took shape in Western Europe, growing numbers of Christians and Jews in the Middle East began exercising the longstanding right to opt for a Western legal system – at least in their dealings with Westerners. In the process, they jumped ahead of their Muslim neighbors, who were required to live by Islamic law. Thus, in limiting choice of law to non-Muslims, Islamic law inadvertently contributed to the divergence of the economic fortunes of Muslims and non-Muslims.

Before the 18th century, the Middle East's minorities had generally done business under Islamic law. Three factors account for this. First, the decisions of Islamic courts were enforced more reliably than those of Christian and Jewish courts. Second, Islamic law offered substantive advantages to certain groups, like women, who received more from an estate in a settlement that conformed to Islamic inheritance regulations. Third, agreements among non-Muslims could be overturned in an Islamic court. Christian and Jewish legal authorities responded to these varied incentives by adapting their own laws to Islamic law.

Consequently, until the 18th century, the Middle East's religious minorities generally invested, borrowed and traded under the dominant legal system of the region. In enjoying all the advantages that Islamic law conferred on Muslims, they also endured the same disadvantages – a reality that largely explains the lack of major gaps in economic achievement among the principal religious communities within the Islamic world before the 18th century.

The sharing of legal practices also had far-reaching dynamic consequences. Until the rise of the West created new legal options for minorities, they found it as difficult as Muslims to accumulate private wealth and to preserve business enterprises across generations. Moreover, they remained as unmotivated to develop complex business organizations.

For around a millennium, then, Islamic legal pluralism also kept Middle Eastern minorities from developing advanced economic institutions. This legal pluralism subsequently turned into a vehicle for modernization and enrichment because of the evolution of foreign institutions.

Jewish and Christian access to Western institutions was intertwined with the progression of the capitulations. As capitulary privileges broadened, the consulates of the

European powers began serving indigenous non-Muslims as well as their own citizens. Foreign courts established under the capitulations began to accept cases involving local Christians and Jews. This effectively enabled the religious minorities to take advantage of Western institutional advances without worrying about the enforceability of their contracts under Islamic law. They could use banks, purchase insurance and enter into agreements involving new organizational forms like joint-stock companies and corporations. And, in time, these opportunities allowed them to dominate commerce between foreign and local merchants.

In the nation-states formed in the early 20th century, including those that emerged from the ashes of the Ottoman Empire, Jews and Christians began with major economic advantages.

While dealing with Muslims under Islamic law, Christians and Jews interacted with foreigners (and sometimes one another) under foreign laws. The arrangement generally suited Western banks, shippers, producers and merchants, who favored doing business with minorities over commerce with Muslims, if only to avoid lawsuits in Islamic courts. In the late 19th century, the largest and most lucrative businesses in Salonika, Istanbul, Izmir, Beirut and Alexandria (among other commercial hubs of the eastern Mediterranean) were disproportionately owned and operated by Christians and Jews.

By that time, many Muslim manufacturers, merchants and financiers, along with local political leaders, recognized the immense handicaps they endured on account of Islamic law. Starting in the mid-19th century, they introduced successive legal reforms that enabled Muslims to conduct business under alternative institutions. The menu of available organizational forms thus expanded. Also, secular courts emerged to adjudicate conflicts involving modern business practices. And by effectively narrowing the jurisdiction of traditional Islamic courts, the new courts set precedents for further curtailments later on.

However, the consequent Westernization of commercial life in the region could not eliminate the gap that had opened up between the economic fortunes of Muslims and minorities. For one thing, religious minorities had a big head start in capital accumulation, which gave them advantages in the most lucrative economic sectors. For another, they enjoyed incumbency advantages because of global ties forged over a period when they faced only limited Muslim competition. In the nation-states formed in the early 20th century, including those that emerged from the ashes of the Ottoman Empire, Jews and Christians began with major economic advantages.

EARLY AND LATE ISLAMIC INSTITUTIONS

Of the institutions that played prominent roles in the Middle East's failure to keep up with Western Europe, several are traceable to Islam's canonical Age of Felicity: the Koranic rules of inheritance, the permissibility of polygyny, the ban on *riba* [interest], the absence of the concept of corporation, the choice of law for non-Muslims, the prohibition of apostasy, and the absence of Muslim merchant organizations.

The remaining institutions that figured in the decline were born after Islam's initial few

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decades, or took much longer to have an impact. Among the latter: Islamic contract law, which took shape over several centuries; the *waqf*, which emerged as a well-defined and distinctly Islamic institution in the eighth century; the Islamic court system, whose procedures took form gradually; and the capitulations, which Muslim rulers started to extend to foreign merchants early in the second millennium.

Under a restrictive definition of what qualifies as "Islamic," these latter institutions might appear as deviations, contextually and temporally specific responses divorced from Islam's essence. The capitulations are now widely condemned as both a strategic mistake and as profoundly un-Islamic. Some Islamists also reject the *waqf* as a perversion that allowed the circumvention of inheritance rules. Nothing in Islam limited the menu of commercial organizations to those enshrined in Islamic contract law, or fixed the procedures of Islamic courts.

The shortcomings of Muslim empires, including those of the Umayyads, Abbasids, Fatimids, Seljuks, Ottomans and Safavids, are thus sometimes dismissed as irrelevant to the question of whether Islam contributed to the Middle East's economic backwardness. Likewise, the idea that institutions in the first category – those known to Muhammad and the early caliphs – might have had negative eco-

nomic effects is dismissed out of hand because no Muslim-governed state, except possibly the earliest, implemented them without compromise.

Such dismissals are akin to arguing that because the Soviet Union failed to eliminate private property, its miserable record says nothing about the economic merits of communism. To take them seriously would amount to abandoning meaningful social analysis. Whatever the analytic challenges, there is a huge demand for an answer to the question of whether the original institutions of Islam posed permanent obstacles to economic modernization. A close look suggests that, with some significant exceptions, they did not.

Inheritance

The Islamic inheritance system only delayed organizational modernization because the partnership structure remained the sole starting point for developing large, durable commercial organizations. Once the corporation and the partnership with tradable shares joined the menu of available organizational options, the Islamic inheritance system ceased to undermine enterprise continuity or longevity.

Consider a corporation operating in a country that continues to practice the Islamic inheritance system. The corporation's ownership is divided into, say, 10,000 shares. The owner of 2,000 of these shares dies, prompting their division among his 10 heirs – 200 shares for each. This division need not make any difference to the survival of this corporation. Heirs who prefer cash to shares may sell without endangering the company.

Marriage Regulations

By the same logic, a system permitting multiple wives need not undermine enterprise continuity or longevity, once modern organizational forms and their infrastructure exist. Ordinarily, it makes no difference to a com-

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pany's survival whether a given block of its shares belongs to one wife or is subdivided among four.

Opposition to Charging Interest

The ban on *riba*, the third of the seven problematic institutions present from the beginning of Islam, was a steady irritant to suppliers and users of credit. By requiring the use of alternative stratagems for putting a price on loans, it raised the cost of credit contracts. But the added costs must have been small.

In any case, the ban never really prevented transactions involving interest: nowhere do Muslims find it difficult to borrow for a fee that amounts to interest. If financial markets of the Middle East failed to modernize except through institutional transplants from the West, then, the reason is not that dealing in interest was considered un-Islamic. Rather, obstacles to forming modern business organizations precluded the emergence of banks and stock markets in a timely fashion.

Note, too, that the capitalization of stock markets in major countries of the Middle East has been growing at double-digit rates in recent decades. The very fact that the late 20th century saw the emergence of a massive "Islamic finance" sector testifies to the lack of any fundamental incompatibility between the ban on *riba* and modern finance.

The Corporation

The fact that the Islamic legal system emerged without a concept of corporation clearly contributed to keeping Middle Eastern businesses small and family-based. However, the Koran contains no explicit statement barring corporations, so if a demand for the corporate form had emerged and its institutional preconditions had been in place, it could have been adopted without difficulty.

Indeed, as global modernization fostered an awareness of the corporation's uses, countries of the Middle East absorbed the corporation into their domestic legal systems. This rapid (if delayed) diffusion of the corporate form suggests that its absence from Islam's original organizational menu did not pose an insurmountable obstacle to its discovery or emulation later on. The lack of contemporary Islamist opposition to the corporation strengthens the point.

Choice of Law

The fifth original Islamic institution, choice of law, might have helped the region by effectively forcing Islamic courts to compete for clients. In fact, there is little doubt that allowing Islamic law to trump the legal systems of non-Muslims and permitting anyone to sue in Islamic court depressed the competition. This did not pose an appreciable handicap as long as economic life under Islamic law remained sophisticated by global standards. However, in time, changes in economic institutions in Europe turned the prevailing choice of law into an instrument that was biased in favor of minorities.

The region as a whole benefited from the opportunities Islam provided for doing business under Western institutions. On the downside, though, limiting access to Christians and Jews caused Muslims to fall behind economically. So Islam's distinct form of legal pluralism did play a major role in the region's observed economic trajectory.

Apostasy

Both the Koran and the remembered sayings of the prophet Muhammad contain references to apostasy as a religious offense. On the basis of these references, Muslim jurists of the seventh century declared apostasy to be punishable by death. Thus, by making it practically impossible for Muslims to do business under a non-Muslim legal system, Islam's apostasy law contributed to the economic ascent of religious minorities that were not limited by the rules.

The Muslims of the Middle East did eventually embrace modern economic institutions through legal reforms spearheaded by secular governments. Since those institutions have now been fully accepted, does the apostasy law still matter to the Middle East's economic performance? Yes – insofar as it leads Muslims to refrain from proposing bold reforms, from criticizing established policies and institutions identified with Islam, and from pushing back against the demands of conservative clerics.

Merchant Organizations

The final problematic pattern present at the birth of Islam is the absence of organizations to serve merchants' interests in foreign lands. Initially, this did not represent a handicap for Muslims, for merchants weren't organized anywhere else. But it was problematic in the Mediterranean trading emporium once Western merchants formed guilds and appointed consuls to represent them.

The absence of the corporate form of commercial organization and the persistence of Islamic partnerships eventually hindered the emergence of Middle Eastern merchant organizations. Such organizations would not have had to be created from scratch had they been part of Islam's original institutional complex. Now, of course, chambers of commerce and associations of industrialists are common in the Middle East. So the last of the original handicaps no longer poses an obstacle to economic development.

THE PERSISTENCE OF UNDERDEVELOPMENT

With the possible exception of the apostasy law, not one of the Islamic institutions that turned the Middle East into an economic laggard remains an obstacle to economic development in the 21st century. Reforms of the 19th and 20th centuries allowed Muslims to borrow from banks, to invest in stock markets, to establish corporations that could pursue a wide range of objectives, and to protect themselves from financial claims. Yet the Middle East remains an economically backward region. Might this book have overlooked certain deeper causes of backwardness? Could economic underdevelopment have become a chronic condition because organizational capabilities were never critical in the first place?

It is possible that the region's institutional history is irrelevant to explaining current patterns. My own view suggests it mattered in three ways, each involving "path dependence" – the persistence of historical influences.

Missing Complementary Institutions

First, only a subset of the institutions needed could be borrowed from abroad. Indeed, transplanting a legal code, organizational form or business technique is not the same thing as appropriating the social system that produced, refined and sustained it. The performance of a borrowed institution necessarily depends on pre-existing local institutions and depends on the capacity of the recipient community to adapt.

Consider the transplantation of commercial courts modeled after those of France – a process that started in the 1850s. The judges appointed to serve on Turkish and Egyptian commercial courts did not become proficient at applying the French commercial code overnight. It took time to train competent lawyers; local norms of fairness and liability did not change instantly. Nepotism and judicial corruption have remained rampant,

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in part because at the time of the reforms state employees were not accustomed to arm's-length transactions. They dealt with the employees of other organizations as individuals rather than as functionaries representing those organizations. This pattern has persisted to a greater extent than in parts of the world that modernized earlier.

No reliable data exist on the extent of corruption in the 19th century. The Corruption Perceptions Index created by Transparency International (an organization that monitors the business climate across the globe) does, however, provide data for recent years. And according to the index, business considers corruption, defined as the abuse of public office for private gain, to be a far greater problem in the Middle East than in Western Europe.

In 2009, on a 0 to 10 scale running from "least clean" to "most clean," the five most populous countries of Western Europe received a population-weighted average score of 6.7 (Germany 8, Britain 7.7, France 6.9, Spain 6.5, Italy 4.3). The corresponding average for the

CHRISTIAN HEEB / AURORA PHOTOS

three most populous countries of the Middle East was 3 (Turkey 4.4, Egypt 2.8, Iran 1.8). Modifying the region's business practices has apparently proved more difficult than rewriting its formal laws.

These chronic problems do not exist independent of historical context. The judges appointed to serve on specialized commercial courts lack proficiency because centuries of organizational stagnation removed the need for judges equipped with more sophisticated skills. No modern law schools existed because commerce remained largely personal, and training in Islamic law remained adequate to handle the disputes that commonly arose among people doing business under traditional Islamic institutions.

The region's commercial norms had co-evolved with its traditional organizational forms, contracts and means of enforcement. The prevalence of corruption is itself rooted in old patterns. Centuries of efforts to sidestep the inflexibilities of the *waqf* contributed to what one may call a "culture of corruption." In the modern era, this culture of corruption has undermined campaigns to strengthen the rule of law.

Weak Civil Society

The second part of the answer to the question of whether the institutional legacy contributed to the Middle East's present economic failures involves mechanisms constraining political change. In addition to creating incentives for corruption, the *waqf* system helped to keep civil society weak through several channels. It tied the hands of the caretakers managing vast resources, disallowing mergers that might have facilitated political coalitions beyond direct state control. The fact that the Middle East began to modernize without a strong civil society in place made it easier for states to take the lead in the development of sectors that might otherwise have advanced through decentralized private initiatives.

The top-down development programs prevalent in the region have been criticized for limiting private enterprise through over-regulation and misregulation. Yet, state centrism and the associated insensitivity to the needs of merchants gained currency only because the nations created after World War I had weak private sectors to start with. Whatever the accomplishments of state-centered development, the process reinforced the prevailing weaknesses of civil society. Furthermore, state-driven development has fostered a suspicion of organized dissent and political decentralization, both of which are essential to self-correction and self-generated innovation. Autocratic rule in the region stands, then, as a legacy of traditional Islamic law.

Consider, too, that economic underdevelopment is self-reinforcing. It has bred resignation toward autocracy that is rooted in fears that steps toward democracy could cause political instability and economic retrenchment by exposing suppressed political cleavages and inviting further foreign interference.

At the start of the 20th century, almost all large commercial enterprises in the Middle East were owned either by foreigners or by religious minorities because various Islamic institutions hindered private capital accumulation and because Muslims were slow to embrace modern economic institutions. With the shrinkage of these entrepreneurial communities (most importantly, through the Turkish-Greek population exchange of 1922-23) and emigrations associated with the founding of Israel, the Middle East's private sector was forced to accumulate physical and human capital from low bases.

Reactions to Economic Failures

We arrive, finally, at a third reason that the Middle East's institutional history has cast such a long shadow. The Middle East's loss of economic standing created fertile ground for the spread of protectionist ideologies, like Turkish statism and Arab socialism. It also triggered the rise of the diffuse global movement that aims to restore the primacy of traditional Islam by shielding Muslims from the influences of globalization.

In promoting the notion of an inexorable clash of civilizations, Islamism has fostered political uncertainty that is inimical to investment. It has induced policymakers and business leaders to eschew reforms, like freedom of the press, that might leave them vulnerable to charges of impiety. It has also provided pretexts for suppression of intellectual curiosity and hostility to experimentation. Islam's age-old prohibition of apostasy has compounded the resulting conservatism, all the more so in countries whose political regimes draw legitimacy from Islam.

The economic effects of Islamism have not been uniformly negative: Islamist movements have provided services to economically marginalized groups ill-served by state bureaucracies. In any case, Islamists aim to restore premodern economic relations only in some areas. Their opposition to economic modernization focuses on a few issues: the immorality of interest and insurance, the unfairness of extreme income inequality, the mixing of sexes that accompanies tourism, the destructiveness of unregulated advertising and consumerism. Even on these matters, Islamists are divided among themselves, with some accepting modern practices that others condemn as un-Islamic.

With the possible exception of the Taliban in Afghanistan, even militantly anti-modern Islamists have failed to restore economic patterns that were prevalent before the 19th century. They have little quarrel with the corporate form, or transfers of company shares through stock markets, or modern accounting, or publications that provide commercial intelligence.

Though it has lagged, the Middle Eastern economy has not stood still. Massive transformations in the 20th century allowed it to register growth rates in line with the West. But to catch up, it would have had to grow faster than the West – as did Japan, followed by other countries of East Asia. And poor policy choices linked to the region's institutional heritage have contributed to maintaining the gap that opened up centuries ago.

ISLAM AND THE CAPACITY FOR CHANGE

For the Middle East, as in the rest of the non-Western world, the economic transformation of the West presented both a problem and an opportunity. On the one hand, it created a host of military, political and cultural challenges. On the other, it allowed the region to modernize in a hurry simply by borrowing institutions that had taken shape in the West over many centuries. Could a conservative religious ethos that fosters resistance to learning and borrowing from abroad be a fundamental cause of why the catch-up process remains incomplete almost two centuries after the region set out to modernize economically?

That doesn't fit the facts. The Middle East has undergone massive institutional changes over the past two centuries in response to pressures from inside and out. In some places, beginning with the republic of Turkey in the 1920s, Islamic law was abrogated in its entirety. Where it survived (the Arabian peninsula), it has been modified beyond recognition.

The corporation is not only acceptable in Islamic countries, but a popular organizational form. Banks are an integral component of every economy. Shares trade hands daily in Middle Eastern stock markets. Were an 18th century merchant to come back to life, he would be impressed not with the economic practices that have endured, but by the massive changes that have taken place over a span of two centuries.

Skeptics might point to the centuries of organizational stagnation that preceded modernization as evidence of entrenched conservatism. They could add that the reforms came largely as a result of foreign prodding. If a 16th century merchant came alive two centuries later, before the start of reforms, he would have been struck by the familiarity of the prevailing forms of contract, credit practices and investment instruments.

But not everything would have looked the same. Military practices changed drastically: The Ottoman Empire adjusted and readjusted its weaponry, tactics and organization. Hence, it is not resistance to change itself that would have accounted for the sameness of commercial and financial practices. Key commercial and financial institutions were self-enforcing and mutually reinforcing. They generated incentives that undermined indigenous economic modernization, even as successive reforms took place in other domains, including the state bureaucracy.

When economic modernization did take

off in the 19th century, states were in the lead on various fronts. The founding in 1851 of Sirket-i Hayriye, the Istanbul-based joint-stock ferry company, furnishes one example. The Ottoman and Egyptian adoptions of the French commercial code a few years later provide another. Still another consists of the establishment – again, in the 1850s – of foreign-financed state banks in the Ottoman Empire and Egypt, using transplanted organizational templates.

By allowing its private sectors and civil societies to remain weak for centuries, the Middle East's premodern institutions set the stage for today's bloated state bureaucracies – and, in many places, government policies and social norms that undermine innovation and creativity.

Much research has been done on these state-driven reforms. By contrast, demands for change from below – from merchants, financiers, and investors – stimulated and shaped the modernization process. Communities all across the region invited banks to establish local branches. Complaints about the inadequacies of traditional institutions, including law courts, fostered a climate of opinion conducive to borrowing foreign commercial institutions. At the time of the founding of the aforementioned Sirket-i Hayriye joint stock company, local Christians and Jews were already using modern organizational forms, and Muslims began doing so, too, once complementary institutions fell into place.

These transformations reconfirm that communities of the region did possess a capacity and hunger for change. As the evolution of Western economic institutions caused an increasingly visible divergence of living standards – first between Middle Easterners and Westerners, and then among religious communities within the Middle East itself – reforms gained increasing acceptance.

It was not lost on anyone that the institutions transplanted to the Middle East had originated in Christian Europe. Although opposition arose to changes involving family life, gender relations and social hierarchies, opposition to purely economic transplants has generally been insignificant. The anti-interest movement that spawned Islamic banking took off in the 20th century for reasons of cultural identity protection rather than a commitment to traditional economic life. Today, very few Muslims really seek to purge interest from their financial transactions. Furthermore, even that conservative minority is comfortable with other aspects of modern banking with foreign origins. In sum, the Middle East has demonstrated time and again on economic matters that it can take advantage of new opportunities – including ones that emerge in secular realms and in overwhelmingly non-Muslim countries.

Islam's acceptance of cross-cultural and cross-religious borrowing of institutions is also evident in the origins of the principles and regulations that formed classical Islamic law. Most of these grew out of the Middle East's existing institutions, including those of the Romans and Persians as well as the Jewish and

Christian tribes of Arabia. Even though many generations of Muslim interpreters have colluded to obfuscate the foreign origins of classical Islamic law, it did, in fact, represent a vast – and in some respects magnificent – synthesis.

THE PAST AND THE FUTURE

My interpretation offers an optimistic message for the future of the Islamic Middle East – but also carries a pessimistic message for the region's economic performance in the near term.

Start with the bad news: the region cannot be lifted from its present state of underdevelopment in a hurry. By allowing its private sectors and civil societies to remain weak for centuries, the Middle East's premodern institutions set the stage for today's bloated state bureaucracies – and, in many places, government policies and social norms that undermine innovation and creativity. Consequently, with a few exceptions, the countries of the region are uncompetitive in the global marketplace for industrial products and services. And, with few exceptions, their civil societies are too beaten down to provide the checks and balances essential to sustained democratic rule.

Even if the region's autocratic regimes were magically to fall, the development of strong private sectors and civil societies could still take decades. Trust in strangers and in organizations, essential to impersonal exchange, is low by today's global standards, creating a substantial obstacle to efficient economic cooperation. Also, new democratic regimes would inherit bureaucracies accustomed to corruption.

Another unresolved difficulty is that in spite of institutional reforms that implicitly acknowledge the unsuitability of classical Islamic law to modern needs, the region as a whole has yet to come to terms with the reasons it became an economic laggard. The idea that outsiders are somehow responsible for the Middle East's underdevelopment resonates with much of the population – including secularists who consider Islamic law backward and obsolete. In particular, the role of classical Islamic law in blocking organizational modernization and stultifying Middle Eastern (and particularly Muslim) enterprise is hardly understood.

This limits the rhetorical tool kit of proponents of globalization and modernization. It also sustains sterile debates about the virtues of embracing Islam for solutions to poverty, economic mismanagement and a sense of powerlessness common in autocracies. Not even the typical Islamist appreciates the limitations of Islamic law (generally known as *Shariah*) as a basis for social, economic and political order in the 21st century.

The good news is that the region borrowed the key economic institutions of modern capitalism sufficiently long ago to make them seem unforeign, and thus culturally acceptable even to self-consciously anti-modern Islamists. These institutions can be improved, recombined and applied to new domains without falling into conflict with Islam as a religion. They can be debated in isolation from public controversies over what Islam represents and its relevance to the present.

Furthermore, Islamic economic history offers abundant precedents for promoting free enterprise and limiting the government's economic role. In no period has private enterprise been lacking. Widely admired Islamic empires had shallow governments that left the provision of social welfare, education and urban amenities to *waqfs*. A predominantly Muslim society is not inherently incompatible, then, with an economy based on free competition, openness to credit transactions and innovation, and a government eager to support private enterprise.