

# Institutions, Organizations, and Interests

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This paper was written for the conference on *The Dynamics of Institutions in Perspective: Alternative Conceptions and Future Challenges*, organized by Eric Brousseau, Pierre Garrouste, and Emmanuel Raynaud in Paris October 3 and 4, 2008. I appreciate the opportunity offered by the organizers, conversations with Avner Greif and Naomi Lamoreaux over the last year about organizations, and comments on the very first draft by Roger Betancourt and Doug North. This paper builds on the concepts of limited access and open access social orders developed in Doug North, John Wallis, and Barry Weingast *Violence and Social Orders: A Conceptual Framework for Interpreting Recorded Human History*, forthcoming, Cambridge University Press, 2009. But the paper differs substantially in the way it treats the relationship between institutions and organizations. North and Weingast should not be implicated in these ideas.

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Doug North's heuristic notion that institutions are the rules of the game and the method of enforcing the rules, and that organizations are the teams that play the game serves as one starting point for understanding the dynamics of institutional change through time. Human actors and the organizations that coordinate their activities, continually face fundamental choices between playing under the rules or devoting resources to changing the rules. Implicit in North's notion of an institution are rules that apply equally to all the teams, although some teams may try to cheat. By definition, as it were, institutional change becomes changes in the rules, whether those rules are formal law, informal norms, or shared beliefs about human interaction. Rather than accepting as a starting point that institutions shape the incentives that determine how organizations act, this paper asks whether there are patterns of social interaction where the organizations (teams) set the rules and the rules may be different for different teams. If so, then the dynamic of institutional change is driven by the behavior of organizations. These two perspectives on the interaction of organizations and institutions correspond to two types of social orders: modern, developed, or open access societies where the interests of individuals support and sustains a set of unbiased and credible rules which are distinct from non-modern, undeveloped, or limited access societies where the interests of individuals supports and sustains a set of credible, but limited number of organizations and the rules are more or less subject to change. One type of society appears to be capable of credible commitment to institutional rules through time, while the other type does not.

Avner Greif offers a more complicated notion of an institution as the complex of rules, norms, organizations, and beliefs – what he calls “institutional elements” -- that provide an internally consistent way of structuring human interaction. Again by definition, institutional

change in Greif's framework occurs constantly as the elements of institutions change. In Greifian terms it would not matter whether institutional rules set the parameters for organizations, or whether organizations set the parameters for institutional rules, either (or both) of the interactions would be part of the institutional framework. For most of his recent book (2006A) Greif focuses on the interaction of individuals, beliefs, norms, and institutional rules and explicit consideration of organizations is minimized, although he is clearly concerned about the quasi-independent role of organizations (2006B).<sup>1</sup> Greif's framework major advantage is explicit recognition of the endogenous interaction of institutional rules, organizations, and beliefs, but at the expense of the (relative) empirical clarity that North's definition of institutions as rules and organizations as team brings. North's concepts are closer to what we need to understand what seems to be a common and widely shared belief amongst social scientists that a primary source of modern economic development: the ability to devise credible unbiased rules that persist through time and enforce them in a consistent manner.

Confusion reigns with respect to the definition of institutions over the long term. A recent paper by Acemoglu and Robinson "De Facto Political Power and Institutional Persistence," begins with the observation that in many countries the form of political rules and organizations and the form of economic rules and organizations change regularly over time and yet, somehow, institutions persist.<sup>2</sup> If rules and organizations change, how can institutions not

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<sup>1</sup>Avner is clearly concerned about the importance of organizations and I hope that he will present a paper on organizations in Paris.

<sup>2</sup>Acemoglu and Robinson, 2006B, p. 325: "Institutional persistence, in this context, refers to the persistence of *a cluster of economic institutions*, such as the extent of enforcement of property rights for a broad cross section of society... Such lack of property rights enforcement may be driven by quite different specific institutions, e.g., risk of expropriation, entry barriers, or

change? In most societies in history and the modern world, both the rules, the organizations, and the identities of the major players changes too consistently to support a blanket assertion that institutions are persistent.<sup>3</sup> If we identify institutions with amorphous concepts like well defined property rights or rule of law, then the institutions may persist, but this runs us perilously close to defining institutions by outcomes rather than by empirically observable structures in human societies.

This paper uses North's definition of institutions and organizations, Greif's notion that all institutional elements are endogenous (but not his inclusive definition of an institution), and focuses on the formation of individual interests within the dynamics of social interaction. Under some configurations of institutions and organizations, the dynamics result in individual interests that produce a willingness among individuals to support their organizations at the cost of not sustaining institutional rules. Under another configuration, the dynamics produces a willingness to support institutional rules at (perhaps) the cost of not supporting their organizations. The meaning of "willingness to support" will become clearer as the paper proceeds (I hope). For

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economic systems such as serfdom or slavery. In turn, these different specific economic institutions may exist under different political institutions, including dictatorships, absolutist monarchies, oligarchies, and corrupt or even populist democracies. Given this rich array of possibilities, a useful framework must specify which aspects of institutions can change, which others have a tendency to persist in equilibrium, and how the persistence of certain types of institutions could have lasting effects on economic outcomes." For similar attention to the persistence of institutions see Acemoglu, Robinson, Johnson, and Yared, 2007 and Engerman and Sokoloff, 2008.

<sup>3</sup>Mussachio, 2008, finds that the institutional rules governing creditor rights in bond markets in Brazil "vary too much, both over time and within and across countries, to support the assumption of a stable relationship between legal origin and credit and between creditor rights and bond market development." If you pay attention to the details of the institutional rules, they change much more frequently than the apparent persistence of the institutions would suggest.

example, Democrats who accepted the Supreme Court's decision that George Bush had beaten Al Gore in the 2000 presidential election supported the rules over their organization; Kenyan's who agreed to change their constitution in the winter of 2008 by creating the office of Prime Minister to bring and end the violence supported their organizations over their institutional rules.

Throughout the paper I assume that the world all people live in is a complex and unpredictable place. Although there is persistence in the world, it is also fundamentally unpredictable and non-ergodic. Part of this flows from complexity and randomness in the physical world, but most of it flows from the complexity of the social world. Human institutions, in the Greifian sense, are complex non-linear systems. Sometimes small changes produce unexpected and, occasionally, very large effects.<sup>4</sup>

All people form beliefs about the causal relationships between events and other people in the world they live in. The combination of their tastes and preferences, their causal beliefs, the alternative choices they face, and the costs and benefits attached to those choices determine the interests that people possess. I assume that people are intentional, that is, they act in what they perceive to be in their interest given their preferences, beliefs, choices, and relative prices. The question to be asked is whether there are certain patterns of institutions and organizations that lead people living in a dynamic and somewhat unpredictable world, to find that their interests lie in supporting abstract rules that apply to everyone, or to support the specific organizations they belong to? Thus the title: institutions, organizations, and interests.

North, Wallis, and Weingast 2009 (hereafter NWW) propose that societies can be

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<sup>4</sup>I am simply asserting these conditions for this paper, without making any assumptions about the underlying structure of the world.

ordered in two different fundamentally different ways. In one social order, limits on the number and type of organizations create rents that coordinate powerful individuals and so help ensure social order. Individuals are closely tied to their organizations and have a strong interest in supporting the organizations they belong to rather than supporting generalized rules that apply to everyone. These limited access social orders, manipulate the interests of everyone to produce coordinated social outcomes and limit violence. In contrast, open access social orders limit violence by consolidating control over military and police forces in the government; control the government through some type of constitutional procedures; and ensure that competition for control of the government is maintained by allowing individuals to freely form economic and other social organizations for a wide range of purposes. Economic competition sustains political competition, political competition sustains economic competition, and open access to organizations enables competition in both sectors to survive. One social order manipulates interests by limiting access to organizations, the other social order opens access to organizations.

In the book, NWW maintain North's assumption that institutions set the rules for organizations. This paper questions whether that is the right way to think about limited access social orders, and thus for most of human history and the contemporary world. In societies that manipulate interests by limiting access to organizations, it is the organizations that constrain the rules, not the rules that constrain the organizations.

What follows lays out the logic of this argument in more detail. First, the formation of interests in Greif's analytical framework is developed to explain institutions and institutional change. Second, social behavior when where interest formation is limited is compared to social behavior when interests are not limited by restrictions on the ability to form organizations. This

enables us to see why the same political and economic rules, formal or informal, work differently when interests are and are not manipulated. This entails an examination of how political and economic behavior are related. Third, and much more briefly than I would have liked, this preliminary version of the paper will show how early 19<sup>th</sup> century America came to adopt new institutional rules regarding the formation of organizations that parallel the main argument.

## **2. The formation of interests**

When faced with a choice between two alternatives, an individual chooses that alternative which is in her “interest.” Defining interests in this way is tautological, since interests are revealed by choice; but it is hard to see any other place to start. Human beings are intentional, they have interests and attempt to pursue them, but their motivations are various and often obscure to the external observer. We can, as economists often do, put more weight on intentionality and assume that individuals are rational, that is that they make the best choices over a specified range of choices according to specified criteria. The rationality assumption is a powerful analytic device, but not one we need to employ here.

Interests are the result of factors internal and external to the individual. Individuals have tastes and preferences: some people prefer brown to blue, others blue to brown. Individuals also have beliefs about how the world around them works. Beliefs are integral to interests. In order for people to pursue desirable outcomes they must have ideas about how to achieve those outcomes. Those ideas are beliefs. For an individual choosing between apples and oranges, the choices are clear. But the options may be less clear if one of the choices is to take action X,

which will produce reaction Y, from which the individual will gain from an activity Z. This choice involves a belief about the causal relationship between X, Y, and Z. An individual who wants Z has to have causal beliefs about the causal relationships among X, Y, and Z.

If X is turning the spigot, Y is water coming out of the faucet, and Z is that the individual obtains water, then a person who chooses water acts by first turning the spigot. If X is saying her prayers every night, Y is God looking upon her with favor, and Z is that she will live in eternal peace after death, then the person who chooses eternal life acts by first saying her prayers. Whether choice X is turning the spigot or saying prayers, the choice to do either is an intentional act designed to achieve a certain outcome based on a set of causal beliefs about the world. If we want eternal life, then it is in our interests, *ceteris paribus*, to say our prayers at night. Understanding human behavior therefore requires that we understand beliefs about causality as a central feature in the process of interest formation and choice.

Beliefs are only part of interest formation, however. The range of choices available to individuals as well as the relative prices associated with those alternatives are as important as beliefs in shaping interests.<sup>5</sup> Institutions, in the North or Greif definitions, are primary determinants of the range of choices available to individuals. Institutions also directly and

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<sup>5</sup>Economists often focus exclusively on relative prices, holding preferences, beliefs, and the range of choices constant, *ceteris paribus*. “The study of some group of tendencies is isolated by the assumption other things being equal: the existence of other tendencies is not denied, but their disturbing effect is neglected for a time. The more the issue is thus narrowed, the more exactly can it be handled: but also the less closely does it correspond to real life. Each exact and firm handling of a narrow issue, however, helps towards treating broader issues, in which that narrow issue is contained, more exactly than would otherwise have been possible. With each step more things can be let out of the pound; exact discussions can be made less abstract, realistic discussions can be made less inexact than was possible at an earlier stage.” Alfred Marshall, *Principles of Economics*, Bk.V,Ch.V in paragraph V.V.10).



indirectly affect the relative prices attached to specific choices. Relative prices reflect the ongoing process of choice within any society, whether resulting from a price making market or simply reflecting the technical trade-offs of producing apples or oranges in a Robinson Crusoe economy.

Interests, then, result from the interaction of the tastes and preferences of individuals, the range of choices they face, the relative prices of the trade-offs they must make between those choices, and their beliefs about how different events, and therefore choices, in the world connect to one another. We can abstract the four elements of interest formation as preferences, relative prices, institutions and beliefs. Any reasonable theory of human society will take these four elements of choice as endogenously determined by the interaction of individuals within society. Under plausible definitions, beliefs would include knowledge of the physical world (technology and science), and relative prices would encompass the effects of climate, geography, and other external physical events. The four factors constitute all the necessary elements for explaining social and individual behavior.

The genius of Avner Greif's approach to institutions is to bring the endogenous elements into an equilibrium set of social arrangements. His key insight is that the only beliefs that we can plausibly consider individuals holding are beliefs about the actions of others that are consistent with the institutions and relative prices that individuals actually face. That is, in conceptual terms, beliefs are limited to those causal relationships that are actually consistent with the behavior of the people around us. This enables Greif, *ceteris paribus*, to describe an "institution" as encompassing preferences, beliefs, and institutions as well as rules, norms, and organizations. Laying out the logic of the self-sustaining relationships between institutions and

beliefs is an enormous accomplishment that requires focusing on a few key elements. The logical argument only requires the interaction of individuals, but the spirit of the argument suggests that more than individuals matter. I want to hold on to Greif's basic insight about the interaction of institutions and beliefs, but draw out more explicitly the importance of organizations by treating them as independent from institutions rather than an institutional element.

Two features of Greif's framework are important here. He creates a logical equilibrium structure in which the activities of the group are coordinated by arrangements completely sustained within the group. Everyone's interests leads them to behave within the boundaries of the choices formed by the institutional structure. The group is self-sustaining without external intervention. The scale of the group could be a whole society, somewhat like Genoa, or a smaller group embedded in a larger society or societies, like the Maghribi traders. Both groups could be denoted as organizations, that is, as a specific group of individuals bound by a common set of institutions, beliefs, and interests (even though their individual interests could, at times, be at odds within the framework of the organization). If such a group forms without any external constraints, then we want to focus on the self-organizing dynamics of the organization. A limiting case of such a group could be a voluntary organization, ala Mancur Olson (1965 and 1982), where all individuals have the option of exit. Greif includes organizations where violence may be credibly used or threatened to coerce members to cooperate or stay. Organizations like the Maghribi, however, also form within the constraints and supports of larger societies, where some arrangements between group members may be enforced by parties external to the organization. In both cases, the internal arrangements of the organization must create interests

for each of its members to stay a member. Whether an organization utilizes external constraints and supports is not of particular interest to Greif who wants to explain why institutions can be independently self-enforcing, but the role of external forces is central to my argument.

The second aspect is the nature of beliefs. While beliefs about the physical world a group of people hold may be important, the critically important beliefs are beliefs about how other individuals will behave. That is, ideas that really matter are ideas about the causal determinants of individual behavior. While there must be an evolutionary constraint on having ideas about the physical world that do not adequately deal with common place physical phenomenon like gravity, whether a belief about the physical world is literally “true” or not may not be critically important (“the world is flat,” and other examples, abound). Ideas about the behavior of people, however, can never be universally true in the sense that ideas about gravity on the earth’s surface can be.<sup>6</sup> Social behavior is infinitely variable. Even the physical constraints of eating, sleeping, defecating, and procreating are subject to infinite variety within and across human cultures.

The infinite variety of possible behavior, however, does not imply that all behavior and thus all beliefs about behavior, can be realized in any specific situation. As Greif so neatly shows, given the constraints of institutions, preferences, and relative prices only a narrow set of beliefs about how other people behave are sustainable.<sup>7</sup> One result of the limitations on

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<sup>6</sup>Even physical ideas and beliefs, like gravity, which hold uniformly on the earth’s surface, do not hold in the same way in outer space.

<sup>7</sup>The “narrowness” of set of beliefs is meant to refer only to the actual set of ideas relative to the entire set of beliefs that could be held, not that the beliefs that are held are narrow in any absolute or pejorative sense.

sustainable beliefs is the importance of time. At any point in time, the existing preferences, beliefs, institutions, and relative prices constrain the feasible choices of individuals. North and others call this path dependence. In the path dependence perspective, beliefs, institutions, and relative prices are not persistent because they cannot change, but because they are embedded in a larger social process. In Greif's equilibrium framework, all the elements have to change together. The endogeneity of beliefs, institutions, and relative prices itself is itself a cause of path dependence.

Persistence and continuity through time can be deceptive, however. Paradoxically, endogeneity is also a major cause of dynamism and unpredictability in social institutions. The highly non-linear and endogenous relationships between the preferences, beliefs, institutions, and relative prices that shape interests and determine human choices is, in the terms of modern science, a complex and non-ergodic system. Small changes in any of the conditions can produce large and unintended consequences, a butterfly effect. Societies are like the weather: from the standpoint of an individual the behavior of the society around him contains elements of persistence and predictability, but also holds the threat of unpredictable change. The world is not dynamic in the sense of dynamic growth and development, but dynamic in the sense of constant and somewhat unpredictable change.

In this dynamic world, some individuals find it in their interest to commit acts of violence, rape, pillage, plunder, cruelty, deception, fraud, and theft, just to mention a few of the less desirable interests that may form. Individuals find it in their interest to be loving, caring, giving, charitable, other oriented, and generally nice to be around. Many individuals demonstrate both sets of interests, how do we ensure that the individuals we come in contact

with act on the second rather than the first set of interests? How do we form beliefs about the interests of others?

In simple human societies where the typical group size is small, strangers are treated with grave suspicion and ongoing relationships are conducted with kin and those we know intimately. But societies where the typical group is 25 people and occasional gatherings of 200 or so are the largest groups, are not capable of sustaining a high degree of coordination, organization, or specialization. In order for societies to develop beyond the scale where most people have immediate and regular face to face contact and personal knowledge, there must be ways for us to form expectations and beliefs about the interests of other individuals. This process is particularly important for individuals with whom we wish to interact and cooperate.

There seem to be two basic ways of comprehending that another's interest is in concert with ones own interest.<sup>8</sup> One way is to believe that the other has a sufficient interest in our well being that we are confident they will act in our interest (along some dimensions). Families and kin relations are an obvious case. So, too, are the interests of a crime lord who claims a large share of his minions income, enough so that both sides can believe that the crime lord will act in the minions interests (within certain parameters). The other way to form beliefs about others occurs when we perceive constraints on other individuals that influence their interests and lead to predictable behavior. For example, in most modern societies we interact with others we do not know. We (may) believe that others will not act in proscribed or illegal ways because of the threat of legal sanction or physical punishment create an interest in acting legally. This

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<sup>8</sup>This discussion focuses on the positive side of beliefs in others interests. Beliefs that other individuals do not take my interest into account, will act in unpredictable ways, or will actively attempt to harm me are also important.

perceived interest of people we don't know enables us to believe they will act predictably (on certain margins).<sup>9</sup> The first way of comprehending interests usually entails personal interaction, the second can function with or without personal knowledge.<sup>10</sup> Interests in cooperating with another occurs when we believe, rightly or wrongly, that the interests of the other person are aligned appropriately with our own. Coordinated social activity is, therefore, the result of interest formation.

NWW begin their analysis with a world in which individuals base trust on personal interaction, and ask how, in a world where violence is a viable option, some individuals can deal with dangerous and potentially violent individuals with some degree of confidence. They begin with specialists in violence, who mistrust one another, and will not lay down their arms and coexist because they believe such behavior will lead the other specialist to destroy or enslave them. Armed conflict is the equilibrium outcome. The solution proposed, in simple terms, is the violence specialists agree to divide the land, labor, and capital in their world between them, agree to enforce each others privileged access to their resources, and if the value of the rents they earn from their privileges are large enough under conditions of peace rather than violence, each specialist can credibly believe that the other will not fight. The specialists remain armed and dangerous and can credibly threaten the labor around them to ensure each other's rights.

The arrangement is represented graphically in Figure 1, where the X's are the two violence specialists, the horizontal ellipse represents the arrangement between the specialists that

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<sup>9</sup>Beliefs do not have to have a rational and logical internal structure. There is no reason people can't simply believe they won't be cheated, thus the relevance of the trust literature.

<sup>10</sup>John McCain devoted time in his acceptance speech at the Republican National convention assuring listeners that he worked for them and had their interests at heart.

create their organization/institution, and the vertical ellipses represent the arrangements the specialists have with their clients. It is the rents the specialists receive from controlling their client organizations that enable them to credibly commit to one another, since the rents are reduced if they fail to cooperate and fight. At the same time, the existence of their agreement enables each of them to better structure their client organizations, because they can call on each other for external support. Whether we think of the ellipses as institutions or organizations is important, before doing that, however, we need to be cognizant of two different types of organizations.

Organizations are groups of people with shared interests and goals. An *adherent organization* is one where all of the members have an interest in cooperating with each other (on the relevant dimensions of the organized activity) at all points in time. In an adherent organization interests are structured in such a way that all individuals have an interest in belonging to the organization, even if their interest results from being coerced. In Greif's terms, adherent organizations are institutions, where the elements of formal rules, informal rules, norms, and shared beliefs coordinate the organization.

In contrast, a *contractual organization* is one where relationships between the group members are not inherently self-sustaining, and the group maintains itself only through the presence (or potential presence) of an external third party. The third party may enforce relationships within the organization or between the organization and other external parties.

In Figure 1, the horizontal relationships between the violence specialists create an adherent organization, the vertical relationships between the violence specialists and their clients are contractual organizations because they rely on the external presence of the other violence

specialists. The vertical organizations might be organized as kin groups, ethnic groups, patron-client networks, or organized crime families. The combination of the three organizations, the “organization of organizations,” mitigates the problem of violence between the really dangerous people, the violence specialists, creates credible commitments between the specialists by structuring their interests, and creates a modicum of belief that the specialists and their clients share a common interests because the specialists have a claim on the output of their clients. The figure is a very simple representation. In a functioning society, elites in the dominant coalition include economic, political, religious, and educational specialists whose privileged positions create rents that ensure their cooperation with the dominant coalition and create the organizations through which the goods and services produced by the population can be mobilized and redistributed.<sup>11</sup>

Going back to the terminological questions, in Greif’s terms all three ellipses together form an institution: the complex of rules (formal and informal), organizations, and beliefs that sustain coordinated behavior. In North’s terms, Figure 1 represents three connected organizations (the teams), governed by a set of institutions (the rules of the game), whose players have beliefs about the structure of their world.<sup>12</sup>

Each one of the organization possesses it own institutional rules. The development of the rules exhibits several characteristics. First, at the level of the specialists in the dominant coalition, their ongoing relationship may lead to regularities in their actions that become norms,

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<sup>11</sup>North, Wallis, and Weingast, 2009, chapter 2. Earle, 1997 and 2003, and Johnson and Earle 2000, provide a series of anthropological examples of how chiefs come to power and the scale of society increases by the systematic manipulation of economic interests.

<sup>12</sup>This is a combination of North 1990 and North 2005.



then informal rules, and finally formal rules. The form these institutions take is governed by the relationship between the specialists. The institutional rules regulate the relationships between the specialists and between the specialists and the organizations they head. By necessity, the institutional rules must apply to each of the specialists individually, that is, the rules apply uniquely to each one of the specialists and identify his personal characteristics and shape his unique interests.<sup>13</sup> These rules are subject to renegotiation whenever the underlying circumstances of any of the powerful players changes.

North's heuristic definition of institutions as rules of the game and organizations as teams does not quite fit this picture of the dominant coalition. Implicitly, all the teams in North's framework play by the same rules, even as they must decide whether to devoting resources to production, to evading, or to changing the rules. In the framework of Figure 1, different rules apply to different people, the institutions that govern the relationships between powerful individuals in the dominant coalition often apply personally. There may be persistence in the form of institutions within the coalition (king, dukes, barons, etc.), but the individuals operating within those institutions cooperate only if the institutions create interests that lead them, as individuals, to cooperate. The personal and idiosyncratic nature of institutional rules must be kept in mind, rather than the assumption that all institutional rules are meant to be applied impartially.

Second, one of the privileges the specialists enjoy is the exclusive ability to form organizations. A primary source of rents creating interests within the dominant coalition is the

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<sup>13</sup> The rules that the dominant coalition will enforce within each of the organizations are therefore different as well.

ability to use the coalition to help enforce within the organizations of the coalition members. The rents created by those exclusive privileges are part of the glue holding the agreements between the specialists together. In Figure 1, the rents from the vertical organizations make credible the agreements in the horizontal organization of the dominant coalition. Limiting access to external support for organizations creates rents and shape the interests of the players in the coalition. At the same time, the institutional structure gives leaders of organizations tools to shape the interests of their clients.<sup>14</sup> The nature of the (vertical) client organizations is critical to the whole structure. Because the specialists can call on the dominant coalition to enforce agreements within their client organizations, those organizations are contractual. The dominant coalition as a group, therefore, has a lever to use over an individual member by withdrawing third party services, a tool to help coordinate the dominant coalition. By denying those tools to non-sanctioned organizations, the coalition is able to limit organized opposition and better secure their own rents in a way that strengthens coordination.

Third, in Greif's endogenous institutions way of thinking, the internal dynamics of the complex organization of organizations has a marked influence on the actual institutional rules in place at any point in time. When push comes to shove and violence looms, the rules are adjusted to accommodate the personal identity of the major players and to shape their interests in a way to maintain cooperation. The recent events in Kenya are a good illustration. When violence broke

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<sup>14</sup> The leaders control positive access to higher levels of the society and can wield negative sanctions by calling on the violence and coercive power of the coalition. For example, in Alston and Ferrie's description of patronage in the post-bellum American South or Kettering's account of patronage in 17<sup>th</sup> century France the ability of elites to control access to the courts and to intercede on behalf of clients is a powerful coordinator of interests within the patron-client networks.

out after a disputed election, resolution of the violence involved rewriting the constitution to create the position of prime minister for the opposition leader. Kenya is a good example of how the organizational needs of the specific individuals and organizations govern the formation on institutional rules in real time. Using North's terminology, rather than the rules shaping the teams, in this world the *teams shape the rules*. The rules are both personal and somewhat flexible. People cannot believe that the rules are unchangeable and have those beliefs verified by experience.<sup>15</sup> Another, more accurate, way of stating this is that people believe their interests are served and protected by the organizations they are associated with, rather than by institutional rules.

The entire complex of organizations, institutions, and beliefs creates a set of interests for individuals leading to cooperative outcomes. Organizations occupy the central place in this process and limiting access to organizations shapes interests. Organizations are a primary driver of both the shape of institutions and their change over time. This is a social system that *manipulates* the interests of individuals through the structure of organizations. Manipulate may seem an inappropriate word, since manipulate implies intentionality. No individual or group is consciously and intentionally attempting to create a pattern of interests within the entire society. However, the decision to support specific contractual organizations is a deliberate and intentional decision, and those decisions are continually being reconsidered within the dominant coalition. The pattern of interests in a society results, in part, from the kind and distribution of contractual organizations. It is in the later indirect sense that interests are manipulated. When a

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<sup>15</sup>People, of course, can believe anything, but in a Greifian world, a belief that the rules are unchanging will be unsustainable.

society decides to open access to contractual organizations to a wider group of individuals, it ceases to manipulate interests in this way.

The complex of organizations and institutions has implications for beliefs as well. In particular, this type of society does not result in a sense of personal identity that extends far beyond the immediate organizations they are embedded in. Identity, an individual's belief in who he or she is, is an important element in belief systems.<sup>16</sup> Identity in pre-modern societies was not closely associated with larger social units.<sup>17</sup> Identity, and thus an important element of causal beliefs, in pre-modern societies is shaped by the immediate organizations we live within.

Manipulation of interests occurs both because the rules governing organizations are idiosyncratic, each organization creates a unique set of rents for its members, and because the ability to form an organization, the ability to access the rules, is limited to a small segment of society. What happens if these constraints change? What happens if rules are applied equally to all organizations, the notion implicit in North's definition of institutions and organizations, and if those organizational forms (the specific form of organizational relationships the society will support) are open to a wider group of individuals?

This is where the Greif framework does diverge from North's and from the NWW framework in a more substantive way: the identity of the third party. For Greif, the entire

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<sup>16</sup>For an example of this see the work of Kranton and Akerloff.

<sup>17</sup>As Taylor (2007) puts it, p. 210: "in seventeenth century France... The educated had a model of the ancient republic. But for many others, the only way they could understand belonging to a larger whole, like a kingdom, or a universal church, was through the imbrication of more immediate, understandable units of belonging – parish, lord – into the greater entity." There is an enormous literature on the change in identity associated with modernity, particularly the rise of national identities. Anderson 1991, Gellner 1983, etc.

complex of organizations and beliefs is an institution and all the elements of the institution are endogenously related to each other. All of the interests sustained by the institutions, organizations, and beliefs arise within the group of people under consideration, nothing external is needed. Whether the Greifian institution is formally called a state or not, whether it uses violence or not, whether it is geographically or numerically large or small, it is a self-contained unit. The entire institution is always an adherent organization, it does not rely on external actors to maintain its integrity. Within a Greifian institution, there is no need for a state, indeed there is no necessary need for formal rules. But a Greifian institution may contain contractual organizations within it. A Greifian institution, like the medieval Catholic church perhaps, is an adherent and incentive compatible organization, but individual organizations within the larger structure do depend on and utilize external third party enforcement of relationships. Bishops and dioceses are not adherent organizations, but dependent on the structure provided by the larger church.

The NWW framework focuses on the importance of violence because all societies must figure out how to manage violence if they are to develop larger societies. That leads them to focus on the dominant coalition, the arrangements within the coalition that manage violence among powerful individuals, and the ability of coalition members to structure other contractual organizations. Whether we want to call the dominant coalition “the state” or not isn’t clear. Limited access societies typically do not meet the Weberian criteria for a state: consolidated control of military resources within one organization. To that extent, NWW are in complete agreement with Greif that important organizations can be sustained without the formal action of a formal state.

Nonetheless, in the transformation of societies from limited access to modern open access in the 19<sup>th</sup> century and later, the formal state occupies a central role. The state provides the external support for contractual organizations and the state must, somehow, figure out through a set political, economic, and social institutions how to make open access to the same set of rules for everyone (or at least all citizens) sustainable. This brings us to the point where a discussion of the interaction of political and economic development in the process of modernization can go forward.

Interests flow from the interaction of preferences, beliefs, institutions, and preferences. Organizations are intermediary in the process, but critical to structuring interests that allow individuals to cooperate. Cooperation cannot be sustained unless individuals believe that cooperation is in the interest of other individuals. Organizations structure interests and so facilitate cooperation. Considered as rules of the game, one role of institutions is to function as supports for organizations. As long as most rules are idiosyncratic and personal, the rules by themselves cannot support impersonal relationships. As long as rules are personal and idiosyncratic, people cannot believe that the rules will constrain the behavior of people they do not know or cannot identify.

### **3. The connections between economic and political systems**

The difference between a society that limits access to organizations and manipulates interests in the process and a society that opens access to organizations lay at the heart of the difference between modern, developed societies and the developing world. Rather than explaining how and why the transition between them occurs, this section contrasts the

relationship between politics and economics in limited open access societies and then moves on to emphasize the social dynamics produced and sustained by open access. The argument stresses the close connections between political and economic systems, their behavior at a point in time, and their development over time. The approach, however, carry greater implications for how we think about politics than economics. As societies move from limited to open access, the function of politics shifts away from balancing the interests of powerful organizations through ongoing manipulation of the rules and towards the creation, maintenance, and enforcement of institutional rules. The rule must support entry and thus an open competition between organizations. Competition maintains a balance of political and economic interests. Politics is transformed from the active manipulation of interests to maintain balance between those interests, to the more passive formation of general rules.<sup>18</sup>

Open access societies do not reduce the pressure to change the rules in favor of powerful interests, rent seeking does not go away. Nor are rules immutably fixed, there is constant debate and contention over what the rules should be and whether the rules should be changed. But political competition over the shape of specific institutional rules operates within a set of general constitutional rules that appear to change more slowly. Often these rules are embodied in written constitutions, although simply writing down rules neither makes them constitutional nor permanent. We want to understand why some societies over the last 200 years have gotten much better at forming, maintaining, and enforcing general rules, while most societies find this an unmanageable task.

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<sup>18</sup>At the same time, open access governments also tend to expand their provision of public goods, so that governments are typically larger as a share of GDP in higher income countries.

Modern developed societies are characterized by more complex and numerous organizations of all types. The ability to support more complex organizations affects social outcomes in three ways: a direct effect, and interactive effect, and a dynamic effect. Better organizations make economic and political systems more productive in simple and direct ways. Open access to organizations also changes the interactive relationship between economic, political, and other social systems in a way that makes it possible to sustain open access in both systems. Finally, open access changes the dynamic relationship between institutions and organization and the way in which societies change over time.

The direct effect of institutions that support more complex and sophisticated organizations is a straightforward increase in the productivity of individuals in a basic economic sense: societies with denser networks of organizations are more productive. Within those societies more productive individuals tend to be located within complex and often larger organizations. While we rarely talk directly about the productivity of the political system, there is a parallel concept of state “capacity.”<sup>19</sup> Political organizations in developed societies have more capacity to deliver public goods and services, and to do so in an impersonal and unbiased manner. The importance of rich and varied organizations outside of narrow political and economic organizations produces a vital “civil society.” Since the process of development consists, in part, of raising the productivity of individuals, an important part of the development agenda is creating and sustaining more productive organizations in developing countries. A substantial part of the agenda of the new institutional economics and social sciences deals

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<sup>19</sup>This reflect our profound distrust of more productive governments. The Weingast paradox: a government with more capacity poses a greater threat to the private sector, at the same time that it holds out greater ability to secure property rights, provide justice, and other public goods.



directly with this issue: how do we design institutions that result in organizations that enable more productive interaction between individuals?

We have come a long way in understanding how specific institutions work in specific historical settings: corporate forms for business, electoral institutions, constitutional political arrangements, financial markets, federal fiscal structures, contract law, and property rights in land to give just a few examples. I will call these institutional forms: patterns of rules and arrangements abstracted from their surroundings. Unfortunately, while our understanding of how abstract institutional forms work has improved substantially, we have also learned that institutional forms do not necessarily travel well. The corporate forms that work one way in the United States work another way in Latin America, fiscal decentralization is not everywhere a panacea for corrupt governance, and elections have not brought about democratic societies with governments responsible to citizens through the electoral process. For all of our progress over the last thirty years, all of the innovative new ways of thinking about how institutions work, and all of the cross-country growth regression that show how important institutions are for economic and political development, we have not advanced our ability to take institutions that work in developed societies and transplant them to developing societies in a way that produces similar results. In part, this is because each of these institutional forms is part of the larger Greifian institutional setting of a society. Taking one piece of the institution from one society and putting it into another society will not produce the same outcomes, because the other elements of the institution setting are different.

But another reasons for our inability to transplant institutions is the inherently different dynamics of limited and open access societies. The essential properties of many institutional

forms -- elections, corporations, contract law, judicial systems, and property rights – have been successfully transferred/adopted across open access societies. While the institutional forms always look different across societies, they deliver largely similar outcomes.

In a limited access society, however, the dominant coalition manipulates the economy to produce rents and uses those rents to structure relationships between powerful actors.

Economics and politics are never independent of one another, and similar close connections between politics and economics often exist with religious and educational systems. These are social systems structure of interests is manipulated by the structure of organizations.

Lets begin a thought experiment with the assumption that we could introduce free and unbiased elections into a limited access society, in which all individuals to vote their interests. While the introduction of elections will change relationships within the dominant coalition because a new element has been added to process of allocating power within the coalition, it will not change the fundamental distribution of interests within society. Individuals will still have interests shaped by organizations headed by elites, and if voters vote those interests society will not be transformed into a representative democracy.<sup>20</sup> The failure of elections to transform societies has been well documented by Przeworski, et. al (2000). Indeed, elections often provide historical points where conflicts between elements in the dominant coalition spill over into more overt conflict, sometimes into violence. Elections then become triggers for situations where the

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<sup>20</sup>Keefer and Vlaicu 2008, have a very interesting analysis of how patron-client networks function in a societies with elections, and why democratic outcomes where elections produce government responsiveness to citizens is highly unlikely. Keefer and Vlaicu stress the inability of governments to credibly commit to policies as the reason why patron-client networks continue to be important even after elections are instituted. I am arguing the reverse, that even with elections in place, patron-client networks reflect the overall organization of the society. The networks are organizations that create and manipulate interests.

rules are changed, a subject considered in more detail shortly.

NWW develop the concept of the “double balance:” the idea that patterns of social organization in all of a societies social systems must exhibit a rough correspondence. The case in point is economics and politics. Open access economies cannot be sustained by a limited access political system. Political interests will manipulate the economy to create rents that strengthen themselves. Likewise, an open access political system cannot be sustained by a limited access economic system, since the pattern of interests in the economy will eventually dominate the political process. The two systems can either both be open access or limited access, but societies cannot choose one of each. Similar logic applies to other elements of the society.<sup>21</sup>

Elections in an open access society have a completely different dynamic. Because the political system cannot limit access to organizations, interests form throughout the society beyond the control of the politicians. Coalitions (i.e. formal and informal organizations) form and disperse. Electoral choice, while an imperfect reflection or aggregation of individual interests, nonetheless can and does convey information to and discipline the political system. The ability of both formal political organizations and informal interest groups to serve as focal points for the discussion and promotion of interests means that political decisions that have economic or social effects lead to adjustments by existing organizations or the formation of new organizations to support or oppose policies.

Political support and opposition are mobilized through a much wider variety of means than just voting. Open access societies manage to create and sustain a much larger and more

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<sup>21</sup>The double balance is really a n-balance, but double balance sounds better.

vibrant “public space” ala Habermas. The public space facilitates debate and discussion, the formation of public opinion, and the formation of interests. The civil society literature emphasizes how the ability to freely form multiple and independent organizations is critical to public discourse.<sup>22</sup> Competitive politics is impossible without open entry into organizational forms throughout the society.

In an open access order, political and economic behavior remains closely linked, but the relationship is deeper and not as apparent as it is in a limited access order. Political and economic decisions are seemingly independent, but linked by the common pattern of open access. Attempts to create rents through limiting access occur all the time, nothing about human nature changes in an open access order, but the ability to respond to changing circumstances with new organizations enables the mobilization of interests in a way impossible in a limited access society. NWW stress the deep connection of politics and economics in the open access order and argue that open access societies are more adaptively efficient because both political and economic organizations are able to form, adapt, or disappear more readily in the face of unpredictable change.

A problem with North’s formulation of institutions as the rules of the game and organizations as the teams was raised earlier. In many limited access societies it appears that the teams constrain the rules, rather than the rules that constrain the teams. Institutional rules are shaped by the structure and interaction of organizations in the dominant coalition. People’s beliefs are not focused on the flexibility of the rules, the incredibility of commitments to the

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<sup>22</sup>Rosenblum, 1998, has a nuanced appreciation of why all forms of organization are important to the operation of a civil society.

rules so to speak, but instead on the importance of organizations to their well being. People correctly believe that the concrete aggregations of specific individuals they interact with are more important in shaping their interests than a set of abstract rules. The introduction of elections into limited access societies provide clear examples of how this works.

After independence, African and Asian nations led by bright, motivated leaders with the best of intentions, adopted the electoral forms of western democracies. In few cases have these electoral institutions resulted in republican governments that represent the will of the people, have been able to maintain order, or have actually honored the explicit rules of the electoral process by stepping down from power. Rather than creating more stability and predictability, elections seem to have become focal points for uncertainty. Elections appear to make some societies more, rather than less, unpredictable and periods surrounding elections are often periods of tension and of potential change.<sup>23</sup> Take the last two years. In Bangladesh, concern over violence in upcoming elections led to a declaration of a state of emergency and the Army taking over power in January 2007, although elections were finally held in August 2008. In Kenya, violence broke out after a disputed election, leading the contending parties to compromise on a major change in the constitution. On September 15, 2008, after tension surrounding elections in March and June threatened to produce civil war, Zimbabwe has restructured its government to allow opposition parties more say.<sup>24</sup>

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<sup>23</sup>I am not trying to make an absolute statement about elections and I realize I am not offering any systematic empirical evidence.

<sup>24</sup>“Mugabe, 84, has been in power since independence in 1980 and went from being praised as a liberator who freed the former British colony from minority white rule to being vilified as an autocrat. He and Tsvangirai, 56, have been enemies for a decade, and Tsvangirai has been jailed, beaten, tortured and tried for treason – charges that were dismissed in court.

Each of these cases represents dramatic and readily observable changes in the institutional rules in response to an electoral crisis. It is tempting to argue that constitutional changes in time of crisis demonstrate the lack of credible commitment to government institutions and the fundamental rules of the game that explain why these societies are both economically and politically less developed. It is also tempting to suggest that the presence of corruption is so pervasive in these societies that no institutions can provide stable government. But there is another way to interpret both why many societies face repeated crises of these types and why the crises make sense. The crisis reflect the ongoing dynamics of a limited access social order.

In limited access societies the institutional rules treat powerful individuals and organizations differently: the teams shape the rules rather than the rules shaping the teams. Lets assume that everyone in the society *believes* that a set of institutions providing for regular elections would be a good thing. Nonetheless, during a crisis in limited access societies, even individuals who believe in the efficacy of rules, are forced to make either a sacrifice to sustain the rules or a sacrifice to sustain the organization they are a part of (be it ethnic, tribal, political, or economic). If the electoral rules require a winning coalition to take power and the election of a new leader threatens to ignite a civil war, then it may be in everyone's interest to avoid the civil war by adjusting the rules and restructuring existing political arrangements to accommodate a new structure for the dominant coalition. It is not just beliefs that determine the formation of interests, the menu of alternatives available to chose from and the relative prices associated with

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Under a complicated arrangement, Tsvangirai is the prime minister with executive powers to chair a new council of ministers responsible for forming government policies. He is deputy chairman of a Cabinet of ministers that Mugabe will head." Washington Post, Sept. 15, 2008.

those choices also determine interests.

To the western observer looking in from the outside, this behavior seems like a lack of commitment to rule of law or constitutional government. Enlightened opinion in both the developed and developing world blames the periodic crises on the inability of societies to enforce institutional rules, like election rules, as the result of an underlying lack of belief that adherence to the rules will ultimately deliver better outcomes.<sup>25</sup> Our conceptual models of how societies operate should begin with their actual dynamics. Ten thousand years of recorded human history that overwhelmingly suggests that outcomes like those in Bangladesh, Kenya, and Zimbabwe are the historical norm. Yet we continue to insist that these societies are somehow broken or dysfunctional, that the social dynamics found in open access societies, which are neither very numerous nor have a long historical record, are somehow the natural way societies should be organized.

Where do these western ideas about the organization of societies and the right institutions come from? The idea that laws should apply equally to everyone has a long history as an ideal, but a short history as a reality. Not only the laws, but policies and the institutional rules supported by the state varied significantly across individuals and organizations, even in the early 19<sup>th</sup> century United States, one of the first societies to grapple with the problem of making institutional rules impersonal. I will not get bogged down in the history of why these changes occurred, but at the end of the 18<sup>th</sup> century, western European society was moving slowly and

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<sup>25</sup>Economists are the worst offenders, who often seriously argue that if a change in institutions would make everyone better off that the change should be self-implementing. Economists, however, are not alone in holding these beliefs. Many policy experts, political scientists, sociologists, and development experts blame the failure of institutional change on the moral and ethical character of leaders, laying blame on corruption or lack of political will.

unevenly toward the conversion of some elite privileges, enjoyed individually by elites, to a number of elite rights enjoyed equally by all elites.<sup>26</sup> Initially the right to form organizations was not open, even within elites. As late as 1800 in Britain, France, and the United States the ability to form a political party or a corporation of any type (business, municipal, religious, or charitable) was not considered a right readily available to all, even to those near the top of the social pyramid. Again, I will not trace the intellectual history of the movement toward open access, even in just these three countries, but the section that follows lay out a brief institutional history of how the United States came to secure open access to organizations.

The process, however, involved two parts. First, (although not necessarily first in a chronological sense), the idea that institutional rules had to apply equally to everyone to whom they applied was not a new idea, but implementing it proved to be an institutional innovation. Making organizational forms available to everyone is an institutional change in the simple and concrete Northian sense of changing the rules. Equality implies impersonality: rules that apply equally must apply without consideration of the identity of the individual. Second, impersonal access to organizations was paired with an increasing sophistication of the organizational structures themselves. Call these ways of structuring “organizational forms,” mirroring the use of institutional forms earlier. The partnership and the corporation are organizational forms, for example. Development occurred simultaneously in both impersonal access to organizational forms and the sophistication of the forms themselves. The two process were connected, they

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<sup>26</sup>There seems little doubt that this was not the first time this had happened in western history, Athenian Greece, Republican Rome, and Italian city states all seem to have moved towards more equally defined rights for elites.



were endogenous.<sup>27</sup>

Just as we can describe the limited access order as a Greifian institution, we can explain the open access order as a Greifian institution with its own equilibrium of institutions, organizations, and beliefs and the interests that emerge out of the open entry process to sustain the entire complex. Open access to organizational forms increases the number of organizations and, because all individuals enjoy the same right to use the organizational forms (that is, the right to implement the same institutional rules), any rents associated with the organizational forms are quickly competed away at the margin. Unlike the limited access organization, which is a source of rents for its leadership and relative security for its members, the open access organization is a means to higher productivity but not to rents at the margin.<sup>28</sup> Equal enforcement of the rules protects open access and, critically, provides for enough organizations to credibly prevent political actors from limiting economic access in order to create political coordination. Whether a belief in a “government of laws rather than a government of men” was the cause of or the result of these developments, the western predilection for open access *rules* is rooted in this process.

In this environment, the relative interests any individual has in supporting organizations and in supporting rules shifts towards supporting the rules, for a number of reasons. One, an individual’s attachment to the specific organizations he or she is a member of is relatively

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<sup>27</sup>It is easy to see why limited access societies do not develop similarly sophisticated general rules to structure organizations. If all powerful organizations operate under unique rules, then the benefits of adopting better generalized rules that apply to all organizations are quite limited. Time spent formulating and adopting general rules simply wastes time and effort if the underlying social dynamics won’t sustain the general rules in the end.

<sup>28</sup>Higher productivity can come in either in production or consumption: manufacturing firms and charitable organizations are examples of each.

weakened because of the presence of other alternative organizations. The zero marginal rent condition of a competitive outcome is the limiting case here. If a person works for Ford and Ford becomes more productive, the person's income rises. But the rents from working at Ford, and therefore the interest the person has in supporting policies that favor Ford, are substantially reduced by the opportunity of working at Chevrolet or Toyota. Open access does not eliminate these types of interests, but it may reduce them in relative terms. Two, the proliferation of economic and social organizations, severely constrains the ability of political organizations to secure the support of economic and social organizations through deliberate rent creation. Raising tariffs and import quotas on Toyota did garner political support from Ford and Chevrolet for the American politicians who promoted the policies, but in the long run it led to Toyota entering the American market as an American producer. The rules excluding Toyota cars were much easier to enforce than the rules excluding Toyota factories. Excluding factories would have violated the commitment to open entry institutional rules. Third, the greater number of organizations that each individual belongs to illuminates the importance of open access enforced by impersonal application of the institutional rules. In a crisis, the individual faced with the choice of either sacrificing something to sustain the institutional rules or sacrificing something to sustain the organizations they belong to, are more likely to find it in their interest to sacrifice to maintain the rules.<sup>29</sup>

Individuals in an open access society do not have to believe that the rules are sacrosanct

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<sup>29</sup>Al Gore and his Democratic supporters who accepted the Supreme Court's decision awarding Presidency in the 2000 U.S. election were, by their actions, demonstrating that their interests lay with maintaining the rules rather than supporting their organization.

and inviolate, nor do they have to believe that the rules always apply equally to everyone. What they have to do, or enough of the citizens of these societies have to do, is in times when changes in the rules are being contemplated is be willing to make sacrifices to support the rules rather than to support organizations. The sacrifices may not have to be large, indeed they are very often trivial, since most of our public decisions do not involve questions about the entire structure of the society (if an open access society regularly faced those kinds of problems, who knows what would happen).<sup>30</sup>

It is a bit paradoxical that strengthening organizations, increasing the sophistication of organizational forms, and dramatically raising the productivity of individuals and society over time should simultaneously shift the relative interests of individuals away from sustaining organizations and towards sustaining rules, but it is only a relative shift. Open access societies actually make a much larger commitment to sustaining organizations in general, rather than the large amount of resources committed to sustaining the organizations that support the dominant coalition in a limited access society. The results are most easily seen in politics, since open access politics is often involves competition over the nature of specific rules, conducted within a more general framework of constitutional rules. For example, when Franklin Roosevelt felt the Supreme Court was blocking the Democrats attempts to change national government policies during the 1930s, he threatened to increase the number of Supreme Court justices. Public reaction to Roosevelt's plan was negative and the plan died, not because people were opposed to the new policies, the New Deal programs were widely popular, but because of the perception that Roosevelt was violating a fundamental underlying rule of the system involving separation of

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<sup>30</sup>Weingast's, 2006, idea that all successful constitutions limit the stakes of power is similar.

powers.<sup>31</sup>

We see these effects everywhere in patterns of social interaction in the different social orders. The patterns are so pervasive that they are often not immediately apparent and we often characterize them as the inexplicable result of culture. Modern societies have an aversion to seeing the deep dynamic interconnection between competitive politics and competitive economies. Our “belief” that politics and economics should be separate, that when politics and economics are closely connected that corruption ensues, is part of the dynamic that sustains open access in both systems. We do not want the political system to limit access in the economic system, or any other significant part of society. Politics should set the rules and then enforce them in a fair and unbiased way. Economic interests should have no part in the political process.

One of the most striking implications of the argument about institutions and organizations is that open access societies will place less importance on organizations and more on rules. They will become more impersonal. And, where community is defined as a form of social organization, they will become less communal. As the title of Stephen Marglin’s new book suggests, *The Dismal Science: How Thinking Like An Economist Undermines Community*, sustaining open access does shift relative interests away from supporting organizations and towards supporting institutional rules. The benefit of the shift is greater impersonality, exactly what critiques of capitalist modernity complain about. It is a shift that many fear has

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<sup>31</sup>Since the U.S. Constitution does not prescribe the number of justices in the Supreme Court, there was nothing “unconstitutional” in Roosevelt’s proposal. It met the letter of the law, but not the spirit, as it were.

impersonalized and irreversibly reduced the quality of human life.<sup>32</sup> Economists are almost completely mute in these discussions, but the persistence of the concerns reflects the underlying change in the pattern of human interaction in modern societies. What delights economists and frightens almost everyone else, is that modern society creates a complex of institutional rules, organizations, and beliefs in which it is many people's interest to support impersonal rules and intangible entities like the nation, the state, or the corporation.

#### **4. Institutions, Organizations, and Interest in the 19<sup>th</sup> Century United States**

The lack of a well specified definition for institutions that can be implemented empirically is one of the biggest obstacles to understanding how and why institutions affect social behavior. North's notion of ideas as the rules of the game quickly becomes empirically intractable when "rules" are expanded to include informal rules, norms, and shared beliefs. Greif's notion of an institution has too many moving parts to be useful as a general empirical framework. The difficulty of measuring institutions has led many to define institutions using very general characteristics like secure property rights or rule of law (Acemoglu and Robinson are only the most visible proponents of such an approach, see the quotation in footnote 2). This poses the danger of measuring institutions by outcomes rather than as empirically observable structures. The basic problem is not an econometric one. If our empirical investigations are based on measures of institutions that do not actually exist (for example, are based on expert

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<sup>32</sup> Putnam's notion of bowling alone, 1983 and 2000, has given these fears of alienation and unsociability its most recent colloquial expression, but the fears go much deeper. The large literature on nationalism, of the increasing identification of individuals with large, amorphous, and impersonal entities like the state trouble many critics of modern open access society. Taylor 2007, Anderson 1991, Gellner 1983 are leading examples but only the tip of the iceberg

opinions of the institutions in a society) then even if we find that institutions do promote development, we have not made any progress toward investigating real and concrete rules that we could reasonably attempt to use in a real society. We are left with amorphous concepts like well enforced property rights.

It is important that we not confuse the pattern of social outcomes with our conceptual ideas about institutions. Let me be very clear: well defined property rights are not institutions, they are outcomes. They are outcomes that reflect thousands, if not millions, of interactions between individuals, rules, beliefs, and opportunities. We want to explain is why those outcomes are sustainable in a handful of modern societies and why in most historical and contemporary societies those outcomes cannot be sustained at all, and if they are sustained they only apply to a small share of the population and for limited periods and under special conditions.

We should be empirically concrete about institutional rules. This applies even though we know that writing down a law or a rule does not mean the law is enforced, nor do the words in the law tells us what the law actually means. Establishing what rules are and how they work turns out to be a job for detailed and informed history, an enormously expensive kind of research.

Our theoretical frameworks should provide us with ideas about what institutions matter for generating the patterns of outcomes that we observe. The preceding sections lay out a framework which suggests that the following institutional rules should be important in an open access society:

- 1) A rule that says all rules must apply equally to everyone.

- 2) Rules structuring organizational forms.
- 3) Rules that require everyone (or some large class of persons like citizens) have the right to form legitimate organizations.
- 4) That the range of rules about organizations is comprehensive, in the sense that they encompass business and economic organizations, churches and religious organizations, municipal and other government organizations, parties and political organizations.

I hoped to devote much more time and space to the historical study, but time and space have worked against me. What follows is a very brief history of the institutional rules governing these four factors in American history.

In the late 18<sup>th</sup> century there was a long history of common law – law formed in the judicial system that was common to everyone and everywhere – in both Britain and the United States. Yet, there was no operative sense that in most areas of government policy, and particularly in legislatures, that all laws should apply equally to everyone. Private and special laws, passed to the benefit of an individual or group were quite common in 18<sup>th</sup> and early 19<sup>th</sup> century America. Acts creating organizations were usually done through the creation of a charter, whether the organization was public or private, economic or charitable, religious or secular. Virtually every act of the legislature creating organizations was done via “special” legislation. Special legislation extended far beyond the realm of chartering organizations, however, into almost every aspect of legislation.<sup>33</sup>

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<sup>33</sup>See the opening section of Binney, 1894, for a discussion of special legislation and its pervasiveness.

Americans worried that the creation of special economic interests would be used by political factions to manipulate the democratic process. This fear of faction figured prominently in Whig political theory and played a central role in the coming of the revolution and the redrafting of the national constitution in 1787.<sup>34</sup> One of the underappreciated paradoxes of American history is that the founding fathers feared that the formation of political and economic organizations, parties and corporations, would undermine democracy. Little did the founders anticipate that by the 1850s the United States would be the first society with mass political parties, laws that allowed for the free creation of economic corporations, and by a good margin, more corporations than the rest of the world combined.

In the 1790s and early 1800s, political and economic organizations, along with churches, schools, voluntary associations, and municipal governments proliferated. Americans were suspicious of many of these organizations (particularly the economic and political ones). Of course, they were much less worried about the organizations that they happened to belong to. Many of these organizations received the imprimatur of the larger society through a formal charter, even voluntary associations (Novak, 2001) Massachusetts's history is well documented, and the process of chartering, even though politically contentious throughout the early 19<sup>th</sup> century, proceeded quickly in every area of organizational competence.<sup>35</sup>

Support for organizations extended well beyond the granting of charters. State and local governments became deeply involved in the promotion of infrastructure investments in transportation and finance that would spur economic growth. Many of these projects involved

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<sup>34</sup>See Bailyn 1967 for the coming of the revolution, and Wood 1969 for the constitution.

<sup>35</sup>See Handlin and Handlin, 1969 and Maier 1993 for an introduction to Massachusetts.



the use of public funds and the granting of charters that conferred special privileges. Voters were both enthusiastic and wary. Voters were enthusiastic about the creation of banks and canals that would raise the value of their lands and make it easier to get their goods to market. Yet voters were wary that the corrupting effect of special interest legislation would lead to a demise of democracy. In the 1820s and 1830s, their enthusiasm led the states to make large investments in banking and transportation. A substantial share of these investments turned sour in the economic downturn of the late 1830s and 1840s.<sup>36</sup> At that point, wary voters sought ways to correct the political defects.

Americans did not want to stop public investment in infrastructure. They wanted to stop the corrupting influences that state involvement in public investment created. They wanted corporations, but they worried that promoters of corporations (and lobbyists) could entice legislators and voters to grant the promoters special privileges. Promoters promised to provide valuable public service at little or no cost to the taxpayer in return for privileges. The promises turned out to be too good to be true. American states realized that a democratic society could not resist such temptations. One solution would have been to remove government from infrastructure investment and other activities altogether. Instead, the states sought ways to reduce the temptations.

Their immediate solution was to change their constitutions to mandate that everyone could get a corporate charter. Opening entry reduced the rents associated with a charter and eliminated the political incentives to manipulate chartering for political ends.<sup>37</sup> They also

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<sup>36</sup>See Wallis 2003 and 2005 for a discussion of the 1830s and state involvement in infrastructure.

<sup>37</sup>At least that was the theory, see Wallis 2006 for an extended discussion.

changed their constitutions to change the procedures by which debt could be issued, requiring a majority of voters to approve an increase in taxes sufficient to service the debt before bonds could be issued. In the 1840s, eleven states revised their constitutions. Ten of the eleven included some procedural restriction on debt issue. Ten of the eleven changed the state's relationship to corporations, eight mandated that state legislatures pass general incorporation laws allowing anyone who met fixed and impersonal criteria to obtain a charter via an administrative process. The first steps towards open access to business organizations had been taken. Table 1 gives the states, their constitutions, and whether they adopted provisions with respect to debt, corporations, and taxation in the 1840s.

The provision with respect to taxation required legislatures to levy “general” property taxes. Under general property taxes all property was to be assessed in value by the same method, usually by a calculation of market value, and all property was to be taxed at the same rate relative to its value. General property tax provisions were intended to prevent state legislatures from creating tax preferences. Again, ten of the eleven states adopting new constitution included a provision for general taxation.

The “general” in general incorporation laws and general property taxation meant two things. It meant that these laws and taxes were to apply equally to everyone and it meant that the special exceptions to the laws and taxes would not be allowed.<sup>38</sup> Just as the states began changing their constitutions to open access to corporations, they also began changing their constitutions to prohibit special legislation in wide areas of government activity. Table 2 gives

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<sup>38</sup>This is a bit too simple, since general laws did not necessarily result in the prohibition against special laws. But in the end, that was the outcome.

the dates when states adopted broad constitutional prohibitions on special legislation, along with the dates of more limited earlier prohibitions. The text of the first broad prohibition, in the Indiana constitution of 1851, is reported in Appendix 1. Prohibitions varied from state to state, of course, but the general pattern over the 19<sup>th</sup> century was to adopt fairly strict limitations on special legislation. These constitutional provisions were quite literally attempts to prevent legislatures from creating special interests.

Restrictions on special legislation extended to other organizations as well. Again in the 1840s, state constitutions began requiring that state legislature create general rules for the organization and/or incorporation of municipal governments. Just as with business incorporations, the intent was to both make it easier for cities to get access to organizational forms and, importantly, to reduce the political temptations to manipulate the organizational form of city governments at the state level. Table 3 gives the dates that states adopted general organization or incorporation procedures for municipal governments. Just as with corporations, the constitutional provisions began changing in the 1840s and spread gradually throughout the country over the rest of the century. There was nothing automatic about the spread, however, some states did not adopt provisions until well into the 20<sup>th</sup> century.

The intentions of the reforms that began on a wide scale in the 1840s was to take the political incentives out of manipulating access to organizational forms out of the hands of the state legislatures by creating general procedures. General procedures did not eliminate political manipulation of the procedures, that still occurred, but to the extent that access was truly opened it eliminate the rents associated with special privileges. Like all national experiences, the American experience was unique. Americans were among the first societies to attempt making a

democracy work. They understood that the manipulation of economic privilege for political purposes could undermine the representative process. Their solution was to increase the role of the government in promoting organizational forms, while simultaneously limiting the possibility of rent creation by opening access to those forms to everyone.

## **5. Conclusions**

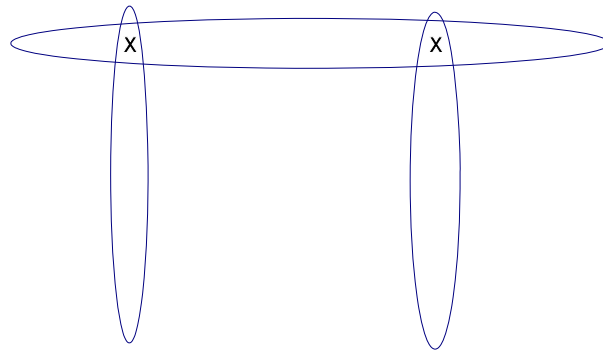
This preliminary draft lays out two perspectives on the dynamics of institutions and institutional change. One way of organizing societies is to manipulate interests through limits on the formation of organizations. In these societies, institutional rules are at the service of the powerful organizations that create and coordinate interests. Politics manipulates economics to ensure a modicum of coordination and stability. In crises, rules are changeable in the service of creating interests that sustain order.

The other way of organizing societies opens access to organizations in the political, economic, religious, and other social systems. Interests are no longer manipulated by intentional creation of organizations, since the rules allow the formation of any organization within very broad limits. The inability to manipulate and coordinate interests in an intentional way, makes possible the operation of competitive polities and competitive economies. Open access societies are, by their very nature, much better at adapting to unpredictable change, and therefore are more adaptively efficient than limited access societies.

The benefits of adaptive efficiency cannot be realized by limited access societies by the piecemeal adoption of institutions of an open access society. The social dynamics of limited access societies leads the same set of institutional rules to produce different outcomes than in an

open access society. The paper pays close attention to the role of electoral institutions. The main implication of the argument that organizations determine the rules in limited access societies, rather than the rules setting the constraints within which organizations operate, has dramatic implications for the function of politics in limited and open access societies. We are just beginning to understand how the complex of institutions, organizations, beliefs, preferences, and relative prices work in the two social orders.

Figure 1



In the figure the two X's are the violence specialist. The horizontal ellipse represents their organization, the "dominant coalition." The dominant coalition is an adherent organization. The specialist limit the ability to form organizations to themselves. Their client organizations, the vertical ellipses, are contractual organizations, which can utilize the dominant coalition as a third party enforcer.

Table 1  
States That Wrote New Constitutions  
Or Amended Constitutions between 1842 and 1852,  
And whether the changes affected Debt, Corporations, and Taxation.

Wrote New Constitutions		Debt	Corporations	Taxation
Rhode Island	1842	Y	Y	Y
New Jersey	1844	Y	Y	Y
Louisiana	1845	Y	Y	Y
	1851	Y	Y	Y
New York	1846	Y	Y	
Illinois	1848	Y	Y	Y
Kentucky	1850	Y	Y	
Michigan	1850	Y	Y	Y
Virginia	1850			Y
Indiana	1851	Y	Y	Y
Maryland	1851	Y	Y	Y
Ohio	1851	Y	Y	Y
Wrote First Constitution				
Iowa	1847	Y	Y	
	1857	Y	Y	
California	1849	Y	Y	Y
Wisconsin	1848	Y	Y	Y
Florida	1838		Y	Y
Amended Constitutions				
Arkansas	1846			
Pennsylvania	1857	Y		
Michigan	1843			

Source: Wallis, 2005.

A “Y” means that the state adopted some provisions regarding debt, corporations, or taxation.

Table 2  
Date When States Adopts General Framework for Laws

State	Full	Partial Early Adoptions	
Indiana	1851		
Iowa	1857	1846	
Nevada	1864		
Maryland	1864	1851	
Florida	1868	1839	1869
Texas	1869		
Illinois	1870	1848	1872
West Virginia	1872		
New York	1874	1846	
Pennsylvania	1874		
New Jersey	1875	1844	
Colorado	1876		
Louisiana	1879	1879	1845
California	1879	1849	
Minnesota	1881		
Washington	1889		
North Dakota	1889		
Wyoming	1889		
Montana	1889		
Idaho	1889		
South Dakota	1889		
Mississippi	1890		
Kentucky	1891		
Utah	1895		
South Carolina	1896		
Alabama	1901	1861	
Oklahoma	1907		
New Mexico	1911		
Arizona	1912		
Georgia		1865	
Michigan		1835	1909
Kansas		1859	
Maine		1875	
North Carolina		1835	1916
Delaware		1831	
Arkansas		1868	1951
Rhode Island		1951	

Source: Jessica Hennessey (thank you)

Note, states that are not included in the table are states for which we do not yet have constitutions or have not yet made a determination about general legislation.



Table 3  
When States adopt Constitutional Provisions  
Providing General laws for Organization of Municipalities or  
General Incorporation for Municipal Governments

	First General Law for Cities Adopted	For Organizing Cities	Subsequent Provisions	For Incorporating Cities
New York	1846	1846		
Wisconsin	1848	1848	1874, 1909, 1921, 1939, 1949, 1961	
Illinois	1848	1849	1904, 1970	
California	1849	1850	1887, 1892, 1902, 1911, 1914, 1932	1879
Michigan	1850	1851	1964	1850
Ohio	1851	1859		
Kansas	1859	1864		
Maryland	1864	1864		1954
Nevada	1864	1866	1924	
Nebraska	1866	1866		
South Carolina	1868	1868	1969	1868
Arkansas	1868	1868		
Florida	1868	1868	1928, 1934, 1968, 1959, 1968	1868
North Carolina	1868	1874	1971	
Pennsylvania	1874	1876	1922, 1969	
Colorado	1876	1876		
Texas	1876	1889	1912, 1920	1876
Washington	1889	1889		1889
South Dakota	1889	1889	1963, 1972	
North Dakota	1889	1889	1980, 1981	
Wyoming	1889			
Idaho	1889			1889
Mississippi	1890			1890
Kentucky	1891			
Utah	1895	1896		1895
Minnesota	1896	1907	1958, 1974	
Oklahoma	1907			1907
Montana	1922			
West Virginia	1936	1951		1936
Rhode Island	1951	1959		
Hawaii	1959	1965	1978	
Connecticut	1965			
New Hampshire	1966	1974		1966
Louisiana	1974			1974

Table 4  
Year when state adopts Constitutional provision allowing  
for Municipal Home Rule

<b>State</b>	<b>Statehood Year</b>	<b>Home Rule Year</b>
Missouri	1821	1875
California	1850	1879
Washington	1889	1889
North Dakota	1889	1889
Minnesota	1858	1896
Oregon	1859	1906
Oklahoma	1907	1907
Arizona	1912	1910
Nebraska	1867	1912
Ohio	1803	1912
Texas	1845	1912
Michigan	1837	1912
Colorado	1876	1912
Maryland	1788	1915
Pennsylvania	1787	1922
New York	1788	1923
Wisconsin	1848	1924
Arkansas	1836	1926
Utah	1896	1932
West Virginia	1863	1936
New Jersey	1787	1947
Rhode Island	1790	1952
Tennessee	1796	1953
Georgia	1788	1954
Alaska	1959	1959
Kansas	1861	1960
South Dakota	1889	1962
New Hampshire	1788	1966
Iowa	1846	1968
Hawaii	1959	1968
Florida	1845	1968
Connecticut	1788	1969
Illinois	1818	1970
Montana	1889	1972
Wyoming	1890	1972
South Carolina	1788	1973
Louisiana	1812	1974
Kentucky	1792	1994

**Appendix 1:**

## Indiana Constitution of 1851

Section 22. The General Assembly shall not pass local or special laws, in any of the following enumerated cases, that is to say:

Regulating the jurisdiction and duties of justices of the peace and of constables;  
For the punishment of crimes and misdemeanors;  
Regulating the practice in courts of justice;  
Providing for changing the venue in civil and criminal cases;  
Granting divorces;  
Changing the names of persons;  
For laying out, opening and working on, highways, and for the election or appointment of supervisors;  
Vacating roads, town plats, streets, alleys and public squares,  
Summoning and empanneling grand and petit juries, and providing for their compensation;  
Regulating county and township business;  
Regulating the election of county and township officers, and their compensation;  
For the assessment and collection of taxes for State, county, township or road purposes;  
Providing for supporting common schools, and for the preservation of school funds;  
In relation to fees or salaries;  
In relation to interest on money;  
Providing for opening and conducting elections of State, county or township officers, and designating the places of voting;  
Providing for the sale of real estate belonging to minors, or other persons laboring under legal disabilities, by executors, administrators, guardians or trustees.

Section 23. In all the cases enumerated in the preceding section, and in all other cases where a general law can be made applicable, all laws shall be general and of uniform operation throughout the State.

Section 24. Provisions may be made by general law, for bringing suits against the State, as to all liabilities originating after the adoption of this Constitution; but no special act authorizing such suit to be brought, or making compensation to any person claiming damages against the State, shall ever be passed.

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