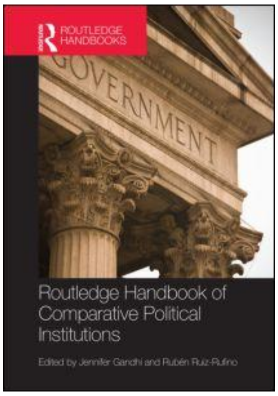

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Jennifer Gandhi, Rubén Ruiz-Rufino

The new economic institutionalism in historical perspective

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Margaret Levi, Victor Menaldo
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THE NEW ECONOMIC INSTITUTIONALISM IN HISTORICAL PERSPECTIVE

Margaret Levi and Victor Menaldo[1]

The new institutionalism arose in the 1980s, more than thirty years ago, in reaction to narrowly individualistic approaches in economics, political science, and sociology. Behavioralists and conventional neo-classical economics "interpreted collective political and economic behavior as the aggregate consequence of individual choice…[and] viewed institutions as epiphenomenal, merely the sum of individual level properties" (Powell and Dimaggio 1991: 2). The new institutionalists, building on a long tradition, claim that rules, norms, and customs—often arbitrary and artificial—structure human interaction, and they use institutionalist approaches to explain major macro-outcomes and long-term secular change.

The new *economic* institutionalists are methodological individualists who recognize the constraints and incentives encapsulated in institutional arrangements. They are both micro and macro. By combining the analytic tools of rational choice with serious consideration of institutional arrangements, both formal and informal, the new economic institutionalists build on microfoundations to reveal how institutions intervene between preferred choices and actions to meaningfully affect outcomes of interest to economists, political scientists, and sociologists. In contrast, the *historical* institutionalists, who came to prominence in the mid-1980s (Evans *et al.* 1985), have a determined emphasis on structural features, i.e. the type of economy or regime. At least until the 1990s, the historical institutionalists paid little attention to microfoundations (Thelen 1999). On the other hand, they did emphasize how institutions shape preferences and behavior (Steinmo *et al.* 1992), an insight embodied in the work of older economic institutionalists but initially lost (if subsequently found) by their successors.

Here we focus on the new economic institutionalism, but hasten to note that all variants of contemporary institutionalists have their roots in the older versions of institutionalism that date back to at least the seventeenth century. Consideration of how institutions influence individual behavior and collective action has a distinguished history. Major thinkers have long sought to address big questions with important policy implications; and each subsequent generation built (and builds) on the questions, tools, and insights bequeathed by the prior ones. While earlier institutionalists, comprising the authors of classical works in political economy, flirted with the origins of order, secularism, and markets, the new economic institutionalists fashioned a rigorous analytic approach to explain real world variation in the quality of institutions, state capacity, democracy, economic development, and the welfare state. The most recent economic institutionalists use state-of-the art models and methods to explain why underdevelopment remains pervasive—despite the now widespread knowledge that institutions account for a large share of the variation in the outcomes that constitute development.

Earlier generations of institutionalists, including such luminaries as Thomas Hobbes, Adam Smith, and Karl Marx were not necessarily aware that they were making inroads into the study of institutions. They did not often use the language of rules and beliefs to describe and explain social life. What they did was stretch the limits of their imagination to conjure worlds that were not their own but *could be*. In the process, they came up with the first justifications and organizational blueprints for centralized order, liberalism, and capitalism. Because many of these institutions had not previously existed, or were vehemently opposed by reactionary thinkers and forces, their contributions were groundbreaking.

A later generation, which includes Douglass North, Barry Weingast, and Robert Bates, were self-consciously institutionalist. They imported the logic and implications of neo-classical economics while taking up the torch from the classical political economists, who had put politics at the center of their analyses of social life. In their models rules and beliefs, but also power, trust, and distributive politics, play a central role.

More recently, institutionalists try to make sense of the fact that government predation, repression, politicized legal systems, corruption, citizen-on-citizen predation, and inveterate mistrust persist (e.g. Besley and Persson 2011; Acemoglu and Robinson 2012); this despite the fact that their forbearers, the first economic institutionalists, adduced that strong and competent states, the rule of law, and democracy are the key to promoting welfare-enhancing policies and development.

Indeed, thanks to robust empirical evaluations of the theories exposited by the new economic institutionalists, we have established that institutional variation explains a big share of the observed variation in economic growth, regime types, and public policies. We now have compelling evidence concerning how the rule of law and concomitant institutions contribute to development: by reducing the transaction costs of impersonal exchange (Wallis and North 1986; Knack and Keefer 1995; Hall and Jones 1999), facilitating the generation of greater revenues (Levi 1988; North and Weingast 1989; Olson 1993; Kiser 1994; Barzel and Kiser 2002), and enabling democratization and pluralism (Clague *et al.* 1996; Weingast 1997; Acemoglu and Robinson 2006). And we can document how democracy endows states with greater fiscal and administrative capacity, if not legitimacy (Levi 1997; Schultz and Weingast 2003; Stasavage 2011), fosters the provision of public goods (Lake and Baum 2001; Bueno de Mesquita *et al.* 2003; Albertus and Menaldo forthcoming-b), and promotes greater global integration (Eichengreen and Leblang 2008).

Meanwhile, institutional variation among democracies matters for the scope and quality of governance. Proportional representation is associated with the provision of social insurance and greater economic equality, better environmental stewardship, and lower incarceration rates (Fredriksson and Millimet 2004; Iversen and Soskice 2006; Lijphart 2012). Majoritarianism deters corruption and excessive government debt (Persson and Tabellini 2005). Federalism and political decentralization may improve the provision of public services at the local level and promote more responsible spending (Weingast 1995; Rodden and Wibbels 2002; Wibbels 2005; Diaz-Cayeros 2006; Treisman 2007).

In arguing that institutions have a profound impact on the organizations, policies, and even the identities that constitute people's everyday reality, the new economic institutionalism forces us to grapple with an uncomfortable conclusion, however: Although "bad" institutions are potentially subject to change, they nonetheless continue to condemn a huge swath of the world's population to lives that are short, nasty, and brutish—through no fault of their own (Fukuyama 2011; Acemoglu and Robinson 2012). These institutions include unchecked autocratic authority and weak bureaucracies that promote predatory behavior, corruption, and civil strife. They therefore breed insecurity and underdevelopment, if not the serial violation of human rights and tragedies such as famines (Sen 1981). Paradoxically, it is Hobbesian absolutism that has often replicated the state of nature depicted in the Leviathan across today's developing world, not transcended it.

This realization ushers in the critical puzzle that contemporary institutionalists are grappling with. If "good" institutions are the key to promoting the means by which humans achieve greater welfare and societies flourish, such as economic growth or egalitarianism, if not ends with intrinsic value, such as civil liberties, then why don't all societies simply adopt these institutions? A fledgling theoretical literature stands on the shoulders of giants in economics, economic history, political sociology, and comparative political science and confronts this paradox. Scholars have arrived at four explanations for why there is often a paucity of reforms that might bring about more optimal equilibria despite the now common knowledge that certain institutions should engender outcomes preferred by a greater swath of society: commitment problems; information asymmetries; collective action difficulties; and scope conditions.

This chapter continues as follows. We will first examine how earlier generations of institutionalists, the classical political economists, provided the scaffolding necessary to address the puzzle of underdevelopment. We will explore how the ancestors of the new economic institutionalism imagined new worlds where none had existed before, and outlined foundations for secular authority, liberalism, and capitalism, despite the fact that religiously justified rule, disorder, absolutism, and illiberalism were the only game in town. We will argue that they fashioned a more primitive, yet visionary, articulation of the question of where development comes from; in doing so, they bestowed on the next generation of institutionalists a fruitful research agenda. We then turn to the new economic institutionalists and explore how they marry the study of economics to the study of politics to generate clear, falsifiable predictions about where order, liberalism, and development come from, and how this equilibrium is sustained. We conclude with a question: How do we make sense of a world in which many of the practical problems first diagnosed by the classical political economists endure, even though knowledge of what institutions contribute to development has become widely available?

From Hobbes to North

Some of the earliest theorists of the state, Bodin (1530–1596) and Hobbes (1588–1679), deserve the label of the first institutionalists. Having lived through horrific periods of civil strife, they argued for the establishment of government institutions capable of creating constraints on human action through laws and the arrangements devised to uphold law-abidingness. Their primary goals were order and stability. However, the autocratic institutions they promoted, while certainly enabling economic growth by ensuring relative peace, had the conjoined effect of blocking innovation by stabilizing power in some hands and thus reducing competition, enhancing the repressive capacity of rulers, and denying voice to the vast majority of the population.

Given these normatively suspect outcomes, we can only speculate about why these "proto-institutionalists" proffered such a stark and draconian solution to the problem of anarchy and disorder. One hypothesis that comes to mind is that it was the only response to the stranglehold that religious apologists continued to have on the legitimation of monarchy in Western Europe well after Westphalia. The product of consummately secular assumptions that fed directly into deductions inspired by geometry instead of the Bible, the Hobbesian social contract and its attendant political system did not require a metaphysical justification. Such a heterodox approach to the study of political institutions did require, however, some respect for convention: arriving at the modal normative conclusion, the superiority of absolute monarchy, albeit through different means. It was almost impossible to imagine any other prescription.

What were the limits of these theorists' imagination? Not only was it perhaps difficult to predict how the consequences of absolutism might ultimately play out in the real world, but Bodin and Hobbes were constrained by their historical and cultural context. In the face of a paucity of successful experiments in self-rule that could operate over large territories and prove sufficiently flexible and enduring, it might have been a step too far to hypostasize a social contract that put rulers and ruled on a more equal playing field. For example, the direct democracy practiced in Ancient Athens was an idiosyncratic reflection of its relatively small size and a relatively equal distribution of property, knowledge, and sophistication among its (male) citizens, a social structure that would only be recreated again, millennia later, among white colonists in the thirteen American colonies.

This suggests that one way to think about the progress that has been made by subsequent generations of institutionalists since Hobbes is succeeding theorists' ability to stretch beyond their predecessors' creative limitations. It fell upon them to imagine widespread liberty when none existed, to imagine a vibrant civic life when most of the population was still composed of illiterate peasants, to imagine how political institutions might be specifically crafted to produce such outcomes even though institutions had, hitherto, not been engineered to produce improvements in social welfare.

It is almost a century later when a new set of theorists prepared to do just that emerged. Locke (1632–1704), Montesquieu (1689–1755), and Rousseau (1712–1778) all emphasize an interaction between the governors and the governed. They, too, want to promote law and order, but they also seek means to ensure institutional change in order to break up ossified power relationships that fail to advance the interests of the general population. They did not put it in these modern terms, but these Enlightenment thinkers inferred that the absolutist solution to disorder only served to "raise the stakes" of politics and promote further disorder down the road. Its ultimate empirical implication, which would soon be attested to during both the American and French revolutions, is that there may be strong, perverse incentives for the marginalized to illegally contest power, lest a despot with few constraints on his authority and paranoid about threats to his rule act first and deprive the former of their "life, liberty, and property."

Of course, although thinkers such as Locke and Montesquieu attempt to be scientific in their claims, their work on government and governance is largely normative. Nonetheless, their introduction of a new, more egalitarian basis for the social contract stretched the limits of imagination beyond the political status quo of their age: they sought to provide a way to think about how to impose systematic limits on executive authority to align the incentives of the rulers and the ruled. In doing so, these institutionalists introduced a way to reduce the stakes of politics while continuing to undertake a largely "scientific" and secular approach to the study of institutions. The idea of a more reciprocal social contract had arrived.

These ideas were far from academic. They were soon instantiated in the limited, secular, and deliberately engineered government of the first modern republic, the United States. This political experiment would ultimately prove that previously contentious and seemingly irreconcilable conflicts over political authority, property, and religion could be defused and contained; and over a huge territorial expanse, no less. This was achieved through the practice of constitutionalism, federalism, and individual rights.

As institutions evolved to support a more democratic polity, they did so in harness to the concurrent growth of capitalism. The result was theoretical emphasis on individual actors working in their own self-interest, but under the right institutional conditions able to produce a collective good. Bernard Mandeville (1670–1733) is among the first to both trumpet and raise concerns about a highly individualized society. Best known for his *Fable of the Bees* (Mandeville and Kaye 1924 (1714)),[2] that pioneering text was an elaboration of his earlier popular poem, "The Grumbling Hive" (Mandeville 1705). Mandeville's private vices became transformed into public virtues only if selfishness reigned and corruption was tolerated; virtuous individuals, from his perspective, created a far smaller economy and duller society.[3]

But it is also noteworthy that during the long seventeenth century, fairly sophisticated notions of self-interest were promulgated; notions that accord well with the institutionalist approach to political economy that now predominates. When their life is on the line, it is hard for individuals to exercise moral restraints that allow them to behave as the better angels of their nature. Thinkers both then and now understand that this does not imply that individuals are, by nature, ruthlessly egotistical. Rather, in some contexts, the price of morality, the ability to give others the benefit of the doubt, and to trust them fully, is prohibitive. People can be individualistic and selfish, yes; and under some circumstances narrowly focused on economic well-being. But, even those most closely associated with the concept never fully believed it. Hobbes argued that people prefer to act according to the golden rule, although most of the time their circumstances prevent it. Absent the centralized provision of the rule of law, in a world of theft and predation, people must resort to defensive selfishness.

It is during the Scottish Enlightenment that David Hume and Adam Smith well and truly establish the basis for contemporary institutional theorizing in which the combination of self-interest within rules is linked to producing economic well-being. Indeed, they went farther than that, arguing that appropriate institutions actually bring the best out of people living in a society. For Mandeville, the key is the transformation of private vice into public virtue. For Smith, it is private interest embodied in good husbandry governed by protection of property rights that produces public virtue. The combination of the division of labor, the invisible hand, and—lest it be forgot—appropriate laws enables individuals with wide-ranging capacities to generate economic growth for the country in which they reside. Recall that Smith authored not only *The Wealth of Nations* (1993 [1776]) but also *The Theory of Moral Sentiments* (1982 [1759]). In his second opus the emphasis is on human behavior and norms; his complex theory goes beyond the narrow characterization of self-interest for which he is currently caricatured.

Smith did have an implicit theory of politics, of course; one that is taken up by the classical liberals and more contemporary conservatives who perceive government regulation as a threat to efficient markets and to various forms of personal freedom. Smith's contemporary David Hume brought political institutions even more directly into his theorizing. He harked back to the pre-Hobbesian concern with historically informed classical statecraft, and he shared with Locke some skepticism about the nature of the capacity of the poor and humble to withdraw their consent (Ryan 2012: 418, 486). Hume, however, unlike Smith, recognized and assumed economic scarcity and the conflicts of interest it creates (Commons 1934: 6, 71, 74). Equally important, he had a developed set of arguments concerning the incentives and psychology of the individuals whose choices, when aggregated, produced macrobehavior. He brought to bear his variant of empiricism, which incorporates passions, ideas, and imagination, as well as interests, into a model that allows us to better understand the complexities of our world. That allowed Hume to almost envision modern democracy and the tensions it would face in the increasingly complex economy that accompanied the Industrial Revolution.

Neo-classical economics built on *homo economicus*, the division of labor, and the mechanisms for aggregation of interests, ideas inherited from Smith, Hume, and their successors. More recently, some new economic institutionalists and all behavioral economists have come to recognize the importance of passions and beliefs, long neglected in conventional economics,[4] albeit present in their bloodlines. What these late eighteenth and early nineteenth century political economists neglected or under-theorized were the vast variations among what states do and how well they serve their publics. Making sense of this requires models of power, legitimacy, and institutional change.[5]

Weber more directly considers power, legitimacy, and sources of change. He takes seriously the rights and treatment of the governed, the constraints on the governed by means of law and popular support, and, if not institutional change per se, at least the comparative statics that help account for why change might (or might not) occur. Perhaps Weber was the first to alert us to the importance of institutional complementarities, an issue taken up today in the "Varieties of Capitalism" literature (see, e.g., Hall and Soskice 2001; Hall and Gingerich 2009), as well as in other approaches (e.g. Acemoglu *et al.* 2001, 2002; Fukuyama 2011; Acemoglu and Robinson 2012). Ancient Rome and feudal China had large bureaucratic structures, but not the economic institutions to support a modern state. Weber was sensitive to the nexus between political and economic institutions.

Huntington (1968) took Weber's analysis of political authority to its logical conclusion. He speculated about disparaged bases of legitimate and stable political authority in countries experiencing the growing pains of modernization. He zoomed in on the transition from traditional sources of legitimate political authority to legal-rational authority rooted in impersonal rules. Whereas Weber largely neglected to foresee and therefore address how turbulent and discomfiting the social and political changes unleashed by economic development would be, Huntington deftly identified the blind spots that characterized modernization theories such as Weber's, and later Lipset's and Rustow's.

Huntington did not believe that the diffusion of new organizational, communications, and transportation technologies, alongside the steady march of industrialization, presaged a smooth, let alone teleological, progression of social and political liberalization. Instead, these changes might very well lead to chaos and disorder; that is, if they were not interdicted with new, deliberately constructed, ways of imposing social order and organizing politics that could mimic the basis of traditional authority forsaken by Weber: cooptation and patronage. Huntington's preferred solution to the rampant authority vacuums, anomie, and resistance unleashed by modernization was the cultivation of inclusive political parties that could fulfill the neglected functions of social control on the bumpy road to legal-rational legitimacy. In this way, Huntington brought institutions back in to the study of modernization and social change.[6]

Huntington's 1968 book is located near the end of a long chain of scholars identified now with the "old institutionalism." In the United States,[7] Thorsten Veblen (1912 [1953], 1914) and others initiated a variant of institutional theory in the early part of the twentieth century. Drawing on the "instinct habit" psychology of William James, the evolutionary theory of Darwin, and his own concern with social position, Veblen rejected fully rational decision-making and brought to bear a nuanced view of uneven influence and power (Hodgson 2007). John Commons (1924, 1934) soon identified himself with this group, and it is Commons—far more than Veblen—to whom several leaders in the new economic institutionalism, including both Douglass North and Oliver Williamson, claim a lineage.

Commons, however, has thus far proved more important for his emphasis on institutions than for his actual theories and models. His books are mostly out of print, and his name is all but forgotten by today's students, unless they have an interest in labor economics (Commons 1926), where his work still breathes. Even so, he belongs in this list of those who exercised a major influence on contemporary economic institutionalism—albeit less for his writings than his example and preoccupations. He brought to institutionalism a life rich in practical economic experiences combined with a deep knowledge of political economic theory.[8] In his perspective, institutions shape individual preferences and beliefs, but their ultimate source is in transactions, which generate conflict of interests. Institutions, that is, laws, rules, and regulations, are the means by which to solve social order problems by embodying collective action. He was fundamentally concerned with the non-contractual basis of contracts:

> I make conflict of interests predominant in transactions. But I conclude that this cannot be allowed to be the only principle, because there are also mutual dependence and the maintenance of order by collective action. I start, like economists, with scarcity, as universal for all economic theory. Then I proceed, as did Hume and Malthus, to show that out of scarcity derives not only conflict, but also the collective action that sets up order on account of mutual dependence.
>
> *(Commons 1934: 6)*

While predicting a revival of interest in Commons (a revival yet, if ever, to come), Kenneth Boulding summarized nicely the problem with this body of work: "Commons' theoretical structure remains today exactly where he left it: a tangled jungle of profound insights, culled by an essentially nontheoretical mind from a life rich with experience of economic realities" (Boulding 1957: 8). Commons' insights on transaction costs were refined and made more theoretical only a few years later by Ronald Coase (1937). One of his most notable insights was that institutions provide the basis of legitimacy for competition and for innovations that threaten the existing order. But it lay with Joseph Schumpeter (1942) to develop this critical insight into the full-blown theory of "creative destruction."

Even so, rereading Commons today—despite the literal dustiness of the pages and the denseness of the prose—alerts us to questions and issues that still require research and thinking if we are to understand the prevalence and persistence of so many "bad" institutions: how institutions provide legitimacy to various practices, how institutions shape preferences and beliefs, the steps needed to build the rule of law, the role of custom, and the fragility of social order.

More sociological authors, such as Philip Selznick (1957, 1966), Seymour Martin Lipset (Lipset 1950; Lipset *et al.* 1956), Reinhard Bendix (1978), and Edward Banfield (1958), shared with Commons a focus on how institutional arrangements solve certain problems of public goods and social order, while creating others. But their way of approaching these questions, also critical to the "new" institutionalists, was distinctly different than the methods used by the first generation of rational choice and sociological/organizational institutionalists, as Stinchcombe nicely summarizes:

> Institutions…shaped the creation and functions of units in markets and the relations between them. But unlike the institutions of modern institutionalism, people ran these institutions by organizing activities on their behalf. Institutions were, in the first instance, created by purposive people in legislatures and international unions, and in pamphlets of business ideologists in Northern England. Modern institutionalism, to create a caricature, is Durkheimian in the sense that collective representations manufacture themselves by opaque processes, are implemented by diffusion, are exterior and constraining without exterior people doing the creation or the constraining.
>
> *(Stinchcombe 1997: 2)*

Government, especially laws, regulations, and organizations, played an important role in these accounts, but what was lacking was both a theory of the state and an explicit account of how institutions create preferences and shape behavior. Historical institutionalism[9] arose as a corrective to the "old institutionalists," the behavioralists who ignored institutions altogether, and to the economic and rational choice institutionalism which had arisen in the early 1980s with the publication of Douglass North's *Structure and Change in Economic History* (1981).

Building not only on Smith (and Coase), but also on Marx, in his effort to understand long-term secular change, North looks for the underlying matrix of incentives, constraints, and risks that structure individual choice. His emphasis on transaction costs, property rights, and commitment problems was pioneering in the sense that he was able to meld insights from neo-classical economics with the primary concern of political scientists and sociologists: how power, at least bargaining power,[10] matters for the construction, governance, and legitimacy of both political and economic markets. North argues that the self-interest of rational rulers bent on holding on to power and maximizing their own stream of revenues could usher in, under the right conditions, more optimal and stable equilibria. This could be accomplished through the self-enforcing provision of private property rights and public goods with similar transaction cost reducing properties: the standardization of weights and measures, time, and, most importantly, civil law and contracts. However, such rules and the institutions they created to sustain their wealth and power could also, over time, undermine the general welfare and prove destabilizing. As North noted (1981: 20), "The existence of the state is essential for economic growth; the state, however, is the source of man-made economic decline."

In this sense, institutions mattered and mattered absolutely. While the rules of the game and the attendant expectations about the future were themselves the byproduct of political strategies adopted by rulers who aimed to consolidate authority and maximize rents, their independent effects were pronounced and far reaching. If rulers were constrained to provide property rights to a relatively large number of citizens and similar transaction cost reducing public goods to remain in power, the result was usually representative government. Only this could adequately guarantee a self-enforcing commitment to these Pareto improving policies. The ultimate economic upshot would be economic development, because citizens would be incentivized to work, save, and invest in productivity enhancing endeavors instead of theft or rent-seeking. The ultimate political upshot would be a strong state flush with tax receipts and access to cheap and consistent credit. If rulers could somehow fulfill these objectives without the support of a broad coalition that included the merchant class, and without the consent of the taxed, then they would fail to provide property rights or other transaction reducing public goods. The logical result would be underdevelopment—due to predation of the ruler against the ruled and the ruled against each other, or at least the fear of predation—and weak states bereft of consent and revenues (see also Levi 1981, 1988, 2006).

While his emphasis on transaction costs, property rights, and rents is consistent with neo-classical arguments, his concern with how to acquire and process information and norms aligns him with those pushing the boundaries of what standard models can achieve. Institutions create the rules of the game for North and organizations facilitate collective action, but equally important are the cognitive limitations that configure the choices and beliefs of individuals and their reference groups. In his later work North attempted to better theorize about the role of ideology through the conception of "mental models" (Denzau and North 1994) and the incorporation of how cognitive limits impinge upon and shape rational decision-making (North 2005).

The new economic institutionalism that North spawned encouraged a generation of scholars to develop new theories of and empirical approaches for studying democracy, state building, economic growth, and solutions to a whole range of collective action and commitment problems. Barry Weingast and Kenneth Shepsle, initially influenced more by William Riker than North, brought to institutionalism the insights of game theory, deriving important and testable propositions about institutional equilibria and disequilibria in Congress and other voting bodies (Shepsle and Weingast 1981, 1987). Weingast, on his own, and in collaboration with North and others, also used game theory to consider the relationship between rule of law and democracy (Weingast 1997), the establishment of credible commitments that make cooperative relationships possible (North and Weingast 1989; Milgrom *et al.* 1990; Greif *et al.* 1994), and most recently how beliefs are established and affect collective behavior (Rakove *et al.* 2000; Weingast 2005).

Robert Bates (1981, 1983) was one of the first researchers to bring the modern study of institutions to the developing world and to try to make sense of why seemingly irrational and pathological policies were so ubiquitous there. Taking North's assumptions about rational and self-interested rulers to heart, Bates speculated that in the post-colonial nation states of Sub-Saharan Africa, in particular, rulers responded to perverse incentives inherited from their colonial masters to retain power by pandering to nascent urban constituencies that could provide them with political support and rents. This called on adopting industrialization policies that ran against these countries' comparative advantage and were subsidized by indirect taxes on the countryside imposed via marketing boards that allowed the state to monopolize the pricing and distribution of cash crops. This allowed weak states such as Kenya and Ghana to simultaneously erect protectionist barriers for infant industries rooted in overvalued exchange rates, raise revenues, and ration credit and agricultural inputs via rural clientelism.

Besides the consolidation of power by rulers among a narrow, urban proletariat and a mass of unorganized farmers, the upshot was the distortion of behavior in the marketplace. Farmers eventually stopped producing enough food, nascent manufacturers allocated dear capital to wasteful investments and supplied low quality goods at exorbitant prices, and urban labor grew reliant on subsidized food. This pathological equilibrium was built on an erstwhile Russian and Prussian trick: squeezing the peasantry. Like those examples before it, it ultimately proved unsustainable: balance of payment problems and attendant macroeconomic and political crises undermined the revenues and political coalitions at the core of this strategy. Haber *et al.* (2003) would later identify a similar vein of crony capitalism in Mexico and illustrate how mechanisms of credible commitment to property rights first identified by North worked to offer selective protection to a few oligarchs at the expense of entrepreneurs and the majority of the population, with similar results to those exposed by Bates.

Bates helps bring the new economic institutionalism into political science and in the process takes up a preoccupation of political science that economics largely neglects: a conceptualization of power and the recognition of its importance for the analysis of institutional arrangements. In her work on revenue production and on conscription, Levi (1988, 1990, 1997) not only makes key to the analysis the influence of those with resources on which rulers and government actors are dependent, she broadens the notion of resources to include the withdrawal of compliance and consent. Even the seemingly powerless may indeed possess "weapons of the weak" (Scott 1985).

It is Jack Knight (1992), however, who brings issues of conflict, distribution, and ultimately power onto center stage. Knight applies his model to the transformation of norms of bride-wealth, common property, and clan exogamy (Ensminger and Knight 1997). As the forms of power change, so do the norms.[11]

Meanwhile, it is Elinor Ostrom who develops and applies models of institutions that solve a variety of common pool resource problems. Her work determinedly emphasizes the cognitive limits of individuals and the influence of norms and contexts on their decision-making, monitoring, and collective actions (Ostrom 1990, 1998, 1999, 2005).

Other scholars also theorize the sources and sustenance of norms. Less concerned about the role of power than are Bates, Levi, or Knight, what they emphasize are the informal institutionalization of relationships that solve difficult problems, such as in trade (Greif 1994, 2006), and interethnic cooperation (Fearon and Laitin 1996). Relying on game theory, Greif offers an alternative to North's definition of institutions. For Greif, "An institution is a system of rules, beliefs, norms, and organizations that together generate a regularity of (social) behavior" (2006: 30). The inclusion of both organizations and beliefs has significant implications for how to model institutional change (Greif and Laitin 2004).

Where North and Greif converge, however, is on the importance of beliefs in understanding not only why institutions arise but also why problematic institutions are retained. Marx, Schumpeter, and most political economists who followed recognize how powerful actors keep in place institutions in their own interest that are not necessarily in the general interest. But it is not solely a story of power, at least not power in the form of observable material interest. It is also a story of what the population believes is in their interest or what they believe it is possible to do. A snowballing of protest can be one precipitant of the recognition that others share one's perspective or that it safe to act (Granovetter 1978; Kuran 1989, 1995). Often it requires information and leadership to change what people think the world is like and what they can do about it (Ahlquist and Levi 2013).

Acemoglu and Robinson are, in many ways, the culmination of the different ideas introduced by the old economic institutionalists and formalized and honed by the new ones. They situate their work at the intersection of the primacy of power and how formal institutions shape individual behavior through the provision of economic policies that incentivize either consistent productivity and egalitarianism or inefficiency and oligarchy. Across very influential articles and books (e.g. Acemoglu *et al.* 2001, 2002; Acemoglu and Robinson 2006, 2012), they have outlined dynamic theories of institutions in which democratization or the rule of law institutions that sustain property rights are introduced or undermined by changes in the balance of power in society. In their view, all institutions are next-best solutions to commitment problems. They reflect the preferences over economic policy of those who wield power; but they would not exist if those with *de facto* power could somehow perpetuate their threat of coercion into the indefinite future. Indeed, *de jure* institutions are selected because *de facto* political power is transitory. Different groups in society have a fundamental conflict of interest over the distribution of social gains and those with a temporary edge impose the rules of the game upon society to guarantee a favorable distribution of resources into the future, even after their raw power fades.

Not all commitment problems have institutional solutions, however. The "best" institutions theoretically presage increases in absolute wealth across social classes. Unfortunately, these cannot always be crafted to simultaneously guarantee a favorable economic distribution for those who wield power and the most Pareto Optimal equilibrium that grows the biggest possible pie. This is a difficult hat trick and historically rare. This is why, and, perhaps in an effort to chastise economists who believe examples of systematic inefficiency bespeak irrationality, Acemoglu and Robinson are wont to remind us that it is foolhardy to think about politics through the prism of the Coase Theorem. Relative gains matter, and gains from trade may therefore be forsaken. Increased welfare can be used to bolster *de facto* power of those who are shut out of formal office. Development threatens the institutional equilibrium that benefits whoever controls economic policy. The losers from institutional reform may cling to suboptimal institutions if they fear that a transition to an *ostensibly* Pareto superior outcome will only serve to threaten their political power and economic rents (Sutter 1995; Acemoglu *et al.* 2005; Albertus and Menaldo forthcoming-b).

The problem is about time-inconsistency. New winners from institutional change have incentives to renege on any agreement to compensate the losers after the reforms have come to pass. If these potential losers hold power today, they will block said reforms because guarantees of side payments or other inducements are not credible tomorrow. "Rather, the natural tendency is for the gainers to husband their winnings and to stop their ears to the cries of the afflicted" (Rogowski 1989: 17). This insight helps explain the puzzle that free trade is relatively rare historically, and an arena of pitched battles between social classes and sectors, despite the fact that it is Pareto improving in the textbook sense: gains from trade at the macro-level are axiomatic if nations specialize along the lines of comparative advantage (Rogowski 1989). This can also explain why many long-lived dictators run their economy into the ground and otherwise forgo policies that may strengthen their opponents. It may even explain why they choose to fight to the death rather than relinquish political power (Albertus and Menaldo forthcoming-a).

Enduring underdevelopment is therefore explained by the fact that powerful actors often opt, strategically, for the largest possible slice of pie from a smaller overall pie instead of a smaller slice from a larger pie. Yet, under moderate levels of inequality, a temporary burst in *de facto* power by a coalition of the middle classes and the poor can introduce democracy. To avoid revolution, the rich will step down and allow democracy to become a credible commitment to redistribution; and, yet, this should not pose an existential threat to capitalists after transition. The result is liberal democracy coupled with secure property rights and public investments that usher in enduring economic growth.

However, North, Wallis, and Weingast (2009) have pointed out that, even if credible commitments to protect the privileges and rents earned by elites who block democracy and progress can be extended, this is not sufficient for ensuring that a transition to a more liberal order will occur. The fabric of developing societies—what the authors call "natural states"—is supremely delicate, and liberalizing reforms that aim to shrink hard-earned privileges and rents cannot merely be compensated for, on an ad hoc basis, with side payments or other compensatory schemes. Institutions in much of the developing world have been molded and fine-tuned over long periods of time to deter powerful actors from deploying violence to upset the political order or enlarge their piece of the pie. Indeed, the state or other political actors are wont to dispense rents in proportion to the *de facto* power that each group possesses. Therefore, rents are often "the glue that holds society together" in underdeveloped countries in which power and concomitantly the potential for violence are widely distributed, and threatening to withdraw them through neoliberal reforms may unleash a violent backlash.

North, Wallis, and Weingast remind us that the groups' potential for violence interact in complex and nonlinear ways, and the uncertainty about how each group might respond to reforms that threaten their rents often cows states into the most rational strategy; that is, a risk averse conformity to the status quo based on the realization that the opportunity costs of reform in developing societies are steep. Every reform that is attempted is a forgone opportunity to deploy rents to foster peace, itself a still quite scarce and highly valued commodity throughout the world.

Next steps

There are other sources of underdevelopment still. Even if the losers from reform can actually believe promises that their welfare will not be reduced in the wake of changes to the rules of the game, the competence or integrity of the policymakers in charge of institutional reform may be questioned. In turn, imperfect information of this sort may create perverse incentives by policymakers to signal reliability through suboptimal behaviors (Besley 2006; Acemoglu *et al.* 2010; Albertus and Menaldo 2012). These may weaken the foundation of the rule of law or democracy, offsetting the benefits of institutional reform. How citizens and other stakeholders curtail these information deficiencies is key to understanding when and how "better" institutions can be selected and whether new technologies such as social media can help move a critical mass of actors closer to the Pareto frontier: compel them to adopt and abide by more efficient, fairer, and more stable institutions.

Yet the obstacles to this type of institutional engineering should not be underestimated. Collective action on the large scales implied by modern nation states is very difficult. Once you have stable coordination around one focal point, coordination on a superior equilibrium is a victim of the tyranny of self-fulfilling prophecies. Switching to a Pareto improving scenario calls for finding a way to convince individuals stuck in their ways that a critical mass of others are going to change their behavior (Laitin 1992; Mackie 1996; Ahlquist and Levi 2013). Sometimes, what is needed is not Twitter, perhaps, but an old-fashioned, and perhaps traumatic, exogenous shock (Acemoglu and Robinson 2006; Miller 2012). What those shocks might look like in a future with fewer overtly repressive regimes and with an accelerated news cycle, and why exactly they might induce changes in beliefs and the motivation to coordinate different strategies with collectively beneficial consequences, are open questions.

Scope conditions may also mitigate the effectiveness of putatively good institutions. The local context in which formal institutions are implemented matters (Ostrom 1990). So does the interaction of these formal institutions and informal institutions. Indeed, informal institutions at the local level may be more critical to local governance and development than national-level policies (Tsai 2007). This means that veritable changes in policy and human welfare may lie at the subnational level and be a product of changes in informal, rather than formal, institutions. This is a door that has been pushed wide open by entrepreneurial researchers, who are increasingly using big datasets and innovative survey research to ask seemingly smaller questions at smaller and smaller scopes.

Conclusion

This brief review of the history of the "new" economic institutionalism reveals enduring questions but some methodological advance in the efforts of social scientists to facilitate "good" institutions and eliminate the "bad." The review also reveals the importance of having a theory not only of the institutions themselves but of the human actors who build and are shaped by those institutions. The move into behavioral economics is just the most recent in a long collaboration of political economists with psychologists, sociologists, and political theorists who reveal how decision-making is not fully "rational"; the ways power matters; and the sources of legitimacy. This collaboration was lost to conventional economics for nearly a century as neo-classical economics came to dominate the field. With the rise of the "new" economic institutionalists, we are once again bringing interdisciplinary knowledge to bear on the puzzle of how to improve the quality of our societies and of the lives lived in them.

Notes

1 We wish to thank the editors of this volume as well as Ira Katznelson for their helpful comments on an earlier version.
2 Steven N. S. Cheung brings the "fable of the bees" into contemporary transaction cost economics with his discussion of the externalities of beekeeping Cheung (1973).
3 See Alan Ryan (2012) for how Mandeville was reacting to what he perceived as the problematic conception of republican virtue.
4 But not, of course, in all economics. See, e.g., Hirschman (1977).
5 In addition, there are issues of the relationship between government and citizen obligations regarding welfare, taxation, and the like. Considerations of public goods exist in Smith but are far too limited.
6 Migdal (1988) would later explore how similar reconstitutions of political authority at the local level would allow states to consolidate their hold on power after colonialism in ways unforeseen by modernization theorists—by working through intermediaries, so-called strongmen such as Afghani warlords and Senegalese chiefs. These local brokers retained a modicum of traditional authority, whether legitimate

or coercive, and exercised power in strong societies able to adapt to the destructive changes wrought by capitalism and globalization.

7 There is also a European counterpart that included Sombart in Germany and the Webbs in Britain (Hodgson 2003: 548).

8 For interesting discussions of Commons' contributions, see Boulding (1957), Hodgson (2003), and Stinchcombe (1997).

9 This approach begins with the seminal work of the Social Science Research Council (SSCR) Committee on States and Social Structure, culminating in *Bringing the State Back In* by Evans, Rueschemeyer, and Skocpol (1985). This line of research blossomed, marked by the publication of *Structuring Politics*, edited by Steinmo, Thelen, and Longstreth (1992), *Politics in Time* by Pierson (2004), and the edited volumes by Mahoney and Rueschemeyer (2003) and by Streeck and Thelen (2005). Debates and arguments raged about the relative virtues of the competing historical and economic variants of institutionalism. The publication of *Varieties of Capitalism* (Hall and Soskice 2001), however, is one of many indicators of the increasing merger of the two approaches.

10 See Moe (2005) for a critique of this narrow version of power that cannot adequately account for the role of or consequences for those without any significant bargaining clout.

11 Power is also key to the variant of new economic institutionalism adopted by international relations scholars, those largely identified as neo-realists (Fearon 1998: Keohane 1986). However, given that the questions we are raising lie more in the domain of comparative politics than in international relations, we leave this important body of research to others to discuss.

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