

# Institutions, Organizations, Impersonality, and Interests: The Dynamics of Institutions

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Impersonality -- treating everyone the same without regard to their individual identity -- ranks near the top of good institutional outcomes in the pantheon of growth theory. Rule of law requires laws that apply equally to all citizens and judicial systems that apply the laws impartially. Secure and transferable property rights require identification of ownership without respect to individual identity. Viable contracts require that any legal competent individuals enjoy the same abilities and responsibilities with respect to contractual terms. Competitive markets, competitive polities, religious tolerance, and mass education all require a society to recognize that individuals be treated the same. Lady Justice, sword in one hand and scale in the other, blindfolded so that she cannot see the identity of the persons whose fate she weighs in the balance, is an icon of the modern open access society. While impersonal relationships require blind justice and therefore formal rules, impersonality is not just a matter of law. In order to be sustainable on a wide scale, impersonality must pervade norms of behavior, notions of fairness, equity, and tolerance, and even of morals and ethics. As a result, societies with institutions that support impersonal relationships *throughout* society are relatively rare. The first appear in the historical record only around 200 years ago.

This paper grapples with understanding the institutional dynamics of a society that is capable of sustaining impersonal relationships in many areas. The first question is whether institutional economics defines impersonality the right way. The second question is how rules and personal relationships structure organizations and what happens to social dynamics when the rules about organizations become impersonal. The third is how impersonal rules for organizations shape the interests of individuals, possibly leading them to support impersonal rules on a wide basis. The next section considers the questions in greater detail and subsequent

sections take them up.

### **1. The problem of impersonality**

Impersonal relationships, notably in the form of impersonal exchange, have received a great deal of attention from social scientists and have been a central focus of institutional economics. For the most part, investigations begin by asking how individuals can deal with people they do not know personally: specifically how individuals who have not interacted in the past and do not expect to interact in the future can confidently interact (relate) with one another in the present? Answering questions like this has advanced our understanding of how institutions work, as in the research on impersonal exchange and the literature on trust and credible commitment.<sup>1</sup>

Defining an impersonal relationship as dealings between individuals who do not know each other personally, however, differs considerably from the impersonality of Lady Justice, which defines impersonality as treating everyone the same. The first task of this paper is to separate the problems of what can be called, for purposes of clarity, anonymous and impersonal relationships. *Anonymous* relationships or *anonymous* exchange refers to situations where people who are not personally known to each other interact on some dimension. *Impersonal* relationships refer to situations where people are treated according to the same rules, whether they are personally known to each other or not.<sup>2</sup>

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<sup>1</sup>For impersonal exchange see North (1981, 1990, and 2005) and Greif (2006). For trust see Fukuyama (1995), Cook, Hardin, and Levi (1995), and McCubbins and Lupia (2000). For the credible commitment literature see North and Weingast (1989).

<sup>2</sup>I am grateful to Nick Crafts for suggesting the terms anonymous exchange.

The distinction is quite important. Any society larger than a thousand people must be able to support and sustain anonymous relationships. Social institutions that sustain anonymous relations had to have developed between 5,000 and 10,000 years ago, when the first large scale societies appeared. Since institutions capable of producing anonymous relationships arose 5,000 years ago, it appears that such institutions did not, by themselves, produce impersonal societies, since impersonal societies can be traced back only 200 years. The second task of this paper is to show how institutions sustain anonymous relationships on some dimension of human interaction by embedding the anonymous relationship in a web personal, rent creating relationships. For example, Greif shows how communal courts in medieval Italy, which were biased against outsiders and non-citizens, were nonetheless capable of providing unbiased judicial decisions on a narrow range of matters. In order for the community responsibility to work, however, all the traders had to be able to identify each other as citizens of a specific city, e.g. Genoa or Pisa. If one trader from a city cheated, all traders from that city were punished. It was the rents created within the city hierarchies, which were inherently personal, that enabled the city merchants and their courts to deliver unbiased justice for a limited number of contracts. It is possible to enable anonymous relationships between people who do not know each other personally, by embedding individuals in a social context that is personal, not impersonal. Awareness of the larger social situation in which their interactions take place are part of the shared beliefs that make anonymous exchange possible.<sup>3</sup> Using a similar logic, North, Wallis, and Weingast (2009, hereafter NWW) show how creation of personal privileges can create rents that enable powerful individual to credibly commit to non-violent relationships and thus can order a larger society.

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<sup>3</sup>Granovetter's (1995) concept of social "embeddedness" is relevant here.

The privileges cannot be impersonal: if they were they would not be privileges and they would not create rents.

This is one of the most general conclusions of the new institutional economics: the creation of rents through institutions can generate incentives for individuals to act in predictable (and therefore credible) ways. The simplest application of the folk theorem relies on the logical inference that two individuals who expect to interact repeatedly and who each receive a rent from their unique relationship, have an incentive to honor commitments to each other so as not to threaten or lose the stream of rents in the future. It is essential that the returns to the personal interaction be unique to the two parties and their relationship, otherwise either party could defect and seek other partners. Whether the incentives are positive or negative, institutions and organizations can shape the interests of individuals, and thus the choices they make, by creating returns to specific relationships.

Institutions are complexes of formal rules, informal rules (norms), and shared beliefs held by individuals.<sup>4</sup> Rules and norms can either be personal or impersonal. If, however, coordination of individuals is achieved by creating rents (incentives) for specific individuals, then it will be very difficult for such a theory of institutions to explain the rise of societies where impersonal relations are a general phenomenon, since impersonality erodes rents by its very nature. If anonymous rules are sustainable only because they are embedded in a social context (i.e. institutions) that depends on personal privilege, then a gradual accumulation of anonymous rules will not suddenly transform the society from a system of personal relations into one of impersonal relations. The anonymous rules only work if they are embedded in an personal

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<sup>4</sup>For these definitions see North 1990 pp. and 2005 pp. , Greif 206, pp. , NWW, pp.

society: take away the context of personal relationships and the anonymous relationships become unsustainable.<sup>5</sup> It is hard to see how such a process can lead to a generalization of anonymous rules into an impersonal society.

Solving the conundrum of how impersonal rules might arise throughout a society requires us to move into the realm between institutions and individuals and explicitly consider organizations. The third task of this paper is to show how formal and informal rules governing the formation of organizations effect the dynamics of social interaction and so change the social context for individual interaction. Consider two versions of North's (1990) sports analogy, his heuristic definition of institutions as the rules of the game and the means of enforcement, and organizations as the teams playing the game. In the first scenario, the rules are constrained to apply equally to all teams, even if enforcement is imperfect and individual teams may decide to play more or less within the rules. In the second scenario, different rules apply to different teams. Whether teams chose to play by the rules, cheat, or devote resources to changing the rules provides the dynamic process underlying institutional change. When the rules change in the first scenario, they change simultaneously for all the teams. In the second scenario, the dynamic relationship between the teams will be very different, as they are negotiating and contending over the formation of idiosyncratic team specific rules rather than impersonal rules.

The analogy assumes that a sports league exists that can enforce impersonal rules, a league that plays the role of a state that can act as an impersonal third-party. North's question

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<sup>5</sup>NWW develop this insight with respect to the control of violence; Greif uses the general logic to explain anonymous exchange; Bates uses it to explain how a protector can credibly commit not expropriate his clients; and Tilly uses it to explain how European states were able to combine "capital and coercion" to constrain national states, to give a few examples.

then became how can a state make a credible commitment to enforce the rules impersonally? In the second scenario, anonymous exchange is possible but impersonal exchange is problematic if not impossible, since the rules treat different people differently. To compare the two scenarios, we need to understand how what kind of institutional dynamics can sustain impersonal rules and how individuals and organizations could come to find it in their interest to support impersonal rules.

One insight of North's analogy is that the dynamics of institutional change flows from the interaction of the teams themselves. Another is that the rules apply both to the internal structure of the teams and the relationships between the teams. Some of the most important rules governing dynamics between organizations are the rules about forming organizations: who can form organizations and under what conditions? If the rules about forming organizations are impersonal, then every one possesses the same rights to form an organization. A society that ensures cooperation and stabilizes social relationship by creating rents for specific organizations, will not be able to support impersonal rules for the formation of organizations, since impersonal rules allow and encourage entry, and entry erodes rents. The fourth and final task of the paper, therefore, is to show how open access to organizations can be sustained. Specifically, how can it be in an individual's interest to support the impersonal enforcement of formal and impersonal rules, even at some cost to the individual and the organizations of which he or she is a member?

Framing questions about institutions in terms of anonymous relations is a central and crucial part of institutional economics. It is the question to ask for most of human history and for most human societies today. But understanding how institutions support anonymous relationships does not help us understand how impersonal relationships develop over a wide

range of social interactions. If we want to understand modern social development, the rule of law, thriving markets, and vibrant political democracies, we need to ask a different question. We need to ask why individuals find it in their interests to support impersonal rules.

## 2. Impersonality

Impersonal relationships occur when two individuals interact in a way that does not depend on their personal identity. Another way of saying this is that societies are capable of creating and sustaining an impersonal identity of “citizen” or “resident” that applies equally to a large class of people.<sup>6</sup> The essence of impersonality is treating everyone the same. Impersonality pervades open access societies, in law, markets, education, religion, politics, and the delivery of public services.

While there is nothing controversial in this definition of impersonal relationships, it is not always the one most used in the social science of institutions. The problem of impersonal relationships or impersonal exchange is often motivated by considering how two individuals who do not know each other personally and have no expectation of a continuing relationship in the future can come to agree on a social relation. Greif and North both place impersonality at the heart of modern institutional development, but the point holds for a much wider literature.<sup>7</sup> Greif describes impersonal exchange:

What were the institutions, if any, that supported interjurisdictional exchange characterized by separation between the *quid* and the *quo* over space and time?

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<sup>6</sup>Impersonal rules do not have to apply to everyone universally. Whether a rule is impersonal or not always depends, in part, on the identity of the people it applies to.

<sup>7</sup>See Fukuyama (1995), Cook, Hardin, and Levi (1995), and McCubbins and Lupia (2000) for a discussion of trust between individuals. For the credible commitment literature see Weingast, Weingast and North, etc.

Specifically, were there institutions that enabled such exchange that was also impersonal, in the sense that transacting did not depend on expectations of future gains from interactions among the current exchange partners, or on knowledge of past conduct, or on the ability to report misconduct to future trading partners?

The theoretical and historical analysis presented here substantiates that in premodern Europe impersonal exchange characterized by separation between the *quid* and the *quo* across jurisdictional boundaries was facilitated by a self-enforcing institution: the community responsibility system. (Greif, 2006, p. 309)

Greif motivates impersonality as a relationship between two individuals who did not know each other, but could nonetheless reach agreements that spread across space and time.

North has long stressed the importance of impersonal exchange for economic development and he clearly had impersonality in mind when he defined institutions as the rules of the game and the methods of enforcement: rules in an athletic event should apply equally to all participants. North (1990) wrestled with defining impersonal exchange and placing it within a transaction cost framework.<sup>8</sup> His solutions illuminate the problem at hand, as he identified three kinds of exchange and two kinds of impersonal exchange:

“Personal exchange involving small-scale production. Repeat dealing, cultural homogeneity (that is a common set of values), and a lack of third-party enforcement (indeed little need for it) ...”

“Therefore a second general pattern of exchange has evolved, that is impersonal exchange, in which the parties are constrained by kinship ties, bonding, exchanging hostages, or merchant codes of conduct. Frequently the exchange is set within the context of elaborate rituals and religious precepts to constrain the participants.”

“The third form of exchange is impersonal exchange with third-party enforcement. It has been the critical underpinning of successful modern economies involved in the complex contracting necessary for modern economic growth. Third-party enforcement is never ideal, never perfect, and the parties to exchange still devote enormous resources to attempting to clientize exchange relationships. But neither self-enforcement by parties

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<sup>8</sup>Specific discussions of North’s approach to personal and impersonal exchange can be found in North, 1981, pp. 182 and 204; 1990, pp. 22, 34-35, and 55-60; North, 2005, pp. 70-71, 84, and 119.

nor trust can be completely successful.” (North, 1990, pp. 34-35)

North started with the genetic human endowment that enabled people to use face to face interaction and repeated dealings to develop credible relationships.<sup>9</sup> The rise of impersonal exchange, therefore, involved dealing with people who one “didn’t know” personally and, therefore, impersonal was implicitly defined as “not personal” or “not known.”

And yet, very little of the impersonal exchange under kinship ties, bonding, exchanging hostages, or merchant codes of conduct could be reasonably classified as impersonal under the “treat everyone the same” definition. People can deal with people they do not know personally, but only because these anonymous relationships are embedded in social organizations that prescribe roles and behavior and constrain the participants. Anonymous exchange explicitly does not invoke treating people the same, as the parties to the exchange are constrained by kinship ties, etc. All of these social institutions are embodied in organizations that create unique (and therefore personal) roles and identities for individual actors. Individuals are able to deal confidently with some people they do not know, because their anonymous relation with the unknown individual is embedded in a social organization that effectively constrains both their behaviors. This is not quite the antithesis of treating everyone the same, but it is nowhere near the notion of impersonality as defined here.

Constraining the behavior of individuals involves both positive and negative incentives,

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<sup>9</sup>The genetic endowment argument is clearly laid out in his 2005 book. The ability of people to deal with one another in small groups forms the basis for the “foraging” order in NWW. The evolutionary heritage plays a central role in evolutionary psychology and the general notion that modern humans are evolved to deal with small groups and are, therefore, maladapted for the complex societies that have developed over the last 10,000 years; Cosmides and Tooby 1992, Pinker, 1997.

and may also involve coercion. NWW frame the question in terms of dealing with the problem of violence: the solution to inducing cooperation between individuals is to embed them in organizations and relationships where their interests are shaped in such a way that both parties can see the other party's incentives to cooperate. With respect to violence, this is accomplished by devising individual privileges that create rents that are threatened by the possibility of violence (the logic of these arrangements are considered in the next sections.) The prevalence of these types of arrangements in all large societies that appeared over the last 10,000 years, led NWW to call this the "natural state." Natural states use the creation of individual privileges and rents to bind powerful individuals into a sustainable coalition.

The point of this discussion is *not* to suggest that North or Greif had the wrong definition of impersonal, both appreciated the importance of treating everyone the same. Because both North and Greif are trying to develop general theories of institutions, their theories must span anonymous and impersonal relationships. They compounded the two types of relationships when it may have been more productive to separate them.

Impersonality underpins all modern developed societies. Treating everyone the same involves enforceable impersonal rules with two characteristics. First, the same rules must apply in the same manner to all people (or all citizens). Second, the rules must be enforced impersonally, impartially, and without bias. Even societies that have unbiased third-party enforcement of the rules will not be able to sustain impersonal exchange if different rules apply to different people.<sup>10</sup> The dynamics of institutional change involve competing organizations and

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<sup>10</sup> NWW consider the difference between biased enforcement and unique identity on pp. 154-158.

their attempts to shape institutions, both formal and informal, to their own ends. If we think of the “state” as the organization that organizes other organizations, then the political economy puzzle is to understand how states evolved that could enforce rules in an unbiased manner as the impartial third-party, particularly with respect to the rules about forming and structuring organizations. These are important puzzles to set ourselves and, ultimately, to solve, but we need to start with the right question. The place to start is with what constitutes “interest.”

### **3. Interests**

When faced with a choice between 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 and preferences 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. If milk is \$1.00 and juice is \$2.00 it may be in my interest to purchase milk, but when milk is \$2.00 and juice is \$1.00 it may be in my interest to purchase juice. Institutions are one important determinant of the range choices available to individuals. Institutions also 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. 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 include knowledge of the physical world (technology and science), and relative prices encompass the effects of climate, geography, and other external physical events. The four factors constitute the necessary elements for explaining social and individual behavior.

Greif's approach to institutions brings these 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. The logical argument only requires the interaction of individuals, but the spirit of the argument suggests that organizations matter as well. I want to draw out the importance of organizations more explicitly.

Greif's institutions are logical equilibrium structures in which the activities of a group of people are coordinated by arrangements completely sustained within the group. Individual interests lead everyone to behave within the boundaries of the choices formed by the institutional structure. The group is self-sustaining and does not require external intervention. The scale of the group could be a whole society, 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, including non-voluntary organizations where violence may be credibly used or threatened to coerce members to cooperate or stay.

Organizations like the Maghribi traders, 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 understanding how impersonal societies develop.

#### **4. Organizations**

In our dynamic world, individuals sometimes find it in their interest to commit acts of violence, rape, pillage, plunder, cruelty, deception, fraud, and theft and sometimes 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, all relationships are personal, strangers are treated with grave suspicion, and ongoing relationships are conducted with kin and those we know intimately. 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.<sup>11</sup> In order for societies to develop beyond the scale where most people have immediate and repeated face to face contact and personal knowledge, there must be ways to form expectations and beliefs about the interests of anonymous individuals who do not know each other personally. Increasing the size of society requires a solution to the problem of anonymous relationships.

There appear to be two basic ways of comprehending that another's interest is in concert with one's own interest.<sup>12</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, 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. The perceived interest of people we don't know enables us to believe they will

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<sup>11</sup>Evolutionary psychology and biology build on the notion that many human genetic predispositions, both physical and behavioral, are rooted in our long history in hunter-gatherer societies. Binmore, 2005, builds a theoretical framework for explaining "natural justice," the proclivity of people to use fairness and equity norms as focal points in social interaction, as a result of this history.

<sup>12</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. See Cook, Hardin, and Levi for a discussion of how people trust.

act predictably (on certain margins).<sup>13</sup> The first way of comprehending interests usually entails personal interaction, the second can function with or without personal knowledge. Interests in cooperating with another occurs either when we believe, rightly or wrongly, that the interests of the other person are aligned appropriately with our own or we can confidently predict what other people's interests are in a given social situation. 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 NWW solution, in simple terms, is for the violence specialists agree to divide the land, labor, and capital in their world between themselves and agree to enforce each other's privileged access to their resources. 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 X and Y are the two violence specialists, the horizontal ellipse represents the arrangement between the specialists that create their organization/institution. The vertical ellipses represent the arrangements the

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<sup>13</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.

specialists have with the labor, land, capital, and resources they control: their “clients,” the x’s and y’s. The horizontal arrangement between the specialists is made credible by the vertical arrangements. The rents the specialists receive from controlling their client organizations enable them to credibly commit to one another, since the rents are reduced if cooperation fails and the specialists fight. There is a reciprocal effect. The existence of the agreement between the specialists enables each of them to better structure their client organizations, because they can call on each other for external support. The specialist’s organization is what NWW call the “dominant coalition.”

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 result from being coerced.

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 relationship 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 client organizations might be organized as kin groups, ethnic groups, patron-client networks, or organized crime families. The combination of multiple

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, members of the dominant coalition include economic, political, religious, and educational specialists (elites) 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>14</sup>

Nothing in the logic underlying Figure 1 suggest that the rules, norms, or beliefs governing the relationships between X and Y, between X and his clients, or between Y and his clients, need to be the same. Instead, there is a strong presumption that the relationship between X and Y will be asymmetric rather than symmetric, since it is the unique privileges that each possesses that make their agreement credible. Likewise, the clients of X not only are likely to be organized in a way that differs from the clients of Y, it is very important to X and Y that their clients not be interchangeable, since that threatens the agreement between X and Y to respect each other’s resources. The key to the whole arrangement is that the rents X and Y derive from their client organizations enable them to credibly commit to one another. The interests created by these organizations must interlock, that is, the ability of X and Y to form organizations depends on their coordination and cooperation, since the contractual client organizations are

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<sup>14</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.

structured by the third-party enforcement of the dominant coalition.

Each one of the organizations possesses its 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, then informal rules, and finally formal rules. The form these institutions take is governed by the relationship between the specialists and those rules (formal or informal) must be self-enforcing. The dominant coalition institutions are dynamic and subject to changes in any of the parameters effecting the situation of the members of the coalition. Other sets of rules apply to the contractual client organizations, rules that are third-party enforced by the dominant coalition. By necessity, the institutional rules for the coalition and the client organizations 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. These are *idiosyncratic* rules that apply differently to different individuals. These rules are subject to dynamic 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* fit this picture of the dominant coalition. Implicitly, all the teams in North's framework play by the same rules. The teams must decide whether to devote resources to production, to evading, or to changing the rules. In the framework of Figure 1, however, different rules apply to different people and different organizations, 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.

Second, the most valuable privilege members of the dominant coalition enjoy is the exclusive ability to form organizations. A primary source of rents within the coalition is the ability to use the third party services of the dominant coalition to enforce arrangements 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. Limiting access to external support for contractual 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>15</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, 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 idiosyncratic rules are adjusted to accommodate the personal

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<sup>15</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.

identities of the major players and to shape their interests in a way to maintain cooperation. Events in Kenya in early 2008 provide a good illustration. When violence broke 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 of institutional rules in real time. Rather than the rules shaping the teams, in this world the *teams shape the rules*. The rules are both idiosyncratic and somewhat flexible. People cannot believe that the rules are unchangeable and have those beliefs verified by experience.

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. Beliefs and interests are explicitly used in the way defined earlier. People believe that the organizations they belong to and their way of doing things (culture) are an inherent part of providing social order. The possibility of civil war between powerful factions is a real and persistent fear in most societies (read Federalist paper #10). Given these beliefs, when instability threatens it is very much in people's interests to support their organizations, rather than abstract rules, and to change the rules if necessary to maintain a balance between dangerous organizations.

The society depicted in Figure 1 can sustain anonymous exchange. Once a coalition of powerful players is formed it is their interest to facilitate trade between a growing number of people. This exchange is anonymous, but not impersonal. In the community responsibility system, for example, merchants in each commune are deeply embedded in social organizations, like guilds, and a power structure where interlocking rents create interests that sustain

cooperation within the commune. Long distance, inter-commune trade is facilitated by a threat. If a merchant from commune A cheats a merchant from commune B, and the courts in commune A refuse merchant from commune B compensation, then the goods of any of the commune A merchants are confiscated by the commune B court. “When this cost [ceasing trade] was too high a commune’s court’s best response was to dispense impartial justice to non-members who had been cheated by a member of the commune.” (Greif, 2006, p. 310) It was critically important that merchants be identified (accurately) as members of different communes, since it is the credible threat of the cheater being “punished by his own community is at the crux of the community responsibility system.” (p. 326) As a result, individual merchants were not treated impersonally, but “these arrangements enabled a trader to establish his communal and personal identity in interactions with merchants who did not know him personally. Living in the quarters of a particular community represented a way of demonstrating ones’ communal identity.” (p. 334) The community responsibility system supported anonymous exchange, but only in a social context where communes created significant incentives (rents) for their members to interact, and those relationships within the commune were not impersonal. As Greif suggests, the end of the community responsibility system came about when communes became too large to monitor the identity of traders.

In a natural state, personal identity is closely linked to the immediate organizations that people 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 many pre-modern societies is not closely associated with

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<sup>16</sup>For an example of this see Akerloff and Kranton, 2000.

larger social units.<sup>17</sup> Identity, and thus an important element of causal beliefs, in all societies is shaped by the immediate organizations people live within.

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 *shapes* the interests of individuals through the structure of organizations. While no individual or group is consciously and intentionally attempting to create a pattern of interests within the entire society, the decision to support specific contractual organizations is a deliberate and intentional decision, and those decisions are continually being reconsidered within the dominant coalition.

Interests are shaped 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 a contractual organization, the ability to access the rules, is limited to a small segment of society. Organizations are 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

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<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.

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.

## **5. Rents, Rules, and Organizations**

The previous section placed organizations and individuals in the context of a larger set of social relationships, this section reverses the perspective and looks at social relationships from inside organizations. Understanding how organizations work has been a mainstay of the new institutional economics, beginning with Coase's (1937) insights about the firm, continuing on through Williamson (1975 and 1985), Grossman and Hart (1985), and a host of others. As Gibbons has argued in a series of papers designed to draw together lines of inquiry in economics and sociology, organizations can be thought of as interlaced bundles of relationships and contracts (1998, 1999, 2003).

One starting point for a theory of organizations is the folk theorem intuition that two individuals can maintain a relationship over time if both individuals receive a rent from the relationship. The players in the folk theorem receive rents from their specific relationship, so their individual identity and the identity of their partnership matters. The existence of rents makes the relationship incentive compatible. The folk theorem is not quite enough to build a theory of organizations, however. The folk theorem partnership is an adherent organization, one where both parties have an interest in cooperating. Looking forward into the future, if the parties perceive the rents may not be sufficient to ensure cooperation at any point in time, then defection is anticipated and cooperation unravels. There are ways for the partners to protect against defection, like giving hostages, which provide insurance against the possibility that rents will become zero or negative at some point. The threat of killing the hostage imposes large penalties

on defection, creating the possibility of incentive compatibility and time consistency for the partnership.

As Gibbon urges, rather than thinking of an organization as only a collection of formal rules embodied in contracts, we should also think of organizations as bundles of interpersonal relationships that generate returns for the members that depend on their continued interaction.<sup>18</sup> This is not so different from the description of the natural state that NWW supply: an interlocking set of interests sustained by privileges that enable credible cooperation between members of the dominant coalition. The collection of rules and contracts is not the actual structure of the organization, but a framework that, in principle if not in practice, allocates default decision making responsibilities and penalties for defective behavior. The importance of terms like “relationship-specific” and “relational contracts” reflects the weight that the new institutional economics places on interlocking sets of rents for coordinating cooperative behavior.<sup>19</sup> Many relationships may not follow formal rules, so organizations are not mechanisms, but are collections of idiosyncratic, personalized relationships: the “organizations as garbage cans” idea of Cohen, March, and Olsen (1972). Good rules are not necessarily ones that are always followed. Good rules are one that rarely need to be activated because actual behavior does not trigger the need for the intervention of the third party.

Third-party's are a way to reduce the costs of enforcing rules when it is necessary to do

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<sup>18</sup>Granovetter's notion of “embeddedness” is precisely that contractual relationships are embedded in personal relationships: “In this article, I have argued that most behavior is closely embedded in networks of interpersonal relations and that such an argument avoids the extremes of under- and oversocialized views of human action.” (1985, p. 5040)

<sup>19</sup>Hart and Holmstrom, 2008. Baker, Gibbons, and Murphy 2002.

so. Rather than tying up valuable resources in the form of hostages or other insurance devices rules (contracts) enforced by third-parties offer a more efficient possible way of ensuring that rents stay positive. The two parties agree to terms and penalties for defection that a third-party enforces.<sup>20</sup> The resources of the third-party need only be engaged when necessary, offering gains from resource use and specialization and division of labor. This brings up a very Coasian question: should the third-party be inside or outside of the organization?

In an adherent organization all third-party enforcement is internal, in a contractual organization some or all enforcement is external to the organization. Viewed from the perspective of society, the simple natural state depicted in Figure 1 is in its entirety an adherent organization. The overall organization is made up of the component organizations, the three ellipses, that make up a self-enforcing set of social relationships. Viewed from the perspective of individual organizations, the figure represents one adherent organization linked with two contractual organizations.

The ability to form and structure the contractual organizations depends on the nature of the adherent organization that makes up the dominant coalition, while simultaneously the relationships in the dominant coalition depend on the nature of the client contractual organizations, since it is those organizations that provide the rents that make personal relationships sustainable in the dominant coalition. In figure 1, the rules that help shape the interests of members of the organization headed by X, are simultaneously shaped by X's relationship with Y. The simplest rule between X and Y, is that Y agrees to come to X's aid

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<sup>20</sup>It might be more accurate to say that third-parties specify the kind of contracts that they will enforce.

whenever X calls (and vice versa). The increase in the coercive power of X relative to his clients, the x's, may be sufficient to enable the formation of incentive compatible arrangements between X and the x's.<sup>21</sup> At the same time, the rents flowing to X from his client organization enable him to credibly commit to cooperate with Y.

The third party rules available to the organizations of the dominant coalition members are part of the balance holding the entire adherent organization together. This way of thinking about the source of third party rules differs enormously from the way social scientists have thought about the problem. North's neo-classical theory of the state (1981 and 1990), Olson's stationary bandit (1993), Bates's fable of violence (2001, 2008), Bates, Greif and Singh's organized violence (2002), Tilly's bargain between capital and coercion (1993), Greif's analysis of the podesta (2006), and Barzel's theory of the state (2002) all begin with the premise that an already existing organization of residents bargains with a violence specialist to provide protection and justice. When the problem is set up in this way, the solution is to create a set of payments to the specialist that provide him, under expected circumstances, with sufficient rents to prevent him from defecting: a personalized contract as it were. Credible commitment of the specialist to

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<sup>21</sup>While there are differences among individuals in the ability to be violent in hunter-gatherer societies, the small size of the group means that no single individual will have a preponderance of violence potential against the organized opposition of the group. Every leader has to sleep sometimes and so risks retribution if he oversteps his bounds. With the alliance of X and Y, and Y's promise to come to X's aid if necessary, changes the balance of power between X and his group, by giving him a disproportionate relative power. X can now enter into arrangements with his clients in which he can credibly threaten to use coercive power. Just having Y's promise to back X changes the dynamics of the organized group. What prevented these arrangements from arising before 10,000 years ago is a mystery, but it seems well substantiated that all societies that were able to sustain larger groups (bigger than 1,000) also show clear evidence of social hierarchies (Johnson and Earle, 2000) and usually in the earliest societies an integration of military, religious, and political elites (Trigger, 2003 and Service, 1975).

honor his agreement becomes the pivotal element. The state becomes the single-actor entity that enforces rules in an unbiased manner.

While this approach is logically attractive, in the real world protection and justice are provided by coalitions of powerful individuals, never by single actors. Until we understand how the coalition of protectors is structured, we cannot understand how the coalition will relate to its client organizations. It is the ability of the dominant coalition to coordinate the incentives of its members that enables the coalition to act as a third party enforcer for the member's contractual organizations.

An implication of considering the dominant coalition as the source of rules for the contractual organization is that the kind of rules that the coalition can implement depend on the nature of the organization of the coalition. A succession rule provides an example. Suppose that the coalition is based on sheer power, and coalition members are either military specialists or closely linked economic and political partners (as seems to be the case in several contemporary African nations). Since the dominant coalition is subject to continuous adjustment, it is difficult for the coalition to sustain durable agreements (the composition of the coalition may change next week or month), and as a result it is also difficult for the coalition to sustain rules within contractual organizations. The rule is that the coalition backs its members: Y come to the aid of X, unconditionally. Such a rule is dangerous for leaders, as they must always worry about their own powerful subordinates, who may advance over the leader's dead body, as well as other members of the dominant coalition.

The coalition may implement a succession rule, under which the oldest male child is accepted by the coalition as leader (subject to the child's ability to hold power once he is given

it). The rule has to be accepted in both the dominant coalition and in the client organizations. If a Duke dies, his son must be recognized as the new Duke both by the Duke's retainers and by the other Dukes. The same succession rule may be adopted by all the client organizations or different client organizations may have different succession rules, either way the dominant coalition and the client organizations have to agree on the same rule.

The dominant coalition is an organization of organizations that uses violence and the threat of an integral part of agreements within the coalition. The rules adopted by the dominant coalition to order its internal relationships must be incentive compatible and self-enforcing, for by its nature the dominant coalition is an adherent organization. The relation specific rents that hold the coalition together are based on the rents that members of the coalition derive from their contractual organizations, for which the coalition acts as a third-party. The rules that can be sustained within the coalition depend on the effect of the contractual rules on the rents flowing from member organizations, so the coalition rules and the contractual organization rules are directly related. In a double sense, sustainable relationships within the coalition are embedded in the rents produced by the member's organizations, and sustainable organizations and their rules are embedded in the rents that coordinate the coalition. The dominant coalition exercises the key function of a state: it is the organization that organizes other organization.

As Gibbons might emphasize, the dominant coalition is a bundle of relationships more or less constrained by a bundle of rules, ala the garbage can model of organization. Until 200 years ago, economic, political, and social development in all societies in recorded human history depended on improvement in the relational structure of the dominant coalition and the organizations dependent on it. In principle, the dominant coalition could adopt anonymous

rules that applied equally to all elites, but such rules are subject to the constraint that a rule that reduces elite rents on one dimension must create offsetting and self-enforcing relationships on another dimension or will not be sustainable. How then did elites in a few societies about 200 years ago decide to adopt rules that allowed any of them to form an organization governed by general rules, applicable equally to all elites?

## **6. Institutional Dynamics**

The limited access society depicted in Figure 1 is capable of anonymous exchange, capable of formulating rules that can be sustained by the interaction of interests in the dominant coalition and the contractual organizations, capable even of forming sophisticated organizations, but it is also a society that rests on relationships between powerful organizations and individuals and the creation of rents that shapes their interests. Institutional change occurs along two primary dimensions. One is changes in the rules and norms that structure the dominant coalition and client organizations; the other is periodic reallocations of rents within the coalition. Reallocations of rents can be occasions for violence, even civil war, and the shadow of that violence effects the dynamics of institutional change throughout society.

All societies are subject to constantly changing conditions: relative prices, climate, neighbors, the character of leaders, and the like. Ordering social relationships through rent creation enables people to believe that their relationships will persist through small changes, because the existence of rents on both sides of the relationship means that neither partner is at a margin where a small change in circumstances could lead to defection. To the extent that an institutional change can increase productivity that can be used to strengthen existing organizations it will be pursued. Yet, even if institutional change increases productivity, if the

change lowers rents and increases the likelihood of defection the change will more likely be resisted. Any institutional change that alters rents sufficiently to destabilize the dominant coalition, even if implemented, will be self-defeating. Destabilizing the coalition increases the risks of civil war. If violence breaks out, relationships between individuals quickly polarize into us and them, those who are for us and those who are against us. The importance of group identity and group affiliation assumes an overriding importance. In a very real sense, when violence breaks out within the dominant coalition all the rules become subject to change. It is in the interests of individuals to be associated with powerful groups and it is in the interest of individuals to act in support of their group, rather than in support of abstract rules.

This suggests that when uncertainty about the stability of the dominant coalition rises, institutional changes that strengthen the rents and associated personal identity of coalition members, and so make it easier for coalition members to perceive each other's interests, increase in value relative to institutional changes that raise rents but make it more difficult to identify personal interests. In figure 1, X receives rents from his organization and those rents are dependent on the contractual rules that he can enforce because of his relationship with Y. In one sense of better, the better the rules, the higher the rents. But X also receives rents because of his unique identity within the coalition as the leader of organization X, and the fact that he is the only person who can draw on the third-party services of Y. Rules that strengthen X's organization, but weaken X's mutual dependence on Y, and thus weaken the ties within the dominant coalition, are less likely to survive periods of instability. Organization rules serve two purposes, organizing the client organization and providing rents in the dominant coalition, and the two purposes may be conflict. In general, then, there is nothing inherent in the dynamics of

institutional change that moves towards rules that make organizations more productive.

The key to stability in a limited access order is that only members of the dominant coalition have access to the organizational tools offered by the coalition. Even if every client organization draws on the third-party enforcement of the same rules, nonetheless the personal identity of the coalition member guarantees that he or she derives rents from being able to access the externally enforced rules. The identity of coalition members and the rules the coalition will enforce are not independent of one another, but they are separable. In times of uncertainty about the coalition, the dynamics of institutional change should move in the direction of changes in the rules that assign more privileges and decisions to the personal identity of the coalition member.

The question before us is how the dominant coalition comes to decide that the ability to form organizations that can access third-party enforcement of rules should not depend on the individual identity of coalition members, but should instead be available to all coalition members? With the initial caveat that we are only talking about coalition members, the question is how impersonal rules structuring organizations can arise? The answer depends on the nature of the rules the coalition can support and the nature of interests within the coalition. As limited access societies develop better organizational tools, for organizations inside and outside of the state, they also increase their ability to support anonymous exchange. Anonymous exchange is not embedded in impersonal rules, but in the structure of interlocking interests sustained by rent creation in the dominant coalition and client organizations.

NWW stress three doorstep conditions for a transition from limited to open access: the existence of rule of law for elites, the existence of perpetually lived elite organizations inside and outside the formal structure of the state, and consolidated control of the military. NWW

emphasize that the doorstep conditions are important because they create the possibility for *impersonal* elite relationships, but lets transform that language into creating the possibility for *anonymous* elite relationships. Within the existing set of social relationships, elites who did not know each other personally, are nonetheless identifiable as types of individuals tied to specific organizations, just like the Genoans and Pisans in medieval trade. The doorstep conditions represent a widening of the range of relationships within which elites could treat each other anonymously.

Open access to organizations for elites involved two elements. The first applies both to elites and non-elites and has to do with the nature of rents. The second applies only to elites and has to do with protecting their interests within the coalition.

Economic rent is a relative rather than absolute concept that depend on the alternatives being considered. In the 2008-2009 basketball season, the Los Angeles Lakers will pay Kobe Bryant a reported salary of \$21,262,500.<sup>22</sup> He is the fourth highest paid player in the league. Almost certainly, Bryant would be willing to play basketball for an amount far lower than \$21 million a year, say \$1 million a year. So his rent from playing basketball is roughly \$20 million a year. The rent he receives from playing for the Lakers, however, is far less. Many other teams would be willing to pay Bryant somewhere in the neighborhood of \$20 million a year, so his rents from playing *for the Lakers* are somewhere in the neighborhood of \$1 million a year.

Not all the rents that Bryant receives from playing basketball are available to secure his relationship with the Lakers. The relationship-specific rents are only \$1 million a year, and if the Lakers offer Bryant a salary lower by \$1 million he leaves for another team. Bryant's

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<sup>22</sup><http://www.insidehoops.com/nbasalaries.shtml>

individual-specific rents, the \$20 million rent he gets from playing basketball, is related in part to Bryant's unique personal characteristics and, in part, on the existence of the National Basketball Association (NBA). The NBA is an organization responsible for setting and enforcing formal rules and informal norms. Bryant's individual-specific rents are directly related to the success of the NBA as an organization. To the extent that the NBA's success is related to the public perception that the rules are enforced in a fair and unbiased way, Bryant also has an incentive to support the rules.<sup>23</sup>

The Bryant example illuminates the first element in the rise of impersonality. If the balance between relationship-specific and individual-specific rents shifts away from relationships, more individuals may find it in their interests to act in support of the rules, rather than in support of their organization. This fails as a general explanation for the rise of impersonal rules, however. The interests of individuals are too likely to be compromised by free rider problems and fluctuations in the relative returns to supporting the rules and breaking them. Nonetheless, the emergence of impersonal rules and organizations that enforce them will systematically change individual interests, an issue we return to shortly.

The second factor is capable of explaining the rise of impersonal rules. In the simplest terms, elites may find that the best way to protect their individual interests from intra-elite competition was to open access to organizations. Members of the dominant coalition always have more to fear from each other than from the rest of the population. As military power is consolidated under the state, economic organizations become a more important influence in the

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<sup>23</sup>By most accounts, Bryant is an extremely competitive and motivated individual, and whether his interests in winning (perhaps by bending or breaking the rules or intimidating the referees) dominate his interests in supporting the rules is an interesting problem.

polity, and elites seek to prevent the accession of an elite “faction” that uses the manipulation of economic privileges to control the political system. Under a social order where control of the means of violence was dispersed throughout the dominant coalition, all coalition organizations lived under the shadow of violence and could, potentially, become violent. The rise of powerful non-military organizations (doorstep conditions 1 and 2) enables coalition members to consolidate control of violence in one or more state controlled organizations, the military and police, because coalition members are confident that they can collectively discipline the state to prevent to military organization from abusing its power. But how do coalition members ensure that they can compete economically and politically? They move to impersonal access to the tools that support organizations, so that any elite group can organize to defend or advance its interests.

The logic is easiest to see with business corporations. They are only one type of important organization, but they offer an easily visible form of deliberately structured elite organizations.<sup>24</sup> The first business corporations appeared in Northwestern Europe in the 16<sup>th</sup> century. Corporations had existed in Europe since Roman times. While the complexity and sophistication of corporations developed over several centuries, corporations were always organized privileges. The grant of a corporate charter, creating a legal identity for an organization, occurred within the dynamics of the dominant coalition. Corporate charters were both a grant of privilege (often a monopoly on some activity) and the explicit recognition of a set of contractual rules governing the corporation’s internal and external relationships.

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<sup>24</sup>Even the business corporation is only one among many possible types of business organization. See Guinnane, Harris, Lamoreaux, and Rosenthal (2007) for a discussion of corporations and alternative forms of business in the late 19<sup>th</sup> and 20<sup>th</sup> century.

To use Gibbons' terms, the legal structure of the corporation was a bundle of contractual rules that the dominant coalition would enforce for the corporate organization, although the corporation itself was a more complicated assortment of relationships and rules. Most early corporations enjoyed unique and valuable privileges. Through the 18<sup>th</sup> century, the number of corporations grew slowly and the procedures for granting new charters were heavily weighted towards protecting existing privileges, rather than granting new ones.<sup>25</sup> Pressure to open the system of chartering came from elites, sometimes powerful elites, who were unable to obtain privileges for themselves. For example, the South Sea Act of 1720 established a duopoly of marine insurance in London that stood for one hundred years. In the 1820s a group headed by Alexander Baring and Nathan Rothschild petitioned parliament for a charter to establish a third company, and their efforts were initially frustrated (Harris, 2000, pp. 207-215).

General incorporation acts, which allowed a corporation to be formed through a simple administrative act that did not require explicit permission of a legislature or state body, appeared in the United States in the 1810s, followed by widespread adoption in many states in the 1840s. Britain adopted its general incorporation act "Registering, Incorporation and Regulation of Joint Stock Companies" in 1844, followed by registration with limited liability in 1856. France adopted its registration act in 1867. Changes in the rules supporting organizations extended well beyond business corporations in the early 19<sup>th</sup> century. Churches, schools, universities, political organizations and ultimately political parties, and voluntary organizations of many types were increasing able to avail themselves of state sanctioned rules for their internal and external

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<sup>25</sup>For Britain see Harris, 2000, for France see Freedeman, 1979, for the United States in the early 19<sup>th</sup> century see Wallis, 2005 and 2006. NWW consider the British, French, and American cases in detail, pp. 190-250.

relationships. The first general incorporation act appears to have passed by the New York state legislature in 1783, it was a general incorporation act for churches (Seavoy, 1982). These changes were motivated by elite interests, but for our purposes why the changes occurred is less than the fact that they did occur.<sup>26</sup>

Contemporaneous changes in the ability of elites to form a wide variety organizations are proof enough that the changes in business incorporation were not exogenous but part of a larger pattern. Do not, however, lose sight of the inherently impersonal nature of the rules about forming an organization that a general incorporation law represented. *Any* qualified individual could form an organization *at will* and draw on the support of the state to structure the internal and external relationships of that organization to other organizations and individuals. General incorporation acts did not change the rules that the dominant coalition would enforce, it changed the identity of the individuals who could call on the rules and third-party enforcement.

The advent of impersonal rules for forming organizations effected institutional dynamics in direct and obvious ways. The formation of new economic, political, and social organizations (or elimination of old organizations) occurred quickly in response to new opportunities and alterations in circumstance. The number of formal organizations mushroomed.<sup>27</sup> Negotiations among powerful interests, which before took place between a (relatively) stable group of

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<sup>26</sup>Explaining why these changes occurred is the heart of the transition process in NWW.

<sup>27</sup>The formation of new incorporations after the registration acts increased by a factor of 10 in Britain and France, Harris, 2000, p. 288 and Freedeman, 1993, p. 9. In the United States, the already high rate of corporate formation increased after general incorporation, but there are no national counts. See Wright, 2008, 2009 for estimates. The increase in incorporation was not limited to business, for example, Novak , 2001, documents the incorporation of over 3,000 voluntary organizations in Connecticut between 1787 and 1865.

organizations and individuals, now had to accommodate the rapid rise of new organizations and ever changing, and now uncontrollable, patterns of interest.

Open access to organizations transformed the dynamic nature of political and economic competition.<sup>28</sup> Short of putting the genie back in the bottle by reversing course and limiting access to organizations, elites now found it in their interests to maintain open entry. The best response to Schumpeterian creative economic destruction was innovation, which required new organization (Schumpeterian entrepreneurs being consummate organizers). Open access did not signal the end of interest group politics, groups still had an incentive to press for special privileges, but impersonal rules about the formation of organizations meant that many of the rents that could be created by privileges would ultimately be competed away.

Two elements had to be maintained for the transformation to persist. First, elites had to continue to find it in their interest to support impersonal rules for organizations. Once open access truly took hold, however, going back became quite difficult. Any attempt to limit access created winners and losers within elites, how was a change in policy to be brokered? Such a negotiation was complicated by the changing nature of elites. Open access itself began to erode the distinction between elites and non-elites, and some newly rich and newly powerful non-elites could now demand a voice in the governing process. Any elites who saw themselves as potential outsiders to a new dominant coalition had a strong incentive to maintain the open access rules.

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<sup>28</sup>I do not mean to imply that simply passing a general incorporation law immediately produced open access. “Other European countries shortly followed the lead of France and England in providing free incorporation: Spain in 1869, Germany (North German Confederation) in 1870; Belgium in 1873, and Italy in 1883” (Freedeman, 1979, p. 144). No rule operates in isolation, and the adoption of general incorporation laws did not produce open access in Germany, Spain, or Italy.

The second element concerns the organization of the state and ability of the state to deliver services impersonally. This paper has laid out the rudiments of a theory of the state that defines the state as the organization that organizes other organizations. The advent of impersonal rules for organizations requires a shift in the structure of the state, as several of the organizations within the state were required to deliver impersonal third party enforcement of specific rules. The administrative organization(s) that grant recognition to organizations and the judicial organization that enforces the internal and external rules regarding the actions of organizations must perform their tasks without regard to the identity of the people in the process.

Greif's insight about anonymous exchange leading toward the "path to the modern economy" applies here: societies that cannot support extensive anonymous exchange do not possess the institutional resources to implement impersonal rules. This is also why NWW place so much emphasis on the doorstep conditions. A mature limited access society already knows how to structure sophisticated organizations, like corporations, but those organizational structures are embedded in a framework of personal, rent creating relationships. Moving to impersonal rules for organizations does not involve changing the rules (since the formal rules for the internal and external relationships of the organizations can stay the same), what changes is the identity of who can access the rules. Allowing anyone to create an organization that can call on the support of the state fundamentally changes the institutional dynamics of the whole society.

Impersonal rules require an unbiased bureaucracy: a nameless, faceless, rule bound organization that does not recognize personality or identity, but only relies on whether the rules are being correctly applied. Insistence on impersonal bureaucratic administration of certain state

policies is essential for open access to survive. In an open access society the state provides a wide range of services on an impersonal basis. The enforcement of impersonal rules cannot be based on personal relationships, and so the parts of the state organization that administer impersonal rules must be governed by rules of law not by rules of men.

Impersonal rules are not self-enforcing. They must be embedded in a institutional framework where the dynamic interplay of economic and political forces generate interests that make the impersonal rules sustainable. The adoption of impersonal rules for forming organizations changes the dynamic of elite relationships within the dominant coalition.

Impersonality is one facet of equality: treating everyone the same. Equality is a more complicated concept, however. Equality of opportunity requires impersonality, as everyone gets the same opportunities; equality of outcomes requires treating everyone differently according to their endowments and abilities to ensure equal outcomes. Without going more deeply into the nature of equality, the following argument attempts to answer the question posed at the beginning of the paper: how can individuals find it in their interests to support impersonal rules rather than the organizations they belong to, even at some immediate cost?

Interests result from a combination of factors: opportunities, relative prices, preferences, and beliefs. As opportunities broaden, the rents associated with any specific relationship decline relative to the rents individuals accrue because of their personal abilities, as in the Kobe Bryant example. University professors undoubtedly benefit more from living in a society where universities compete for their services than they do from increasing the endowment of the university they happen to be located at. These kinds of interests in maintaining the system of competition, however, will be unreliable constraints motivating people to support the rules rather

than their organization in general, because in specific instances the benefits of acting against the rules may be too great.

Well organized interests are faced with similar competing incentives. On one hand, they would like to use their position to influence the state and society to create rents for themselves, ala Mancur Olson (1965, 1982). On the other hand, they understand that their ability to organize, and to form new organizations, is critical to their continued success in a constantly changing dynamic environment. This is true of both political and economic organizations.

Just as allowing open access to economic organizations unleashes Schumpeterian creative economic destruction, allowing open access to political organizations unleashes creative political destruction. Schumpeter's theory of politics in *Capitalism, Socialism, and Democracy* (1942) was not only perilously thin, but Schumpeter was wrong about the protective strata of politics that enabled capitalism to flourish evolving into a suffocating shell of socialist regulation. Not only did that not happen historically, but allowing open economic competition profoundly affected the dynamics of politics. New and unpredictable patterns of interests, thrown up by innovation and growing markets, were not captured or smothered by politics but the reverse.

Rent seeking plays a major role in the operation of open access politics, that part of human nature has not changed, but so far at least, the rent seekers in open access societies have not been able to sew up a package of interlocking rents that persist over time and are capable of limiting entry on a wide scale. New technologies, industries, firms, and groups are always on the cutting margin of economics and politics and because they are on the margin, they have a strong stake in maintaining open entry. Coalitions of political, economic, and social interests vie for

control of the polity, but no specific coalitions in the developed world have been capable of exerting long term hegemony. A viable competitor to the existing coalition of interests always emerges, as Arrow's impossibility theorem suggests. Losers never go away, they just reorganize. The only way to short circuit the formation of a competing coalition would be limiting the ability of a new coalition to organize.

In Greif's framework, the only sustainable casual beliefs individuals can hold are ones that are consistent with actual outcomes. Economists often dismiss beliefs in equality as unrealistic, given the clear and obvious inequalities in endowments and outcomes across individuals. But perhaps it is only part of the belief in equality that needs to apply: that part that says treat everyone the same.

At the heart of the social process is a new institutional dynamic where powerful organizations have an incentive to keep access to organizations open, which means that the dynamics of coalition formation are always in flux. When society, through the agency of the state, moves against the interests of a particular group, then that group organizes, pushes back, and forms coalitions with other organizations. Rent seeking is not eliminated, but rents are eroded through entry and competition. The beliefs of the larger society that sustain the process are relatively simple. Treating everyone the same has two requirements. First, the rules apply equally to everyone and enforced in an unbiased way. Second, changes in the rules also apply to everyone equally. If people believe that a system that treats everyone the same will ultimately work in the end, then when circumstances lead to changes in the rules, the losers take their lumps, reorganize, and return to play another day. But if losing means leaving the dominant coalition, reorganization can only occur if a group is in the dominant coalition, then losing today

is not an option if losing today precludes a group from organizing in the future. The belief does not create a slavish desire to follow all rules. Instead, the belief creates a predisposition to equate following the rules today with being able to organize in the future. Since applying the rules in an unbiased manner is visible evidence that everyone is being treated the same, within the existing rules, and the expectation that the rules will allow everyone to organize to pursue their interests in the future (which may include lobby for changing the rules in the future) individuals find that their interests usually lie in supporting the rules (even if they do not always obey them).

## **7. Conclusions**

This paper has laid out a framework for understanding how societies can support impersonal relationships on a wide scale. Impersonality requires that all individuals are treated the same by the larger society, regardless of the personal identity of the individuals involved.

Understanding the rise of impersonality is a goal of the new institutional economics. We have, however, labored under a confusion about the meaning of impersonality. Taking the genetic predisposition of people to create relationships with people with whom we interact repeatedly as the baseline, the new institutional economics and social sciences have asked how people who have no personal knowledge of each other and no expectation of a relationship in the future are capable of forming a productive relationship. We have come a long way in understanding how anonymous relationships can be made to work: “that is impersonal exchange, in which the parties are constrained by kinship ties, bonding, exchanging hostages, or merchant codes of conduct. Frequently the exchange is set within the context of elaborate rituals and religious precepts to constrain the participants.” (North, 1990, p. 34-5) But anonymous exchange

is not impersonal exchange. Long distance trade in medieval Europe depended on identifying individual traders as members of organizations, as Genoans or Pisans. Two merchants with no personal knowledge of each other could confidently trade only because they understood the social networks in which each was embedded.

Drawing on the conceptual framework of North, Wallis, and Weingast, anonymous exchange can be seen as an element in a larger pattern of social organization, which they call the natural state. When larger human societies emerged five to ten thousand years ago, solutions to the problem of dealing peacefully with people whom one did not know personally must have developed. Larger societies were made possible when powerful individuals were able to reach credible agreements to limit the use of violence. Each member of the dominant coalition headed, or was a member, of their own organization. Agreements within the coalition were credible because each client organization was able to call on the other powerful members of the dominant coalition to act as third-party enforcers within the client organizations. The rents from the client organization provided the means of sustaining credible agreements within the dominant coalition. Limiting the ability to form organizations for which the coalition would act as the third-party enforcer was critical to the entire arrangement.

Gibbons' describes organizations as bundles of relationships and contracts. Repeated relationships enable two individuals to form expectations about each other's behavior. Since both individuals expect to gain from the relationship, the arrangements are self-enforcing, what we can call an adherent organization. Rules and contracts enable them to pre-commit to actions in circumstances where the rents to one party may become negative in the short-run. The kind of rules that can be enforced is much wider if a credible third-party exists. An organization that

utilizes third-party rules is a contractual organization. The design of a natural state enables the members of the dominant coalition to credibly cooperate, and their cooperation enables the coalition to act as third-party enforcers for member's client organizations. The increased productivity of the client organizations produces rents which are used to credibly commit the members of the dominant coalition to each other. The dominant coalition is an adherent, rather than a contractual organization.

In this kind of society, anonymous exchange can be sustained because the individuals engaged in anonymous exchange can be identified as members of larger organizations. This is not impersonal exchange, since in no sense is everyone treated the same. The rules that the dominant coalition will enforce for the client organizations need not be the same for all organizations, nor are all individuals subject to the same rules. Rules are always subordinate to rents and relationships within the dominant coalition. Individuals have little reason to believe that rules will always be enforced, and the interests of individual therefore lays with defending the organizations of which they are a part.

When the dominant coalition decides to extend and enforce a set of contractual rules for all contractual organizations that any elite forms, the institutional dynamics of the coalition change. The conditions under which elites might willing to make such a change are not really the issue in this paper (although it is a very important issue), but elites must find themselves in a position where defending their interests against other elites is best accomplished by opening access to organizations. If any elite can form an organization, manipulating the interests of elites in order to ensure cooperation with the coalition becomes much more difficult. The pattern of interests that arises is unpredictable and constantly changing.

The rules about forming organizations have now become impersonal (at least for elites). Any person has the same right to form an organization and draw on the third-party enforcement of the state. At the margin, the definition between an elite and non-elite begins to blur, there is no element in the institutional dynamic that works against diluting the identity of elites, like there is in a natural state. The state, the organization that organizes other organizations, has to develop the bureaucratic capacity to recognize organizations in an impersonal way. Organized interests are able to form to work against inequitable treatment of citizens. These organized movements may not bear fruit, but they become part of the mix of elements that the political actors can bring into a coalition to contest for control of the state.<sup>29</sup> Open access economics plays a critical role in keeping open access in politics, as groups that are threatened by adverse government policies organize to resist changes and urge other policies that benefit them.

Rent creation and rent seeking are never eliminated, but competition tends to erode rents and make coalitions built simply on rent creation unstable over the long term. Changes in the rules always benefit some more than others and a continual interplay of interests produces changing rules over time. One stable default for rules, however, appears to be that new rules apply equally to everyone.<sup>30</sup> Governments in open access societies appear to be much better able to deliver public services impersonally to all who qualify: driver's licenses, old age pensions,

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<sup>29</sup>It make take centuries for the non-elites to be completely integrated into the society of citizens, women did not get the right to vote in Switzerland until 1971.

<sup>30</sup>I had originally hoped to discuss in this paper how American states came to adopt constitutional provisions that required state legislatures to pass "general" laws that formally applied equally to everyone a forbade the passage of special laws that singled out individuals or groups for special treatment. The prohibitions against special laws for specific purposes became widespread by the late 19<sup>th</sup> century. See Wallis, 2009, for a discussion of those constitutional provisions.

access to public utilities and services, property rights and registers, and contract enforcement and justice. Impersonal exchange, and impersonal relationships, are supported throughout these societies, because the expectation of almost everyone is that the rules will be applied impartially. That belief must be grounded in the reality of how rules really are applied.

Impersonality, treating everyone the same, is an outcome not an institution. Impersonal rules do not automatically enforce themselves. Organized human interaction continues to depend more on relationships than it does on formal rules. Organizations may be better described as garbage cans than smoothly functioning machines. All societies are, in the last analysis, organizations of organizations. Simply knowing the rules is not enough to describe how a society actually works.

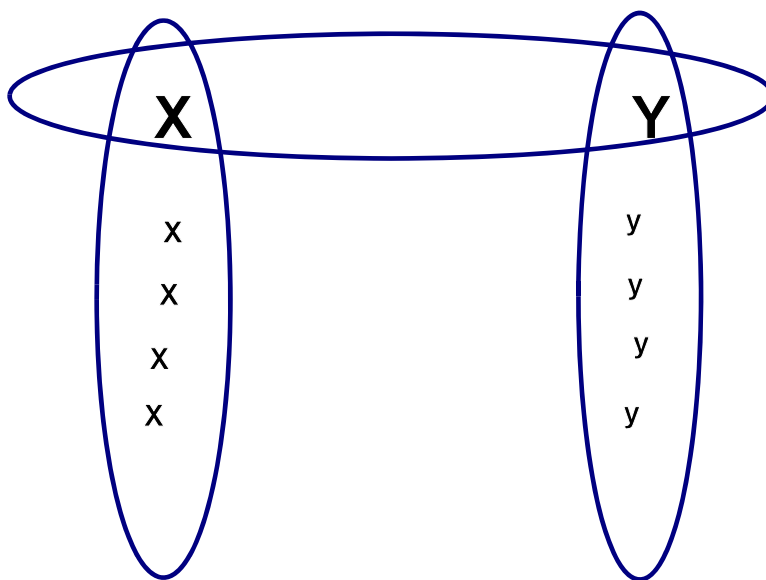
But all societies capable of coordinating human actions for groups of larger than several hundred people must be able to solve the problem of anonymous relationships: people sometimes have to deal with people they don't know personally. Larger social organizations require rules, even if the rule is very simple, Y will always come to the aid of X and side with X in any dispute. Coordinating the interests of powerful individuals through rent creation is how larger societies are built. Rent creating institutions provide the institutional framework within which anonymous exchange and anonymous relationships can flourish. The skill with which a dominant coalition of a society supplies third-party rules to its organizations determines how successful that society will be. The new institutional economics has come a long way in understanding how that process of sustaining anonymous exchange works.

What we are just now coming to realize, is that changing the rules about who can form organizations that the larger society will support can transform the institutional dynamics of the

whole society. Only a handful of societies in human history have managed to make the enforcement of third-party rules for organizations accessible to every citizen, that is, to make access to those third-party rules truly impersonal. In turn, imperfect as they are, those societies have managed to make impersonal relationships on a wide scale a reality.

Figure 1

In the figure “X” and “Y” are the violence specialist, their clients are the “x” and “y” respectively. 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.



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