

# 6

## Explaining Differences in External Institutions across Societies

### 6.1 Introductory Remarks

*Explanans:*  
Explanatory  
variables

Chapters 6 and 7 comprise the third part of this book. In Chapters 2 to 4, we assumed institutions – both external and internal – to be exogenously given and inquired into the consequences for individual choices. In Chapter 5, we looked at the consequences of different sets of institutions for economic growth and other economically relevant indicators at the aggregate level. We attempted to explain certain phenomena by differences in institutions. Hence, in Chapters 2 through 5, institutions served as *explanans*.

*Explanandum:*  
Explained  
variables

In Chapters 6 and 7, we shift our focus and investigate whether we can use economic theory to explain the origins and changes in institutions. Institutions are thus no longer exogenously given; instead, we now ask which incentives and mechanisms might lead to the choice and change of institutions. Hence, institutions now serve as *explanandum*. For purely practical reasons, we first deal with external institutions, then with internal institutions. Simply put, there has been more research into the origins of external institutions than into the origins of internal institutions. If we were to proceed purely chronologically, it would make sense to first deal with the origins of internal institutions. A great number of institutions were internal institutions before evolving into external institutions by collective action. Chapters 6 and 7 each cover “hot” topics in the sense that over the last couple of years, much original research has been published on the questions introduced here.

Explaining the origins and the change of institutions also involves questions regarding groups of institutions that are closely connected to each other and that as a group constitute a regime type. Democracies, for example, are made up of dozens of different institutions, many of which deal with the ways in which elections are to be held, popular votes are to be transferred into parliamentary seats, the government is to be elected and so on. The rule of law as the attempt to make everybody subject to rules that share certain qualities and are produced according to a

transparent and highly regulated procedure is another example. Possible questions regarding these groups of institutions are: Under what conditions are people likely to establish those institutions that make up democracy? What are likely paths in the development of these institutions over time? When will institutions be implemented that foster the rule of law? For a long time, these questions were almost completely ignored by economists, but this has changed in the last decades. From the point of view of traditional economists, these questions seemed a bit aloof. At second glance, however, they seem almost obviously relevant. After all, the democratic form of government has been the exception throughout human history; still today, the overwhelming majority of humans live in autocratic states. In Chapter 5, we saw that economic freedom is directly related to income and economic growth. Thus, the questions just posed are also economically relevant. Since the 1990s, there has been a fundamental transformation in Central and Eastern Europe, and also elsewhere in the world. Consider, for instance, the processes of democratization in East Asia and Latin America. To make well-grounded policy recommendations to policymakers in such states, we first require knowledge about the different sets of institutions - or regime types - as well as about the difficulties inherent in transitioning from one form to another. More generally, if we are interested in successfully implementing a specific set of institutions, we need to be clear about the factors that determine the presence - or absence - of those institutions. Suppose some institutions were completely determined by factors beyond our control, such as the climate or resource endowment. In such a case, trying to create these institutions in inhospitable climates or in the absence of necessary resources would be futile.

Under what conditions does democracy manifest?

#### Chapter Highlights

- Critically discuss various theories on the emergence of private property rights.
- Understand how governments use the delineation of property rights to further their own interests.
- Familiarize yourself with some "grand theories" purporting to explain institutional change.
- Get acquainted with the concept of institutional competition.
- Have a look at the components that a "general theory of institutional change" is likely to comprise.



This chapter is structured as follows. In Section 6.2, we discuss the traditional theory of the development of property rights which has also been coined the "naïve" theory. In Section 6.3, we present a theory that is less naïve, as it explicitly accounts for political economy aspects, i.e., it takes the interests of the relevant actors explicitly into account. In Section 6.4, we move from discussing a specific group of institutions – property rights – to institutional aspects of whole governments, that is, autocracies and rule-of-law states. The concept of institutional competition is briefly discussed in Section 6.5. In Section 6.6, we attempt to name the elements for which a general theory of institutional change needs to account. Section 6.7 formulates open questions.

## 6.2 Origins and Change of Property Rights: A Traditional View

In this section, we focus on the development of and change in a specific type of institution that is crucial for economic development – property rights. When economists think "high quality institutions" – they often think "secure property rights." This is why we begin this chapter by looking into how property rights might have first emerged and then changed over time.

Assume that a state exists and that, on a fundamental level, a decision has been made to grant private property rights. All well and good. After such a basic decision, a great number of details remain to be resolved such as goods possibly exempted from being held as private property, the terms under which private property rights can be exchanged, the responsibilities attached to property, and so on. To begin with, it seems plausible (and innocent) to assume that the state is interested in designing private property rights such that private actors are able to conduct as many mutually beneficial transactions as possible. The better off private actors are, the higher the national income, and, perhaps more important to the state, the higher the tax revenues.

Since the 1960s, economists have been devising theories to explain the origins of property rights, for example, the one by Harold Demsetz (1967), which Eggertsson (1990, 249ff.) sees as part of a "naïve theory of property rights." Models found in this branch of theory refrain from explicitly modeling the political process or the conflicting interests of the actors involved.

Demsetz's (1967) central idea can be summarized in one sentence: (Private) *property rights develop if an internalization of externalities is associated with social net benefits*. Hence, the development of and change in property rights can be due to at least two causes:

*Property rights as result of a process of internalization*

1. A change over time in externalities associated with some activity.
2. Due to technical change, internalization is possible at lower cost than before.

Demsetz draws on the case of the Inuit in Labrador, Canada to illustrate his theory. Originally, the Inuit hunted beavers only for subsistence. In the early 1800s, however, due to a sharply increased demand for beaver fur by the Hudson Bay Company, the Inuit had an incentive to hunt more and more beavers. You already know the resulting common pool problem. It is individually rational to hunt beavers to the extent that the marginal revenue for fur just covers the cost of hunting. Collectively, this result is not necessarily optimal, as the beaver population might shrink over time, possibly even become extinct. Thus, it can be socially optimal ("collectively rational") to restrict beaver hunting in the present in order to prevent beavers from dying out in the future and ensure that there still will be beavers to hunt in the future.

As long as there are no exclusive rights to parts of the beaver population, hunters have an incentive to "produce" a negative externality, that is, to hunt more beavers than socially optimal. Internalization was possible in this case as the cost of implementing private property rights, for instance, in the form of fences, was lower than the expected benefits associated with it. "Putting up fences" created private property rights to beavers – as well as the land on which they lived – and excluded all non-owners from hunting beavers on grounds that they did not own. Private property rights could also have developed if – independent of beaver fur prices – the cost of erecting fences had decreased through technological progress. Demsetz compares the development of private property rights in Labrador with that of Native Americans in the southwest of the USA. There, hunting animals was not associated with any commercial activity. Instead, livestock that required a great deal of pasture space were important. As there was no benefit to erecting fences in this environment, fences were not built and no



private property rights that would have enabled the owners to exclude non-owners were created.

You might have noticed that Demsetz *does not explicitly model the political process*. There is no discussion of how the Inuit managed to overcome the problem of collective action, or of what incentives the local government had to support the creation of private property rights. Implicitly, this theory is based on (at least) two problematic assumptions:

1. Governments are benevolent, that is, they have an incentive to design property rights optimally.
2. Political transaction costs are zero.

In a paper that appeared eleven years later, Gary Libecap (1978) asks the same question as Demsetz, but with regard to the emergence of property rights in mining in the western part of the USA. He finds that changes in mining rights occur as a response to increases in the value of mining resources, so his findings are completely in line with those of Demsetz. His research deserves mention not only because he relied on statistical analysis to arrive at his conclusions, but also because the demand for more precisely defined rights is seen as a function of how much the resource is valued. The explanations regarding the emergence of private property rights and their change over time offered by both Demsetz and Libecap can be interpreted as the view that institutions will adjust to changed circumstances and that this adjustment will be towards the highest possible degree of efficiency. Now, institutions do not adjust themselves but as a consequence of relevant actors bringing change about. Before we proceed to explanations taking the interests of the relevant actors explicitly into account in Section 6.3, we turn to a contribution that puts measurement costs at center stage. Here, change towards more efficient institutions was driven by technological progress which made the precise measurement of both inputs and outputs possible.

Douglas Allen (2011) posits that the Industrial Revolution enabled an "institutional revolution" that unfolded between 1780 and 1850. "Measurement" costs play a central role in this theory. Allen argues that before the Industrial Revolution, reliably measuring time - not to mention the weight of output - was close to impossible. This makes any kind of cooperation in which time plays a role costly: for example, meetings at a specific time are difficult to have if those who want to meet do not have identical information about what

time it is. Any inputs based on time – such as the hourly wage rates covered in most modern labor contracts – are impossible without being able to reliably measure time. More generally, monitoring agents is extremely costly in such an environment and other ways to constrain “cheating, fraud, embezzlement, theft, shirking” (Allen, 2011, 11) are necessary. One result of the Industrial Revolution was a significant decrease in measurement costs, thus making certain institutions possible. Allen is particularly interested in public governance – the ways in which the state supplies public goods – and argues that the modern public bureaucracy, which is bound by general rules and largely based on merit, would have been impossible prior to the Industrial Revolution.

### **Making sense of the strange mores of British aristocrats**

The most fascinating part of Allen's *The Institutional Revolution* is his attempt to make sense of seemingly strange institutions that were in place before the institutional revolution occurred. Seen from today, the traditional mores and conventions of British aristocrats are anywhere between appalling and outright strange or even comic. They used to live in countryside mansions that were usually much too large for them and more or less isolated from modern urban life. They socialized only with each other, making the aristocracy a very homogeneous group. They did not engage in any kind of traditional business such as buying and selling goods. Instead, they spent a great deal of time on leisure activities. From the outside, it might appear that they were just rather lazy parasites. Allen explains that such an evaluation would be utterly wrong.

In a monarchy, the monarch needs agents that supply public goods, for example, defense of the country or management of the law courts. The monarch also, perhaps especially, needs tax collectors, which is, essentially, the function of an aristocracy. If a public bureaucracy in the modern sense is impossible (e.g., because of measurement costs, as discussed above), there are two alternatives: either sell a public office to the highest bidder or grant patronage to trustworthy aristocrats. Both mechanisms have their pros and cons and which one is better is case-specific.

Let us focus on patronage. Patronage essentially means that in the event an aristocrat was caught cheating, the monarch had the power to throw him out of the aristocracy. This, of course,



could be a serious threat only if such ostracism was really costly to those caught cheating. And that is where the strange mores come in. First, to enter into aristocracy, "fungible" assets had to be converted into assets that were difficult to liquidate, hence the mansions that were usually much too large. In the event an aristocrat was banished from the aristocracy, he could not simply move to the city and start over as an ordinary person because getting rid of these large mansions was extremely costly. Making sure that aristocrats got rid of all their business interests ensured that no attractive option outside of aristocratic life existed for them. Making sure that aristocrats socialized only with each other ensured that once removed from the group, a former member would no longer have any friends, with all that that implies. And so forth. In economic terms: *By incurring sunk costs and deliberately creating hostage capital, aristocrats were able to credibly signal their loyalty to the monarch.* The price of being caught stealing or shirking was so high, it virtually guaranteed that they would not engage in such behavior.

Critique Allen's "institutional revolution" is fascinating, but not entirely convincing. The technological advances that accompanied the Industrial Revolution were not confined solely to the West, and yet the institutional revolution only took place there. There does not seem to be any plausible reason why the general trend towards ever more efficient institutions would occur only in the West. And, of course, we have presented his approach in this section because political economy considerations are largely absent from his account.

As mentioned before, this view of institutional development has been called "naïve" (by Eggertsson, 1990, 249ff.); I prefer to call it the "efficiency view" of institutions. It is based on the assumption that if the value of a resource increases and it makes sense ("is efficient") to clarify ownership by creating property rights, this will happen. However, there is no attempt to explain the mechanism through which this occurs. At the extreme, such a view implies that we are living in the best of all possible worlds, a doubtful proposition at best, given the poverty and hunger so prevalent across the globe. And yet, such efficiency arguments continue to be made, most forcefully by Donald Wittman (1995) who claims that political institutions are efficient in democracies. In Section 6.5, we present and discuss a mechanism that is said to lead to more efficient

institutions everywhere and that has been discussed extensively over the last 20 years or so, namely, institutional competition.

### 6.3 Origins of and Change in Property Rights and the State: Accounting for Political Economy Factors

In his 1981 book *Structure and Change in Economic History*, Douglass North develops a theory of the state that focuses on the exchange relations between representatives of the state and the populace. He begins with a paradoxical observation: *On the one hand, the existence of the state is a necessary condition for economic growth, but on the other, the existence of the state is also a source of economic decline* (North, 1981, 20). North's theory goes beyond the naïve theory of property rights, because, according to North, the state is often responsible for inefficient property rights that do not fully exploit a society's growth potential. North uses his theory to explain the origins of inefficient property rights regimes, i.e., a delineation of property rights that does not lead to maximizing national income. By accounting for political economy factors, North explicitly takes the interests of those running the state into account. This is why this section is broader than the previous one and includes the state as a subject of analysis.

Why are property rights often designed suboptimally?

North defines the state as an "organization with a comparative advantage in violence, extending over a geographic area whose boundaries are determined by its power to tax constituents" (North, 1981, 21). Although property rights are not explicitly mentioned in this definition, a connection between the state and property rights is easy to establish. Property rights entail the right to exclude others from use. An organization with a comparative advantage in the use of force is capable of delineating and enforcing private property rights. One central condition for productive domestic exchange of goods is to keep invaders away from the state's territory, which has long been recognized as one of the state's fundamental functions. North (1981, 21) even claims that it is impossible to develop a useful theory of the state divorced from property rights.

According to North, all theories on the existence of the state can be assigned to either of two groups: contract theories (à la Hobbes) or predatory or exploitation theories (à la Marx). As we just saw, theories regarding the development of property rights are closely linked to theories of the state.

Contract theories vs. predatory exploitation theories



<b>Note</b>
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<p>Contract theories are based on the notion that societies collectively agree on a social contract that specifies how they will live together. Predatory exploitation theories are based on the notion that some parts of a society are able to increase their wealth at the expense of other parts of society (thus "exploitation").</p>
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The central idea of contract theory à la Hobbes is compatible with economic arguments: All members of society will be better off by avoiding a state of anarchy in which life is "solitary, poor, nasty, brutish and short" (Hobbes, 1982 [1651]). They can do so by subordinating to a ruler whose authority is limited by a social contract. Hobbes assumes that the physical capabilities of individuals are not so unevenly distributed that one member of society – or a very small group – is able to impose his ideas on the rest of society. The normative branch of constitutional economics builds its central idea on the notion of a social contract. All members of society can be made better off if they voluntarily give up their (implicit) right to fight, since fewer resources need to be spent on stealing others' goods and protecting one's own goods. James Buchanan is the best-known advocate of this approach in economics.

In contrast to Hobbes, Marx assumes, first, that common interest within different social groups ("classes") leads to collective action and, second, that in every historical era, one class has been able to enrich itself at the expense of other classes. For instance, in capitalism, the capitalists exploit the working class. Predatory theories are quite popular among institutional economists: Daron Acemoglu and his various co-authors, for example, always start from the assumption that a small elite runs the state attempting to maximize its rents from doing so. But North and his various co-authors also rely heavily on predatory theories of the state. For them, changes of property rights are a consequence of changes in the bargaining power of the ruling elites vis-à-vis the non-ruling masses. Technological progress – and in particular technological progress regarding military technology – is an important determinant of bargaining power.

According to North, *both groups of theories have their benefits and drawbacks*. Contract theories emphasize the advantages resulting from the initial social contract, but tend to ignore later

interactions. Predatory exploitation theories emphasize the potential for exploitation by those who control the state, but ignore the advantages that can result from the existence of the state.

The model proposed by North is based on the assumption that all individuals maximize their utility and is characterized by the following three properties:

1. The state exchanges several services (protection, justice) for revenues. Because the production of protection and justice exhibits economies of scale, the state is able to provide these services at lower costs than the citizens. This implies that the overall income of society is higher if a state exists.

<b>Note</b>
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Economies of scale exist if production output can be doubled without having to double production <i>inputs</i> .
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2. The state and its representatives attempt to behave like a discriminating monopolist, and thus try to tax different social groups according to their inability to avoid taxes in order to maximize government revenues.
3. Maximization of state revenues is subject to a restriction: There are other states, but also individuals within state territory, that are willing to provide the same services as the state. The easier it is to substitute these suppliers for each other, the narrower the scope of actions available to state representatives.

The services offered by the state include, among other things, the design of property rights and their enforcement. The governing actors are interested in *maximizing* their *revenues* and thus design property rights accordingly. If national income can be maximized by reducing transaction costs, rulers will go for it because this leads to an increase in their tax revenues. According to North, this implies that the state will provide several public goods. However, the nexus between lower transaction costs and higher tax revenues frequently does not hold. From the state's just mentioned objectives, North derives three implications (1981, 24f.). Only two of them are relevant here:

1. Maximizing tax revenues is frequently incompatible with maximizing national income. If such friction exists, rulers will opt in



favor of maximizing their rents - and inefficient property rights will result.

### Example

Here is an example for a conflict between maximizing the rents of the ruler and maximizing societal welfare. Granting a corporation a monopoly in the production of certain goods - examples range from lighters to high-tech weapons - is likely to be sub-optimal from the point of view of national income: there will be little competition. High prices and little innovation are the likely outcomes. A ruler might nevertheless be interested in granting such monopolies because taxing a very small number of monopoly firms is a lot easier than taxing many small competing firms.

For many rulers, granting monopoly rights is attractive

Also, if powerful constituents can threaten to move to another state or to stay and throw out the current ruler, the ruler has incentives to discriminate between subjects and to offer more favorable property rights to the relatively more powerful. According to North, these are the two main reasons why states so often provide inefficient property rights.

2. Specification and enforcement of property rights require that state representatives delegate part of their power to agents. This implies that the *principal-agent problem* you encountered in Chapter 3 comes into play. You can also think of the strange mores of the British aristocracy that were described earlier as the means by which the British king tried to mitigate some of the principal-agent problems that North has in mind.

Based on the observation that collective action often occurs even in the presence of widespread free-riding, North derives several conclusions and open questions for his model. He summarizes his conclusions thus:

1. The stability of states can, *inter alia*, be explained by the difficulties associated with overcoming the problem of collective action.
2. Institutional change is primarily initiated by the rulers, not the ruled, as the latter are not able to overcome free-riding problems.
3. Revolution will originate within the ruling class, not on the streets. In such revolutions, the existing ruler is exchanged for a different ruler from the elites.

4. If the ruler is the agent of a social group or class, succession rules will be in place so as to reduce the probability of violent regime change after the ruler's death.

Finally, North suggests that a theory of ideology is necessary to explain under what conditions the problem of collective action can be solved and under what conditions there is no solution.

### Ideology

Merriam-Webster defines ideology, *inter alia*, as "a manner or the content of thinking characteristic of an individual, group, or culture." For North, ideologies are key to understanding human behavior. In *Structure and Change in Economic History* (1981, 48), he describes ideologies as "intellectual efforts to rationalize the behavioral pattern of individuals and groups." He emphasizes three functions of ideologies:

1. They are an instrument of economization with which individuals can reduce decision costs.
2. They are indissolubly linked to moral and ethical judgments about fairness.
3. They are changed when they are not consistent with individual experiences.

North stresses, in multiple publications, the crucial importance of ideologies in explaining human behavior (e.g., North, 2005). Some of his insights regarding the relevance of ideas are taken up in Chapter 7.

There is a clear difference between the naïve theory of property rights presented in Section 6.2 and the theory presented here: North offers convincing *arguments why rulers might have an incentive to design property rights suboptimally*, implying that with a different delineation of property rights, national income could be higher.

## 6.4 Explaining Differences in Institutions

### 6.4.1 Preliminary Remarks

For a long time, economists assumed that their results were valid irrespective of the type of regime in place. They assumed, in other words, that it did not matter whether the country was ruled by an



autocrat or democratically. In the 1950s, several economists began to ask whether one might be able to explain political processes using the economic approach. This was the birth of public choice theory, a research program that began in the USA and spread from there to Western Europe. Given the history of the economic theory of politics, it is understandable that most scholars in this field initially analyzed different institutional arrangements within democratic systems. Thus, the fundamental assumptions of early public choice theory included (a) that regimes were given and (b) that they were democratic.

There are many explanations for why institutions vary so widely across countries. Consequently, there are also many explanations of regime change. I distinguish between three approaches used to explain these differences here: approaches based on geography (Section 6.4.2), approaches based on culture or history (Section 6.4.3), and approaches based on the social conflict view (Section 6.4.4). The explanations do, of course, overlap sometimes, but they are distinct enough that sorting them this way has some value. The following sections can be brief because we touched upon these issues already in Chapter 5.

## 6.4.2 Explaining External Institutions Based on Geography

Geographic conditions can impact the likelihood of state formation

In Chapter 5, we saw that the quality of some institutions can be explained by a country's resource endowment. There, climate and soil, the disease environment, whether a society had access to the sea or was landlocked, and even the orientation of continents were mentioned. Here, we go one step further and ask whether differences in geography can explain even the emergence of states as we know them. Moselle and Polak (2001) ask how the development of states can be explained at all. After all, it is by no means self-evident that historical processes would always lead to the emergence of a single actor or organization enjoying a *de facto* monopoly in the use of violence. In countries such as Afghanistan, Rwanda, or Somalia, the use of violence is not a government monopoly. Indeed, the phenomenon of failed states is evidence that development towards a state in the modern sense is by no means certain or guaranteed. Moselle and Polak argue that the probability of state development varies across different regions of the world and that statelessness is more likely in lowlands and steppes than in hilly and fertile regions, as the former are harder

to protect. Moselle and Polak use this idea to explain why there were so few states in pre-colonial Africa. This approach is thus more interested in explaining the *absence* of a set of institutions that make for what we call a state, rather than the existence of a particular set of them.

### 6.4.3 Explaining External Institutions Based on Culture or History

It is possible that some of the large differences in external institutions across countries are due to the history of those countries. Certain historical events might have very long-lasting effects. This would imply that the external institutions prevalent in a country today are a consequence of external institutions possibly implemented hundreds of years ago. Today's external institutions might also be determined by the internal institutions that were valid in a country a long time ago. As a sort of shorthand, one can refer to this as the effect of culture on external institutions. Let us first look at (historical) external institutions that have an influence on today's external institutions.

Historic external institutions can impact today's external institutions

Being invaded or even colonized by another power is likely to have important effects on a country's institutions. One important example in which the identity of the colonizer still matters today – often decades or even centuries after colonization occurred – is the country's legal system, or, in other words, the external institutions of a country in their entirety. Legal scholars divide the world's legal systems into a very limited number of legal families. Aside from legal systems based on religion (such as Islamic or Hindu law), the first important distinction is between the civil law and the common law family. Under civil law, law is almost exclusively produced by legislators and the role of judges is limited to "*la bouche de la loi*" (the mouth of the law). Under common law, the role of the judge is much more important. Should there be gaps in legislation, it is the judges who fill them with their decisions. Therefore, this kind of law is often referred to as case law. Rules regarding court procedure differ widely under the two families. Under common law, the adversaries themselves accuse or defend. As a consequence, lawyers and their strategies play an important role. Under civil law, it is the judge who questions the parties.

The common law emerged in England. Today, England and most of its former colonies are coded as belonging to the common law



family. This includes countries such as Australia, Canada, and the USA, as well as Bangladesh, India, and Pakistan, among others. Regarding civil law, many scholars propose a tripartite division into French, German, and Scandinavian, of which the French has been most influential. In Europe, countries such as Italy, Spain, and Portugal, as well as the Netherlands, are coded as belonging to this group. Since Spain and Portugal exported their laws into their colonies, virtually all of Latin America is said to belong to the "French civil law" family. There is also socialist law, which is based on the idea that productive resources should not be the property of individuals but the state.

In a series of articles, Rafael La Porta and his co-authors show that being part of a particular family of law has important consequences for a wide variety of institutions, including how difficult it is to set up a new firm (more difficult in French civil law countries), the degree to which the media is owned by the state (higher in French civil law countries), the regulation of labor (more difficult to fire people under French civil law), and so on. The authors find that countries belonging to the French civil law family come out worst, a view well summarized by former US President George W. Bush when he said: "The problem with the French is that they do not even have an own word for entrepreneur." Given that the French civil law countries usually come out worst, one might expect them to be the slowest growing. However, although there seems to be a strong link between a country's colonization experience and many of its currently valid institutions, there is no strong link between these institutions and the speed at which the economies in the various countries grow. The papers on legal origins are among the most cited of all papers in economics, but they are also among the most criticized. For example, Daniel Berkowitz and his co-authors (2003) argue that the way the law was initially transplanted and received is a more important determinant than affiliation with a particular legal family. They claim that the origin of a legal system is not a good predictor for the actual implementation of the law. The authors consider as far more important whether the law was transformed according to the specific situation of a society, whether it was imported voluntarily or enforced by a colonial power, and so forth. According to their findings, countries that have developed legal orders internally or adapted transplanted legal orders to local conditions and/or had a population that was already familiar with the basic legal principles of the transplanted

law have more effective legal rules than countries that received foreign law without similar predispositions.

When in 1972 Chinese Prime Minister Chou en Lai was asked about the impact of the French Revolution, he is said to have answered: "It is too soon to tell." Now, Daron Acemoglu and his co-authors (2011) believe that the time for definitive answers has come. They ask whether countries that were invaded by the French were observed to grow faster because the French implemented radical institutional reform that enabled the Industrial Revolution to take off. Examples of such reforms include drastically reducing the power of the landed aristocracy and breaking up cartels, such as merchant guilds, that made it very difficult or even outright impossible for outsiders to enter a market.

Around the turn of the nineteenth century, Germany was made up of dozens of rather small states. Some of these were not only invaded by French armies but the French also implemented far-reaching institutional reforms in them. These are the states that were "treated" by the French. There were also numerous German states - primarily in the east and south of the country - that were not invaded by the French and can be thought of as "untreated." Acemoglu and his co-authors compare the development of the treated with that of the non-treated German states. As a proxy for income and wealth, they use urbanization rates (defined as that part of the entire population that lives in cities with 5,000 or more inhabitants). They find that urbanization rates in treated areas start to diverge significantly from those in untreated areas only after 1850.

In Chapter 5, we learned that Acemoglu and his co-authors believe that the colonization history of a country can have persistent negative effects on its long-term development. If the disease environment made survival difficult, colonizers were likely to establish extractive institutions that enabled them to take a great deal of wealth out of the country in little time. Countries that were so "treated" still have problems developing. With regard to the French Revolution, the authors show that development-enhancing treatments are also possible. Their message is clear: powerful players are free to set and implement external institutions at their discretion. These institutions are the most important single determinant of future economic growth.

This approach is not without its critics. There are many scholars who believe that external institutions, at least to some degree, need



to rely on internal institutions. If this is true, then the power to improve people's lot in a short time by importing external institutions that function well elsewhere might be severely constrained. There are many historical examples of not only foreign powers, but also domestic revolutionaries, attempting an extreme overhaul of institutions that failed miserably. Gregory Massell (1968) recounts the story of how the Soviets tried to make the populations in their central Asian republics give up the *Sharia* - and how their efforts ended in almost complete failure. Berkowitz et al.'s (2003) observation that legal transplants are more likely to be successful if they are adapted to local conditions was mentioned previously. A more recent example, and a cautionary tale, is that of the USA - and other Western powers - spending billions and billions of dollars and sacrificing the lives of hundreds of soldiers to implement external institutional institutions conducive to growth and development in Afghanistan and Iraq. As of now, it seems that these efforts have had very limited success.

#### 6.4.4 Explaining External Institutions Based on Social Conflict View

All of the "social conflict" explanations assume that different actors have different interests and that their interests would be best served by different institutions. In that sense, these different actors, or groups of different actors, are thus in conflict with each other. However, this conflict is only partial because they would all be worse off if no cooperation between them took place. In game theory terminology, the game they are playing is, hence, a mixed-motive game. On the one hand, there are advantages of cooperation, in that everyone will obtain at least some benefit. On the other hand, there are disadvantages to cooperation, the chief of these being that no one is going to get exactly what he or she wants.

Institutions have distributive consequences. In all likelihood, different institutions will make some people worse off - and others better off. Those who are satisfied with the currently valid institutions are unlikely to demand major change, whereas those who believe that the currently valid institutions are unfavorable to their interests are likely to favor change. The chances of getting one's most preferred institutions are assumed to be a function of one's bargaining power vis-à-vis the rest of society.

## Note

Bargaining power can be defined as the ability and willingness to inflict costs on others and thereby reduce the total social surplus.

The currently valid institutions can be thought of as reflecting the relative bargaining power of the relevant groups. As long as their relative power remains unchanged, the institutional status quo can be considered an equilibrium. Institutional change becomes more likely when the bargaining power of a particular group improves relative to the bargaining power of other groups, which could occur, for example, as the consequence of technological change.

It is important to realize that not all individuals who share the same interests manage to become groups. The difference between latent and actual or manifest interest groups is pointed out by Mancur Olson (1965) in a rightly famous book. We have already relied on some of Olson's arguments in Chapter 4; here, we present the core of his book in a little more detail.

### **On the organization of consumer and producer interests: the collective action problem**

In Chapter 4, using the example of the dam, we saw that the voluntary provision of a public good by those who benefit from it is rather unlikely. The individual hopes that the sum of voluntary contributions by everyone else is sufficiently high to ensure provision of the public good. But because all individuals share this expectation, no public good will be privately provided. In reality, however, certain groups are able to overcome the collective action problem. Olson (1965) describes in which situations this is more likely to occur.

1. When public good provision is coupled with the provision of a private good that can be consumed only by those who contribute to the public good. For instance, the public goods bundle provided by labor unions – improved wages and working conditions – can also be consumed by non-members. However, labor unions often additionally provide private goods such as insurance and consulting services that are limited to their members. If access to these private goods is



attractive, there can be sufficient private incentive to join and thus contribute to the costs of providing the public good.

2. When there is **compulsory membership**. For example, perhaps you can work for a firm only if you are a union member (a *closed shop*). This is not necessarily a convincing condition for (initially) overcoming the collective action problem, but a mechanism with which the continuity of an already existing organization can be ensured. Compulsory membership presupposes legislative action or a general agreement with the employer. Both require that the labor union has already overcome the collective action problem and, furthermore, that it possesses significant strength. Otherwise, legislators or employers would not have consented to the institution of compulsory membership.
3. **Low number of involved individuals**. It is immediately clear that the provision of the dam is more likely if five farmers attempt to set it up than if 500 farmers try to do so. As soon as one of the five is not cooperative, the other four can (informally) sanction him much more easily than 400 farmers could sanction 100 farmers because it will be more difficult for 400 than for four farmers to coordinate their behavior.

The latter argument implies that there is an asymmetry in the **organizability of interests**. Since in general, the number of producers is lower than the number of consumers, **producer interests are easier to organize than consumer interests**. Beside the number of involved individuals, the importance of producing a particular collective good for the utility level of the potential providers might play a role: For farmers, subsidies to milk production can be existentially important so they seem to be more likely to overcome the problem of collective action. On the other hand, consumers usually spend only a very small part of their entire budget on agricultural products. Trying to set up the "organization of milk drinkers" to give weight to consumer interests appears, therefore, rather unlikely.

Olson's theory thus predicts that only a few groups are likely to overcome the problem of collective action. The number of manifest interest groups is likely to be limited, and the number of those

groups commanding veto power will be even smaller. This view of institutional change is elaborated on in Voigt (1999a).

Daron Acemoglu and James Robinson (2005) proffer a similar explanation of regime change. They distinguish between two groups: the powerful elites and the less powerful non-elites. The non-elites demand a distribution of the collective surplus that is more favorable to them. If their threat to stage a revolution appears credible, the elites have an incentive to start negotiations and make at least some political concessions to the non-elites. The credibility of threats can change over time, for example, because the non-elites overcome the dilemma of collective action, because of technological progress that makes their input more valuable, and the like. Acemoglu and Robinson assume that negotiations take place and the two groups agree on a modified constitution that entails a larger share of the collective surplus for the non-elites. At this point, the elites face the problem of being unable to credibly commit to their own promises. If the non-elites are demonstrating in front of the palace, the elites have an incentive to promise improvement. But why would they keep their promise once the heat of the moment has passed and demonstrators are back at home?

External institutions reflect the relative bargaining power of competing groups of society

According to Acemoglu and Robinson (2005), democracy can serve as a tool that helps the elites turn their promises into credible commitments. If most voters are poor, they are likely to vote in favor of (re-)distribution, for example, in the form of social and welfare policies. Extending the right to vote to the poor can thus serve as a commitment device of the elites. Extending the right to vote to ever more groups of society is equivalent to an extension of democracy. The authors thus view the transition from autocracy to democracy as the elites' response to threats from the non-elites. In an extended version of their model, a third group – the middle class – is introduced. If it is sufficiently large, more gradual institutional change becomes possible – and also likely.

Democracy as a tool of the elite to make commitments credible

Douglass North, John Wallis, and Barry Weingast (2009) (hereafter, NWW) have published no less than a "conceptual framework for interpreting recorded human history" – the subtitle of their book. They start from the observation that violence has been a major problem for most societies for the whole history of mankind. In other words, more often than not, there has not been a state, at least not one that meets Max Weber's definition, i.e., an



organization commanding a monopoly of legitimately using violence. NWW propose that human history has known only three types of social order: (1) foraging, (2) limited access, and (3) open access.

Under this framework, explaining institutional change implies explaining the transition between these three orders. I here focus only on the transition from (2) to (3). Limited access orders are based on personal relationships and the ability to form organizations is limited. In limited access orders, violence is controlled by relying on a dominant coalition. Members of the dominant coalition share the rents that emerge from the absence of violence. In open access orders, cooperation between individuals is based on impersonal institutions that treat all individuals alike. Positions in both politics and the economy are open to everyone and are allocated according to merit. All individuals have the right to found political or economic (e.g., corporations) organizations. In open access orders, all violence is controlled by the state and the military is under civilian control. The authors group the overwhelming majority of today's countries into their second category. Roughly speaking, only the (more established) OECD countries are believed to be open access orders.

NWW's take on the transition from limited to open access orders emphasizes that doing so must be in the interest of the overwhelming majority of the players who make up the dominant coalition. When the elites in the limited access order become able to deal with each other impersonally, then that society will be on the threshold of becoming an open access order. NWW identify three threshold conditions: (1) the rule of law for elites, (2) perpetually existent organizations in both public and private spheres, and (3) consolidated control of the military by politics. If the vast majority of those members of the elite who form the dominant coalition realize that they can make themselves better off - in interactions with each other - by not relying on personal relationships but on general rules, they will be in favor of what NWW call "rule of law for elites." This sounds like a *contradictio in adiecto*, but what they really mean by the term is that no member of the elite enjoys particular privileges; all of them are treated according to the same rules. However, these rules for the elite are not necessarily, indeed not probably, the same rules by which everyone else has to live, hence the awkward-sounding term "rule of law for elites."

### When rent seeking is beneficial

In Chapter 4, we saw that rent seeking is conventionally interpreted as wasteful. Lobbyists not only invest resources into lobbying politicians that could be spent more productively, but the rules that they lobby for are in all likelihood detrimental to overall welfare. NWW propose a different take on rent seeking: according to them, sizable rents are a precondition for holding the dominant coalition together. As soon as one of its members suspects that it is not receiving the rents it deserves, this member might turn to violence – which is likely to make most everyone worse off.

This idea can be extended even further: all groups that aim to change institutions in such a way that they will be getting a better deal can be viewed as seeking rents. Now, if ever more groups manage to overcome the dilemma of collective action and, in the end, the overwhelming majority of citizens are represented by at least one such group, then it is not unlikely that they will be able to agree only on general rules according to which all citizens are dealt with in a like manner. This is nothing else but the rule of law. In other words, even rent seeking can foster the rule of law and be hugely beneficial (Voigt, 1999b).

The main difference between NWW and Acemoglu and Robinson is that the latter basically rely on two actors (the elite vs. the non-elite), whereas the former model the elite as a coalition of a multitude of actors. In their explanation of transitions, NWW focus on the bargaining that takes place within the dominant coalition, hence explicitly giving up the monolithic actor assumption relied on by Acemoglu and Robinson.

There are other theories regarding the transition from an authoritarian to a non-authoritarian regime. Assuming that such a transition is socially beneficial and that revolutions waste resources, a non-revolutionary transformation path, such as a negotiated transformation pact, seems superior, although fraught with difficulty. Sutter (1995) describes a punishment dilemma that the new (non-authoritarian) government faces vis-à-vis the former (authoritarian) government. Before taking over, the new government has an incentive to assure the autocrat exemption



from punishment. As soon as the new government is in power, however, the population might demand that the former autocrat be punished. Anticipating this, autocrats have an incentive to block a peaceful transition away from autocracy. This implies that an optimal political rule is time inconsistent with respect to dictators (you know about this problem from Chapter 4, where we discussed it in relation to political business cycles). To explain: In order to prevent potential dictators from becoming actual dictators, they have to be threatened with drastic punishments. *Ex ante*, the optimal rule would thus contain a serious punishment threat. As soon as a dictator has taken over – and society would like to get rid of him – it would be desirable to be able to credibly assure exemption from punishment in order to ensure a peaceful transition to a non-authoritarian regime. *Ex post*, the optimal rule would, hence, only threaten very moderate punishment.

### When citizens prefer less – rather than more – separation of powers

In general, it is plausible to assume that citizens prefer more, rather than less, separation of powers. If various political actors have only limited powers, misuse of power seems less likely and citizens will consequently be better off. Interestingly, Acemoglu et al. (2013) identify settings under which voters have an interest to dismantle checks and balances. Their model assumes that there are two groups in society, namely, the rich and the poor, and the poor outnumber the rich. If checks and balances function well, the executive's discretion is low, as is its overall income. This enables the rich, who are assumed to have solved their collective action problem, to bribe government into policies furthering the interests of the rich. In such circumstances, the poor might prefer fewer checks and balances; because the overall income of the executive will increase, bribing it will be more difficult, implying that policies are closer to the preferences of the poor. Acemoglu et al. (2013, 859) point out that this result is likely in "weakly institutionalized states," which are described as states in which "the rich lobby can successfully bribe politicians or influence policies using non-electoral means."

The theories presented here emphasize different aspects of regime transformation. We have not presented a comprehensive theory of

regime transformation because there is none. In the following section, we discuss a particular approach to explaining institutional change that focuses on the diffusion of institutional change across space.

## 6.5 Institutional Change via Institutional Competition?

In Section 6.2, we discussed the naïve theory of property rights emergence. One reason why this theory still has many supporters although it is seen by some as naïve could be the mechanism invoking institutional change that is described in this section. Douglas Allen – the same author who makes sense of the seemingly strange habits of British aristocrats – justifies the view of institutions as efficient when he writes: “in the Darwinian struggle between nations, firms, and individuals, societies are driven to find institutions that get the job done best under the circumstances faced at the time” (Allen, 2011, xi). In other words, entire societies can be seen as in competition with each other and only those whose institutions are halfway efficient will survive or prosper.

Although the notion of “institutional competition” can be traced back at least to Kant and Montesquieu, economists consider an essay by Charles Tiebout (1956) as the cornerstone of the notion concerned with the diffusion of institutions across space. The basic idea is very simple: *It is not only the suppliers of traditional goods that are in competition with each other, but also the suppliers of bundles of public goods.* Following Tiebout (1956), mayors can be thought of as providing bundles of public goods that cater to citizens. Citizens are then assumed to move to the place that offers that bundle of public goods which best suits their preferences. (Local) institutions can also be thought of as public goods. This is why Tiebout’s theory is directly relevant here. If a mayor now observes that other mayors are able to attract more citizens (or firms, or foreign investment, etc.), she is assumed to have incentives to improve the quality of the institutions offered by her. There is, hence, a competition for citizens and one important action parameter are institutions. Therefore, this process is often referred to as “institutional competition.”

In economics, this idea was first raised in regard to the competition between local entities within a country but is now found in the context of nation-states competing for (scarce) mobile resources.



Here, the owners of mobile resources are interpreted as representing the "demand side" for an institutional environment that allows them to reap the returns on their invested capital.

Governments are also in competition with each other

There are two opposing views on institutional competition. On the one side, it is argued that institutional competition can lead to more effective control over governing agents, as the competitive process forces the governing agents to give more thought to the preferences of the governed (see, e.g., Besley and Case, 1995). On the other side, it is argued that institutional competition might lead to a race to the bottom: If capital keeps moving to where its returns are highest, states might not enact regulations that are costly to mobile firms (such as environmental regulation), and also reduce social and welfare spending (such as social policy) (see, e.g., Sinn, 1997; see also Mueller, 1998).

Following Albert O. Hirschman (1970), the migration of mobile resources is called exit. Further, it is assumed that *exit* leads to loss of popularity of the government and that the latter thus has an incentive to adjust public goods bundles such that there is a net inflow of mobile resources. Another mechanism for effecting changes in public goods bundles, also according to Hirschman, is voice. Voice means that those who are negatively affected by some policy choices speak up and demand improvement. If we assume that – due to globalization – relocation of one's assets to another country is much easier than was the case in the past, *voice* might be sufficient to achieve changes in the supply of public goods because the threat of *exit* is much more credible in the presence of low mobility costs.

Conditions for institutional competition to be socially beneficial

Proponents of the first view of institutional competition often posit that institutional competition increases social welfare by inducing less efficient institutions to be replaced with more efficient ones. Viktor Vanberg (1992, 111) argues that two conditions must be fulfilled in order for institutional competition to be socially beneficial. First, it must be possible to *try out potentially beneficial institutional innovations* in order to ensure that they are likely to be *factually implemented*. Second, there needs to be a *mechanism of selective retention* that reliably eliminates errors, meaning that less efficient practices (routines, tools) are systematically replaced with efficient ones. This is, therefore, an evolutionary view of institutional competition. To show that institutional competition is socially beneficial, one needs to be able to identify the mechanism through which selective retention takes place.

Although the analogy between goods competition and competition with regard to public goods bundles seems convincing at first sight, there are at least *two problems with this analogy*:

Problems of the analogy

### 1. Characteristics of goods.

Competition in goods has to do with individual goods. If supplier and buyer can agree on a price and conclude a contract, mutually beneficial exchange is possible. Conversely, institutional competition refers to public goods that are often intangible. Individual willingness to pay is not sufficient for the provision of such goods. Rather, collective action – based on collective decision-making rules – determines which bundles of public goods are actually provided. As soon as one deviates from the unanimity rule with regard to all individual constituent goods, it can happen that the public good is a collective “bad” for some individuals, if only for the reason that they have to pay for its provision without ever utilizing it. If I hate soccer and all gatherings of soccer fans but am forced to support the sport because part of my tax bill is used to support it, I might well perceive this good as a “bad.”

The possibility of exit is only partially relevant, as the same structural problem is equally present in other jurisdictions. A different picture would emerge if an individual could assemble his or her own individual “menu” of public goods from a variety of suppliers.

### 2. Communication of preferences.

Following the terminology of Hirschman, the demand-side preferences are communicated to the supply side via *exit* and *voice*. Within the realm of regular goods competition, buyer exit requires some interpretation on the supplier’s side, as the buyer usually does not specify a reason for exit. With respect to institutional competition, exit requires a lot more interpretation. After all, the institutional supply side is only one factor determining the expected returns to mobile resources. In the final investment decision, many other, non-institutional factors also play a role, for instance, the number of potential consumers and their purchasing power.

Voice is unlikely to have any effects if it does not occur collectively. Individuals who observe a deterioration in the quality of the provided bundle of public goods will be able to do something about it only if they are able to overcome the problem of collective action (Olson, 1965). Due to the asymmetric organizability of interests, only certain preferences are articulated via voice. Often, this results



in institutions being changed in the manner suggested or demanded by the organized actors. It appears problematic to claim that institutional competition closes the gap between politicians and voter preferences because “the” preferences of the voters might not even exist.

Finally, the signals sent by exit and voice are not always crystal clear. We already stated that the signals induced by institutional competition usually require more interpretation than signals in simple goods competition. Due to the combination of public goods characteristics and the asymmetric organizability of interests, it seems questionable whether consumer preferences (in the traditional sense) can be communicated clearly. Put differently: *Exerting the exit option is by no means sufficient evidence of actual deterioration in the quality of the public goods bundle and neither does the absence of voice necessarily imply that the demand side is satisfied with the quality of the supplied public goods.*

In recent years, the “spatial diffusion” of institutions has been discussed. The idea is that institutions do not spread across space randomly but that factors like geographical proximity, but also cultural or historical closeness, make adoption more likely. This concept is broader than the one just discussed as institutions could also spread across space via coercion. In a paper analyzing the diffusion of constitutional rules, Goderis and Versteeg (2014) explicitly name four instruments that are used for coercion. Whereas colonization and military occupation seem both outdated and outlawed, making membership in international organizations contingent on first implementing certain institutions seems to be a very current practice. This can also be said of making payment of foreign aid conditional on certain institutional reforms. Regarding the spatial diffusion of constitutional rules, Goderis and Versteeg (2014) find that shared legal origins, competition for foreign aid, a shared religion, and shared colonial ties are the main drivers.

## 6.6 Elements of a General Theory

### 6.6.1 Preliminary Remarks

In Sections 6.2 to 6.4, we covered several specific aspects of change in external institutions. The aim of this section is to assemble a list of elements that a general theory of institutional change requires. A general theory of institutional change would be able to explain

all kinds of institutional change, no matter where or when it occurs. As there is no generally accepted theory on this topic yet, we cannot present one. The book by Acemoglu and Robinson (2005) is probably closest to such a theory.

First, changing external institutions requires an explicit process of collective decision-making. This is most obvious in a country with a democratic constitution where at least a parliamentary majority is required to amend the constitution. That the needed majority has been achieved is often due to the efforts of interest groups who demand certain institutional changes. Note that this aspect of institutional change is unique to external institutions; parliaments cannot change internal institutions.

Economics is based on methodological individualism, meaning that in explaining any phenomenon (e.g., a change in external institutions), we need to show that the relevant actors have an incentive to act in a particular manner. Otherwise, we would risk committing the functionalist fallacy (Elster, 1984, 28ff.). So, the question is: What role do individual decisions play in regard to the origins and change of institutions?

Definition

**Functionalist fallacy:** Improper direct linking of the social function of an institution and its origin.

The decision situation of an actor who is subject to any set of external institutions can be schematically illustrated using Matrix 6.1.

Each cell of the matrix describes individual behavior vis-à-vis a set of external institutions. The four letters depicting the four

**Matrix 6.1** Individual decision situation with regard to the choice of external institutions

		Choice within rules	
		Comply with institutions	Not comply with institutions
Choice of rules	Not demand institutional change	A	C
	Demand institutional change	B	D



possible combinations are used to structure the arguments in this section. If the behavior of most members of a group can be grouped into cell A, institutional change appears unlikely. If, however, the behavior can be grouped in cell D, institutional change appears a lot more likely.

Here, we combine two levels of analysis that are usually considered separately in constitutional economics: the level of choice within rules, where one can either comply or not comply with (given) institutions, and the level of choice of rules, where one can either demand or not demand institutional change.

<b>Note</b>
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Constitutional economists distinguish between the <i>choice of rules</i> and the <i>choice within rules</i> .
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Determinants of institutional change It would be very useful to be able to predict under which conditions we should expect which behavior, but even if we cannot predict specific behavior – and thus institutional change – six factors should be particularly relevant:

1. The bounded rationality of actors.
2. The problem of collective action.
3. The path dependency of institutional change.
4. Political transaction costs.
5. The relative power of the relevant actors.
6. Prevalent internal institutions.

As we will see right now, more often than not, the first four factors inhibit institutional change. But if they do not inhibit such change, factor 5 can give us a clue regarding its direction: If the power of a certain group has increased relative to the power of all other relevant groups, we expect to see change in line with the interests of the group whose relevance has increased. Finally, factor 6 can be considered a constraint on the set of external institutions that can be enforced.

All six aspects are briefly discussed in the following.

### 6.6.2 Satisficing Behavior

Recall the concept of bounded rationality discussed in Chapter 1. Within this concept, Herbert Simon (1955) posits a hypothesis regarding the utility function of boundedly rational actors.

He assumes that actors do not attempt to maximize utility in each and every situation, but that they *satisfice*, that is, they are content once they attain a certain utility level. As soon as that threshold is reached, actors have no incentive to change their behavior. Thus, if an actor has so far behaved in conformity with existing institutions, there is no reason to believe he or she will start disobeying rules or insist on institutional change. The necessary condition for changing one's behavior from cell A to any of the other cells in Matrix 6.1 is that the utility experienced from unchanged behavior has significantly decreased in comparison to previous periods. Note that these considerations take place within a single person – and that no cooperation with others is necessary.

### 6.6.3 Collective Action Problems

Satisficing behavior is not the only reason why not every reduction in utility (relative to the utility associated with other options) is accompanied by a demand for comprehensive institutional change. Institutions are made up of rules that all actors in society are expected to comply with. They can, therefore, be thought of as public goods, the effects of which unfold because a multitude of actors is bound by them. An institutional change would affect not only one person, but all persons with similar preferences. And as you now know, in such a situation, each actor hopes that the – costly – demand for institutional change will be made, and paid for, by someone else, thus allowing him or her to *free-ride*.

#### Definition

**Free-rider:** Actor who benefits from a good without contributing to its provision.

As all actors hope to free-ride, collective action is unlikely to happen frequently, even in situations where taking collective action could benefit everyone. The behavior of discontented actors who are not able to overcome collective action problems so as to demand institutional change will either remain unchanged (and can thus be grouped in cell A in Matrix 6.1), or switched to breaking existing rules (i.e., be grouped in cell C). Whether institutional change is more likely to occur if more people break existing rules individually is entirely uncertain. The problem of collective action will only be overcome every now and then and



not regularly. This is one way to explain why institutional change does not occur continuously but rather discretely.

#### 6.6.4 Path Dependency of Institutional Change

##### Definition

**Path dependency:** Present decisions are influenced and constrained by past decisions.

The concept of path dependency is usually employed to explain the diffusion of technologies. However, according to Douglass North (1990a, 92–104), the concept is also very useful in the analysis of institutional change and, with just a few modifications, it is possible to draw an analogy between competing technologies and institutions (for a detailed discussion of this analogy, see Kiwit and Voigt, 1995). The central point of the original path dependency argument is that technologies can persist even though there might be more efficient competing technologies (see, e.g., Arthur, 1989). This is due to network externalities: The more people use a technology, the greater is the utility of everyone using the technology. For example, if I am the only person in the world using Facebook, I am never going to have any “friends.” If one specific technology enjoys a widespread user base, suppliers of competing and possibly more efficient technologies will find it difficult to capture market share due these network externalities. The most frequently used example to illustrate path dependency is the arrangement of letters on modern keyboards. Supposing that you use an English version, the letters on the upper left hand side of your keyboard are almost certain to read QWERTY. Now, some people claim that a different arrangement of the letters on the keyboard would have been more efficient – but that it never became generally accepted due to substantial switching costs. New keyboards would need to be installed; everybody being accustomed to the current arrangement would need to be retrained and so on.

Proponents of path dependency claim that inefficient technologies can often come out on top and that competing, superior technologies cannot make any headway without government intervention. Thus, a purely market-based solution could lead to sustained inefficiencies. If the concept of path dependency can be applied to institutions and the function of institutions is to reduce

uncertainty (and thereby enable economic prosperity), it must be concluded that institutions can originate and change without any improvements being made to economic growth and development. Along these lines, Paul David (1994, 218f.) writes:

[I]nstitutions generally turn out to be considerably less 'plastic' than is technology and the range of diversity in innovations achieved by recombinations of existing elements is observed to be much broader in the case of the latter. Thus, institutional structures, being more rigid and less adept at passively adapting to the pressures of changing environments, create incentives for their members and directors to undertake to alter the external environment. . . . Finally, it may be remarked that because the extent of tacit knowledge<sup>1</sup> required for the efficient functioning of a complex social organization is far greater – in relation to the extent of knowledge that exists in the form of explicit, codified information – than is the case for technological systems, institutional knowledge and the problem-solving techniques subsumed therein are more at risk of being lost when organizations collapse or are taken over and 'reformed' by rivals.

If institutional change is subject to path dependency, this could be part of an explanation why inefficient institutions can survive. As such, the presence of path dependency would rather help to explain the stability of institutions over time rather than their change.

### 6.6.5 Political Transaction Costs

Under the Coase theorem, scarce goods will be used efficiently given that property rights are well specified (see Chapter 2). Assuming that political markets are analogous to goods markets, does this mean that, in political markets, efficient policies and institutions are always chosen?

#### Note

Reminder: The Coase theorem only holds if property rights are well defined and transaction costs are zero.

<sup>1</sup> The term *tacit knowledge* dates back to Michael Polanyi (1998 [1952]). Tacit knowledge is knowledge that is incorporated in our actions, even though we are not able to articulate this knowledge. With regard to institutions, tacit knowledge implies that institutions also contain knowledge that cannot be articulated. If institutions are abolished, the tacit knowledge contained in them is also lost.



Remember from Chapter 2 that the Coase theorem only holds if there are enforceable property rights and transaction costs are negligibly low. If the Coase theorem is going to work for political markets, it means that these conditions must be met in these markets, too, which is even more doubtful than it is for traditional goods markets.

Transaction costs are the costs of using the market. In turn, political transaction costs are the costs of using the "political market." Binding agreements should be much harder to achieve on political markets than on traditional goods markets. Even defining the exchange will be difficult. Furthermore, in case of contract breach, it is unclear how, or even if, the conflict could be mediated. All in all, there are many reasons to believe that political transaction costs are highly relevant. They constrain the possibilities for changing the status quo, thus contributing to stabilization. Twilight (1992) conjectures that politicians deliberately manipulate political transaction costs in order to limit political opposition with respect to certain political domains. *Political transaction costs stabilize efficient as well as inefficient institutions.* Acemoglu (2003) wonders why there is no political Coase theorem. He points out that there is no generally accepted "initial allocation" nor is there a neutral third party endowed with any sanctioning power that could enforce any potential deal between any of the concerned parties. He concludes that the origins and change of institutions can be better explained with recourse to the relative power of the relevant actors. This leads us directly to the next argument, namely the relative power of the relevant actors.

### 6.6.6 The Relative Power of the Relevant Actors

Until now, we have identified several factors that are obstacles to fast and comprehensive institutional change, rather than being conducive to it. To explain institutional change, it seems plausible that we need to inquire into the incentives of the involved actors. This involves identifying how well they are organized, which resources they can use, which strategies are at their disposal, and so forth. If some group becomes more relevant over time, we would also expect the design of institutions to change. Institutions influence the distribution of incomes. Groups whose relevance for national product has increased and who have managed to overcome the problem of collective action will sooner or later demand

that institutions change to better meet their needs. One way to think of it is to contrast *de jure* and *de facto* power. *De jure* power is reflected in external institutions. When the actual power of a relevant group increases relative to that of all other groups, its *de facto* power increases. In order for *de jure* and *de facto* power to be aligned again, the external institutions are likely to be changed to reflect the new situation in the country.

For example, until the sixth century BC in Rome, the cavalry, provided by the nobles, were the only relevant factor in the empire's military strategy. Introduction of the phalanx – which had been invented in ancient Greece – led to a strengthening of the infantry. Use of the phalanx was considered necessary because Rome had suffered a devastating defeat in 477 BC. However, the infantry was composed mostly of plebeians, or plebs, who were not politically involved at all. This resulted in class struggle, as the plebs were burdened with increasing duties (such as military service) without any additional benefits (such as political participation). Due to their increased relative power, the plebs were able to force several institutional changes such as participation in political decisions, lifting of restrictions regarding both occupation and marriage, and some release of debts incurred for buying armor necessary for becoming part of a phalanx (more details and additional examples can be found in Voigt, 1999a, 128–137; Acemoglu and Robinson, 2005 provide a very similar approach).

### 6.6.7 The Relevance of Internal Institutions

The above-discussed elements of a general economic theory of institutional change emphasize the demand side. These elements focus sharply on the ability of potential beneficiaries of institutional change to realize their demands. For a comprehensive theory, however, we also have to account for the supply side. In a democracy, political entrepreneurs have an incentive to discover the preferences of unorganized voters and provide suitable legislation. In this context, the norms prevalent in large portions of the population should play a major role. From empirical evidence (Lewis-Beck and Stegmaier, 2019), we know that many citizens do not condition their voting decision solely on their expected individual monetary benefits, but also on their perception of whether groups they care about are treated fairly. This can explain

Institutional change depends both on the demand side and the supply side



why public servants – who usually cannot lose their jobs – might vote for a party that champions the interests of the jobless. In turn, this provides an incentive for politicians to take prevalent justice and fairness norms seriously.

### 6.6.8 A Short Summary

Institutional change is a rather unlikely event as many conditions need to be met before it occurs. A first necessary condition is that a sufficiently large number of people are unsatisfied with the currently valid institutions and that they are ready to incur costs to demand institutional change. Efficiency-enhancing institutional change is by no means guaranteed, as political transaction costs are likely to be significant. Although institutions tend to be resistant to change, shifts in the relative power of social groups will be reflected in corresponding changes in external institutions. The shifts will also indicate the direction of institutional change. Finally, politicians have an incentive to take into account the justice and fairness norms prevalent in large portions of society as these can be decisive in elections.

## 6.7 Open Questions

This chapter has made clear that there is a multitude of approaches to explaining specific aspects of institutional origins and change. There is no one comprehensive approach that integrates traditional political economy arguments (relevance of power) as well as specific institutional economics assumptions (bounded rationality, relevance of internal institutions such as justice norms). Thus, one central question raised by this chapter is whether such an integrated approach is possible.

Many other questions also arise: To what degree is a country's current development determined by its past? To what degree is it possible to change a development path?

### QUESTIONS

1. It is not very flattering to call a theory "naïve." Explain why the theory proposed by Demsetz (1967) is called a naïve theory.
2. Discuss how North's theory of property rights development bridges the gap between contract theories à la Hobbes and predatory exploitation theories à la Marx.

3. Explain why – using North's theory – maximization of ruler income and maximization of social product can be irreconcilable.
4. What competition and transaction cost restrictions is a ruler subject to according to North's theory? To what degree do both restrictions make likely inefficient property rights?
5. What is the role of collective action for institutional change? How can institutional competition be linked to collective action?

## FURTHER READING

The commonalities, but also the differences, between public choice, social choice, and political economy are discussed in Mueller (2015). Tullock (1987) is one of the first monographs to provide an economic theory of autocracy. It contains a number of empirical examples, but no integrated theoretical approach. Wintrobe (1998) offers such a theory, based on the application of simple economic arguments.

The publications of Mancur Olson on the transition from anarchy to autocracy have inspired a number of other essays, including Niskanen (1997). Moselle and Polak (2001) distinguish between anarchy, organized banditry, and the predatory state. In direct contrast to Olson, they argue that "the unbridled predatory state is likely to reduce the welfare of the populace relative to anarchy and organized banditry" (Moselle and Polak, 2001, 5).

Nunn (2014) is an up-to-date survey on how historical events affect current institutions. The various findings of the economic theory of legal origins are summarized in La Porta et al. (2008). Those interested in digging deeper will find Zweigert and Kötz (1998) helpful. Among the very many critical assessments regarding the significance of legal origins, two are particularly helpful: Spamann (2010) recodes the original coding – and ends up with a completely different dataset. Klerman et al. (2011) point out that colonial history might be more important than belonging to a particular legal tradition.

Kirstein and Voigt (2006) discuss the self-interest of rulers. They conjecture that promises to behave in a specific manner are not credible at the constitutional level. The authors argue that constitutional-level promises will be implemented only if all actors involved have an interest in the implementation, not only at the time of signing the



contract but also at the time of its implementation. The authors identify parameter constellations under which neither the ruler nor the ruled can increase their payoffs by unilaterally deviating from their promises.

The concept of "spatial diffusion" is described in more detail by Elkins and Simmons (2005).

A critical and entertaining account of the traditional concept of path dependency can be found in Liebowitz and Margolis (1989).

Alesina and Spalore (2005) discuss the determinants of state size. Dixit (1996) provides a detailed analysis of political markets using the concept of political transaction costs.