



Contents lists available at ScienceDirect

Journal of Economic Behavior & Organization

journal homepage: www.elsevier.com/locate/jebo



Institutions, organizations, impersonality, and interests: The dynamics of institutions[☆]

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ARTICLE INFO

Available online xxx

JEL classification:

O1
N1
L1
D2
D02
D23

ABSTRACT

Institutional economists concerned with rules often focus on the trade-off between individuals and social incentives. This paper argues that the real trade-off that individuals face is between the organizations they belong to in contrast to social rules, and asks when do individuals find it in their interests to act in the interests of their organizations and when do they support impersonal rules? The answer involves a distinction between *anonymous* relationships between individuals who do not know each other personally, but know the organizations that the other belongs to, and *impersonal* relationships in which all individuals are treated the same.

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1. Introduction

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 politics, 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 more 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. People must find it in their interest to support and obey the rules impartially. 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 societies capable of sustaining impersonal relationships in many areas of human interaction. Such societies require rules and norms that are widely understood and enforced in an unbiased manner, and they require that individuals generally have an interest in following the rules. The approach to

[☆] This paper was written for the conference on *The Dynamics of Institutions in Perspective: Alternative Conceptions and Future Challenges*, organized by Eric Brousseau, Pierre Garrouste, and Emmanuel Raynaud in Paris October 3 and 4, 2008. I appreciate the comments of Pierre Garrouste and Benito Arrunada conversations with Lee Alston, Mushtaq Khan, Steve Webb, Nicolas Meisel, Nick Crafts, Eric Brousseau, Jerome Sgard, Avner Greif, Naomi Lamoreaux, Roger Betancourt, Werner Troesken, Barry Weingast, and Doug North. This paper builds on the concepts of limited access and open access social orders developed in Doug North, John Wallis, and Barry Weingast *Violence and Social Orders: A Conceptual Framework for Interpreting Recorded Human History*. North and Weingast, however, should not be implicated in the extensions presented here.

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rules in this paper differs substantially from the normal way that economists and other social scientists think about rule following. The tension between rules and individual incentives is usually conceived as a tension between the interests of the individual and the group, as in Rousseau's "stag hunt" or Olson's "logic of collective action." Rule following behavior is modeled as a trade-off between individual gains from deviating from the rules set against the costs imposed on deviators (who are caught and punished with some probability). The emphasis on the individual versus the group reflects the presumption that the origin of the rules or norms lies in the welfare of the larger collective.

In contrast, this paper focuses on the tension between groups and the rules. Most societies are made up of many groups, each group with its own rules and norms. Rules and norms that develop in specific circumstances and apply to specific individuals in specific organizations cannot be "impersonal" rules or norms that apply more broadly outside the organization to large numbers of people. Impersonal social rules must apply equally to all people in all groups, and so an inevitable tension arises between the rules and interests of specific groups (organizations) and the wider society.

A simple but pervasive example of this tension in all human societies is the proclivity for groups of adolescent males and/or females to create norms and even formal rules of behavior within their groups that are at variance with the rules of the society around them. Parents agonize over the possibility that, when faced with a choice between the interests of their peer group and the interests of the larger society, their children will choose to follow their peer group rules rather than the social rules. Adolescent peer groups organize on a more personal and less structured basis than the informal and formal organization most adults belong to, but adults face the same problem of acting in support of the interests of their organizations rather than acting in support of the formal (and perhaps impersonal) rules of the larger society when the interests of their organizations come into conflict with the social rules. The appropriate question to ask is: when do individuals find it in their interest to support their organizations and when do they find it in their interests to support impersonal social rules, when the two are in conflict?

Concrete examples of such choices occurred in 2000 and 2007/2008. In the American presidential election of 2000, George Bush and Al Gore ran an extremely close race that turned, in the end, on the results of voting in the state of Florida. The Governor of Florida was George Bush's brother, Jeb, and the Attorney General of Florida ruled that Bush had won the Florida balloting when many still felt that more investigation was warranted. The Florida ruling was immediately taken up through the court system. When the Supreme Court ruled in favor of Bush, Al Gore and the Democratic Party, at considerable expense to their interests as individuals and as an organized party, accepted the Court's decision. The legal rules had played out, a decision was reached, and Gore and the Democrats accepted it.¹ In contrast, in December 2007, when the presidential election in Kenya produced a close result and the incumbent, Mwai Kibaki, was declared the winner, Raila Odinga, the candidate of the losing Orange Democratic Movement protested the results. Over the next two months, violence repeatedly broke out in Kenya and hundreds of people were killed. At the end of February, a negotiated agreement, the National Accord and Reconciliation Act, created the framework for the competing factions to restructure the Kenyan constitution, including the creation of a new office of Prime Minister to be filled by Odinga, and substantially increasing the number of cabinet posts to accommodate the organizations of Kibaki and Odinga. In the United States in 2000, Democrats acted to support the rules and against the interest of their organization. In Kenya in 2008, Kenyans acted to support their organizations against the rules, and ended their organized conflict only after the formal rules had been fundamentally altered in a very personal way. When do individuals find it in their interest to support their organizations and when do they find it in their interests to support impersonal social rules, when the two are in conflict?

The first part of the paper, composed of four sections, unpacks the concepts that make up the question. What is impersonality? While impersonal relationship and exchange are fundamental concepts in the new institutional economics, the "treating everyone the same" definition of impersonality is not the commonly used definition. Instead, impersonality is usually defined as "dealing with people you do not know." In order to distinguish the two definitions, "anonymous" relationship is used to denote relationships between people who do not know one another personally, but nonetheless can recognize the other person's social identity. The first section considers the implications of the two definitions, particularly with respect to rules. The second section gives a specific definition to the concept of interest. More than tastes and preferences, individual interests are shaped by tastes, preferences, beliefs, the choices available, and the relative prices associated with the choices. Whether an individual "finds it in their interest" to support an organization rather than to support impersonal rules is a function of all these factors. The third section lays out an economic approach to the nature of organizations, in which the interests of the individual members are aligned to sustain coordinated and cooperative behavior. The fourth section looks into how a system of mutually supporting organizations might arise in a society, drawing on the argument of North, Wallis, and Weingast (2009 hereafter NWW). They describe a "natural state" in which an interlocking set of organizations provide incentives for individuals and the organizations to limit the use of violence, sustain a modicum of coordination, and enable third-party enforcement for organizational arrangements. The use of third-parties to enforce or adjudicate arrangements within organizations and between organizations, moves the discussion into the realm of rules, but rules that are by their very nature personal and idiosyncratic rather than impersonal.

¹ In his concession speech Gore said, "Over the library of one of our great law schools is inscribed the motto, "Not under man but under God and law". That's the ruling principle of American freedom, the source of our democratic liberties. I've tried to make it my guide throughout this contest as it has guided America's deliberations of all the complex issues of the past five weeks. Now the US supreme court has spoken. Let there be no doubt, while I strongly disagree with the court's decision, I accept it." As quoted in the *Manchester Guardian*, December 14, 2000.

The second part of the paper, in three sections, considers institutional dynamics through time. Rule following is never a static process. As individuals and organizations adapt to rules they find margins on which they can evade or modify the rules. Impersonal rules must be consistent with institutional dynamics that lead powerful interests to find it in their interest to sustain them. How does the interplay of individuals and organizations shape the continuous process of change in the beliefs, norms, and rules that together make up the institutional structure of a society?

2. Part I: concepts

2.1. Impersonality

Impersonal relationships occur when two individuals interact in a way that does not depend on their personal identity. Impersonal relationships only occur in societies that are capable of creating and sustaining an impersonal identity of “citizen” or “resident” that applies equally to a large number of people.² 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 often 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 relationship. 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. We need to separate two types of relationships. For purposes of clarity, *anonymous* relationships or *anonymous* exchange refers to situations where people who are not personally known to each other interact on some dimension, although the parties know the social identity of the other in the relationship. Social identity, the group, organization, tribe, city, etc. that an individual is identified with, is a key element of anonymous relationships. In contrast, *impersonal* relationships refer to situations where people are treated according to the same rules, whether they are personally known to each other or not.³ Social identity is not a part of impersonal relationships since, in the limit, all people are treated identically.

North and Greif both place impersonality at the heart of modern institutional development, but the point holds for a much wider literature.⁴ North has long stressed the importance of impersonal exchange for economic development and he clearly had impersonality in mind when he used the sports analogy to define institutions as the rules of the game and the methods of enforcement and organizations as the teams: rules in an athletic event should apply equally to all participants (North, 1990). North wrestled with defining impersonal exchange and placing it within a transaction cost framework.⁵ His solutions illuminate the problem at hand, as he identified three kinds of exchange, including 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 nor trust can be completely successful.” (North, 1990, pp. 34–35)

North begins with the idea that humans are enabled by their genetic endowment to use face to face interaction and repeated dealings to develop credible relationships.⁶ 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.”

² 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.

³ I am grateful to Nick Crafts for suggesting the terms anonymous exchange.

⁴ See Fukuyama (1995), Cook et al. (1995), and Lupia and McCubbins (1998) for a discussion of trust between individuals. For the credible commitment literature see Weingast (2006) and North and Weingast (1989).

⁵ Specific discussions of North’s approach to personal and impersonal exchange can be found in North (1981), pp. 182 and 204; North (1990), pp. 22, 34–35, and 55–60; North (2005), pp. 70–71, 84, and 119.

⁶ 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) and Pinker (1997).

And yet, very little of the North's first type of impersonal exchange⁷ under kinship ties, bonding, exchanging hostages, or merchant codes of conduct could be reasonably classified as impersonal under the "treat everyone the same" definition. In those relationships, 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. This is anonymous exchange. Anonymous exchange explicitly does not invoke treating people the same, as the parties to the exchange are constrained by kinship ties, etc. 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.

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? 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. Again, what Greif describes is anonymous exchange: exchange embedded in larger social organizations that enable individuals to credibly deal with one another because expectations about the other's behavior are grounded in the social constraints on the other person.

The point of this discussion is *not* to suggest that North or Greif misunderstood the nature of impersonality, both appreciate the importance of treating everyone the same. Because both North and Greif were developing general theories of institutions, their theories must span anonymous and impersonal relationships. Yet, they compounded the two types of relationships when it may have been more productive to separate them.

Constraining the behavior of individuals involves both positive and negative incentives, and may also involve coercion. NWW frame the basis of social cooperation 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 create individual privileges and rents through social organizations, and use those rents to bind powerful individuals into a sustainable coalition. Natural states create organizations that make anonymous relationships sustainable in larger societies.

Unlike natural states, impersonality underpins all open access 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.⁸ The dynamics of institutional change involve competing organizations and 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, and the organizations it organizes include government organizations, then the political economy puzzle is to understand how states and governments 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."

2.2. 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.

⁷ What North calls the "second general pattern of exchange."

⁸ NWW consider the difference between biased enforcement and unique identity on pp. 154–158.

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 milk or juice 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 should 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 and beliefs as well as rules, norms, and organizations. The logical argument only requires the interaction of individuals, but the spirit of Greif's 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. We need a theory of organizations.

2.3. Rents, rules, and 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, 1985), Grossman and Hart (1986), and a host of others. As Gibbons (1998, 1999, 2003) 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. Relationships between individuals are sustained by repeated interaction and the existence of rents to both parties. Contracts are agreements between individuals enforced outside of the relationship by third-parties. While some organizations can be described as self-enforcing sets of relationships, most organizations rely on some form of contractual enforcement using third-parties. A robust theory of organizations should encompass both relationships and contracts, rather than relying on one or other as the "organizing" principle.

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.⁹ 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 their relationships incentive compatible. The folk theorem partnership is what we can call an *adherent* organization, an organization where both or all members have an interest in cooperating at every point in time. Adherent organizations are inherently self-sustaining or self-enforcing, they do not require the intervention of anyone outside of the organization. Mancur Olson's famous "Logic of Collective Action" (1965) essentially relies on the existence of rents enjoyed by members of the organized group, which he calls selective incentives, to explain voluntary association. Members only cooperate if the rents are positive and, critically, if the rents are only attainable within the organization.¹⁰

If the members of an adherent organization look forward into the future and they anticipate that rents may not be sufficient to ensure the cooperation of every member at every point in time, then defection is anticipated and cooperation may unravel. There are, however, ways for the members 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. This makes possible incentive compatible and time consistent arrangements for the organization. The logic of various forms of folk theorems lays out how such punishments for deviators (non-cooperators) might be credibly punished (Benoit and Krishha, 1985; Fudenberg and Maskin, 1986).

The folk theorem is not enough to build a complete theory of organizations, however. Many organizations utilize formal or informal rules enforced by people outside of the organization. The other starting point for a theory of organizations is to assume that the institutional capacity to enforce rules and contracts already exists in the larger society. The question then becomes one of arranging relationships between members in such a way as to maximize the net value of the relationship and then divide the value between the members.¹¹ In these types of organizations, individuals still create valuable relationships that generate rents for each member. It is the rents that hold the organization and the relationships together. The difference is the ability to appeal to an external agency, a third-party, to enforce various terms of their agreements. Organizations that rely on some form of external enforcement of agreements are *contractual* organizations.

Gibbons (1998, 2003) urges us to think of organizations as more than a collection of formal rules embodied in contracts, but to think of organizations as bundles of interpersonal relationships that generate returns for the members that depend on their continued interaction.¹² 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.¹³ 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 et al. (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.

Thinking about organizations as incomplete relationships as well as incomplete contracts, may seem foreign to the economic way of thinking. Economists often operate with an engineering model of organizations as fixed relationships between inputs and outputs. Economists also find it useful when modeling the interaction of players in game theoretic formulations, to evaluate the conditions under which one of the players find themselves just indifferent to continuing to cooperate: the conditions under which that player receives zero rents. Economists also understand, however, that individuals cooperate only if they have an incentive to do so. Which implies directly that individuals only make choices that yield positive rents and only cooperate if positive rents result. What economist often subsume in their models, however, is that rents generate predictability.¹⁴ The behavior of an individual who receives a sizable rent from taking a particular action is more predictable, in the sense that his behavior is unlikely to change if conditions change in small ways.

Ongoing relationships are based on the predictable behavior of the partners. Partners can sustain a higher degree of cooperation when members of the relationship expect to receive higher rents on an ongoing basis. Members who are pushed to the margin are not reliable partners. If one member receives a total benefit equal to his total costs of membership, then rents are zero and that member is indifferent to cooperating. The behavior of an indifferent partner is unpredictable. Any

⁹ Rent is defined in the classical sense of a return to an asset or choice above its opportunity cost, not in the DUP rent-seeking sense.

¹⁰ If individuals could obtain the same returns outside the organization, the incentives would not be selective, and they would not be rents associated with membership.

¹¹ For example, Bolton and Dewatripont begin their *Contract Theory* with the explicit assumption that "The benchmark contracting situation that we shall consider in the book is one between two parties who operate in market economy with a well functioning legal system. Under such a system, any contract the parties decide to write will be perfectly enforced by a court, provided, of course, that it does not contravene any existing laws." (2005, p. 3).

¹² 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).

¹³ Hart and Holmstrom (2008). Baker et al. (2002).

¹⁴ Economists understand this, it is just rarely emphasized.

small change in circumstances may lead him to defect. Organizations want to ensure that all members earn some positive rents so that their behavior is predictable.¹⁵

Relationships govern the actions of the organization and its members, not rules. The rules serve as a way to structure credible relationships at lower cost, if a credible third-party is available. Relationships operate in the shadow of the rules, and it is only when relationships erode or break down that the rules come into play. The behavior of an organization is not described by its rules.¹⁶

Third-parties are one way to reduce the costs of enforcing rules when it is necessary to do so. Rather than tying up valuable resources in the form of hostages or other insurance arrangements within the organization, rules and contracts enforced by third-parties offer a more efficient possible way of ensuring that rents stay positive. An organization's members accept terms and penalties for defections that the third-party enforces. The resources of the third-party need only be engaged when necessary, offering gains from resource use and specialization and division of labor. The incentives facing third-parties are an endogenous part of this relationship. Which brings us to the difficult problem: where do third-parties come from and how can people believe that third-parties be credible? This is an essential question in the existence of impersonal relationships and impersonal exchange.

2.4. Organizations, third-parties, and the natural state

The problem of creating credible third-parties involves the formation of beliefs about the behavior of others. 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, trustworthy, 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 trustworthily rather than strategically? How do we form beliefs about the interests of others? How do we form beliefs about the interests of the third-parties?

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 30 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.¹⁷ In the lexicon of organizations, all hunting and gathering bands are adherent organizations, held together by the value of the relationships within the group, enforced by the folk theorem threat of breaking off relationships. 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.¹⁸ 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 minion's income, enough so that both sides can believe that the crime lord will act in the minion's 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 act predictably (on certain margins).¹⁹ The first way of comprehending interests entails personal interaction, the second can function with or without personal knowledge. Trust in anonymous relationships must be based on the second type of comprehending interest. 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.

North, Wallis, and Weingast ask how is it possible to create social arrangements that limit the use of violence in groups larger than a hunter-gatherer band. They begin their analysis with a world in which individuals base trust on personal interaction, and show how, in a world where violence is a viable option that cannot credibly be deterred by a third-party (like the state), some individuals can deal with dangerous and potentially violent individuals with some degree of confidence.

¹⁵ Positive rents may be created through negative means. Individuals may be coerced to participate in an organization and coerced if they defect.

¹⁶ Marriages are relationships, and marriage law applies not to the conduct of marriages but the conduct of divorces. Marriage law, therefore, does not describe the behavior of people in their marriages, but does describe how the parties interact during a divorce.

¹⁷ 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 that existed for most of human history and only began changing in the last 10,000 years. 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.

¹⁸ 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.

¹⁹ Beliefs do not have to have a rational and logical internal structure. There is no reason people cannot simply believe they would not be cheated, thus the relevance of the trust literature.

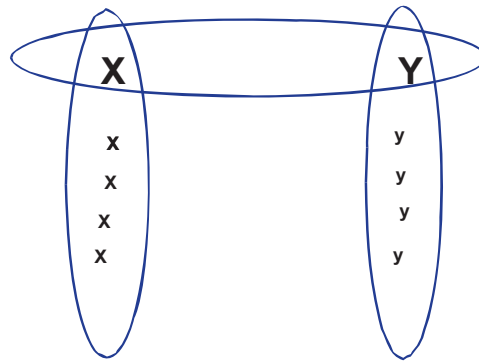


Fig. 1. In the figure “X” and “Y” are the violence specialist, their clients are the “x” and “y”, respectively. The horizontal ellipse represents their organization, the “dominant coalition.” The dominant coalition is an adherent organization. The specialist limit the ability to form organizations to themselves. Their client organizations, the vertical ellipses, are contractual organizations, which can utilize the dominant coalition as a third party enforcer.

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 their privileges under conditions of peace are larger than under conditions of violence, then each specialist receives a rent from peace. If the rents from peace are large enough, 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 Fig. 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 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 those 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.”

In Fig. 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 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.²⁰

The simple society depicted in the figure, though, is enough to see how credible third-parties can emerge out of the social arrangements that limit violence. In the adherent horizontal organization of the dominant coalition, no member has a monopoly on violence. What deters the use of violence is the potential rents that coalition members might lose. Those rents do not come from within the dominant coalition, but from the vertical contractual client organizations. The members of the dominant coalition are able to call on each other to serve as third-parties. Initially, those services might only include simple recognition of each other’s boundaries and clients, as well as a working agreement to live and let live, but the roots of more sophisticated arrangements lie in the credible commitments that coalition members are capable of making to one another.

The logic of third-party enforcement that grows out of Fig. 1 differs substantially from the usual way that the new institutional economics and social sciences have thought about credible third-parties. The ability to enforce rules grows out of the interlocking interests of members of the dominant coalition. Third-party enforcement does not result from one party possessing a predominance or monopoly of violence potential, a comparative or absolute advantage in violence, or by being the “strongest.” Instead, 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 fundamentally and significantly from the way social scientists have thought about the problem. North’s neo-classical

²⁰ NWW (2009), chapter 2. Earle (1997, 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.

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 third-party problem is framed as constraining the strongest individual, the solution is to create a set of payments to the specialist that provide him with sufficient rents to prevent him from defecting under expected circumstances: a personalized contract as it were. Credible commitment of the violence specialist to honor his agreement becomes the pivotal element. The state is conceived of as a single-actor entity, the third-party that enforces rules.

While this approach is logically attractive, in the real world protection and justice are provided by coalitions of powerful individuals, never by single actors. Unless 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.

Nothing in the logic of the coalition of individuals and organization underlying Fig. 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 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 structured by the third-party enforcement of the dominant coalition.

Each one of the organizations possesses its own institutional rules and norms. The form these institutions take is governed by the relationship between the coalition members and the client organizations. 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 may be third-party enforced by the dominant coalition. 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 1990 framework play by the same rules. The teams must decide whether to devote resources to production or to evading or changing the rules. In the framework of Fig. 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.

The most valuable privilege members of the dominant coalition enjoy is the ability to structure organizations using the third-party enforcement of the coalition. Coalition members derive substantial rents from their organizations, and the rents created by exclusive privileges are part of the glue holding the agreements between the specialists together. This strengthens the ability of the coalition to discipline individual members, because the coalition as a group can use the threat of withdrawing third party services as a lever to influence the interests of individual members and, thus, as a way to coordinate the 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.

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 identities of the major players and to shape their interests in a way to maintain cooperation. Kenya in 2007/2008 provides a good illustration. When violence broke out after the 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 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. Anonymous relationships between people who do not know one another are feasible, but only if the individuals can identify the organization that the other person is associated with. People cannot believe that the rules are unchangeable and have those beliefs verified by experience.

People believe their interests are better served and protected by the organizations they are associated with, rather than by institutional rules. 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 Fig. 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 may be anonymous, but not impersonal. In the community responsibility system described by Greif, 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 to compensate the merchant from commune B, then the goods of any of the commune A merchants resident in commune B are confiscated by commune B's 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 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.²¹ Identity in many pre-modern societies is not closely associated with larger social units.²² 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 that lead to and sustain cooperative outcomes. Organizations occupy the central place in this process. 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.

The rules governing organizations are idiosyncratic because 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 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 unless they can place those individuals in the right social context.

3. Part II: institutional dynamics

3.1. Rents, rules, organizations, and individual interest

The limited access society depicted in Fig. 1 is capable of anonymous exchange on a large scale, but not impersonal exchange. It is capable of formulating rules that can be sustained by the interaction of interests in the dominant coalition and contractual organizations, capable even of forming sophisticated organizations, but it is also a society that rests on the creation of rents and, ultimately, relationships between powerful organizations and individuals. 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 reallocation of rents within the coalition. Reallocation of rents can be occasions for violence, even civil war, and the shadow of that violence effects the dynamics of institutional change throughout society. NWW address how such forces might produce a situation where impersonal rules emerge, this section focuses on how it can be in the interest of the dominant coalition to support those rules and why individuals find it in their interest to support impersonal rules rather than their organizations.

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

²¹ For an example of this see Akerloff and Kranton (2000).

²² 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. Also see Anderson (1991) and Gellner (1983).

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 is more likely to be resisted. The dynamics of social relationships are such that any institutional change that alters rents sufficiently to destabilize the dominant coalition, even if the change is implemented, will be self-defeating. Destabilizing the coalition increases the risks 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 immediately 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 organization, rather than in support of impersonal rules.

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. The identity of the coalition members can be separated from the tools the coalition makes available to its members. Even if every 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, they are intimately related. 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.

NWW posit 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. What they might better have said is that the doorstep conditions create an opportunity to transform anonymous elite relationships into impersonal relationships.

Allowing all elites access to the same social tools to support their organizations 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.

Most economic rents are “socially constructed” in the sense that all rents depend on the relevant alternative: the value of the best alternative foregone. A key element of institutions is structuring the range of choices available to individuals, and it is important to understand that institutions often frame choices in such a way that there are more than one relevant alternative to be foregone. For example, in the 2008–2009 basketball season, the Los Angeles Lakers paid Kobe Bryant a reported salary of \$21,262,500.²³ He was the fourth highest paid player in the league. Almost certainly, Bryant would have been 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 was roughly \$20 million a year. The rent he receives from playing for the Lakers, however, was 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. Those organization-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 individual-specific rents, the \$20 million rent he gets from playing basketball, are 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 impersonal rules and informal norms. Bryant’s individual-specific rents are directly related to the success of the NBA as an organization, and 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. 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. What the example makes clear is that the rents Bryant puts at risk if he cheats are not the rents he receives from the Laker’s, but from the larger NBA, i.e. in this case the impersonal rules.

The Bryant example illuminates the first element in the rise of impersonality. If the balance between organization-specific and individual-specific rents shifts away from organization-specific rents, more individuals may find it in their interests to act in support of the rules, rather than in support of their organization. If the value of their alternatives outside the organization they belong to increase, then individuals may find it in their interest to support rules that sustain a larger number of alternatives. Allowing more organizations to form will change the value of outside options for all individuals.

This factor by itself is not capable of providing 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.

3.2. The dynamics of organizations and entry

A 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-coalition competition is to open access to organizations. Mem-

²³ <http://www.insidehoops.com/nbasalaries.shtml>.

bers of the dominant coalition (elites) always have more to fear from each other than from the rest of the population. As military power is consolidated under the government, economic organizations become a more important influence in the polity, and coalition members seek to prevent the accession of a sub-coalition, an elite “faction,” that uses the manipulation of economic privileges to control the political system and deposes part of the existing coalition. When control of the means of violence is dispersed throughout the dominant coalition, all coalition organizations live under the shadow of violence and could, potentially, become violent. The rise of powerful non-military organizations (doorstep conditions 1 and 2) enable coalition members to consolidate control of violence in one or more government controlled organizations, the military and police, because coalition members are confident that they can collectively discipline the government to prevent the military organization from abusing its power. But how do coalition members ensure that they can compete with the government/military organization? They move to open impersonal access to the tools that support organizations, so that any elite group can organize to defend or advance its interests. These interests are capable of sustaining impersonal rules with respect to the formation of organizations, and it is the dynamics of these organizational interests that we must understand.

The logic is easiest to see in the history of business corporations in the United States and western Europe. Business corporations are only one type of important organization, but they offer an easily visible form of deliberately structured elite organizations. The first business corporations appeared in Northwestern Europe in the 16th 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, of a legal identity to an organization, occurred within the dynamics of the dominant coalition. Corporate charters were both a grant of privilege (often including a monopoly on some activity) and the explicit recognition of a set of contractual rules governing the corporation’s internal and external relationships.

The legal structure of the corporation was a bundle of contractual rules that the dominant coalition would enforce for the corporate organization. Most early corporations enjoyed unique and valuable privileges. Through the 18th century, the number of corporations grew slowly and the procedures for granting new charters were heavily weighted toward protecting existing privileges, rather than granting new ones.²⁴ 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; Kingston, 2007).

The first general incorporation acts, which allowed a corporation to be formed through a simple administrative act that did not require explicit permission of a legislative or government body, first 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 19th century.²⁵ Churches, schools, universities, political organizations and ultimately political parties, and voluntary organizations of many types were increasing able to avail themselves of government sanctioned rules for their internal and external relationships. In fact, 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). Although colonial New York officially exercised religious tolerance, only Dutch Reformed and Church of England congregations were able to obtain charters. Without a charter, the congregation had no legal identity apart from its members. Financing a sanctuary with a mortgage required a partnership, which left every member of the congregation legally liable for the entire obligation.

The contemporaneous changes in the ability of elites to form 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 and draw on the support of the government 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 affected institutional dynamics in direct and obvious ways. The formation of new economic, political, and social organizations (and the elimination of old organizations) occurred quickly in response to new opportunities and alterations in circumstance. Rather than constraining the formation of new

²⁴ For Britain see Harris (2000), for France see Freedeman (1979), for the United States in the early 19th century see Wallis (2005, 2006). NWW consider the British, French, and American cases in detail, pp. 190–250.

²⁵ Neither was it the case 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 an increase in the number of business organizations in Germany, Spain, or Italy.

organizations, the number of formal organizations mushroomed.²⁶ Negotiations among powerful interests, which before took place between a (relatively) stable group of 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 nature of political and economic competition. 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 organizations (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 conditions 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 is in place, however, going back became quite difficult. Any attempt to limit access would undoubtedly create winners and losers within elites, so how was a change in policy to be brokered? Such a negotiation would be complicated by the changing nature of elites. Open access itself would begin to erode the distinction between elites and non-elites, and some newly rich and newly powerful non-elites would now be able to demand a voice in the governance process. Elites who were currently on the inside of the governance organization, but feared that they might soon become outsiders, had a strong incentive to maintain the open access rules. Open access to organizational tools would enable them to reorganize and continue to compete.

The second condition concerns the organization of the government and the services it delivers. This paper has laid out the rudiments of a theory of the state that defines the state as the organization that organizes other organizations. One type of organizations that states organize are governments. The advent of impersonal rules for organizations requires a shift in the structure of the government, as several of the organizations within the government must now deliver impersonal third party enforcement of specific rules. Namely, the administrative organization(s) that grant recognition to organizations and the judicial organizations that enforce the internal and external rules regarding the actions of organizations. Here is where Greif's insight about anonymous exchange leading toward the "path to the modern economy" is accurate: societies that cannot support extensive anonymous exchange do not possess the institutional resources to implement impersonal rules. Until institutions that can support sophisticated anonymous exchange are in place, it is extremely unlikely that conditions leading to impersonal relationships to be adopted by elites will arise.

This is 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 specific rules, since the formal rules for the internal and external relationships of the organizations can stay the same, what changes is the institutional dynamics that now allow anyone to create an organization that can call on the support of the state.

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 government policies is essential for open access to survive. In an open access society the government 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 government organization that administer impersonal rules must be governed by rules of law not by rules of men. Since politics is inherently based on personal relationships and coalitions of interest, impersonal rules will not be sustainable without an institutional dynamic sustained by open access.

3.3. Equality and impersonality

Impersonality is one facet of equality: treating everyone the same. Equality is a more complicated concept, however. Equality of opportunity requires impersonality, as everyone enjoys the same opportunities; equality of outcome 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 to them as individuals?

Interests result from a combination of factors: opportunities, relative prices, preferences, and beliefs. As opportunities broaden, the rents associated with any specific relationship and organization decline because the value of their personal abilities increases in alternative relationships and organizations. 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. As in the Kobe Bryant example, when individuals are able to employ their human capital in a wider range of organizations, then the rents they enjoy come to depend more on the existence of other organizations than

²⁶ 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). The already high rate of corporate formation increased after general incorporation, but there are no national counts. The increase in incorporation was not limited to business, for example, Novak (2001), documents the incorporation of over 3000 voluntary organizations in Connecticut between 1787 and 1865.

on the interests of the specific organization they happen to belong to. As noted earlier, individual interests in maintaining the system of organizational entry and competition are unlikely to motivate people to support impersonal rules rather than their organization in general, however, because in specific instances the benefits of acting against the rules may be too great.

Well organized interests are faced with competing incentives in a similar way. On one hand, they would like to use their position to influence the government and society to create rents for themselves.²⁷ 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 appears to unleash creative political destruction. Schumpeter's theory of politics in *Capitalism, Socialism, and Democracy* (1942) was perilously thin and turned out to be wrong. He predicted that the protective strata of politics that enabled capitalism to flourish would evolve in a suffocating layer of regulation. Not only did that not happen, but allowing open economic competition profoundly affected the polity. New and unpredictable patterns of interests, thrown up by innovation and growing markets, were not captured or smothered by politics but the reverse. What Schumpeter failed to see was that open economic access dynamics would unleash creative political destruction as well as creative economic destruction.

Rent seeking plays a major role in the operation of open access politics, that part of human nature has not changed, but 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, at least not in the short period of historical time that open access societies have existed. New technologies, industries, firms, and groups with a strong stake in maintaining open entry are always on the cutting edge margin of economics and politics. Coalitions of political, economic, and social interests vie for control of the polity, but no specific coalitions in the developed world have proven capable of exerting long term hegemony. A viable competing coalition always emerges, as Arrow's impossibility theorem suggests (1950). 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 institutional 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, give the clear and obvious inequalities in endowments and outcomes across individuals. One might have trouble swallowing a belief that all laws are enforced in an unbiased manner, that all politicians are honest, that free markets always produce the best outcomes, or that people engage in impersonal exchange because they have no fear of being cheated. But perhaps it is only part of the belief in equality that needs to apply: that part that says treat everyone the same. While this belief, by itself, is not capable of transforming a society into one where impersonal rules are present and enforced, it is possible that this belief can emerge as a sustainable belief in a society with open access to organizations. That is, belief in equality in more general terms may be sustained by specific rules about equal access to organizations.

If a society possess the social tools capable of supporting complex organizations (and many do not) and extends those tools to everyone (citizens), so that in the dimension of organizations everyone is treated the same, then the dynamics of institutional change are fundamentally altered. Personal relationships, rents, relational contracting, and hierarchy all still exist. None of the fundamental features of how human societies that emerged five or ten thousand years ago wither away: large social organizations are still held together by relationships and rents. But anonymous relationships between people who do not know one another personally, but nonetheless must be able to place each other within an existing social framework, can give way to truly impersonal relationships.

3.4. Conclusions

This paper began with the example of teenage peer groups, one of the most universal human institutions and one that depends for its very existence on ongoing personal relationships. Rather than asking whether a teenager will find it in his or her interest to obey the rules of the larger society, this paper asks when will the teenager find it in his or her interest to follow with the interests of their group rather than follow the social rules? It is only by comparing the interests that individuals have in their own organizations versus their interests in impersonal rules that we can lay out a framework for understanding how societies can support impersonal relationships on a wide scale. Organizations are the critical intermediating factor between individuals and societies. Impersonal rules appear in societies only when powerful organizations and individuals find it in their interest to implement impersonal rules for forming organizations. Out of that seed grows the possibility of supporting a wider range of impersonal rules under which all individuals are treated the same by the larger society, regardless of their personal identity.

Understanding the rise of impersonality is a central 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 has asked how people with 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

²⁷ This follows the line of argument in Olson (1965, 1982), but also applies to the argument in Bhagwati (1982), Krueger (1974), or the rent seeking literature ala Buchanan et al. (1980).

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, pp. 34–35). 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 arrangements 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 and between 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.

Organizations are bundles of relationships and contracts. Repeated relationships enable two or more individuals to form expectations about each other’s behavior. When all individuals expect to gain from the relationship, the arrangements are self-enforcing: an adherent organization. Rules and contracts enable them to pre-commit to actions in circumstances where the rents to one member may become negative in the short-run. The kind of rules that can be enforced and arrangements that can be sustained is much wider, however, 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 contractual 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 organization that sustains contractual organizations. The logic of the natural state provides a logical solution to understanding the real world problem of creating credible third-party enforcement.

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 the subject 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 adopting impersonal rules for the formation and operation of 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 government. At the margin, the definition between an elite and non-elite begins to blur, as there is no institutional dynamic that works against diluting the identity of elites, like there is in a natural state. In order for open access to be sustained, the government must develop the capacity to recognize organizations in an impersonal way. Under open access, organized interests are able to form to work against inequitable treatment of citizens. These organized movements may not always 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 government.²⁸ Open access economics plays a critical role in keeping access open in politics, as groups that are threatened by government policies organize to resist changes that harm them and urge other policies that benefit them.

Rent creation and rent seeking are never eliminated in an open access society, 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.²⁹ Governments in open access societies appear to be much

²⁸ 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.

²⁹ 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 19th century. See Hennessey and Wallis (2010) and Wallis (2010, 2011), for a discussion of those constitutional provisions.

better able to deliver public services impersonally to all who qualify: driver's licenses, old age pensions, access to public utilities and services, property rights and registers, 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 are 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.

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 do not know personally. Larger social organizations require rules, even if the rules are very simple. Coordinating the interests of powerful individuals through rent creation is how larger societies are built. Rent creating institutions provide the organizational 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.

For several centuries, social scientists and social philosophers have tried to understand how it can be in the interest of individuals to support impersonal rules. Framing the problem as a choice between individual interests and social rules has not led us to a satisfactory answer. The failing must be on the theoretical side, as there are manifestly societies where individuals do place the rules above their immediate individual interests. We need a different approach.

Organized human interaction is often grounded in relationships rather than rules. When we take explicit account of how organizations work, we see how and why rules emerge that magnify the scope and complexity of human relationships, and thus human productivity. Third-party enforcement of rules makes organizations even more productive, but credible third-party enforcement requires the interaction of more than individuals. It requires at least two, indeed many, organizations. Rule based social interaction cannot be explained by a framework populated only with individuals and a 'society.' Rule based social interaction can only be explained by a framework of individuals, organizations, and societies. Without including organizations explicitly in our analysis we cannot derive a satisfactory explanation for impersonal rules and individual incentives to support those rules. Individuals have to have credible incentives to form organizations. Under specific, but historically relatively rare, conditions it is possible for powerful individuals and organizations to find it in their interests to "treat each other the same." Those incentives can produce open access to organizations.

Open access to organizations of all types: political, economic, municipal, religious, and educational is a hall mark of modern developed societies. Open entry in economics and politics produces a social dynamic in which individuals find it in their interest to support impersonal rules rather than the specific organizations they belong to. Impersonal rules are consistent with individual rationality, but only through the intermediation of human organizations.

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