The New Institutional Economics: Concepts and Applications

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Chapter 1: Introduction

One of the enduring challenges in economics is to explain the great variability in economic and political performances across countries. While a small number of countries have reached high levels of economic prosperity and political openness, most have experienced short bursts of growth along with considerable economic and political volatility. New Institutional Economics (NIE) has sought to explain these differences by emphasizing the role of institutions as the fundamental determinant of economic and political development. Practitioners of the NIE analyze beliefs and institutions – the rules, norms, and enforcement mechanisms that determine how people interact – using a toolkit that draws from several disciplines. In this book, we present an overarching framework for the NIE, the tools used to explain the evolution and effects of institutions, and a set of case studies that apply institutional analysis to historical examples.

While the NIE can be used to examine the question of what leads to macroeconomic and political performance, it can also be used to examine questions related to the performance of smaller organizations. All human interaction is affected by the institutional structure in which it takes place, and one goal of the book is to the present the reader with a toolkit that can be applied in many settings. Rules, norms, and shared beliefs can explain behavior at the level of the family, the firm, or the national government. Our framework for institutional analysis weds the foundations of property rights and transaction costs (Part I) to the operation of the political system to create the formal rules of the game (Part II) and the dynamics of deep institutional change (Part III). Each chapter begins with a set of tools for doing institutional analysis that is followed by case studies drawn from economic, legal and political history.

This book differs from other books in this area by its reliance on economic history both for its theoretical development as well as for the case studies. We propose a theoretical overview that relies on clear language rather than the presentation of formal mathematical models. The case studies are analytical narratives drawn from economic history. We note that many prominent economic historians have been leaders in the field of the New Institutional Economics with a central role played by Douglass North and scholars that he influenced around the globe. North was the second President, following fellow Nobel Laureate Ronald Coase, of the International Society of New Institutional Economics (ISNIE.) Several economic historians have followed North as President of ISNIE.

We start each chapter with a concept and then present two or three applications from economic history or economic development. Each chapter also includes a list of suggested theoretical and applied readings. We stress that this is not an overview of the entire literature on the NIE, which is now far too big to summarize in a textbook, but our attempt at defining the major concepts at play in the literature utilizing economic history for concepts and examples. Importantly, we tie the concepts together.

We build on the framework for the New Institutional Economics presented in Alston (2007), and the framework on beliefs, leadership and institutions in Alston, Mueller, Melo, and Pereira (forthcoming 2014). The scope of our book is vast, spanning from issues of contracting to why the whole world is not developed. We argue that institutions are the primary cause of development rather than other potential determinants such as geography, culture or technology. The book is broken into three parts, each presenting a framework for a different level of institutional analysis. In Part I, we analyze how the laws and norms of society determine property rights which in turn determine technology, transaction costs and ultimately economic performance. In Part II, we analyze how the determinants and impact of the laws of society and their enforcement, which overall determine political performance. In Part II, the constitution is still taken as fixed, but it fundamentally is the umbrella under which organizations and actors interact to shape and enforce laws. Taken together, Parts I and II can be used to analyze the normal operation of the economic and political systems and the interaction among institutions, property rights, technology, and economic performance. The system is not static, there are new technologies and growth but the underlying belief system and political system remain unaffected. In Part III, we analyze the circumstances under which norms and beliefs can change and how those changes can lead to transitions to different economic and political trajectories. For example at this scale one could be analyzing longer stretches of time which allow differences in fundamental core beliefs. Changing beliefs in turn can transform societies. For example Mokyr (2012) argues that the enlightenment belief that man can change natural conditions to his advantage led to the industrial revolution and ultimately sustained economic development for Great Britain. In Part III we will also analyze the determinants of constitutions which emerge through a process in which beliefs can shape constitutions and under some circumstances constitutions shape beliefs for some organizations and actors in society.

In **Part I: Institutions, Technology and Organizations**, we explain economic performance, starting with the norms and laws of society. The toolkit includes standard neoclassical economics along with the concepts of transaction costs, property rights and institutions to explain technology, contractual choice and economic performance. A framework for understanding this process is presented in Figure 1. In this section of the book, we take the norms and laws of society as given and examine how they affect property rights and technology (Chapter 2); transaction and transformation costs (Chapter 3); and technology and contractual choice (Chapter 4). Beginning the book with a static analysis of how institutions affect economic performance is meant to provide readers a vocabulary for analyzing institutions, organizations, property rights, and transaction costs. These concepts, when tied together, yield a tool kit for understanding economic performance.

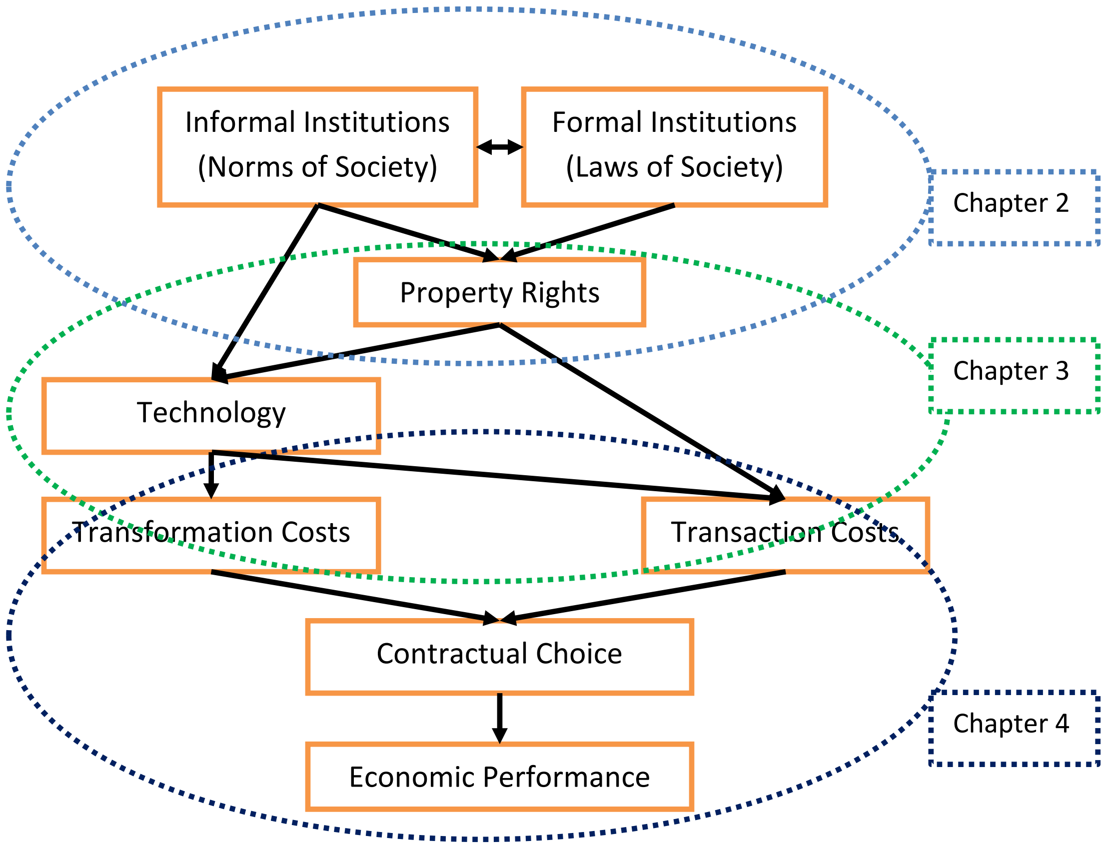
Institutions are “the humanly devised constraints that shape human interaction” (North 1990, 3). We break down the analysis of institutions into institutional statements – rules and norms – and their formal and informal enforcement mechanisms. Rules and norms are similar in many of their characteristics, and we follow Ostrom (2005) in distinguishing between them by the explicit “or else” associated with rules but missing from norms. A rule specifies actions that are permitted, obliged, or forbidden, the circumstances and group to which the rule applies, and the sanctions for violating the rule. Most colleges, for instance, have rules forbidding plagiarism on papers. These rules appear in student handbooks and have the general structure that they apply to students of the college, define plagiarism and when it is forbidden, and specify sanctions. The process by which rules are enforced – a faculty member or college committee – along with the supporting rules and norms and their enforcement define the institution. A norm against plagiarism has many of the same characteristics except that there is no explicit sanction or method of enforcement. Violating a norm against plagiarism might generate feelings of guilt by the violator and contempt for the violator by observers. Norms and rules will certainly differ – a college's rule against plagiarism generally only applies to students whereas the norm against plagiarism also applies to faculty – but they often overlap significantly. When rules are consistent with generally held norms, those rules become much easier to enforce.

Constitutions, which we will analyze in Part III and take as given in Parts I and II, typically sit at the top of a society's hierarchy of rules, followed by other laws of society, created by government and elite organizations, followed by rules created by economic and social organizations. If the laws of society are enforced, then the rules governing other organizations must be consistent with them. Colleges, for example, must make rules that are consistent with the laws of the state in which they operate. A typical sanction for plagiarism is some combination of probation from the college, failure of the exam or course, or placement on academic probation. State courts have found these sanctions to be legal as long as colleges follow their own internal rules, but sanctions that are reached in an arbitrary manner and not consistent with a college's rules are not valid. [1]

The norms and laws of society determine the distribution of economic property rights. An economic (or *de facto*) property right is "one's ability, without penalty, to exercise a choice over a good, service or person" (Allen 1998, 106). These choices include using, selling, deriving income from, and bequeathing the asset. Legal (or *de jure*) property rights are the property rights stipulated by the laws of society and enforced by the government or other entity. Given that any good or service has many attributes, legal and economic property rights often diverge. People with *de facto* rights often seek to acquire *de jure* rights. Frontier settlers often seek to solidify their claim to land by gaining legal title to it (Alston, Harris, and Mueller 2012). Violence can ensue when there are conflicting claims to property rights. However, *de facto* and *de jure* rights can stay separated for long periods. For example, committee chairs in the U.S. Congress have a mixture of *de jure* and *de facto* property rights over the legislative process that can persist for a long time (Shepsle and Weingast 1987).

[1] See *Reardon v. Allegheny College* 2007 PA Super 160 for a case dealing with these issues.

Figure 1 Institutions and Economic Performance



The distribution of property rights affects technological choice. The standard neoclassical theory of production takes technology as given. In our framework, the technological possibilities are determined by the economic property rights and by the norms of society. Patent and trademark law affects the type of technology available and who gets to use it. Laws restricting the use of certain technologies (like very productive fish wheels for catching salmon in the Pacific Northwest) limit producers' property rights and can lead to technical regress (Higgs 1982). Norms can determine whether an inventor of a new technology is likely to be lauded or killed by his neighbors. Mokyr (2012) argues that the norms and beliefs associated with the enlightenment were important determinants of the technology developed during the Industrial Revolution.

Since economic and legal property rights diverge, the state will not protect all economic property rights and individuals will spend resources to establish and maintain "their" property rights. For example, most people lock their houses and cars to protect their property rights. These resources are transaction costs. Transactions occur any time economic property rights are exchanged but transaction costs may be ongoing to maintain rights. Examples of transaction costs are "(1) search and negotiation costs; (2) monitoring labor effort; (3) coordinating the physical factors of production; (4) monitoring the use of the physical and financial capital employed in the production process or in consumption; and (5) enforcing the terms of the contract" (Alston 2007, 3). Transaction costs are a key tool in the NIE toolkit, and our goal is to provide a framework for classifying them and understanding their interaction.

The neoclassical theory of production models firms as profit maximizing entities that make decisions about production levels and inputs at the margin. While we do not abandon the marginal analysis central to the neoclassical model, the underlying assumption of zero transaction costs leaves no room for the study of organizations. Organizations are economic, political and social bodies that consist of individuals "pursuing a mix of common and individual goals through partially coordinated behavior" (North, Wallis, and Weingast 2009, 15).[2] Organizations and individuals engage in transactions that we label contractual. Contractual choices go well beyond the discrete choice of "the firm" versus "the market." Just as social institutions have a constitutional level sitting atop other laws and enforcement, institutions governing contracts include the make or buy decision, how workers are incentivized, and the norms governing individual and group behavior. We use the word "contractual choice" as short-hand for the many institutional decisions that actors make in organizing economic activity. Which type of contract is chosen is always done on a comparative basis, with each contractual arrangement using different technologies and exhibiting different types of transformation and transaction costs. Whether a worker on a cotton plantation in the U.S. South worked on a chain gang, was hired as a wage worker, was contracted as a sharecropper, or was a fixed rent tenant was based on the distribution of property rights, the production technology available at the time, the costs of supervising labor, and the costs of monitoring their use of capital. A new distribution of property rights, such as the abolition of slavery, affected technological and contractual choice. A new technology, like the mechanized cotton harvester, disrupted the organization of production, changing the ways in which labor was hired and incentivized (Alston and Ferrie 1999).

In a world without transaction costs, it is of no consequence how society organizes its resources. Production could be organized through central planning, a state sponsored monopoly, a large corporation, small independent partnerships, market transactions or any number of other organizational forms. Economic actors would take the initial allocation of property rights and bargain to the most efficient outcome (Coase 1937, 1960). However, the economic world is one filled with transaction costs. Institutions are the fundamental cause of property rights and incentives. The joint decisions of which contracts and technologies to adopt are the proximate cause for why countries achieve sustainable economic development.

In **Part II: Government and Formal Institutions**, we present a framework for studying the process of what James Buchanan called "ordinary" or "post-constitutional" politics. Figure 2 starts with economic performance and constitutions and ends with formal institutions, completing the cycle begun in Figure 1. In this framework, actors operate under the umbrella of

[2] While the tools of the NIE can be applied to any type of organization, the focus of Part I is economic organizations. Part II of the book focuses on political organizations.

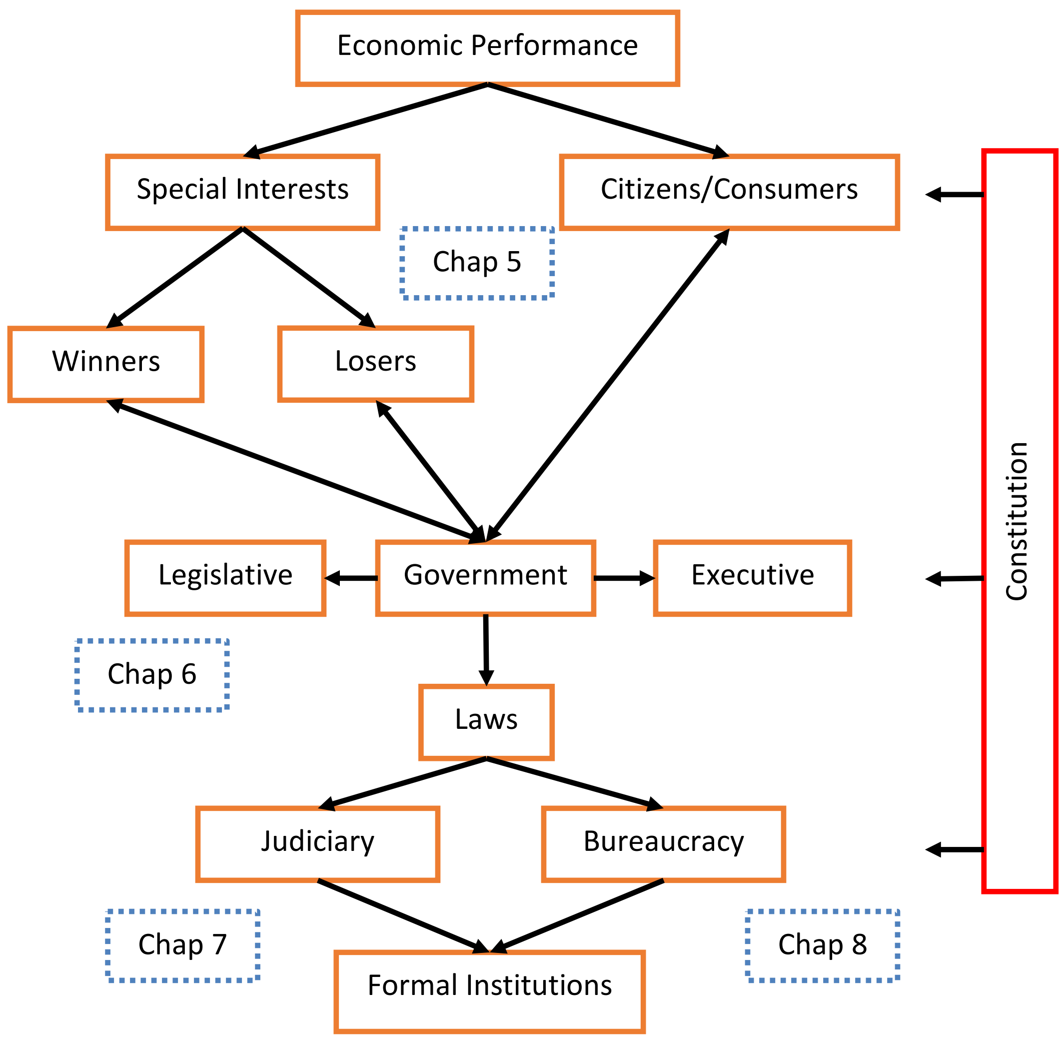
existing constitutional rules, societal norms, and beliefs. The outcomes of the process are the laws of society and their enforcement. These laws can be made at different levels in a federal system and by different branches of government. In the United States, the legislatures pass bills, the judges make common law, and the administrative agencies make administrative law. The flowchart starts with economic performance and then examines how interests are expressed in the political process (Chapter 5); the functioning of the legislature and executive (Chapter 6); the judiciary (Chapter 7); and the bureaucracy (Chapter 8).

Because new constitutions can be the outcome of a process described in Part III of the book, we place the discussion of their determinants in Part III. But in Figure 2 we show the Constitution as an umbrella over the political process.

The normal functioning of the economic system is a process of creative destruction that creates winners and losers (Schumpeter 1942). The losers have an incentive to lobby for rule changes that protect them from market changes, while the winners seek to protect their gains and lobby for additional rules that favor their interests. Winners and losers can be concentrated enough to overcome the collective action problems in lobbying (Olson 1965; Buchannan and Tullock 1962). One group is often concentrated while the other is not, leading to an unbalanced distribution of political power. Free trade might hurt a small group of inefficient domestic producers while helping a large number of consumers, but the concentrated “losers” have a strong interest in protecting their property rights at the expense of the dispersed “winners.” Actors do not only respond to changing economic performance but are also forward looking, lobbying for rules that advance their economic interests.

A given set of demands from citizens and special interest groups is filtered through the legislative and executive branches. The output of this process is a set of laws that is then interpreted and enforced by the judiciary and bureaucracy. Different methods of organizing the rule-making process will yield different outcomes. For instance, many small competing parties within a parliamentary system will yield different rules than a strong two party Presidential system. The institutions governing the political process are important. For instance, the rules and norms that govern the committee system in the U.S. Congress determine who has gatekeeping powers and can bring bills to the floor of Congress. The organizational structure of government is not destiny, as political actors will, if they are able, bargain towards outcomes that are mutually beneficial.

Figure 2: Determinants of Formal Institutions



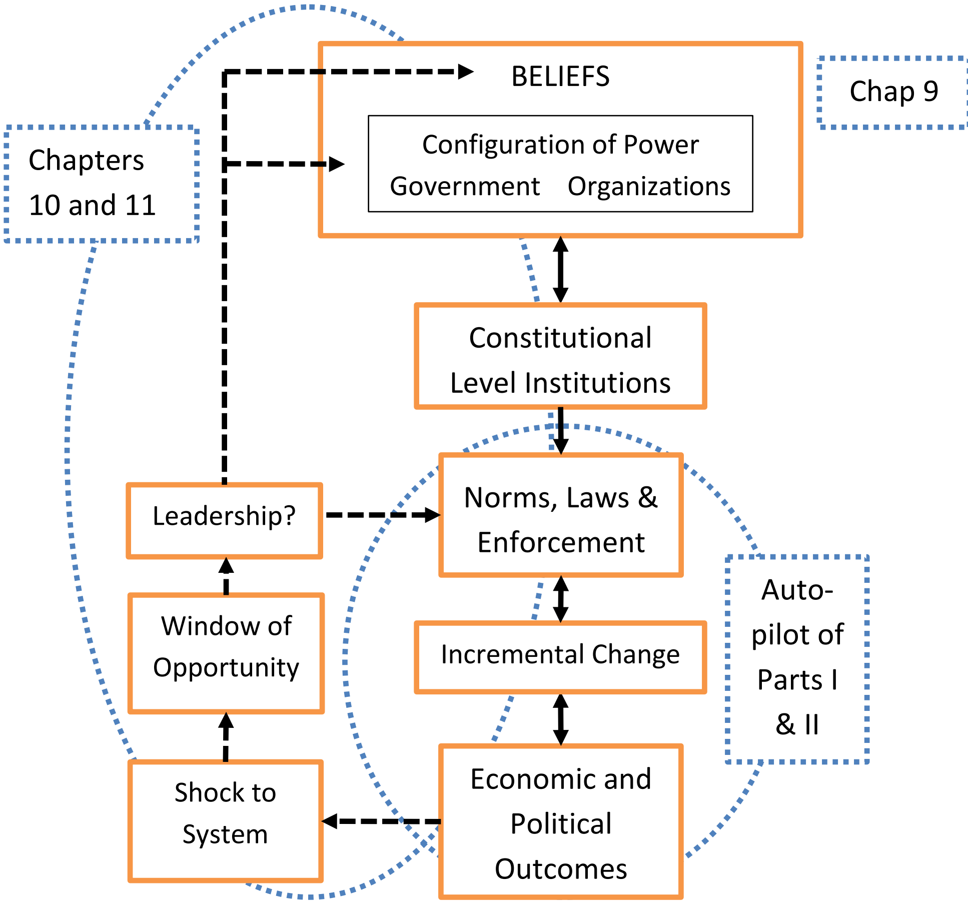
The judicial branch of government plays many different roles. It judges the constitutionality of laws, adjudicates disputes, and, in a common law system, creates law via precedent. The institutions governing the judicial system determine whether judges are independent of the executive and legislative branches, the powers of judges to make and interpret the law, and the incentives to bring cases to the legal system. For instance, it matters a great deal for the rule of law whether the courts that interpret the constitutionality of legislation are independent of the executive and legislative branches. If the courts are not independent, then the laws of society can change in ways that are not bound by higher-level constitutional rules. If courts are truly independent, the executive and legislative branches will enact legislation 'in the shadow' of the court, knowing that the court could overturn legislation it deems unconstitutional. The dismal political and economic history of Argentina since 1945 is a good example of the impact on economic performance from a Supreme Court that has not been independent (Alston and Gallo 2010).

The law is administered through bureaucracies. In the United States, federal agencies not only have the power to adjudicate and enforce the laws of Congress, but can also promulgate new rules. The bureaucracies consist of agents with their own interests, creating a principal-agent problem between the legislature and the agency. Employees within the bureaucracy have interests in how the rules are enforced and how the bureaucracy operates. In the United States, most employees of the Environmental Protection Agency (EPA) want to protect the environment, and, given the often vaguely worded laws they are charged to enforce, have great leeway in using their own judgment. Members of Congress, knowing this, may attempt to starve the EPA of resources, hoping to force the agency to prioritize its efforts and reduce its capabilities. Special interest groups also approach the bureaucracy directly, lobbying for changes in agency rules, adjudication, and enforcement.

In **Part III: Beliefs, Leadership, and Critical Transitions**, we turn from a model of incremental change to explore the dynamics of major political and economic transitions. We introduce four new concepts to understand both stasis and transitions: windows of opportunity, beliefs, leadership, and the configuration of power. In Figure 3 we map out the elements of this framework. At the top of Figure 3 are beliefs and the configuration of power, which we discuss in Chapter 9. The configuration of power includes government and other organizations that have the capability to shape and enforce formal institutions. Because of the plethora of organizations ‘at the table,’ our view of power is expansive; it includes all of the organizations that can influence the outcomes of the political process. It consists of both economic and political interests, though government plays an especially important role as coordinating activity under the umbrella of a constitution.

Governments coordinate and enforce rules under the shadow of a belief structure. Given a certain power structure, those in power choose institutions to best match their expectations of how institutions will affect outcomes. This is dependent on their set of beliefs. Following North (2005) we consider beliefs as the subjective view of actors of how the world works. For the purposes of tractability, we depart from North by taking a narrower definition of beliefs in order to understand the underlying determinants of the formal constitutions and laws of a society. In our framework, beliefs are the expected views of actors on how institutions will affect economic and political outcomes. When outcomes match expectations we will see marginal changes in laws and norms but societies are more or less on auto-pilot as depicted at the bottom of Figure 3 and in more detail in Parts I and II of the book.

Figure 3: Auto-Pilot and Critical Transitions



An exogenous or endogenous shock to the economic and political auto-pilot can open a window of opportunity for significant changes in underlying beliefs and institutions. A shock, indicated by the box at the bottom left of Figure 3, occurs when observed outcomes diverge dramatically from expected outcomes. The shock could be the threat of invasion by another country, an economic or natural disaster, or be the culmination of a long endogenous process that leads to a tipping point, e.g., the citizenry may take to the streets to protest against the current configuration of power or a “leader” can shape a latent window of window of opportunity. During such moments there is a role for leaders, who can take advantage of the shock to shape underlying beliefs and constitutional level institutions. However, in the event that leaders do not step forward to take advantage of these windows of opportunity, the moment can pass without any change in beliefs or fundamental institutions. In Chapter 10 we analyze “constitutional moments” as a specific example of a window of opportunity and the interplay among leadership, belief structures, and interests. At constitutional moments, the organizations revamp the rules under which political and economic organizations interact and contract. This process begins with the auto-pilot at the bottom of Figure 3, is instigated by a shock to the system that creates a window of opportunity, and is taken advantage of by leadership who shape beliefs and the configuration of power in such a way to generate constitutional change. As such, it can be thought of as a single loop beginning with the business as usual and ending with a constitutional level institutional change.

Deep changes in economic and political trajectories entail more than a single "constitutional moment" or critical juncture. Indeed they require reinforcing institutional changes to alter and solidify core beliefs. In Chapter 11 we will flush out the dynamics of the transition to a new trajectory. The institutional deepening requires multiple loops around the circuit to shape beliefs, the configuration of power, constitutional level institutions, and the supporting norms, laws, and organizations. The process ends in a "new auto pilot," in which beliefs are again in alignment with the outcomes of the economic and political systems.

An Annotated Overview of the Chapters

Part I: Institutions, Technology, and Organizations

Chapter 2: Institutions and Property Rights

We begin this chapter with institutions and how they affect property rights. Our discussion of institutions as the "humanly devised constraints that shape human interaction" builds on North (1990), Eggertsson (1990), Ostrom (2005), Alston (2008), and North, Wallis, and Weingast (2009). We define institutional statements – rules and norms – as one part of an institutional structure that also includes the organizations or individuals that enforce those statements and complementary institutions. Institutions define property rights, the specification and enforcement of which are fundamentally important for resource allocation. In a world of transaction costs, it is not a straightforward matter to rearrange property rights, so who has the rights will matter a great deal for resource allocation. This is the message of Coase (1960). Property rights also consist of informal rights determined by custom and culture. Informal property rights shape resource use and typically precede formal property rights. This chapter will discuss the incentives and rationales for private, common, state and open access property rights.

Property rights provide the incentives for people to enhance the value of resources by taking care of and investing in the asset. They also affect resource use because if people can sell/own an asset, resources will tend to end up in the hands of those who value it the most, provided capital markets work sufficiently well. In this chapter we will discuss examples of commons arrangements and the forces that sustained them. We will show that there is no necessary hierarchy of one set of rights trumping the other. Indeed, in most society's property rights are a mixture of formal and informal rights that together shape behavior. For the conceptual work, we will draw most heavily on Coase (1960), Barzel (1997), Demsetz (1967) and Ostrom (1990 and 2005).

This chapter has two case studies: 1) the determinants and impact of property rights in the Amazon (Alston, Libecap and Mueller 1999); and 3) property rights in commons arrangements with Cattlemen's associations as an example (Alston, Harris and Mueller (2012); Anderson and Hill (2004) and Dennen (1976)).

Chapter 3: Property Rights and Transaction Costs

This chapter begins by introducing the concept of economic property rights as the rights to use, consume, obtain income from, and alienate the attributes of resources. We distinguish between legal property rights, the "formal legally enacted laws supported by the states' power of violence and punishment" with economic property rights, which are additionally "supported by the force of etiquette, social custom, [and] ostracism" (Alchian, 1977, 129). We then turn to a description of transaction costs as the costs of "transfer, capture, and protection" of property rights. This definition of transaction costs includes any costs associated with organizing human activity, regardless of whether the activity occurs in hierarchies or the price mechanism. The link between property rights and transaction costs is developed using Alchian (1977), Allen (1991, 2000), Barzel (1989), Coase (1937, 1960), Cheung (1983), Demsetz (1967), Eggertsson (1990), Foss and Foss (2005), Kim and Mahoney (2005), Libecap (1989), Smith (2000) and Williamson (1985, 2006). Coase (1937) and Coase (1960) are the foundation of this analysis and are two sides of the same coin; Coase (1937) shows that if transaction costs are zero, the particular method of organizing production is irrelevant to economic efficiency, and Coase (1960) shows that if transaction costs are zero, the initial distribution or property rights is irrelevant to economic efficiency. The true lesson of the Coase theorem is that since transaction costs are generally not zero, the organization of economic activity and the distribution of economic property rights matter to economic efficiency. We will use a framework for classifying transaction costs and understanding the interaction between different transaction costs developed by Alston and Gillespie (1989).

The case studies for this chapter draw from agricultural contracting, including scattering in open fields (Smith 2000); U. S. slavery (Fogel and Engerman 1974; Fogel 1989), contracting in postbellum southern agriculture (Alston and Higgs 1982), the roles of culture and coercion on henequen haciendas in Meixco (Alston, Mattiace, and Nonnenmacher (2009) and Mattiace and Nonnenmacher (2013)).

Chapter 4: Contractual Choice

This chapter focuses on how transaction costs shape contracts within firms, between firms and between individuals and firms. We treat the "price mechanism" and "hierarchies" as the end points on a spectrum of contractual choices and provide a theoretical justification for and examples of different intermediary forms, such as long term contracts, holding companies, joint ventures, and franchising. The conceptual literature will build on the material from Chapters 2 and 3, beginning with Coase (1937), and will use some of the classics of the literature, such as Alchian and Demsetz (1972), Grossman and Hart (1986) Milgrom and Roberts (1990), and Williamson (1975, 1985). We will compare traditional neoclassical explanations for vertical integration with those from the NIE. This literature is vast and we will focus on a few core concepts –agency, bargaining, coordination, enforcement, and information costs – and their applications.

This chapter has two case studies: 1) the integration of Fisher body into General Motors (Coase (1991, 2000), Klein (1988, 2000, 2007), Klein, Crawford, and Alchian (1978), Roider (2006) and 2) the use of franchising in fast food (Kaufmann and Lafontaine (1994) and Kalnins and Lafontaine (2004)).

Part II: Government and Formal Institutions.

Chapter 5: Special Interests and Citizens

In this chapter we discuss the role of special interests and citizens in determining policies. We will draw on Olson (1965) for the notion of special interest lobbying resulting from concentrated benefits and dispersed costs. The special interest theory of regulation is developed in Stigler (1971), Peltzman (1976), Becker (1983), Mitchell and Munger (1991) and Grossman and Helpman (2001). For the role of citizens we will draw on Denzau and Munger (1986) and Alston, Libecap and Mueller (under review). Denzau and Munger argue that citizens are represented indirectly through competition across politicians. In short, if politicians stray too far from the interests of their constituents, other politicians will compete against them and bring the information to the electoral campaign. Alston, Libecap and Mueller argue that some special interests manipulate the information flows to citizens who either put pressure on politicians directly or indirectly in the Denzau/Munger scenario.

For case studies on special interests, we will draw on Alston's (1984) analysis of farm foreclosure moratorium legislation and Libecap's (1992) work on the origins of meat inspection and antitrust. We will compare Libecap with Olmstead and Rhode (2004, 2005, 2007), which provides an analysis of state and federal regulation of bovine tuberculosis. For the role of citizens influencing policy we will discuss the case of the Landless Peasants Movement in Brazil in Alston, Libecap, and Mueller (under review).

Chapter 6: The Legislature and Executive

A given set of demands from citizens and special interest groups will get filtered through a formal legislative and executive process. To be successful governments need a coordinating mechanism. For the concepts at play we rely on the work of Shepsle and Weingast (1981, 1987); Cox (1987); and Cox and McCubbins (1993). The message is that different governance institutions will yield different outcomes. We will discuss several: a strong two party system within a parliamentary system (Cox 1987); a strong party system within a Presidential system (Cox and McCubbins 1993); a strong committee system within a Presidential system (Shepsle and Weingast 1987); and Presidential system with strong Presidential powers (Alston and Mueller 2006).

For case studies we will rely on: the pivotal role of committees by Shepsle 1978; and Shepsle and Weingast 1987; and the use of strong Presidential powers in Alston and Mueller 2006.

Chapter 7: The Judiciary

One of the foundational insights of New Institutional Economics, derived from the Coase Theorem (Coase, 1960), is that if transaction costs are negligible and property rights are secure and well-defined, then the economy will automatically reach an efficient allocation and organization, independent of the form taken by property rights. This means that as long as the laws are clear and secure the content of the law does not have any impact on efficiency. One thing that this insight highlights is the fact that given that transaction costs are always present and property rights are never unambiguous, the content of the law is tremendously consequential. This central insight has spawned several lines of inquiry that seek to assess and measure the impact of the law and property rights on economic performance, including but not limited to the literatures on Law and Economics, Property Rights, Legal Origins, Law and Finance, and Regulation.

Given the central importance of the law it is necessary to understand the processes through which it arises and evolves, as well as the impacts it has on economic activity and performance. In this chapter we focus on the role of the Judiciary on creating, interpreting and enforcing the law, and the impact this has on economic performance. This includes issues of judicial independence and separation of powers, theories of judicial behavior, and the incentives and outcomes due to different legal forms and types of judicial organization.

For case studies we will use: 1) Alston and Gallo (2010) on the impeachment under Peron and the aftermath of policy instability and economic decline; 2) in the midst of the Great Depression President Roosevelt attempted to “stack” the Supreme Court and there was a public outcry (citation yet to be determined). In both episodes beliefs played a pivotal role.

Chapter 8: Bureaucracies and Regulation

Once the demand for laws and policies have been filtered through the political system and a specific set of laws and policies have been decided by the supply side of government, there is still an important additional step during which their actual form and content can be significantly influenced. The laws and policies have to be implemented, managed and enforced. This is done by bureaucracies and a varied spectrum of agencies and other governmental organizations. Much of the literature simply assumes that the laws and policies will be faithfully implemented by agents according to the original intent of the legislators and politicians. More realistically, however, bureaucrats and regulators will have more information and greater specialization than the principals, so that they can exploit the information advantage to shape outcomes according to their own preferences. The extent to which they can do so depends on the way institutions shape and constrain the form this implementation and enforcement can take. The politicians who delegate the task of executing the policies are aware of this shirking and try to mitigate their losses by designing the structure and process of the bureaucracies and agencies so as to constrain the opportunistic behavior. Their success in doing so varies greatly from case to case and depend the nature of the policies, of the agents and naturally of the country's institutions. In some cases the agents will be essentially free to pursue their own interest (James Q. Wilson,1989); while in others the principals will have complete control over the agents (Weingast and Moran, 1983); with a gamut of intermediary possibilities in between. The NIE thus provides a set of instruments that help explain the *de facto* form and content of policies as well as their impact on performance.

For case studies: 1) Weingast and Moran (1983) on the FTC; 2) Levy and Spiller (1994) on Regulatory Commitment.

Part III: Beliefs, Leadership, and Critical Transitions

Chapter 9: Beliefs and the Configuration of Power

Governments are one actor, and, indeed the most important actor amongst organizations who have power to shape formal institutions. Our view of government departs from the notion that governments exist because they have a comparative advantage in violence to recognizing that governments facilitate cooperation, in part to prevent violence (Wallis and North 2014). The organizations in power, with the government being the focal player, establish institutions under the shadow of a belief structure. We argue that those in power choose institutions to best match their expectations of how formal institutions will affect outcomes. This is dependent on their set of beliefs. We will build on North (2005); Greif (2006); Eggertsson (2005); Schofield (2006) and Alston, Melo, Mueller and Pereira (forthcoming 2014). We will present two case studies: 1) the case of Iceland trapped in a set of beliefs that yielded institutions inconsistent with development (Eggertsson 2005); and 2) the current ongoing transition in Brazil (Alston, Melo, Mueller and Pereira (forthcoming) in which a belief in fiscally sound social inclusion drives the choice of institutions many of which have outcomes that yield a good deal of dissipation.

Chapter 10: Windows of Opportunity and Constitutional Moments

Most societies are locked into a dynamic which we call auto-pilot: those in power make marginal changes to institutions because the outcomes match their expectations which include rents to those in power. This is the major reason why so few countries ever transition to more open economic and political systems. But, there are moments, when outcomes differ dramatically from expectations. This creates a window of opportunity for big changes in institutions via a change in beliefs. When economic or political outcomes differ greatly from expectations, beliefs become malleable and this provides an opportunity for leadership to begin a transition to a new trajectory. By leadership we mean that a person plays the role of recognizing the problem or dilemma to be solved and coordinating action. For the concepts of windows of opportunity and leadership we draw most heavily on Alston, Melo, Mueller and Pereira (2014) but also Eggertsson (2005); Greif (2006) and Schofield (2006).

A window of opportunity entails a process of iterative changes that we discuss in detail in Chapter 11 but many of windows of opportunity result in countries either writing new constitutions; dramatically amending a constitution (e.g. the amendment to abolish slavery in the U.S.); or drafting significant laws (e.g. the back to back Civil Rights and Voting Rights Acts in the U.S.) Because Constitutional changes are qualitatively different from "business as usual," we highlight the views of constitutional economics (Buchanan and Tullock 1962, Brennan and Buchanan 1980, and others). The spirit of the Buchanan et al. literature is that there is a big difference between constitutional rules and choices, versus "operational choices" or laws. For constitutional choices, if the framers are behind a veil of ignorance or uncertainty, nonpartisan behavior would dominate, whereas once the rules are in place partisan behavior would dominate. Of course no framers are ever under a veil of ignorance so a mix of partisan and non-partisan behavior is likely at play. An analogy would be from sports. The designers of a game make the rules for the game, but once the game commences, the players do all that they can to win for their team. When making the constitution they are forming a league of teams consisting of rules for all. A league composed of people willing to agree to the rules is a definition of government. Because direct democracies are costly, we tend to see representative governments dominate. Constitutions lay out the underlying way a society will be governed, e.g. terms of office, bi-cameral or uni-cameral, presidential or parliamentary. Constitutions also spell out what governments cannot do. The citizens have a set of rights or personal freedoms.

Because the framers of constitutions are never completely disinterested participants, they have an objective function consisting of their personal beliefs (e.g. favoring a strong or weak central government) as well as their personal interests (e.g. are they in finance or farming). For the constitutional framing process we draw heavily on McGuire (2003). Most constitutions also need to be ratified so the framers of constitutions need to consider the personal interests and beliefs of those downstream who will potentially ratify the constitution.

Because a constitutional assembly is a collective, leadership matters and the beliefs of leaders play an especially important role. Leadership is composed of three elements: cognition, coordination, and moral authority. A leader must recognize clearly what she is trying to accomplish, e.g. a strong central government for national defense (cognition). A leader must be able to coordinate others such that they agree to the leader's belief about the rules. This in turn may entail considerable compromises as well as persuasion. Lastly, leadership will be more effective if the "leader" has moral authority. Most likely several members of the constituent assembly will have illustrious histories as war heroes or spent time in prison. For this section we will draw on Alston, Melo, Mueller and Pereira (forthcoming); Greif (2006); Riker (1996); and Schofield (2006).

We will present two case studies: 1) the importance of personal interests versus beliefs (ideologies) in the passage of the U.S. Constitution. McGuire (2003) has the definitive account of the voting; and 2) Different clauses in Constitutions may lead to different economic and political outcomes. We will draw on the results from testing the data contained in the "Comparative Constitutional Project" (Elkins and Ginsburg). The most recent survey is Voigt (2011).

Chapter 11: Dynamics of Economic and Political Outcomes

This chapter covers one of the most enduring questions in economics: what explains the great variability in economic growth and performance across countries? Even today only a small number of countries have reached high levels of economic performance and prosperity, while most have experienced at best unsustainable bouts of growth mired in great volatility over time, in patterns that have not led to the convergence of incomes and standards of living to the level of the developed countries. Since Adam Smith's "The Wealth of Nations" there have emerged a great variety of theories and approaches that try to explain these issues. New Institutional Economics has sought to answer this question by emphasizing the role of institutions as the fundamental determinant of economic growth and prosperity, with roots in Douglas North's early work in economic history (North and Davis, 1971; North and Thomas, 1973). In the last 15 years this institution-centered approach to understanding development has been embraced by the mainstream of the economics profession and is now received wisdom. This conversion started perhaps with the seminal paper by Engerman and Sokolof (1997), but really took off with Acemoglu, Johnson and Robinson (2001). Attempts to build indices that capture some aspect of institutions for use in cross-country regressions, as well as clever strategies to control for simultaneity of growth and institutions, have proliferated to the point of exhaustion. Almost invariably the results confirm the primacy of institutions as the main underlying determinant of prosperity, as opposed to alternative hypotheses, such as geography, culture, good rulers or policies. Rather than focusing on this cross-country regression literature we will base this chapter instead on two important recent frameworks that attempt to explain the broad dynamics through which economic and political institutions interact and impact economic and political outcomes (North, Wallis and Weingast, 2009; Alston, Melo, Mueller and Pereira, forthcoming). One case study will be on the development of Brazil, a country that appears to be successfully moving towards higher levels of development (Alston, Melo, Mueller and Pereira, forthcoming). The other will address how and why the U.S. managed to make that transition in the 19th century (North, Wallis and Weingast, 2009).

Chapter 12: Concluding Remarks: Insights from the NIE for Business, Law and Public Policy

In our concluding chapter we will offer some insights of the NIE for Business Strategy, Law and Public Policy. This section will need further reflection before we can be precise but we will take a general insight and illustrate it with an example or two. The overarching motivation is that economic activity gets organized in many different ways: in hierarchies, in the price mechanism, and in lots of hybrids in between. The impact on the performance of countries, firms and individuals of all these ways of organizing economic activity depends on the *de jure* and *de facto* rules of the game that underlie their choices and interactions. How those rules are generated and the effects of those rules -- be it at the constitutional, regulatory, or micro level -- can be studied using the concepts of the NIE.

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