PART III

The Dynamics of Economic and Political Development

In Parts I and II of this book, we covered the core of Institutional and Organizational Analysis (IOA). The concepts presented and demonstrated through a series of examples and discussion cover much of the state of the literature. This toolkit has been tremendously successful in helping researchers, policymakers, and others to better understand how economies and societies function and evolve. What was once a relatively obscure field just a couple of decades ago, largely absent from the main journals and departments, has by now been fully absorbed into mainstream Economics and Law, to the point that concepts like property rights and transaction costs are now used with familiarity as if they had always been part of the orthodoxy. Today, no scholars write about economic growth and development without institutions being a central part of the argument. A reader of the book might therefore feel that the whole story has been told and be tempted to stop reading at this point. Similarly, in political science, the concepts—institutions, norms, property rights, and transaction costs—are used to explain political performance from special interest groups to executive-legislative relations and bureaucracies.

The literature has now moved beyond the core concepts presented so far and has taken up the roles of culture, core beliefs, and leadership as determinants of the economic and political divergence across nations. The studies suggest that comparatively beneficial institutions and norms are important determinants of economic outcomes for societies. Unlike earlier studies that focus on the incentives of the dominant network in general, our framework defines the role of a
leader in coordinating new core beliefs among the dominant network in the face of a shock that makes core beliefs malleable and fundamental institutional changes possible.

In Part I, we presented the main concepts and definitions. We took institutions as fixed, and showed how they impact economic performance. In Part II, we explored how societies create the formal institutions that condition economic and political performance, given a fixed set of higher-level “constitutional” rules-for-making-rules. But, if institutions are the key for better economic performance and institutions are “humanly devised” so that they are a choice variable, then why do societies not simply choose the best institutions and assure optimal economic and political performance?\(^1\) That they do not do so is most clearly seen by comparing economic performance across countries and over time. In 1800, the richest nations in the world were about four times richer than the poorest in terms of GDP per capita. Today, the richest is more than 200 times better off than the poorest. This is a staggering difference that emerged in a relatively short period of history. This great divergence has led to the formation of a small group of about 40 rich and developed nations at the top and a large group of undeveloped or emerging economies at the bottom.

While the shape of this distribution might not seem unnatural, its enduring stability presents a puzzle. There are good reasons in economic theory for predicting convergence of the poor countries over time with those at the top. The scarcity of capital in the poor countries, together with the greater presence of unrealized investment opportunities, should make capital investment in less-developed countries more profitable. Capital should flow to poorer countries where it would finance investment, which in turn would foster greater economic growth, closing

\(^1\) We focus on institutions rather than norms as well because norms are less of a choice variable for those in the dominant network of power.
the gap to the set of richer countries. This dynamic predicted by the theory, however, has not
played out. Alternatively, because labor receives a higher rate of return in richer than poorer
countries, labor should migrate out until the marginal productivity of labor is equal across
countries. Clearly, more labor would migrate, but countries have erected barriers to entry.
Overall, empirical tests fail to uncover evidence of convergence across countries, though some
countries have increased growth dramatically, for example, China. In addition, global income
inequality has reduced while increasing within many of the advanced richer countries. Yet,
overall, very few nations have managed to make the transition from the group of poor to the
group of rich countries in the past century. Most of today’s developed nations reached that status
back in the nineteenth century, and since then only a handful of countries have managed to break
free and join them there, for example, South Korea and Chile stand out as stars in the last 50
years. The remaining great majority of countries has trod along over time with periods of booms
and busts that brought some improvement over time, but not enough to make that transition. This
pattern suggests that it is not simply a matter of time until technological progress and
improvements in human knowledge will raise all boats.

This state of affairs has led to an intense debate in the last two to three decades to find the
fundamental cause of long-term development and prosperity. Whereas proximate causes such as
technology, capital accumulation, human capital, and social capital are clearly important parts of
the development process, the debate focused on the fundamental causes that could explain why
these proximate causes, and ultimately prosperity, failed to materialize in most cases. The top
contenders for the Holy Grail of explanations included primarily geography and institutions. For
a period, it seemed as if the debate was settled by “Institutions Rule.” While this development has greatly improved the literature and our understanding of the world relative to the previous ahistorical and institutionally poor approach, in many cases the incorporation of institutions has been done in too simplistic and naïve ways. McCloskey (2016: chap. 15) depreciatingly calls this the “add institutions and stir” view. That is, although the recognition that institutions are an essential part of the story has been an important improvement, it is not enough to simply take institutions as given or assume that they will emerge as “good” or “bad,” “inclusive” or “extractive,” “adaptively efficient” or “inefficient,” and thereafter recommend how they must be changed or not. In short, as we elaborate in Chapter 8, institutional change will always be highly contextual.

Instead, it is important to understand the complex process through which institutions arise and change over time. The inability of most countries to bring prosperity to their citizens over time, despite the example of other countries that have shown how this can be done, suggests that it is not as simple as choosing the “right” institutions. The prevalence across the world of institutional choice that systematically fails to produce growth and development and yet persists over time is something that needs to be explained. This is an area where there has been much less work in IOA, and where much remains to be done. It is the theme of Part III of this book. In Chapter 8, we present a framework that tries to capture the complex process through which countries choose institutions and how institutions may deepen over time. A change in core beliefs is at the heart of deep institutional change, and our analysis focuses on how this institutional change depends greatly on the core beliefs of those in society with the power to

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2 See the heavily cited article by Rodrik, Subramanian, and Trebbi (2009) with the title “Institutions Rule: The Primacy of Institutions over Geography and Integration in Economic Development.”
change fundamental institutions. Changes in core beliefs emerge as a result of shocks to societies, which may be a tipping point as well. Because of competition during a shock over what to do, there are competing beliefs. At times, leadership emerges as a key factor in changing the core beliefs in societies. We wed the concepts of beliefs, power, shocks, and leadership into a framework. In Chapter 9, we provide several historical examples utilizing the framework to explain changes in economic and political development.

A common explanation for the persistence of institutions that do not lead to growth and prosperity is the standard political economy story of the dominant network blocking reforms that would increase social welfare as a whole at the expense of their own share and permanence in power. This class of explanation is often an accurate description of much of the failure of countries to grow and improve the lives of their citizens. Nevertheless, there remain several unanswered questions. Not all cases of failed development can be accounted by those in power blocking wealth or democratic-enhancing institutional changes. Some societies still choose arrangements that do not produce prosperity or more political inclusion. Even when there are distributive issues, why are intertemporal political exchanges or side-payments to enable change not more common? Even though political transaction costs are typically high, the potential gains of exchange are arguably so large that we would expect this type of bargaining to be more common than it appears to be.

Another institutional explanation argues that the pattern of persistent inequality across nations may result not from a lack of economic growth on the part of poorer countries, but from

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3 Core beliefs differ from behavioral beliefs in a fundamentally important way. Behavioral beliefs are akin to what we described in Chapter 1 as norms of behavior. They are very stable because people act on their behavioral belief that others will act in the same way. Core beliefs are more fundamental beliefs about how the world works. We elaborate in Chapter 8.
the inability of these countries to avoid periods of economic stagnation or decline (Broadberry and Wallis, 2016). This explanation for the divergence of countries’ economic performance over time is consistent with the benefits of voluntary exchange; all countries can be expected to experience the economic growth that results from the tendency of people to engage in specialization and productive exchange. However, some countries’ choice of institutions enables the dominant network to better coordinate in the face of exogenous shocks such as natural disasters, regional geopolitical conflicts, or price volatility of commodities. For many countries, their set of institutions does not provide a viable framework within which members of the dominant network can credibly commit to costly responses to the shocks. In such nations, responses sufficient to continue economic activity at increasing levels are less likely, which creates a higher likelihood of persistent periods of economic stagnation and decline. Broadberry and Wallis dub this explanation “shrink theory,” and its focus on the benefits to the dominant network of coordination complements our focus on the role of leadership in coordinating the beliefs of the dominant network.

In Part III, we cover an approach to these issues that focuses on the underpinnings of the choice of institutions by social actors. Although formal institutions are a choice variable for those in power, the world is complex and uncertain, so that the choice is not a standard optimization problem where one considers the different payoffs in each state of the world together with probabilities and the dominant network goes with the maximizing option. The uncertainty and non-ergodicity of the world means that past experiences and the examples of others provide an imperfect basis on which to make choices for the future. In the absence of clear guides on how to choose the institutions that will induce the desired types of outcomes, those in
power must rely on *something else* that will provide a vision of what is possible and how it can be achieved.

The *something else* are core beliefs and how they shape institutional change. When making choices under uncertainty and non-ergodicity, beliefs provide a lens that fills in the blanks, indicates where to look, filters what does and does not matter, providing guidance, heuristics, and rules of thumbs. The guidance is often very poor and does not necessarily lead to growth and prosperity. There is usually no force pushing for the prevalence of a single “superior” belief, as one might perhaps expect. Instead, beliefs are highly diversified and persistent across societies. Although beliefs change, the evidence is that there is no guaranteed improvement over time. On the contrary, the most common outcome across countries has been poor economic and social performance.\(^4\)

In Chapter 8, we present a framework of: (1) how core beliefs affect outcomes (through the choice of institutions); (2) when core beliefs change (when expected outcomes fail to materialize, creating a shock to existing beliefs and a window of opportunity); (3) who initiates changes in core beliefs (possibly a leader and then a dominant network); (4) who shares the core belief at each stage (first the dominant network who makes the institutions and subsequently most of the rest of society); and (5) how core beliefs take root and change (through subsequent institutional deepening and as outcomes confirm expectation).

While it might seem obvious that core beliefs have an impact on institutions and economic performance, most of the literature, even in institutional and organizational analysis has proceeded as if those impacts are relatively unimportant for most issues and

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\(^4\) The likely explanation for the relative stasis in developmental trajectories is the standard political economy explanation. We are interested in explaining the outliers: those countries that do change their developmental trajectories dramatically, either for the better or worse.
be dismissed through the logic of Occam’s razor, that is, the simplest theory or explanation should prevail. The view is apparent in the reaction to Douglass North’s (2005) book, *Understanding the Process of Economic Change*, published fifteen years after his acclaimed and pathbreaking *Institutions, Institutional Change, and Economic Performance* (1990). While the expectation was that the new book would follow the previous one by reiterating and further developing the importance of institutions for economic performance, North produced a treatise on the importance of beliefs, mental models, non-ergodic worlds, adaptive efficiency, and an emphasis on cognition. The anticipation of confirmation of already-accepted ideas was met instead with unfamiliar statements such as: “the way we perceive the world and construct our explanations about the world requires that we delve into how the mind and brain work—the subject matter of cognitive science” (North, 2005: 5). Apparently, the profession was not prepared for such a sharp epistemological shift, and the book had very little impact relative to expectation. North’s subsequent book, *Violence and Social Orders* (2009, with John Wallis and Barry Weingast), though excellent and pathbreaking in its own way, contained very little on beliefs, and had, accordingly, a much better reception and greater impact on the literature.

Evidence of the growing recognition of the importance of culture and beliefs to understand economic performance is a recent surge in papers that seek to explicitly model and test the coevolution of institutions and culture, that is, the two-way causal interaction of these variables. A recent survey by Alesina and Giuliano (2015) covers more than 200 (mostly recent) academic papers that deal directly with the two-way interaction of culture and institutions. These studies indicate that institutions are conditional on cultural beliefs and have consequences for outcomes. Pareto-inferior outcomes often arise and persist. Those institutions and outcomes can
then have feedbacks, which influence culture and beliefs. These studies have an important
corollary implication for studies of the relationship between institutions and economic
development: institutions can be a function of culture just as culture and other society-level
outcomes can be greatly influenced by institutions. This suggests that those with the power to
shape culture can shape institutions, either directly or indirectly, and will do so to the extent that
such institutional change is perceived to be in their interest.

Though we agree that culture is fundamentally important, we will stick to beliefs as the
determining variable for institutional change for several reasons: culture is more resistant to
change and much more nuanced than beliefs; culture is also less resistant to exogenous changes
by those in power; and culture is much broader than a single cultural belief, and it is the
interaction across the factors that determines culture that may determine core beliefs. This is not
to dismiss culture as unimportant. We see culture as clearly a determinant of social order and in
many ways will likely shape the beliefs of the dominant network as well as the long-standing
norms in a society. But for now, the transmission mechanism remains a bit of a black box.

A recent example of the important interaction of culture and beliefs (or ideas) for
understanding the impact of institutions on outcomes is McCloskey’s monumental trilogy on
objective of the trilogy is to explain the timing, location, and process of the great divergence
through which a small group of countries managed to attain sustained economic growth and
prosperity. For McCloskey, the key factor that unleashed the mass flourishing was the rise of an
idea that increased the dignity with which society viewed commerce and economic activity. The
disdain that commercial pursuits historically elicited had the effect of a dishonor tax imposed by
society (Boudreaux, 2014). As all taxes, it discouraged those activities and investments in human capital and innovation. The basic argument of McCloskey’s trilogy is that the repeal of this dishonor tax by the bourgeois allowed, for the first time, the common man to “have a go,” thus unleashing the waves of discoveries and innovations that underpinned the industrial revolution and the great divergence. However, the importance of attitudes to the institutions that can reflect them also played a role. As the dishonor tax diminished, and innovative entrepreneurial activity filled the gap, this led to a corresponding demand for institutions that better facilitated economic exchange. Thus, beliefs that facilitate economic and institutional change can have significant positive feedback effects: to the extent that the beneficial institutional changes wrought bring greater societal prosperity, then these institutional changes can themselves reinforce the changing attitudes in society toward economic activity.

Mokyr (2017) also stresses beliefs and their interplay with institutions as an explanation of why the Industrial Revolution and the remarkable resulting take-off in human prosperity happened in Europe in the eighteenth and nineteenth centuries instead of other places that had been well ahead in the process at different times in history (such as Song dynasty in China: 960 to 1279). The proximate driver of that growth and prosperity was technological and scientific innovation, but the focus of Mokyr’s analysis are the beliefs that underpinned the development of that knowledge and understanding along with the enabling institutions. In short, it was the increasing acceptance in the Enlightenment: that man can change the world around him that led to innovation and prosperity.

Mokyr stresses the “market for ideas” in sixteenth- and seventeenth-century Europe. The first element of this market for ideas involves the rise of a belief that material progress is not

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5 The metaphor of a dishonor tax was suggested by Boudreaux (2014) in a debate of McCloskey’s theses.
only possible, but also desirable. What provided such an environment in Europe and had been missing in many of the other failed take-offs, was political fragmentation across nations and city-states, and a Republic of Letters linking a large network of thinkers, inventors, and practitioners. Together, these two elements created an environment of competition that fostered the production of useful knowledge, that is, not knowledge for the sake of knowledge, or to glorify God, but rather knowledge of how to understand and control nature so as to benefit mankind. The political fragmentation allowed the innovators and producers of new ideas to evade the repression from those in power that tried to suppress their creativity and diffusion. This period experienced an intense circulation of thinkers and innovators who were sometimes persecuted at home but well received abroad. The result of the market for ideas was the dominance of the belief in useful knowledge that laid the foundation for the institutions that ultimately underpinned the Industrial Revolution and the subsequent unprecedented economic growth. Mokyr’s explanation also displays the importance of institutional choice on the part of the dominant network within a given country. The political fragmentation in Europe meant a comparative diversity of institutional sets within which particular inventors could experience greater or lower levels of reward or repression. A greater diversity of institutional sets, within which comparatively beneficial ones emerged, provides an important blueprint for dominant networks when considering institutional change.

Those with the power to influence core beliefs also have the power and incentive to change institutions, and these changes can have significant positive feedback effects when the changes lead to greater economic and political development for society. Moreover, the divergence of economic and political development across countries now provides a blueprint from which the dominant network in society can consider changes to their own institutional set.
But if the blueprint for a set of wealth-enhancing institutions exists, why the divergence in development outcomes around the world? The persistence of institutions that do not improve economic or political performance has an additional implication for our analysis: institutional change is costly, and marginal change does not typically result in superior outcomes. Therefore, if beliefs, norms, and institutions are sticky, it may take a shock before the costs of institutional change are outweighed by the benefits.

We see these studies of beliefs as complementary to studies that unpack the role of the more common political economy explanations in determining institutional change, and hence, economic development. North, Wallis, and Weingast (2009) as well as Wallis (2016) have an explicit focus on the incentives and beliefs of the dominant network in society. By definition, this dominant network, unlike the majority of society, has the power to influence or determine institutional change across society. This is the closest literature from which the explicit role of core beliefs or mental models takes off. In the next two chapters, we follow in the footsteps of Eggertsson (2005), Greif (2006), North (2005), and Schofield (2006).

The role of a dominant network in orchestrating institutional change requires an interest-consistent explanation about why the new institutions provide expected benefits over the status quo. Given the wealth, power, and impunity of many dominant networks around the world, this isn’t a clearly warranted assumption. At a minimum, diminishing marginal returns would suggest that even if the dominant network captures a lion’s share of the benefits from additional economic development, the benefit alone might not be sufficient to overcome the losses associated with an acquiescence to the rule of law and accountability before an independent and impartial judiciary, or the competitive losses associated with liberalizing access to private and
public associational forms like political parties and corporations (North, Wallis, and Weingast, 2009).

We agree with Wallis (2017) that the majority of fundamental institutional changes must be expected to benefit the dominant network. Where Wallis focuses on the benefits of commitment credibility secured through increases in the rule of law, and coordination in the face of unanticipated shocks, our analysis considers the effect of these shocks on the rent streams of the dominant network, and how these shocks create an opportunity for change in the fundamental institutions of society. Our framework further adds to the literature by focusing on changes to constitutional-level rule sets and beliefs in society in particular, as opposed to the marginal institutional change that can be expected from ordinary operation of political systems around the world. In many instances the expected impact from institutional change is fuzzy and fraught with uncertainty. In these instances leadership can be decisive in bringing about a change in beliefs that will promote change. Moreover, not all leaders are self-interested in the standard narrow economic definition. Some leaders are playing for the history books and want to do the right thing.

We break with the traditional characterization of the dominant network as the sole decision maker and develop an explanation for the role of leadership within this dominant network in coordinating a transition to a new core belief enabling institutional change. We develop this perspective on the role of a leader in the next chapter through a specific framework that describes how beliefs that affect the choice of institutions arise and change over time. Fundamental institutional change entails an iterative process of institutional deepening and is self-reinforcing in terms of core beliefs as long as outcomes match expectations. Our framework is useful to understand the process of development in the modern world and indeed is also useful
for understanding development in the Ancient World. We illustrate the usefulness of our framework in Chapter 9 to analyze the case of four specific countries. The four cases include: (1) United States, 1783–1789: Transitioning from “States Rule” to the United States of America; (2) Argentina, 1912–1955: Budding Belief in Checks and Balances to Populism; (3) Brazil, 1985–2014: Belief in Social Inclusion to Fiscally Sound Social Inclusion; and (4) Ecuador, 1998–2016: From a Neoliberal Belief to a Belief in Inclusive Politics.


