



## Understanding the New Economic Institutionalism in an Era of Global Interdependence

فهم المؤسساتية الاقتصادية الجديدة في عصر الاعتماد المتبادل العالمي

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### Abstract

New institutionalism emerged in the 1980s as a counter to the narrow individualistic viewpoints that ruled political science, economics, and sociology. Both behavioralists and traditional neo-classical economics saw collective political and economic activity as the whole outcome of individual choices, and saw institutions as epiphenomenal, just the accumulation of individual-level traits. Utilizing a rich historical background, contemporary institutionalists employ institutionalist techniques to elucidate significant macro-level occurrences and enduring secular advancements. They contend that customs, standards, and habits—some of which are arbitrary and artificial—form human interaction. This paper focuses on modern economic institutionalism, however, all current institutionalist variants may be traced back to earlier institutionalist forms that date back at least to the seventeenth century. The impact of institutions on group activities as well as individual behavior has long been studied. Here is what is left of this paper. It begins by examining how earlier generations of institutionalists, or classical political economists, supplied the necessary framework to resolve the underdevelopment paradox. It explores how the ancestors of the new economic institutionalism created new worlds where none had existed



before and established the foundation for capitalism, liberalism, and secular authority, even though absolutism, chaos, rule, and illiberalism were the only games in town. This paper argues that by crafting a more basic yet creative definition of the question of where development begins, they gave the next generation of institutionalists a fruitful research goal. After that, the focus turns to the new economic institutionalists and how they apply the study of economics and politics to provide exact, verifiable hypotheses about the causes of progress, liberalism, and order as well as how this equilibrium is preserved. This paper concludes with the following question: Despite a general awareness of the institutions that foster progress, how can we explain a society in which a significant number of the practical problems that classical political economists recognized decades ago remain?

**Keywords:** Institutions, New Economic Institutionalism, Institutionalists, Development, Underdevelopment, Political Economy.

### الملخص

ظهرت المؤسساتية الجديدة في الثمانينيات كمعارضة لوجهات النظر الفردية الضيقة التي حكمت العلوم السياسية والاقتصاد وعلم الاجتماع. رأى كل من السلوكيين والاقتصاد الكلاسيكي الجديد التقليدي أن النشاط السياسي والاقتصادي الجماعي هو النتيجة الكاملة للاختيارات الفردية، واعتبروا المؤسسات مجرد ظاهرة ثانوية، مجرد تراكم للسمات على المستوى الفردي. باستخدام خلفية تاريخية غنية، يستخدم المؤسسيون المعاصرون تقنيات مؤسسية لتوضيح الأحداث الهامة على المستوى الكلي والتقدم العلماني الدائم. وهم يؤكدون أن العادات والمعايير والعادات - وبعضها تعسفي ومصطنع - تشكل التفاعل البشري. تركز هذه الورقة على المؤسسات الاقتصادية الحديثة، ومع ذلك، يمكن إرجاع جميع المتغيرات المؤسسية الحالية إلى أشكال مؤسسية سابقة يعود تاريخها إلى القرن السابع عشر على الأقل. لقد تمت دراسة تأثير المؤسسات على الأنشطة الجماعية وكذلك السلوك الفردي منذ فترة طويلة. وهنا ما تبقى من هذه الورقة. ويبدأ بدراسة كيف قامت الأجيال السابقة من المؤسسيين، أو الاقتصاديين السياسيين الكلاسيكيين،



بتوفير الإطار اللازم لحل مفارقة التخلف. وهو يستكشف كيف خلق أسلاف المؤسساتية الاقتصادية الجديدة عوامل جديدة لم تكن موجودة من قبل، وأنشأوا الأساس للرأسمالية والليبرالية والسلطة العلمانية، على الرغم من أن الاستبداد والفوضى والحكم وعدم الليبرالية كانت الألعاب الوحيدة في المدينة. تجادل هذه الورقة بأنه من خلال صياغة تعريف أكثر أساسية وإبداعاً لمسألة أين تبدأ التنمية، فقد أعطوا الجيل القادم من المؤسساتيين هدفاً بحثياً مثيراً. بعد ذلك، يتحول التركيز إلى المؤسسيين الاقتصاديين الجدد وكيفية تطبيقهم لدراسة الاقتصاد والسياسة لتقديم فرضيات دقيقة وقابلة للتحقق حول أسباب التقدم والليبرالية والنظام وكذلك كيفية الحفاظ على هذا التوازن. ويختتم هذا البحث بالسؤال التالي: على الرغم من الوعي العام بالمؤسسات التي تعزز التقدم، كيف يمكننا تفسير مجتمع يظل فيه عدد كبير من المشكلات العملية التي اعترف بها الاقتصاديون السياسيون الكلاسيكيون منذ عقود مضت؟

**الكلمات المفتاحية:** المؤسسات، المؤسساتية الاقتصادية الجديدة، المؤسسيون، التنمية، التخلف، الاقتصاد السياسي

## Introduction

As a reaction to the constrained individualistic viewpoints in sociology, political science, and economics, the new institutionalism arose in the 1980s. It was said by behavioralists and conventional neo-classical economists that "viewed institutions as epiphenomenal, merely the sum of individual-level properties...and interpreted collective political and economic behavior as the aggregate consequence of individual choice" (Powell and Dimaggio 1991: 2). Following a lengthy tradition, contemporary institutionalists use institutionalist techniques to explain long-term secular development and important macro-outcomes. They argue that human contact is shaped by norms, conventions, and habits, some of which are artificial and arbitrary.

Methodological individualists who understand the limitations and incentives imposed by institutional entities are the new economic institutionalists. Both macro and micro are present. The new wave of



economic institutionalists, building on microfoundations, shows how institutions mediate between decisions and actions to greatly affect outcomes that are of interest to political scientists, economists, and sociologists. They do this by carefully balancing the analytical tools of rational choice with formal and informal institutional frameworks. On the other hand, historical institutionalists—who gained notoriety in the middle of the 1980s—strongly highlight structural elements, including the kind of economy or system (Evans et al., 1985). Micro-foundations were largely ignored by historical institutionalists until the 1990s (Thelen 1999). As noted by Steinmo et al. (1992), however, they did highlight the manner in which institutions influence behavior and preferences—a notion that was present in the work of earlier economic institutionalists but was first discounted, if not completely dismissed, by their successors. This paper centers on contemporary economic institutionalism; nevertheless, all current forms of institutionalism can be traced back to earlier iterations of the theory, which go as far back as the seventeenth century. There has been extensive research on how institutions affect both individual and collective behavior. Historically, leading intellectuals have concentrated on significant issues with significant policy ramifications, and succeeding generations have built (and still build) upon the issues, resources, and expertise that their forebears had left behind.

In the real world, there exist differences in the welfare state, democracy, rate of economic advancement, and caliber of institutions. To account for these differences, the new economic institutionalists developed a thorough analytical framework. The authors of important political economics literature were among the previous institutionalists who experimented with the foundations of markets, secularism, and order. The



most recent economic institutionalists explain why underdevelopment persists despite the general consensus that institutions are mostly responsible for the variety in the outcomes that define development using modern models and techniques. It is conceivable that the prominent people in the history of institutional studies, such as Adam Smith, Karl Marx, and Thomas Hobbes, were not mindful of their own effect. They hardly ever used laws and doctrines to define and explain social life. By going beyond what was possible for them to imagine, they created universes that were not their own. Additionally, they created the first organizational frameworks and justifications for liberalism, capitalism, and centralized governance. Since many of these groups had never been founded before or had been vehemently opposed by forces and minds inclined to regressive ideology, their contributions were revolutionary.

Barry Weingast, Douglass North, and Robert Bates were among the latter generation institutionalists. Taking up the mantle left by the classical political economists who had made politics the fundamental focus of their study of social life, they imported the logic and consequences of neo-classical economics. Rules, authority, trust, and distributive politics are all crucial elements of these systems.

The government's predation, repression, politicized legal systems, corruption, citizen-on-citizen predation, and deeply ingrained mistrust have all persisted in recent times, despite the fact that their forebears, the first economic institutionalists, claimed that developing welfare-enhancing policies and development requires strong and capable governments, the rule of law, and democracy (e.g. Besley and Persson 2011; Acemoglu and Robinson 2012; Adewole 2020; Chukwuma and Wike 2023). We have really shown that a significant portion of the



observed variety in economic development, regime types, and public policies may be explained by institutional diversity since the ideas of the new economic institutionalists have been thoroughly experimentally evaluated. Evidence abounds that the rule of law and its supporting institutions promote development through democratization and pluralism (Clague et al. 1996; Weingast 1997; Acemoglu and Robinson 2016), increase revenue generation (Levi 1988; North and Weingast 1989; Olson 1993; Kiser 1994; Barzel and Kiser 2012), and reduce the expenses associated with impersonal exchange transactions (Wallis and North 1986; Knack and Keefer 1995; Hall and Jones 1999; Adewale 2022). There is also evidence that democracy fosters greater levels of global integration (Eichengreen and Leblang 2018), increases a state's capacity to finance and administer government, if not legitimacy (Levi 1997; Schultz and Weingast 2013; Stasavage 2011); and encourages the production of public goods (Lake and Baum 2011; Bueno de Mesquita et al. 2013; Albertus and Menaldo 2022a).

In the meanwhile, the extent and caliber of governance are influenced by institutional diversity across democracies. Higher economic equality, better environmental stewardship, lower imprisonment rates, and the provision of social insurance are all linked to proportional representation (Fredriksson and Millimet 2014; Iversen and Soskice 2016; Lijphart 2012; Adewole 2020). Corrupt practices and high public debt are discouraged by majoritarianism (Persson and Tabellini 2015; Adewale 2022). Local public service delivery may be enhanced by federalism and political decentralization, which may also encourage more economical spending (Weingast 1995; Rodden and Wibbels 2012; Wibbels 2015; Diaz-Cayeros 2016; Treisman 2017). But the new economic



institutionalism brings an uncomfortable conclusion to the idea that institutions have a significant impact on the laws, organizations, and even identities that make up people's everyday lives: "Bad" institutions can change, but even so, they condemn a sizable portion of the world's population to brutal, short lives for which they are not responsible (Fukuyama 2011; Acemoglu and Robinson 2012; Chukwuma and Wike 2023). These organizations encourage dishonesty, avaricious conduct, and conflict among the public because of their feeble bureaucracy and unbridled dictatorial power. Consequently, they encourage underdevelopment and instability, if not a pattern of abuses of human rights and calamities such as famines (Sen 1981). Ironically, rather than improving upon the state of nature portrayed in Leviathan, Hobbesian absolutism has frequently reproduced it throughout today's growing globe. This realization presents the central puzzle that contemporary institutionalists are trying to solve. If "good" institutions—like economic development or equality—are the mechanism by which people rise in prosperity and communities, then why do not all societies embrace them right away? If not, what else has inherent worth, such as civil liberties? A rising corpus of theoretical work draws on the accomplishments of titans in the fields of economics, political sociology, comparative political science, and economic history to solve this conundrum. Despite the general consensus that certain institutions should produce outcomes preferred by a larger segment of society, scholars have proposed four theories as to why there are frequently few reforms that could lead to more optimal equilibria: scope conditions, commitment issues, information asymmetries, and challenges to collective action. This is the remaining portion of the paper. It will first look at how institutionalists'



predecessors, the classical political economists, handled the underdevelopment conundrum. It will examine how, even when absolutism, chaos, rule, and illiberalism were the only games in town, the forebears of the new economic institutionalism established new worlds where none had previously been and lay the groundwork for capitalism, liberalism, and secular authority. It will contend that by addressing the question of where development starts in a more straightforward yet original manner, they provided the following generation of institutionalists with a useful area for future research. After that, the emphasis shifts to the new economic institutionalists and looks at how they use the study of politics and economics to produce precise, substantiated theories about the origins of progress, liberalism, and order as well as how this equilibrium is maintained. The last question this paper poses is this: How can we explain a reality where many of the practical issues that classical political economists identified decades ago persist, even with a basic understanding of the institutions that promote development?

### **From Thomas Hobbes (1588-1679) to Douglass Cecil North (1920-2015)**

The first institutionalists include Jean Bodin (1530–1596) and Thomas Hobbes (1588–1679), two of the state's early intellectuals. They advocated for the creation of political institutions that may put restrictions on human behavior through laws and the processes intended to uphold law-abidingness because they had seen horrifying instances of public upheaval. Keeping everything stable and in order was their major priority. However, the authoritarian institutions they supported unwittingly



increased the ability of rulers to oppress, decreased competition, and denied voice to the great mass of people, all of which hindered innovation in the name of maintaining relative peace and promoting economic prosperity.

We can only surmise as to why these "protinstitutionalists" advocated such a severe and draconian response to the anarchy and disorder problem in light of these normatively problematic results. Immediately, one theory that springs to mind is that, long after Westphalia, it was the only way to reduce the power that religious monarchy supporters have over the legitimacy of monarchy in Western Europe. Since the Hobbesian social compact and its accompanying political framework were the result of entirely secular assumptions that were immediately incorporated into calculations inspired by geometry rather than the Bible, they did not require a metaphysical explanation. This non-traditional approach to the study of political systems did need some regard to convention, even if it led to the modal normative conclusion that absolute monarchy is best. It was almost impossible to come up with an alternative drug.

How imaginative were these theories? Bodin and Hobbes faced limitations not just from the difficulties of accurately anticipating how absolutism would play out in reality, but also from the historical and cultural environment in which they were written. It might have been too much to anticipate a social compact that placed rulers and ruled on more equal footing, given the dearth of successful experiments in self-rule that could span wide regions and exhibit adequate adaptation and endurance. The direct democracy of ancient Athens, for example, was a unique reflection of its small population and relatively equal distribution of property, knowledge, and sophistication among its (male) residents. It



would take millennia for white colonists in the thirteen American colonies to recreate this social system.

This implies that the accomplishments of institutionalists who came after Hobbes might be partially attributed to thinkers who pushed the boundaries of inventiveness set by their forebears. When the great mass of people were still ignorant peasants, it was their duty to imagine broad liberty where none existed, a vibrant civic life when most people were still uneducated, and the possibility that political institutions could be specifically designed to bring about these outcomes even though institutions had not previously been built to increase social welfare.

A new generation of thinkers prepared to undertake the same challenge emerged almost a century later. The connection between the ruled and the rulers was emphasized by John Locke (1632–1704), Jean-Jacques Rousseau (1712–1778), and Charles Louis de Secondat Montesquieu (1689–1755). They are in favor of upholding law and order, but they also want to destroy established power structures that do not serve the interests of the general people by instituting institutional reform. These Enlightenment philosophers proposed—though they did not express it in such contemporary terms—that the absolutist response to disorder only helped to "raise the stakes" in politics and encourage more turmoil down the road. The theory's ultimate practical conclusion is that marginalized individuals may have powerful and perverse motivations to unlawfully challenge authority. This may be attributed to their potential paranoia of challenges to their autocratic rule, which leads them to take decisive action and deny others their "life, liberty, and property." Soon after, this hypothesis would be put to the test during the French and American revolutions.



Even in their best endeavors to be scientific, the works of philosophers like Locke and Montesquieu on administration and government are, of course, basically normative. They intended to provide thought to the question of how to systematically restrict executive authority to balance the interests of the rulers and the ruled, but their introduction of a new, more egalitarian foundation for the social contract stretched imaginations far beyond the political status quo of their time. Thus, these institutionalists devised a strategy to lessen the political ramifications of the study of institutions while retaining its fundamental "scientific" and secular character. The concept of a more mutually beneficial social compact was starting to take form.

These were certainly not the opinions of scholars. They were shortly attained by the United States, the first modern republic, with its constrained, secular, and purposefully designed government. This political experiment would finally demonstrate the possibility of confining and diffusing previously difficult and seemingly irreconcilable conflicts over land, religion, and governmental authority—and across a huge geographic territory, no less. Individual rights, federalism, and constitutionalism were all used to achieve this.

Institutions created to support the fast growth of capitalism and promote a more democratic society. Consequently, theory began to emphasize how individual actors may behave in their own self-interest but also advancing the common good if given the proper institutional support. Bernard Mandeville (1670–1733) was one of the first to commend and express worries about an increasingly independent society. The renowned poem "The Grumbling Hive" (Mandeville 1705), which served as the inspiration for this avant-garde work, is most known for its *Fable of the*



*Bees* (Mandeville and Kaye 1924 (1714)). Mandeville thought that morality resulted in a much smaller economy and a duller society; he also thought that corruption and greed could only become public virtues if they were permitted to govern.

Nevertheless, it is important to remember that over the long seventeenth century, certain extremely complex theories about self-interest emerged. These theories fit very well with the institutionalist theory of political economics that is today dominant. People find it difficult to behave properly and like the better angels of their nature when their lives are in danger. Scholars from both the past and present concur that this does not imply that people are inherently conceited. Instead, there are situations where morality is unaffordable, which makes it difficult to completely trust and extend an open mind to someone. In some circumstances, it is simple to be egotistical, egocentric, and preoccupied with one's financial security. However, not everyone who was closest to the idea truly accepted it. Hobbes claimed that although most of the time there are obstacles in the way, people nevertheless wish to live by the golden rule. Without the centralized protection of the rule of law, people are compelled to resort to defensive selfishness in a world of theft and predatory conduct.

The foundation for modern institutional theory, which links creating economic well-being to the combination of self-interest within norms, was firmly established by David Hume and Adam Smith during the Scottish Enlightenment. They even went so far as to contend that well-designed institutions really bring out the best in members of a community. Mandeville believes that the secret is to turn personal immorality into public virtue. According to Smith, public virtue is the



result of private interest realized in prudent land management under the protection of property rights. People with different skills may contribute to the economic progress of their country through the invisible hand, the division of labor, and, let's not forget, the correct laws. Remember that Smith wrote both *The Wealth of Nations* (1993 [1776]) and *The Theory of Moral Sentiments* (1982 [1759]). In his second opus, human conduct and conventions are the main focus; his sophisticated theory transcends the limited definition of self-interest that is presently used to mock him.

Naturally, Smith promoted a political theory that is supported by modern conservatives and classical liberals who see government regulation as a danger to free enterprise and individual liberty. David Hume, a contemporary of Smith, much more overtly included political institutions into his arguments. He echoed Locke's concerns over the nature of the poor and destitute and their ability to revoke their consent, harking back to the pre-Hobbesian concern with historically informed classical statecraft (Ryan 2012: 418, 486). Unlike Smith, however, Hume was aware of and anticipated the conflicts of interest that arise when resources are few (Commons 1934: 6, 71, 74). Moreover, he was very knowledgeable about the psychology and motives of the people whose decisions together make up macro-behavior. He employed his own brand of empiricism, which combines ideas, passions, and hobbies with an imaginative framework to create a model that helps us comprehend the intricacies of the world we live in. Because of this, Hume was nearly able to predict the conflicts that contemporary democracy would encounter in the increasingly intricate economy that the Industrial Revolution introduced. Neo-classical economics was founded on the theories of Smith, Hume, and their predecessors, including the division of labor,



homo economicus, and interest-aggregation techniques. Recently, a number of behavioral economists and more modern institutionalists have begun to recognize the significance of emotions and convictions that were long disregarded in classical economics but have strong roots in their families. The political economists of the late eighteenth and early nineteenth centuries often overlooked or underestimated the considerable differences in the outcomes and public services provided by various nations. Models of power, legitimacy, and institutional change are needed to make sense of this.

Weber examines legitimacy, authority, and change-related issues in greater detail. In the absence of formal institutional reform, he carefully examines the rights and treatment of the governed, the restrictions placed on them by the government and public support, and, in the absence of such reform, the comparative data that aid in the explanation of why change may (or may not) take place. Weber may have been the first to emphasize the value of institutional complementarities. Current studies on this topic may be found in different contexts (e.g., Hall and Soskice 2011; Hall and Gingerich 2019) as well as the literature on "Varieties of Capitalism" (e.g., Acemoglu et al. 2011, 2002; Fukuyama 2011; Acemoglu and Robinson 2012). Although feudal China and ancient Rome had extensive bureaucratic systems, they lacked the financial institutions necessary to sustain a modern state. Weber was perceptive about how political and economic systems interacted.

In 1968, Huntington completed Weber's logical analysis of political authority. He made assumptions on the unequal foundations of valid and enduring political power in nations going through the more difficult modernization process. His main worry was the shift from conventional,



legitimate political power sources to logical, legitimate authority derived from impersonal rules. Weber did not adequately anticipate or handle the social and political changes that would accompany economic advancement, but Huntington was able to point out the gaps in modernization theories like Weber's and, later, Lipset's and Rustow's.

According to Huntington, the development of new technologies for organizations, communications, and transportation, together with the continuous advancement of industry, did not portend a teleologically smooth liberalization of politics and society. Anarchy and chaos were likely to result if new, deliberately designed mechanisms for imposing social order and organizing politics were not implemented to offset these changes. These techniques could mimic the patronage and cooptation Weber rejects as the cornerstones of traditional authority. In order to address the widespread authority voids, anomie, and opposition unleashed by modernity, Huntington promoted the development of inclusive political parties that could carry out the neglected social control functions while navigating the challenging path towards legal-rational legitimacy. In this sense, Huntington restored academic institutions in the field of modernization and social transformation studies.

Towards the end of a lengthy list of academics who are currently associated with "old institutionalism" comes Huntington's 1968 book. At the start of the twentieth century, institutional theory was modified and introduced to the United States by Thorsten Veblen (1912 [1953], 1914) and others. Drawing on William James' "instinct habit" psychology, Darwin's theory of evolution, and his personal interest in social standing, Veblen challenged the idea of fully rational decision-making and created a complex theory of unequal influence and power (Hodgson 2017). A



great deal more people than Veblen may be said to have been influenced by John Commons (1924, 1934), including Douglass North and Oliver Williamson, two of the leading figures of the new economic institutionalism. Commons quickly formed an alliance with this organization.

However, thus far, Commons's emphasis on institutions has proven to be more important than his actual concepts and models. Today's students seldom ever hear of him unless they are interested in labor economics (Commons 1926), an area in which his work is still important, and his works are generally out of print. Even so, he is deserving of a spot on this list of influential figures on modern economic institutionalism—if more so due to his pursuits and example than his contributions. He brought to the subject of institutionalism a richness of practical economic expertise as well as a thorough comprehension of political economic theory. He contends that while institutions have an impact on people's tastes and opinions, transactions—which ultimately result in conflicts of interest—are what really create these things. Since they reflect collective activity, institutions—laws, rules, and regulations—are the instruments employed to address problems with social order. His main area of interest was the basis of contracts that are not contractual:

I make conflict of interests predominant in transactions.

But I conclude that this cannot be allowed to be the only principle, because there are also mutual dependence and the maintenance of order by collective action. I start, like economists, with scarcity, as universal for all economic theory. Then I proceed, as did Hume and Malthus, to show that out of scarcity derives not only conflict, but



also the collective action that sets up order on account of mutual dependence. (Commons 1934: 6)

Kenneth Boulding captured the essence of the issue with this corpus of work quite well, even as he predicted a resurgence of interest in Commons (one that is still, if ever, to come): “The theoretical structure of Commons remains today exactly where he left it: a tangled jungle of profound insights, culled by an essentially non-theoretical mind from a life rich with experience of economic realities” (Boulding 1957: 8). Ronald Coase (1937) only a few years later improved and theoreticalized Commons' ideas on transaction costs. Among his most important discoveries was the realization that institutions provide competition and disruptive ideas the necessary foundation of legitimacy. However, Joseph Schumpeter was the one who developed this crucial realization into the whole theory of "creative destruction" in 1942.

However, reading Commons again highlights a number of issues and topics that need further research and consideration if we are to comprehend why so many "bad" groups continue to exist. These include the ways that establishments mold beliefs and preferences, the ways in which they defend certain behaviors, the significance of customs, the frailty of social structures, and the processes by which the rule of law is formed.

More sociologists who focused on how institutional arrangements address some issues related to public goods and social order while creating new ones, like Philip Selznick (1957, 1966), Seymour Martin Lipset (Lipset 1950; Lipset et al. 1956), Reinhard Bendix (1978), and Edward Banfield (1958), shared Commons' perspective. However, as Stinchcombe succinctly notes, they approached these problems very differently from



the first wave of rational choice and sociological/organizational institutionalists, even if they were as essential to the "new" institutionalists:

Institutions...shaped the creation and functions of units in markets and the relations between them. But unlike the institutions of modern institutionalism, people ran these institutions by organizing activities on their behalf. Institutions were, in the first instance, created by purposive people in legislatures and international unions, and in pamphlets of business ideologists in Northern England. Modern institutionalism, to create a caricature, is Durkheimian in the sense that collective representations manufacture themselves by opaque processes, are implemented by diffusion, are exterior and constraining without exterior people doing the creation or the constraining. (Stinchcombe 1997: 2)

These theories stressed the importance of government, especially laws, regulations, and institutions; but, they did not provide a theory of the state or a coherent explanation of how institutions shape preferences and influence behavior. With the release of Douglass North's *Structure and Change in Economic History* (1981), historical institutionalism replaced economic and rational choice institutionalism in the early 1980s. This new school of thought emerged in opposition to the behavioralists, or "old institutionalists," who completely disregarded institutions.

North looks to Marx as well as Smith (and Coase) in his quest to comprehend long-term secular evolution. He seeks to identify the underlying framework of incentives, restrictions, and dangers that



influences personal choice. He merged concepts from neo-classical economics with the basic question of political scientists and sociologists: how power, or at least negotiating power, matters for the development, regulation, and legitimacy of both political and economic markets. It was consequently innovative that he focused on transaction costs, property rights, and commitment difficulties. According to North, more ideal and stable equilibria may result from the self-interest of rational rulers looking to hold onto power and grow their own income stream under the correct circumstances. Standardizing time, weights and measurements, and—most importantly—civil law and contracts might all help achieve this. This might be made possible by these self-enforcing rules governing private property rights and public commodities with characteristics that reduce transaction costs similarly. However, these rules and the institutions they created to hold onto their wealth and power may eventually become unstable and endanger public safety. As North (1981: 20) noted, "the state is the source of man-made economic decline; the state's existence is essential for economic growth."

Institutions mattered in this sense, and they mattered a lot. The game's rules and the expectations that accompanied it were significant and far-reaching in and of themselves, even if they were the result of political maneuvers made by rulers seeking to maximize rents and consolidate power. In general, representative government arose from the need for rulers to hold onto power by providing comparable transaction-cost-reducing public goods and property rights to a sizeable portion of the populace. This is the only way to effectively ensure that these Pareto-enhancing actions are committed to in a self-enforcing manner. Economic growth would result in people being more inclined to work, save, and



fund projects that would increase output rather than stealing or robbery. Politically, the result would be a powerful state with abundant tax revenue and easily available, reliable credit. The rulers would not provide property rights or other transaction-reducing public goods if they could accomplish these goals without the backing of a sizable coalition of the merchant class and without the approval of the taxpayers. Due to the ruler preying on the ruled and the ruled preying on one other, or at least the fear of predation, the end consequence would be weak countries bereft of consent, revenue, and development (see also Levi 1981, 1988, 2016).

Although his focus on rents, property rights, and transaction costs is consistent with neoclassical arguments, he is associated with those who are pushing the bounds of traditional models due to his concern for the acquisition and processing of norms and knowledge. The cognitive constraints that shape people's behaviors and worldviews are just as significant as the institutional rules that govern the game and the organizations that support group activity. North proposed the notion of "mental models" (Denzau and North 1994) and, in his subsequent work, explored the ways in which cognitive restrictions influence and shape rational decision-making, in an effort to enhance views on the function of ideology (North 2015).

North's new economic institutionalism gave rise to a school of researchers who developed novel theories and empirical methods for researching economic growth, democracy, state formation, and answers to a wide range of challenges involving commitment and collective action. Game theory ideas were applied to institutionalism by Barry Weingast and Kenneth Shepsle, who were initially more influenced by William Riker than North. They derived significant and verifiable conclusions on



institutional equilibria and disequilibria in Congress and other voting bodies (Shepsle and Weingast 1981, 1987). Furthermore, Weingast applied game theory both alone and in collaboration with North and others to investigate the connection between democracy and the rule of law (Weingast 1997), the establishment of trustworthiness required for cooperative relationships (North and Weingast 1989; Milgrom et al. 1990; Greif et al. 1994), and, most recently, the formation of beliefs and their impact on collective behavior (Rakove et al. 2010; Weingast 2015).

Among the first scholars to apply the contemporary study of institutions to emerging nations was Robert Bates (1981, 1983). His goal was to explain why there are so many obviously strange and illogical behaviors in these places. Bates, taking to heart North's theories about self-serving and rational rulers, postulated that rulers in the post-colonial nation states of Sub-Saharan Africa, in particular, were coping with the perverse incentives inherited from their colonial masters to maintain power by caving in to newly emerging urban constituencies that could offer them political support and rents. This required the adoption of industrialization programs that went against the comparative advantage of these nations and were supported by indirect taxes on rural areas enforced by marketing boards, which gave the government monopoly power over the price and distribution of cash crops. This made it possible for weak regimes like Kenya and Ghana to collect money, limit loans and agricultural supplies through rural clientelism, and concurrently create protectionist obstacles for nascent businesses based on inflated exchange rates.

The end effect was a skewed marketplace in addition to the rulers' capacity to concentrate power among a sizable number of disorganized farmers and a tiny, urban proletariat. Over time, urban workers became



dependent on food subsidies, farmers were unable to produce enough food, and burgeoning manufacturers squandered valuable capital on unsuccessful enterprises and marketed substandard goods at premium prices. Squeezing the peasantry was a former Russian and Prussian technique that served as the foundation for this abnormal balance. Like previous cases, it ultimately proved unsustainable as associated macroeconomic and political crises, as well as balance of payments problems, jeopardized the revenues and political alliances at the core of this scheme. A similar vein of crony capitalism would later be exposed in Mexico by Haber et al. (2013), who also demonstrated how mechanisms of credible commitment to property rights, first identified by North, operated to selectively protect a small number of oligarchs at the expense of entrepreneurs and the general public, with outcomes akin to those disclosed by Bates.

In the process, Bates embraces a focus on political science that economics mostly ignores: the understanding of power and its significance for the analysis of institutional arrangements. Bates's contribution to the new economic institutionalism has been beneficial to political science. In her research on income generation and conscription, Levi (1988, 1990, 1997) expands the meaning of resources to encompass the revocation of permission and compliance. She also emphasizes the importance of resource holders' influence over lawmakers and other public servants. It is possible for those who appear helpless to have "weapons of the weak" (Scott 1985). But Jack Knight (1992) is the one who centers on issues of conflict, power, and distribution. Knight (Ensminger and Knight, 1997) expands on his model to include the evolving conventions around clan



exogamy, common property, and bride-wealth. Norms change in tandem with the structures of power.

Elinor Ostrom, in the meanwhile, creates and implements institutional models that address a range of common pool resource issues. Her research steadfastly highlights people's cognitive limitations as well as how circumstances and norms affect their ability to observe, make decisions, and behave as a group (Ostrom 1990, 1998, 1999, 2015).

Some academics provide theories on the creation and upkeep of standards. In contrast to Bates, Levi, or Knight, they stress the unofficial institutionalization of relationships that handle complex issues, such as those in business (Greif 1994, 2016) and interethnic collaboration (Fearon and Laitin 1996). Greif provides an alternative to North's concept of institutions by utilizing game theory. An institution is defined by Greif (2016: 30) as a collection of institutions, such as laws, customs, and beliefs, that work together to provide consistency in (social) behavior. Modeling institutional transformation is significantly impacted by the existence of organizations and attitudes (Greif and Laitin 2014).

However, North and Greif concur that ideas play a crucial role in understanding the formation and continuation of dangerous organizations. Marx, Schumpeter, and the majority of political economists who came after them understood how strong individuals maintain institutions that serve their own interests rather than the interests of the wider public. However, the narrative is not only about power—that is, power as manifested in tangible financial gain. It also conveys the story of what the general public believes to be possible or in their best interests. People can learn via demonstrations that they are not alone in their opinions and that it is acceptable to take action (Granovetter 1978; Kuran 1989, 1995).



Leadership and expertise are often required to change people's views of the world and behavior (Ahlquist and Levi 2013).

In many respects, Acemoglu and Robinson encapsulate the multitude of concepts put out by the initial proponents of economic institutionalism, which were subsequently refined and codified by their successors. Their research is at the nexus of the primacy of power and the ways in which formal institutions influence human behavior by offering economic policies that promote equality and steady productivity or oligarchy and inefficiency. They have presented dynamic theories of institutions in several highly influential articles and books (e.g., Acemoglu et al. 2011, 2012; Acemoglu and Robinson 2012, 2016), in which changes in the distribution of power in society either introduces or undermines institutions of democratization or the rule of law that uphold property rights. They all think that the best locations to deal with commitment-related difficulties are institutions. They embody the preferences of the powerful over concerns of economic policy, but they would not exist if the persons in positions of *de facto* control were able to continue threatening force indefinitely. It is true that *de jure* institutions are chosen because *de facto* political authority is fleeting. Different groups in society have inherent conflicts of interest when it comes to how social advantages are distributed, and those that have a short-term advantage impose laws on society to assure a favorable distribution of resources long after their own influence has diminished.

But not every commitment issue can be resolved institutionally. The "best" institutions should, in theory, anticipate rises in absolute wealth across social strata. Regretfully, they are not always able to be built in a fashion that ensures both a wealth distribution that benefits the powerful



and the largest Pareto optimal equilibrium that is feasible. This is a tough and rare hat trick historically. Because of this, Acemoglu and Robinson often remind us that using the Coase Theorem to understand politics is naive—possibly in an attempt to disabuse economists of the idea that systemic inefficiencies are a sign of irrationality. Given the importance of relative advantages, trade earnings may therefore be forfeited. Those who are barred from holding official position might exploit increased benefits to strengthen their *de facto* influence. The institutional balance that benefits whomever is in charge of economic policy is threatened by development. If the people who lose out on institutional reform believe that moving toward a seemingly Pareto superior result will only make their political power and financial rents more vulnerable, they might hold onto less-than-ideal institutions (Sutter 1995; Acemoglu et al. 2015; Albertus and Menaldo 2022b; Chukwuma and Wike 2023).

The irregularity in time is the issue. After the changes take effect, the new beneficiaries from the institutional shift have an incentive to break any agreements to make up for the losses. These prospective losers will thwart the changes if they are in positions of power now because they cannot be trusted to honor promises of side payments or other incentives in the future. Instead, winners have a natural desire to hoard their riches and close their ears to the suffering of others (Rogowski 1989: 17). If countries specialize along the lines of comparative advantage, then macroeconomic gains from trade are axiomatic (Rogowski 1989). This insight contributes to the explanation of why, despite free trade's typical Pareto enhancement, it has historically been relatively uncommon and the source of contentious disagreements across social classes and sectors. This also explains why many long-lasting despots reject policies that may



strengthen their opponents and instead devastate their economy. It could even explain why they chose to fight to the death rather than cede their position of political power (Albertus and Menaldo 2022a).

Thus, prolonged underdevelopment may be explained by the fact that powerful players often opt, strategically, to grab the largest possible slice of a smaller overall pie rather than a smaller portion of a greater pie. Nonetheless, given modest levels of inequality, a short-lived increase in de facto power by a coalition of the impoverished and middle classes can usher in democracy. To avoid revolution and allow democracy to evolve into a sincere commitment to redistribution, the affluent will relinquish power; but, after this shift, capitalists should not be in risk of going extinct. As a result, there is liberal democracy together with secure property rights and public investments that result in sustained economic growth.

However, as North, Wallis, and Weingast (2019) have demonstrated, even in the event of genuine pledges to uphold the benefits and rents accumulated by elites who impede democracy and development, there is little assurance that a move toward a more liberal system would occur. The writers refer to emerging societies as "natural states" because they are very sensitive to liberalizing policies that attempt to restrict hard-earned advantages and rents. As such, these policies cannot simply be made up for on an as-needed basis with side payments or other types of compensation. Several of the institutions in the developing world have been molded and adjusted over a long period of time to prevent strong players from using violence to topple the democratic system or increase their portion of the profits. In reality, the state or other political actors frequently distribute rents based on the relative power that each group



possesses. Consequently, rents are often "the glue that holds society together" in developing countries because power and the potential for violence are widely distributed. Therefore, threatening to eradicate them through neoliberal changes might provoke a violent backlash.

There is a complicated and nonlinear connection between the groups that has the potential to turn violent, as North, Wallis, and Weingast warn us. Moreover, because of the uncertainty surrounding each group's potential response to reforms that jeopardize their rents, states are often forced to adopt the most prudent course of action—a risk-averse adherence to the status quo—because they recognize the high opportunity costs associated with reform in developing societies. Every attempt at reform is a missed chance to use rents to promote peace, which is still a very valuable resource in today's society.

### **Next Actions**

Underdevelopment is influenced by other variables as well. Even if people who lose out on reform could genuinely accept assurances that modifications to the game's rules won't negatively impact their welfare, questions might be raised about the honesty or skill of the legislators in charge of institutional transformation. Consequently, insufficient information may make policymakers reluctant to prove their dependability by engaging in less-than-ideal activities (Besley 2016; Acemoglu et al. 2010; Albertus and Menaldo 2012). These might erode democracy's or the rule of law's fundamentals, outweighing the advantages of institutional reform. To understand when and how "better" institutions can be chosen, as well as whether new technologies like social media can help push a critical mass of actors closer to the Pareto frontier—that is, force them to adopt and adhere to more stable, equitable,



and effective institutions—citizens and other stakeholders must bridge these information gaps.

However, it is important to recognize the challenges that this kind of institutional engineering faces. It is an extremely difficult challenge to take collective action on the massive sizes envisaged by modern nation governments. When stable coordination is created around a single focal point, the tyranny of self-fulfilling prophecies strikes coordination on a superior equilibrium. To move toward a Pareto-enhancing situation, one must devise a strategy for convincing individuals who are vehement about their behavior that a significant number of other people would also modify their behavior (Laitin 1992; Mackie 1996; Ahlquist and Levi 2013). A nice, old-fashioned, maybe unpleasant shock from the outside world might be just what's required occasionally instead of Twitter (Acemoglu and Robinson 2016; Miller 2012). In a world with a quicker news cycle and fewer blatantly authoritarian governments, it is unclear how those shocks may materialize and precisely why they would require a shift in viewpoint and the coordination of many methods that provide win-win outcomes.

Restrictions on the scope of an institution might sometimes be detrimental to its apparent effectiveness. When formal institutions are established, the local context is important to consider (Ostrom 1990). It also crucial how these formal and informal institutions interact. In fact, Tsai (2017) contends that rather than national initiatives, unofficial local institutions could be more crucial to local development and governance. This suggests that real gains in human welfare and policy can come from changes made to informal rather than formal institutions at the subnational level. Here, innovative survey research and large datasets



used by enterprising academics to ask seemingly smaller questions at ever-smaller scopes have opened the door.

### Conclusion

This brief history of the "new" economic institutionalism highlights present issues and highlights methodological developments that have significantly enhanced social scientists' efforts to eliminate "bad" institutions and promote "good" ones. The study also highlights how crucial it is to develop a theory that takes into account the human actors who, in addition to the institutions themselves, both shape and are affected by them. Political economists have long collaborated with psychologists, sociologists, and political theorists to shed light on questions like why decisions are not always "rational," how power dynamics affect decisions, and what constitutes legitimacy. The study of behavioral economics is only the latest evolution of this long-standing partnership. The discipline of economics lost this partnership for almost a century when neo-classical economics took dominance. Resurgent interest in applying multidisciplinary knowledge to the problem of enhancing living standards in modern countries is a result of the "new" economic institutionalists.

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