

Organizations not Atoms: Rules, Organizations, and Long-Term Development

or

An Organizational Theory of Development

John Joseph Wallis

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In the mid to late 19th century a great break in human development occurred. For the first time in recorded human history a few societies began to experience steady increases in material income and wealth. That growth has continued in those societies, albeit with interruptions and unequally, in the almost two centuries since. The countries that began to grow first have continued to grow and, with some exceptions, have continued to be the richest countries ever since. The rise of modern growth is a first order problem in understanding economic development, and to date economists and economic historians have not come up with a compelling explanation for why and how it happened.

Economists have been interested in the absolute and comparative wealth of nations for over two centuries. Our core ways of thinking about economic performance are based on models of constrained individual behavior whose choices aggregate to the wealth and performance of a society's economy. The focus is anti-organizational, in a way we usually do not think consciously about. By that I mean that the constraints that prevent individuals from attaining their full potential come from organizations that limit their opportunities: the state, the church, and other coercive organizations. Organizations limit choice. Adam Smith argued against government interfering in the economy to create privileged organizations that prevented individuals from pursuing their interests in ways that produced larger aggregate wealth. Hobbes

was a dedicated individualist, whose model of Leviathan relied on the atomistic interests of every individual to agree to support Leviathan in return for escape from the state of nature. But the organization of the state was intended to free individuals from the organizational tyranny of religion, which takes up most of the book. Mancur Olson's *Logic of Collective Action* applies atomistic (neoclassical) logic to explain why individuals may find it in their interests to create organizations to further those interests. But then in his next book, *The Rise and Decline of Nations*, he argues that an increase in the number of organizations in a society will eventually cause institutional sclerosis and decline as the organizations pursue their own interest at the expense of the larger society.¹ At root, classical liberalism and neo-classical economics expressed an anti-organizational bias because it was organizations that impinged on individual freedom.

This is not to say that economists do not appreciate the importance of organizations in raising the productivity of people by enhancing coordination between them, nor the importance of organizational change over the long run course of development. It is to say that the double edge nature of organizations for good or ill has never led economists to build a theory of long term development centered on organizations. North (1981 and 1990) and North, Wallis, and Weingast (2009) made major progress on understanding organizations as the locus of institutional change and therefore potentially economic development, but in an explicit double edge way. Organizations were as likely to retard economic performance as they were to promote

¹Marx is also anti-organization, as capital is organized and the state becomes the executive committee of the bourgeoisies. Public choice economics, from which come many basic models in political economy is also basically anti-organization, as individuals in government use the government to promote their individual aims.

it.

Organizations are groups of people who adopt rules to order and govern some of their relationships. The adoption of rules transforms groups into organizations. The basic assumption here is that organizations adopt rules to increase the value of relationships within the organization. Secondary rules are the rules for making rules. All organizations have secondary rules about how they decide to make or change rules. All *agreed upon rules* result from the collective action process governed by the secondary rules. Primary rules are the rules that directly affect how people relate and interact with one another. Organizations range from families to nation states, and all organizations have primary and secondary rules. Organizations are the source of all agreed upon rules. Agreed upon rules do not just appear, they are the result of deliberate collective choice.²

In *Violence and Social Orders* North, Wallis, and Weingast (NWW, 2009) placed organizations at the center of institutions and of development. While this paper extends the ideas and forms those ideas into an organizational theory of development, NWW actually made the case that organizations in most societies are *designed* to retard economic development, even though that is not their primary goal. All societies must deal with the problem of violence and the most dangerous kind of violence occurs between well organized elites. To limit violence as societies grow in size, agreements between elite organizations manipulate rules to create rents for the powerful organizations. If those rents are reduced when intra-elite agreements break down, then the rents and agreements create some credible incentives for elite organizations to honor

²“Agreed upon” does not imply “consent.” The secondary rules usually allocate the rule making process to a small portion of the people to whom the rule will actually apply. The people who do not make the rule, but are bound by it, do not actively give their consent.

their commitments to each other. The incentives are far from perfect, however, and since rents depend on relative prices and relative prices can never be fixed, elite agreements break down periodically. What NWW called the *natural state* was a way to organize elite organizations that manipulate economic interests to secure political agreements: politics manipulates economics to secure political agreements. Building stable agreements between powerful organizations requires hamstringing the economy in the interests of coordinating powerful organizations and limiting organized violence.

In an *open access* society the rules for forming organizations become *impersonal rules*: rules that treat everyone the same. Open access rules for forming political and economic organizations sustains both political and economic competition. Open access rule are impersonal. They can be used by any citizen and apply in the same way to all citizens. NWW closed their argument by arguing that open access to organizational rules and forms in the mid-19th century enabled the transformative effect of competition on societies to work its developmental magic. Economists are easy to convince that competition is good for social outcomes.

Although NWW developed doorstep conditions that made it more likely that a transition to open access would occur, they did not pin down the historical process by which the transition occurred. They did not explain the onset of modern development. They placed rules governing organizations at the center of the transition, but relied on competition to explain why open access societies seem to work better than natural states. The reliance on competition to explain development is a central feature of many economic theories of development. The problem with the logic is that natural states are also really competitive, so competitive that violent competition is a real threat, and it is the costs incurred in violent competition that lead powerful organizations

to manipulate economic rents by suppressing economic competition.

While staying within the natural state/open access framework, and also dodging the question of why impersonal rules were adopted in the first place in the 1840s and 1850s, the argument in this paper explains the effect of impersonal rules on organizations, on economic performance, and political development. This differs considerably from NWW. Rather than conceiving of rules and organizations as separate aspects of a society, here they are taken to be part of the same process. All rules are embodied in organizations. All organizations have rules designed to enhance the value of relationships within the organization. This is emphatically not a Hobbesian world where only the government makes rules (NWW is essentially a Hobbesian framework). All organizations make rules and all of the rules potentially interact. That rules interact across organizations is something we all recognize, but the institutional literatures have not emphasized its importance. Governments create rules that other organizations and individual use, but that is about as far as the analysis goes. Government rules, laws, are usually treated as the frame for social, economic, and political behavior.

In this paper, rules are formed by all organizations from families to nation states and all of the rules potentially interact. Rather than thinking about the impact of laws on individual organizations, the focus is on the interaction of all the rules in all organizations and particularly how those interactions can be enhanced in ways that promote more effective relationships between organizations as well as between individuals. Conceptually the *rule and organization matrix* represents all the rules, all the organizations, and their connections. The connections between rules is as important as the form of the rules themselves. The difference between a natural state and an open access order is that impersonal rules gives all citizens “access” to the

rules, whereas natural states are inherently “limited access orders” where many people are not connected to and do not have access to specific rules. Critically, some connections exist but are difficult to observe in practices because the connecting rules are *default rules*: rules that are enforced but not followed. It can be quite difficult to see how a rule works if it is not being followed, but that is how default rules work.

The argument has two parts. The first examines the types of rules that exist (a glossary is included), how those types of rules interact within and across organizations, and how specific configurations of the rules enable greater (or lesser) coordination between individuals, between organizations, and between individual and organizations.³ A rule and organization matrix with *impersonal external default rules* can sustain much more coordination between individuals and organizations, support more liberty and freedom, lower transaction costs, encourage innovation, enable the formation of more heterogeneous organizations and relationships. While most societies are able to create external rules and default rules, it is not until the 1840s or 1850s that impersonal rules appear on a broad scale. Their appearance increases the effectiveness of all rules as coordinating devices. The theoretical expectation is that when impersonal rules appear, the organization of economic activity will change and become more productive and dynamic, just what we see in Britain and the United States after 1840.

The serious conceptual problem then becomes how impersonal rule provisions, once adopted, were sustained through time. Why and how do societies with governments capable of

³This is an awkward phrasing. When I say the relationship between “individuals and organizations” I mean the relationships between individuals, the relationships between individuals and organizations, and the relationships between organization. All three dimensions are important.

creating and enforcing *identity rules* – rules whose form and enforcement depend on the social identities of the people to whom the rule apply – suddenly become capable of creating and enforcing impersonal rules? As we will see, roughly 75% of all the laws produced by the British Parliament and the American state legislatures before 1850, were identity rules. By 1900, identity rules in the United States and Britain had become much less important. Indiana was the first state to adopt an *impersonal rule provision* in its 1851 constitution, requiring that the legislature pass “general laws” (impersonal rules) for 17 specific purposes, pass general laws whenever possible, and only create corporations through general laws, banning incorporation by special laws. I am not going to delve into the histories of why these provisions were adopted, but I try to identify the societies were able to create impersonal rule provisions in the late 19th century.⁴ The paper will, however, show how these provisions were sustained by democratic developments over time.

The second part of the paper tracks how the adoption of the first impersonal rule provisions changes the way political systems operate, with particular attention paid to the organization of political parties. Before the adoption of impersonal rules political competition is *factional*: many small political groups vying to influence government policy and to possibly control the government. These factions are numerous, small, and short lived and the coalitions they form are similarly short lived and changeable. Identity rules are at the heart of a factional polity. Each faction is focused on their interests and their rule. Political parties in the modern

⁴For more detail on Indiana see Lamoreaux and Wallis (2021). When states adopted impersonal rule provisions the number of private, special, and local acts – acts that named specific individuals, specific organizations, or specific localities – declined dramatically. Appendix table A-1 gives the numbers for Indiana. For greater detail see Lamoreaux and Wallis (2022).

sense of the word do not exist.

Modern mature political parties in mature democracies (I will sort out definitions as we go), are durable, stable, and long lived. They compete in open competitive elections repeatedly over time. They expect that they will lose elections and also expect that even if they lose they will be able to compete again in the future. Control of the government, of government administration, and of government policy is directly the result of elections. Mature parties play for very high stakes. At the same time, mature parties and democracies appear only in societies with impersonal rules. Why?

In factional polities and factional democracies, political factions cannot *expect* to have long and durable lives. What would have to change to create credible expectations of long lives? The second part of the paper develops a theory of the changes in the polity necessary to support those expectations. They are 1) competitive, free and open elections; 2) that electoral winners get control of government administration; 3) and impersonal rule provision. In essence, when a party wins it gets constrained control of making new rules and changing existing rules, but under the condition that any rules they make apply equally to all parties. This gives major parties, those parties with a chance of winning elections, a strong interest in sustaining impersonal rules. Maintaining impersonal rules is central to how the parties collectively assure themselves that they can lose elections and not lose their organizational lives.

The entire argument is based on a theory of rules and organizations, what they are, how they work, the different types of rules that exist, and how coordination within and between organizations is enhanced or retarded depending on the type of rules and the connections between the rules and organizations that structure of the rule and organization matrix. The hypothesis is

that modern development appears only with impersonal rules and the changes that they bring to both the economy and polity. On the economic side organizations become more numerous, more productive, and more heterogeneous. On the political side, the organizations that compete for control of the government transform from short lived factions to mature, long lived political parties competing in a party system that insures that while major parties will lose elections, they will live to compete again in future elections.

2. Rules and organizations⁵

2.1 The fundamental tension

If organizations adopt rules to increase the value of relationships within the organization, then a fundamental tension exists between rules and relationships. Rules work best if they are predictable, while relationships constantly change. Rules will inevitably be “wrong” in certain circumstances when, by applying or following a particular rule, the value of relationships are reduced. Both rules and relationships are inherently collective concepts: it takes two to tango. Rules are the result of agreement between individuals about how they relate to one another. There are no atomistic rules created and enforced by only one person. There may be agreement about rules that seem to apply only to one person, like the king, but *lese majeste* applies to and governs everyone who has a relationship with the king.

One question in theories of organizations is whether we should think primarily of organizations as bundles of rules or bundles of relationships.⁶ Clearly they are both and the tension between the two is a fundamental aspect of organizations and how we should think about

⁵A glossary of rule and organization types is included on page 49.

⁶See Gibbons 2003 for a clear discussion of the two ways of thinking.

them. The sociologist Philip Selznick was concerned with the interaction of rational (rules) and non-rational (relationships) elements in organizations:

But as we inspect these formal structures we begin to see that they never succeed in conquering the non-rational dimensions of organizational behavior. The latter remain at once indispensable to the continued existence of the system of coordination and at the same time the source of friction, dilemma, doubt, and ruin. *This fundamental paradox arises from the fact that rational action systems are inescapably imbedded in an institutional matrix.* (Selznick, 1948, p. 25, italics added).⁷

What Selznick called the fundamental *paradox* I am calling the fundamental tension. It doesn't seem paradoxical that organizations and all human behavior contain elements of the rational and irrational, the larger theoretical debate Selznick was addressing. We need to acknowledge the potentially conflicting elements of organizations. The fundamental tension can be summarized in the phrases "relationships drive rules" and its corollary "relationships erode rules." Because organizations use rules to enhance the value of relationships, there will always arise situations in which rules are ignored, unenforced, or cast aside because relationships have changed. Doing so will make rules less effective as coordinating tools that increase the value of relationships, and so the tension.

Neoclassical economics assumes people maximize utility, even though we only have the vaguest idea of what utility actually is in the real world. Our ideas about utility are vague because what motivates and rewards individuals is so idiosyncratic and variable that it is impossible to sum it up in one variable. Sometimes we use theoretical and empirical proxies, like maximizing share holder wealth or life time income and the like in specific cases, but ascribe

⁷Note that for Selznick the "institutional" structure of an organization was the non-rational part (1948 and 1957). For economists like North, institutions are the rules of the game and the institutional part of organizations are the agreed upon rules, not the non-rational beliefs, values, etc. For an elaboration of the distinction and differing definitions see Wallis (2022).

human motivations generally to the abstract notion of utility. The value of relationships are similarly idiosyncratic and variable. And because relationships always involve at least two people, it is problematic to say that people are “maximizing” the value of the relationship in an organization, because then questions always arise about maximizing whose value? The value of a relationship is always an attribute of collective, not individual behavior. It does not fit neatly into the atomistic world of methodological individualism.

Organizations not atoms. We cannot build a model of how society truly works and the economy performs only by aggregating the behavior and decisions of individuals, or of organizations treated as individuals, because the choices individuals face and their desire to maximize the value of the relationships they enter into (and here the individual desire to maximize the value of relationships is just as valid as maximizing utility in conceptual terms) is intimately shaped by the collective agreements organizations have made about rules. The interaction of rule and relationships is always changing, because relationships drive rules.

North famously defined institutions this way: “Institutions are the rules of the game in a society or, more formally, are the humanly devised constraints that shape human interaction.” (1990, p. 3) That is the opening sentence of *Institutions, Institutional Change, and Economic Performance*. The key phrase is “humanly devised constraints.” Organization devise agreed upon rules to order human interactions in a collective, not individual, process.

2.2 Default Rules:

If the tension between rules and relationships is fundamental, then we should see efforts in all organizations to deal with it. External rules are key to understanding how organizations do

that. *External rules* are rules created or enforced in one organizations that other organizations use for enforcement. External rules are much easier to understand, however, if we first understand how default rules work. *Default Rules* are rules that are that are enforced, but not followed. Unfortunately, the institutional literatures have largely ignored default rules in preference to *prescriptive rules*: rules that are created and intended to be followed (often resources are devoted to policing behavior that does not follow the rule).

The assumption that rules are prescriptive is perhaps the fundamental assumption the institutional literatures make about institutions as rules.⁸ In the existing literatures, institutions coordinate human relationships because if people follow the rules their behavior is more predictable, and expectations about how others will behave are more reliable and accurate. The intuitive importance of institutions in human societies in all the literatures rests on the effectiveness of institutions to support *homogeneous* behavior: if everyone follows the rules their behavior is homogeneous and, therefore, predictable.⁹ These prescriptive rules are enforced and followed. Institutions enhance social coordination by making individual behavior more

⁸The institutional literature is enormous and that institutions should be conceived as rules is a fundamental starting point of the institutional literatures in law, philosophy, history, anthropology, sociology, political science, economics, as well as economic history. For the economics of institutions see Alston, Alston, Mueller, and Nonnemacher (2018). Acemoglu and Robinson (2019) are vigorous proponents of the idea that institution are fundamental to the process of economic and social development. Specific examples of the institutional literature in philosophy are Searle (1995 and 2010), in anthropology Henrich (2016, 2020), in political science Bednar (2015), Bednar and Page (2007), Calvert (1995), and Shepsle (2006), in sociology Dimaggio and Powell (1983) and Tilly (1993). For an overview of the economics of organization see Gibbons and Roberts (2013) and an overview of the sociology of organizations see Greenwood, Oliver, Lawrence, and Meyer, (2017).

⁹Any regularity in human behavior can result in a norm of behavior or a behavioral rule. In this sense rules include any regular behavior. I am, however, only considering rules that result from a deliberate collective action process in this paper.

homogenous and predictable.

Many rules in societies, however, are created by collective action agreements and then not necessarily followed.¹⁰ These default rules are enforced but not followed. To be clear, societies and organizations adopt rules that will be enforced when a dispute is brought to the appropriate authorities within an organization, but the rule will *only be enforced* if one or more of the parties to the rule brings a dispute. In everyday life, the rule is followed or not, without consequences. A default rule gives the parties in a relationship an *outside option*: if either party wants to invoke the rule they can, but the behavior of the parties does not have to follow the rule and no authority polices behavior.

The tendency of the institutional literatures to ignore default rules and focus on prescriptive rules flies in the face of overwhelming empirical evidence from the sociology of organizations that organizations devote significant amounts of resources to rules that are enforced, but not followed. Mark Granovetter famously wrote that anyone who believes that organizations follow all the rules they create were “sociological babes in the woods” (1985, p. 502). Both Meyer and Rowan (1977) and DiMaggio and Powell (1983) frame their fundamental papers as addressing why organizations create so many rules that are not followed. This poses a basic question for economists: why do organizations devote resources to creating rules that people do not follow? The simplest answer is that organizations create default rules that enhance coordination by providing outside options for relationships, even if the behavior exhibited in the relationships does not follow the rule.

¹⁰By “not followed” I do not mean that no one’s behavior follows the letter of the rule. Not following means that there is no specific pattern of behavior induced by the rule. People are free to follow or not follow the rule.

The easiest way to understand default rules is with a concrete example. When I was younger, I spent several years working construction jobs. I was a member of the Laborer and Hod Carriers union. There was also a Carpenters Union. Laborers and carpenters often work in pairs and each laborer/carpenter pair reaches a unique agreement about how they will work together. Each laborer/carpenter pair is an organization with their own agreed upon rules.

The laborer/carpenter pairs are embedded in three other levels of organizations: the firms they work for, the two unions whose work rules govern their relationship, and the state whose government's health and safety rules also apply to them. In each case, the rules at the external levels of society affect the relationships and the productivity (positively or negatively) of the carpenters and their laborers. The external rules thereby affect the productivity of the construction process within the firm. Each laborer/carpenter pair is embedded a *rule and organization matrix* composed of all the organizations and all of the rules, as shown in Table 1, p. 47.

While every organization has its own unique *internal* rules, all the rules in the rule and organization matrix potentially interact. Employment on a union construction site involves lots of rules. And yet, many of the rules are not followed to the letter. *Not all the rules can be followed* because the rules at different levels are not always in agreement with one another. Rules within the matrix conflict with one another, they are *incongruent rules*.

The simplest example is driving (hammering) nails. It is very clear from the union rules that carpenters are supposed to drive nails, laborers are not. Laborers always carry hammers, however, and laborers are often asked to drive nails. Why is there a clear union rule prohibiting laborers from driving nails when it is equally clear that they often do? When a laborer drives

nails it is not thought of as *breaking* the rule, even though everyone involved understands the union rules about driving nails. Every laborer/carpenter pair works in the rule environment in Table 1. The union nail rule is an external rule that allocates authority over the decision about who drives nails to carpenters. The nail rule a specific laborer/carpenter pair actually agree to themselves can be incongruent with the union nail rule because the union nail rule is a default rule. It is always there, but only applies if either the laborer or the carpenter disagree and decide to access the rule.

That default rules provide an outside option in relationships is critical to understanding how default rules enhance coordination. Whether a laborer drives nails or not depends on the unique relationship between individual carpenters and laborers. Disputes between laborers and carpenters, however, will be resolved in favor of the carpenter, so disputes rarely arise. Laborers and carpenters can more easily reach agreements about how they will work together, because the issue of who has the ultimate decision making authority has already been decided. Even though all laborer/carpenter pairs work under the same default rule, the relationship between every laborer/carpenter pair is different. The default rule enables and supports *heterogeneous* behavior, not homogeneous behavior.

Heterogeneity is central to the process of modern economic development. From Adam Smith on, economists have understood that having varied organizations creates more gains from trade and specialization in an increasingly heterogeneous world. Institutional explanations of modern development that emphasize the homogeneous behavior and expectations created by prescriptive rules do not come to grips with this source of heterogeneity at all.

The nail rule seems pretty trivial until you think about. Since new laborer/carpenter pairs

are created quite often, by giving the carpenter discretionary authority from the beginning, new partners do not have long involved discussion about how they should work together. These negotiations incur transaction costs that default rules can reduce. As relationship deepen and mature, the relationship changes, and the nail rule can accommodate a wide range of behavior. All kinds of coordination within the construction firm is ordered by hundreds of similar rules. Default rules are more flexible than prescriptive rules and they are capable of “fitting” in a wider range of situations. The default rules increase the productivity of every laborer/carpenter pair, because the default rules allow individual laborer/carpenter pairs to work out the arrangement that works best for them. A single default rule supports multiple and heterogenous relationships.

The union nail rule *only enhances coordination because it is not always followed*. The opportunity to use rules in this fashion only exists if the rules are incongruent. Having a union rule that is incongruent with the agreements laborer/carpenter pairs reach actually reduces disputes between laborer/carpenter pairs and enhances coordination and productivity. In order for the union nail rule to work, however, all the laborer/carpenter pairs and construction firms must have access to the third party rule enforcement that the unions provide.¹¹

2.3 External Rules and the interaction of rules and relationships.

If impersonal default rules improve the productivity of the firm, why doesn't the firm just adopt the union nail rule as an internal rule? *That is a very good question*. If the firm enforced a default nail rule, where the carpenter always had the right to decide, then the firm would face the

¹¹This does not mean that all union rules are default rules. Many union rules are prescriptive. Unions devote resource to seeing that some of their rules are enforced and those rules to do not always lead to higher productivity. Nor does it mean that all default rules increase productivity either.

problem of enforcement. Could situations arise in which it was better, for whatever reason, for a individual construction boss to over rule a carpenter and let a laborer drive nails? *Any rule works better as a coordinating device the more predictably it is enforced.* Work units in construction firms, even large ones, tend to be small and develop complicated interactions between individuals over time. Changing relationships within the firm may make it difficult, or impossible, to enforce the rule. When I first talked about this to my wife, I asked her to suppose she was the foreman of a construction gang. There was a laborer everyone liked and a carpenter who was a jerk. By enforcing the rule against the carpenter she might induce the carpenter to leave the firm. I didn't even finish the example, as she immediately replied "rule against the carpenter, get rid of the jerk. Relationships drive rules, not the other way around."

This is a serious issue in all organizations. Organizations are concerned with maximizing the value of relationships, and if an agreed upon rule reduces the value of relationships it will be ignored and not enforced, even in cases of a dispute. It is not possible to adopt rules that always maximize the value of relationships over time for a very simple reason: *relationships develop and change over time, while effective rules must be predictable over time.* Predictable default rule enforcement is just as important as predictable prescriptive rule enforcement. Rules whose form or enforcement are expected to change in unpredictable circumstances, however, are less effective coordinating tool if *relationships erode rules.* This is Selznick's fundamental tension.

The solution to the problem depicted in the rule and organization matrix in Table 1 is for the construction firm to kick the enforcement problem upstairs to the unions by using an external rule. Resolving the fundamental tension between rules and relationships is often difficult. If an organization cannot credibly enforce an internal rule, then moving rule creation and enforcement

into an external organization may have significant benefits. If so, we expect to see groups of organizations with relationships to each other banding together to form a new organization in their midst, a new organization capable of creating and enforcing rules that the member organizations can use as external rules. These *coordinating organizations* will still face the problem that relationships erode rules, but may at the margin be able to insulate rule enforcement from the relationships in the member organizations and enforce rules more predictably.

Rather than thinking about why a particular rule works well or poorly in a particular situation, the rule and organization matrix encourages us to think about the system of rules and organizations and how they interact. External rules can ease the fundamental tension if rule creation and enforcement can be shifted to a coordinating organization insulated from the relationships in a particular organization.

External default rules are much more effective coordinating devices as external rules than external prescriptive rules. External prescriptive rules require that behavior be homogenous across all the organizations that access the rule. External default rules are more flexible in their operation, they can tolerate the existence of incongruent rules within the matrix of rules, and they can fit more situations. In fact, as we saw with the union nail rule, external rules often work better if the rules in the coordinating organization (the union) are default rules that are actually incongruent with the rules in the organization accessing enforcement (the laborer/carpenter pairs.) The argument so far as three steps:

- Within organizations rules and relationships are in fundamental tension.
- External rules are a way for interacting organizations to ease the tension, but not eliminate it. This is sometimes done explicitly through a coordinating organization.

- Default rules are often more effective external rules than prescriptive external rules.

Default rules enable more flexible and heterogeneous use of the rule across organizations, because behavior across organizations does not have to conform to the rule.

These propositions should be true in all societies, identity rule societies and impersonal rule societies.

2.6 Impersonal Rules

Implicit in the union nail rule to this point has been the assumption that the unions enforce the rule impersonally. That is, the categories of carpenters and laborers are well understood and the union always rules in favor of the carpenter when a dispute about driving nails is brought to it. What happens if the unions don't enforce the rules impersonally? Unions are well known for favoring longer tenured members of a union over newer members. What if the union usually ruled in favor of carpenters, but occasionally ruled in favor of the more senior union member, even if that member was a laborer? The coordinating power of the default rule will be reduced. Now carpenters and laborers have to know who they each are personally before they know how the rule will apply to them.

The conceptual opposite of an impersonal rule is an *identity rule*: a rule whose form or enforcement varies according to the identities of the people to whom the rule applies. The most obvious cost of an identity rule is that two people in a relationship have to know who the other is before they know how the rules will apply to them. Transaction costs rise in every relationship. Other aspects of identity rules will be discussed in the next section. The key point is that external default rules work much better as coordinating tools if they are impersonal rules. If people know the form of the external rule, how it will be enforced, and that enforcement does not depend on

the identity of the individuals trying to use the rule, the effectiveness of the external default rule is enhanced. *Impersonal external default rules are the most effective way to coordinate relationships within and between individuals and organizations.*

As we will see in more detail in the next section, before the 1840s no society was able to create and enforce impersonal rules on a broad scale. As already mentioned, even in Britain and the American states, 75% of the laws applied to specific individuals, specific organizations, or specific localities: they were identity rules. When societies began moving to impersonal rule provisions, as Indiana did in 1851, the existing identity external default rules were replaced by impersonal external default rules, and the entire rule and organization matrix became more effective at supporting coordination within and between organizations. In principle, all citizens have access to all the rules the government created and enforced, including the rules for forming and governing organizations. The result was more organizations, more productive organizations, and more heterogeneous organizations.

There are more organizations because impersonal rules for forming organizations allow more people to form them. Economic organizations become more productive because transaction costs within and between organizations decrease ala the nail rule logic, and because impersonal external rules are more predictable than identity external rules and individuals can take outside options defined by default rules as given. Heterogeneity of relationships and organizations increases because the same default rule can support a wide variety of idiosyncratic relationships. Heterogeneity enables a greater degree of specialization and division of labor, which promotes economic growth and development. Greater heterogeneity leads to greater innovation. As more alternative arrangements are tried, more successful new arrangements are

discovered.

Finally, impersonal external default rules increases “freedom and liberty.” Individuals are free to enter into relationships that do not have to conform to prescriptive rules. Individuals know they can call on rules as outside options, and if the rules are impersonal, they do not have to worry about the identity of the counter-party in their relationships. Rules are enforced predictably, but do not bind the behavior of individual relationships. This is not an insight of any of the institutional literatures. In fact, most of the economics literature is anti-organizational in the sense that the rules organizations form are regarded as limits on liberties and freedoms, and thus reduces choice as a consequence of trying to provide social order. The truth is more subtle and varied. Default rules can increase freedom and liberty even as more rules appear.

Theoretically, when a society moves from a legal regime of identity rules to a legal regime of impersonal rules economic performance should increase. The effect of moving to impersonal rules will be to enhance the coordinating power of rules throughout out society and the rule and organization matrix. The argument now has four steps:

- Within organizations rules and relationships are in fundamental tension.
- External rules are a way for interacting organizations to ease the tension, but not eliminate it. This is sometimes done explicitly through a coordinating organization.
- External default rules are often more effective external rules than external prescriptive rules. Default rules enable more flexible and heterogeneous use of the rule across organizations, because behavior across organizations does not have to conform to the rule.
- Default rules are more effective coordinating tools if the are impersonal rules. By adopting impersonal rule provisions like Indiana’s all the rules in a society, in the rule and

organizational matrix, become more effective at sustaining coordination and relationships.

Now, what about governments?

3. Impersonal rules and the transformation of factional democracy into mature democracy

Section 2 laid out a bestiary of rules (laid out in the glossary p. 49) that suggests that the spread of impersonal rules in the mid-19th century may have played an important role in the onset of modern economic growth in the last half of the century by making organizations more productive, more numerous, and more heterogeneous. Any government that wants to can create an impersonal rule such as “thou shall not steal.” Some rules before 1850 took this apparently impersonal form, but roughly 75% of the legislated rules in the US and UK took an explicitly identity form: they were rules that named specific individuals, organizations, or localities.¹² I begin by asking why they created so many identity rules and so few impersonal rules, and why governments rarely seemed to have been willing to enforce rules in an unbiased impersonal way even when they were written as if they applied impersonally.

NWW’s logic of the natural state provides an explanation for the predominance of identity rules, even though they did not use that term. Societies with political systems that rely on identity rules are usually “factional” polities. Factions, ala James Madison, are defined as small groups with narrow interests who aggressively pursue those interests, even a a cost to the larger society. The idea that factional political organizations often worked to the detriment of society is part of the origins of the anti-organizational bias in economics, ala Adam Smith, as well as classic liberal ideas more generally. In a polity coordinated largely through identity rules,

¹²In the United States laws that applied to specific individuals, specific organizations, and specific localities were usually called private, special, and local laws respectively. The terms varied across states somewhat as well as across countries.

when interests approach the government they seek a law that creates a particular benefit or accommodation to fit their needs. The process of building a governing coalition in pre-democratic societies without legislatures, in societies with elections and majority governing coalitions, or in a number of cases in between those the two poles, all rely on assembling coalitions of factions. By their nature these factional coalitions are fluid, short lived, and subject to change. The factions themselves were usually short lived, notwithstanding political organizations like the PRI in Mexico which asserted dominance for a long period. Factional politics and factional democracies are the starting point for understanding how impersonal rules emerged and were sustained in a system such as Britain or the United States had in the early 19th century.¹³

In the dozen or so countries that adopted impersonal rule provisions in the mid to late 19th century the organization of the political system transformed from factional democracies dominated by numerous and relatively short lived factions and coalitions, to *mature* democracies dominated by a small number of durable long lived *political parties*. The major parties with a chance to win elections, or in PR systems to hold a place in a coalition government, came to compete repeatedly in successive elections over long periods of time. The number of mature parties was considerably smaller than the number of factions that preceded mature democracy, even though small parties without much chance of winning elections form regularly in mature democracies for purposes other than winning elections. The durable mature parties had longer

¹³The work of Scott Mainwaring and a number of coauthors, in a number of edited volumes as well, is persuasive on the point that party systems in developing countries are factional. See Mainwaring and Scully (1995) and Mainwaring (2018) for an overview of an ever growing literature. For Africa see Reidl and for Asia see Hicken (2009) and Hicken and Kuhonta (2014).

lives, professional and volunteer staffs, and were capable of reaching agreements between themselves that were also durable and long lasting. I have used the terms factional and mature democracies, rather than immature and mature democracies, because I do not want to imply in any way that there is a growth process at work that transforms immature democracies into mature as they age.¹⁴ Indeed, the process seems reversible. Most factional democracies are not about to become mature democracies, even with the passage of long periods of time. And it appears that some mature democracies are on the verge of reverting to factional democracies in the early 21st century.

In a mature democracy control of the government becomes “reciprocal,” in the sense of the term coined by Robert Dahl (1956/2006, p. 21). The major parties compete in elections and expect that losing is a real possibility, but they also expect to be able to compete again. Losing an election is not a permanent loss. The major parties all must deal with the reality that at times they win elections and will be in control and at times they lose elections and are out of control.¹⁵ As John Aldrich described in *Why Parties?* durable competitive parties are necessary for mature democracies: “What matters is the sustained competition that comes from the interaction between or among durable parties, such that it is the fact that any winning party must seriously consider the prospect of losing an election before democracy becomes tenable. A necessary condition for effective democracy, in this view, is that there must be a party system, an ongoing set of parties

¹⁴I am not wedded to these terms, at the moment they are placeholders for kinds of democracies and kinds of political organizations whose meaning seems fairly clear, even in the terminology used to describe them in the social science literature is fairly chaotic.

¹⁵It is more accurate to say that the winning party is in constrained control of the government.

in sustained competition for access to power.” (Aldrich, 2011, p.4)

Although the connection may initially seem remote, societies that adopted impersonal rule provisions in the late 19th and early 20th century all developed party systems with durable political parties that competed in elections without eliminating or suppressing their political opponents when they won elections.¹⁶ The logic of why parties became durable works backwards from the expectations that durable political parties must form if they are to be willing to make the investments in people and rules that will enable them to persist through time. Parties collectively adopt rules that change the rule and organizational matrix. The political system needs to adopt three sets of institutional rules, three elements: free and open elections, political control of government administration passes to those parties who win elections, and sustained support for impersonal rule provisions. Together those three elements enable parties to believe they will be around to compete in the future. In the process, the nature of the political process is profoundly changed. Impersonal rules are supported and sustained over time in these societies, because the organizations that reciprocally control the government – the major political parties – all have interests in maintaining impersonal rules. It is the parties themselves that implement these rule changes. They are, after all, in a position to do so. Before getting to those details, we need to circle back to governments and the fundamental tension: why governments in most societies have trouble creating and enforcing impersonal rules.

3.2 Governments as coordinating organizations

¹⁶The concept of a party system is a bit tricky, since all polities with elections develop party systems. There are party systems in factional democracies and party systems in mature democracies. The party systems are very different, but they fall under the same conceptual category in political science. There are, of course, different types of party systems too.

Governments, of course, are organizations whose essential feature is to provide external rules and rule enforcement for other organizations in society. Establishing and operating a coordinating organizations is not easy, and many do not work well.¹⁷ Is it possible for powerful organizations to create an organization in their midst, like a government, that will enforce impersonal rules? Can a government organization be credibly insulated from the corrosive effects of relationships on rules? Unfortunately, for most of human history and most societies in the world today, the answer appears to be no. Worse than no, it appears in most societies as you move up the rule and organization matrix *that organizations become systematically less capable of supporting impersonal rules and more dependent on identity rules*. In most societies powerful organizations are embedded in a set of relationships with other powerful organizations based on identity rules. What happened in the mid to late 19th century, when governments appeared that could create and enforce impersonal was a real innovation.

North, Wallis, and Weingast explained how powerful organizations were able to coordinate on agreements that limited violence between them: what they called the logic of the natural state. The biggest threats to powerful organizations are each other. The organizations might like to agree to a set of rules that prescribe violence, but such naive rules are not credible *ex ante* as all the powerful organizations will use violence if it suits their purposes. Instead, the

¹⁷There are many examples of private coordinating organization that do appear to work well. See the work of Lisa Bernstein (1996, 2001, and 2015) for a host of persuasive examples. Whether a coordinating organization, private or public, works well or not may depend on whether it is able to create and enforce impersonal rules rather than identity rules. One of the underlying themes of this essay is that government organizations in the United States became more effective coordinating organizations after they adopted impersonal rule provisions. The problem, which we re about to come to, is that most governments create and enforce identity rules.

powerful organizations agree to create and recognize a coordinating organization(s), a government(s), that signifies, clarifies, and enforces their agreements. To limit violence, the agreements devise rules that create different and specific benefits for specific organizations and individuals. The agreement creating the coordinating organization also creates external rules that the member organizations can access. One of the most valuable privileges elite organizations possess is the ability to access the external rules that the coordinating organization will enforce. If the agreement breaks down, the specific benefits disappear. Every member organization, therefore, has some incentives to honor their promise to coordinate through the agreement and not use violence. The elite agreements support identity rules, because everyone is treated differently under the rules. The agreements make the creation and enforcement of impersonal problematic.

The key advantage that natural states have over what preceded them is their ability to support the establishment of coordinating organizations that can provide external rules to a larger group of organizations. The logic of the natural state, however, implies organizations higher in the rule and organization matrix of a society will be *more dependent on identity rules*. Many privileges in a natural state are created by limiting the ability of organizations to access the external rules that the government will enforce.

The underlying reason for identity rules is the destabilizing and corrosive effect of relationships on rules. These forces become more, not less, pronounced the higher organizations are located higher in the matrix. Relationships between powerful organizations are what maintain or destroy agreements and limit violence. This is why agreements at the top of the rule and organization matrix are so fragile, even in stable identity rule regimes. Suppose two coalitions of

powerful organizations with stable rules and agreements experience an unexpected change in circumstances and they threaten to fight. At that point, changing the existing rules or ignoring them altogether, is usually preferable to a civil war. *Maintaining elite organizational relationships drives changes in the rules.* The rule of law is weak in natural states because of that. Circumstances always change, and when relationships between elite organizations change, that requires changes in the agreed upon rules.

How did a few societies get out of this dilemma in the late 19th and early 20th century? How did the existing organizations create new agreed upon rules and new or modified coordinating organizations in which the dynamics of relationships would lead the coordinating organizations to credibly sustain external impersonal rules? More importantly, how did political systems that relied on identity rules to manage their internal political dynamics manage to sustain impersonal rule provisions once they had adopted them? The answer has to involve an explanation of how powerful organization were induced to have, or new powerful organizations were created who had, an inherent interest in supporting and sustaining impersonal rules. More specifically, how could the relationships surrounding and determining control of the coordinating organization(s) be structured in a way that the coordinating organizations produced and enforced impersonal rules?

The answer appears to rest with the appearance of a new form of organization: mature, long lived, durable political parties who had the ability to control governments if they won elections, but were embedded in competitive electoral and party systems that guaranteed that parties that lost elections would be able to compete again in future elections. As Aldrich claimed in the passage quoted earlier, this was a *necessary* condition for “effective democracy.”

3.2 Impersonal Rules and the Party System

The history of impersonal rule provisions is barely written. Even in the United States, where the states explicitly incorporated impersonal rule provisions in their constitutions after 1851, you can look long and hard to find a general history, or even a specialist history, of the 19th century that points to these constitutional changes as a major turning point in the institutional structure of American governments.¹⁸ The business history literature is aware of the passage of general incorporation acts and general incorporation mandates in the constitutions, but there is no general appreciation of their importance.¹⁹ There is almost nothing in the European political histories, and the move to impersonal rules in Britain was accomplished gradually without a sharp break as in the American states. There is still no impersonal rule provision in the US national constitution.

The underlying reason for the lack of a history of impersonal rules can be found in the logic exhibited in the rule and organizational matrix. External rules tie the system together, *but*

¹⁸The exceptions are Charles Chauncy Binney (1894) and Ireland (2004).

¹⁹As evidence I present myself. I became interested in state constitutions in the early 1990s and received an NSF grant to collect and digitize all of the state constitution from the present to 2000. The constitutions for most states are available at “www.stateconstitutions.umd.edu/index.aspx.” I became interested in general incorporation acts and worked on explaining their appearance (Wallis, 2005 and 2006). Through all of this work my interest in the Indiana constitution focused on Article XI, Section 13 “Corporations ... shall not be created by special act, but may be formed under general laws” rather than on Article IV, Section 22 which listed the 17 functions for which the legislature had to pass general laws, or Article IV, Section 23, “In all the cases enumerated in the preceding section, and in all other cases where a general law can be made applicable, all laws shall be general and of uniform operation throughout the State.” I did not see the importance of Section 22 and no one else had either until Naomi Lamoreaux and I began thinking about impersonal rules more thoroughly.

external default rules do not have to be followed to be effective coordinating tools. As democracies developed mature party systems, the systems developed from rules that were not explicitly formed to create or govern political parties. The rules were created to deal with contingent and often idiosyncratic political crises and problems. There were few obvious direct connections between the three democratic elements we are about to explore and, as a result, the histories of democracy emphasize broadening suffrage and electoral rules without seeing how electoral rules were only part of the institutional developments that led to mature democracies.²⁰

There is a rich literature on the history of political parties in Britain, Western Europe, and the English speaking world. While we cannot pinpoint the chronological appearance of impersonal rules in Europe, unlike Indiana in 1851, we can begin to test hypotheses about the development of mature democracies by correlating observable elements of impersonal rule provisions with democratic elements. The existence of general incorporation laws leave a footprint in the number of corporations chartered and we can proxy for impersonal rule provisions by counting the number of corporations across societies.

How does the adoption of impersonal rules provisions affect the political system? In a factional political system before the adoption of impersonal rule provisions, political organizations could not reasonably enter into agreements with each other that required a long time to come to fruition, because the expected life time of factions and coalitions was limited. The way legislatures in factional democracies work in practice is represented theoretically in the way Baron and Ferejohn (1989) model legislatures . They showed how a legislature with a

²⁰For example, Berman (2017) divides into “liberal democracies” and “electoral” and “illiberal” democracies using universal male suffrage as the criteria for a liberal democracy, pp. 3-5 and Table 9.1 p. 174. There are dozens of similar examples.

randomly chosen agenda setter, chosen each session, could avoid vote cycling and policy stability. The agenda setter had a fixed amount of resources to allocate among districts. The agenda setter maximizes his return by allocating just enough to individual legislators to get them to support his overall allocation package. When he secures the votes of a sufficient majority, no other legislators receive an allocation. The allocation is a simple identity rule: each legislator got a different amount depending on their opportunity cost and value to the agenda setter.

Legislative majorities in real factional democracies are built by assembling short lived coalitions lubricated by identity rules. Identity rules keep the legislative machine running. This is why 75% of the legislation passed by Parliament and American states legislatures before 1850 was identity legislation that explicitly named and benefitted specific individuals, specific organizations, or specific localities. If impersonal rule provisions are imposed that lubrication begins to dry up.

The first impersonal rule provisions adopted in many societies have been rules for forming corporations. Rather than going through the political process to obtain a charter, under an impersonal rule a corporation can be formed by a simple administrative act. When societies adopt impersonal rule provisions for forming corporations – Britain in 1844, the American states in the 1840s and 1850s, France in 1869 -- many more economic organizations come into existence. In Britain and France the number of corporations grew by an order of magnitude with a decade (NWW).

When this happens the legislature loses effective control over economic entry, a major tool for creating economic rents in a factional polity. Coalition building now requires more complicated deals that stretch over longer periods of time and across legislation that necessarily

affects larger numbers of legislators and constituents directly, as almost every piece of legislation now applies to everyone.²¹ When impersonal rule provisions are implemented the organizational structure of the political system has to change. How could politicians and legislators living in a world where no one could expect that a particular coalition would last for more than a couple of legislative session, come to believe that a political party could have a durable life of decades or longer?

The existing political histories and political theories about political parties are not particularly revealing on this question. Influential work on parties usually begins with the premise that mature (or modern) parties appear because they are necessary organizational responses for groups who want to compete in elections with broad suffrage requirements. This is true of Schattschneider (1942), Sartori (1976), and Aldrich (1995/2011). Aldrich's book *Why Parties?* is among the most influential contemporary work on parties and is also a history of parties in the United States. Since the goal of parties is to win elections, changes in the institutional structure of parties should be driven by competition between parties. This is the explicit frame in which party histories are generally written. As quoted earlier, Aldrich concludes that durable parties are necessary for mature democracies, but at the same time he does not feel it necessary to explain how or why parties became durable: "The first critical point is that 1860 saw the emergence of the two-party system featuring the Democrats and Republicans. *The durability of the two-party system is not surprising.* The durability of the two particular parties is more so." (Aldrich, p. 166, emphasis added) This explains, in part, the intense focus of the

²¹Impersonal rules for creating corporation are not always the first impersonal rules to be adopted, see the essays in Lamoreaux and Wallis 2017 for some history on this point.

democracy literature on suffrage and elections rather than parties: mass parties follow suffrage reforms.

Both historically and in the modern world the appearance of a two-party system (or a multi-party system in countries with proportional representation) with durable parties *is a surprising phenomena*. Even in the world today, most countries in 2022 have some form of elections, a number fluctuating around 75% of all countries. All of those countries have political organizations that compete in elections that we call “parties.” All the countries have party systems, but in very few countries outside of the developed world are party systems composed of durable long lived parties. The party systems outside the developed world can be accurately characterized as factional party systems, just like the Britain or the United States in the early 19th century.

It is natural to explain why parties became durable in a small number of countries by writing the history of the competing parties within their party systems. In these histories party competition that drives the formation of durable parties. This is true of the histories of the United States, it is true of Britain, and it is true of the “pluralist” literature of the 1960s which attempted to explain why democracies grew and survived in the late 19th and early 20th century Europe. In 1950 a political scientist writing about democracies and parties would find that almost all of the democracies in the world had durable political parties. Durable political parties would appear to be an inherent element of all democracies in existence.

Yet, elections appeared in more than a hundred new democracies since 1950 and very few of those countries developed competitive party systems with durable parties. It can hardly be the case the electoral competition explains why parties become more durable. What was different

about the Britain, the English speaking world, and a handful of European countries that led to durable parties?

3.3 Expectations and Durable Political Parties

Sustaining a political system where parties have more durable lives requires that politicians themselves develop expectations that parties would be around longer in the future, even if they lose the current election. Here we can draw on the insights developed in section 2. Could a coordinating organization, or organizations, develop rules that enable political organizations to have more confident expectations that they would be able to compete in future elections even if they lost the current one?

Conceptually, we can ask what set of agreed upon rules could be enacted to guarantee parties would have longer lives? Since politicians and political organizations collectively control the rule creation process, they could implement a series of changes in the rules, even if the changes were initially intended to benefit one party, if, over time, competing parties all agreed to the rule changes when they were in control of the government (whether they supported them initially or not), then the rules would be sustained. We can then go back to the histories to see if those institutional changes in the rules were in fact implemented. This will not adequately answer questions about why politicians changed the rules in the first place, but it will answer the question about how party systems with durable parties were sustained.

The hypothetical agreements involve three elements: competitive elections, constitutional changes in government administration, and impersonal rules. Together these three sets of institutional rules create a party system capable of sustaining durable long lived political parties.

Competitive elections: durable parties have to believe when they lose an election that they

will be able to return and compete in an open and fair election in the future. Ultimately, free, fair, and open elections required rules under which voters were allowed to cast their ballots without undue outside influence. Sustaining competitive elections also involved parties forswearing the use of violence as an electoral technique, either against other parties or directly threatening voters. In a party system where elections are competitive and open, major parties know they will lose elections in the future, but existing parties can also believe they will have a chance to compete in future elections even if they lose the current one.

Constitutional arrangements for government administration: All parties must agree to changes in constitutional structures so that the leaders of government organizations, such as cabinet ministers, are either directly subject to election or are appointed and easily removed by elected officials. The selection of the leaders of government organizations must depend on elections. Elections must matter to governments and elections matter much less if control of the government lies outside of the electoral system, say with the king.²² By placing control of government administration with elected officials political party leaders became both government officials when their parties were in power, and party officials when their parties were out of power. Robert Dahl described this as a system of “reciprocal control.” The parties put themselves under the discipline of elections, and insure that the parties that win elections have access to positions of control within the government.²³ How then was the winning party to be prevented

²²The second element was not a major obstacle in the United States, where the original state constitutions and the second national constitution all vested control of the government in elected officials. It was, however, a major element in European reforms.

²³In Dahl’s *Polyarchy*, which lays out the elements of political systems as they develop toward democracy, the last element is “8. Institutions for making government policies depend on votes and other expressions of preferences.” (1971, p. 3) Reciprocal control has two dimension.

from using its control of the government and legislature to change the rules in order to suppress or eliminate the losing parties?

Impersonal rule provisions: Since the party that wins an election has disproportionate influence over the legislative process and the formation of new rules, all parties have to agree that whatever rules they pass when in power apply equally to everyone. The party in control cannot pass identity rules that discriminate against or suppress the parties out of power. A firm commitment to impersonal rules insures that when a party loses an election it is capable of competing again in the next election. Support for impersonal rule provisions must be baked into the institutional agreed upon rules that structure the party system. All the organizations with a legitimate chance to control the legislative process and the government must have clear incentives to support and sustain impersonal rules.

The three elements of the agreement the parties reached can be institutionalized in agreed upon rules passed by the legislatures or embedded in constitutions. Perhaps unexpectedly, the new party systems does not need to include many rules about the formation and operation of political parties themselves. Any rules about parties could be used to adversely affect some parties over others.²⁴ Instead of rules about parties, the party system creates rules about elections,

One is that the major parties exert control reciprocally, coalitions trading control with election outcomes. The second is the politicians are both government officials and private actors on a reciprocal basis. Dahl raises the term reciprocal control when talking about James Madison in *Toward a Democratic Theory*,

²⁴This does not mean there are no rules about parties. Holding competitive elections requires rules governing how candidates are able to get their names on the ballot, how the ballots are structured, and rules like that may include provisions that directly affect parties. There are, however, no rules mandating the organizational structure of parties that parallel the rule governing the structure of economic organizations, for example. It means that the parties are largely “extralegal” organizations. Schattschneider put it this way: “The extralegal character of

government administration, and impersonal rule provisions that are external to the parties themselves. The parties are embedded in a rule and organization matrix. Just as default rules do not translate directly into observed behavior, few rules about parties are prescriptively enforced. Not all of the rules governing elections, government administration, and impersonal rule provision are default rules, but many effectively are.²⁵ The agreed upon external rules create assurances and incentives for parties to become more durable through time, to abide by the results of open and competitive elections, and to continue to sustain impersonal rule provisions. This is true whether the rules are enforced prescriptively or as default rules.

Control of the government becomes reciprocal. Organizations that periodically control the government – durable, mature, political parties operating in a party system where rules external to the parties shape their interests – have a strong and abiding incentive in maintaining competitive elections and impersonal rules. Parties become longer lived and the number of parties with a significant chance to influence elections declines. The major parties remain competitive in many ways. They are, however, integrated into and through the party system. The parties stop trying to suppress or eliminate each other. Instead they accommodate one another.

political parties is one of their most notable qualities. In a highly legalistic system of government such as the United States, therefore, the parties seem to be a foreign substance. It is profoundly characteristic that the fundamental party arrangements are unknown to the law.” (1942/2004, p. 11).

²⁵For example, the enforcement of the general law provisions in my home state of Maryland are described in Friedman, (2011-2012). In Maryland private citizens have the ability to bring a suit against the state legislator or Governor for creating special laws. Friedman was the assistant state’s attorney in a 2011 case in which the 1864 constitutional provision prohibiting special laws was exercised. The provision is a default rule. If no one brings a suit to the courts, the law stands. There is no public or private authority that enforces Maryland’s general law provisions prescriptively.

The parties adopt agreed upon rules that appear in one part of the rule and organization matrix, in order to sustain the existence of party organizations in another part of the rule and organization matrix.

3.4 The international context: Europe in the late 19th and early 20th century

As a check on the hypothesis that electoral reforms, changes in government administration, and expanded impersonal rule provision led to competitive, durable, and stable party system we can utilize the experience of European countries in the late 19th and early 20th centuries. The logical argument can be reversed. If the three reform elements were *necessary* to create durable party systems, then only party systems with those elements should have been durable and stable over time. Between WWI and WWII, some democracies in Europe retained their party systems and mature democracies, while other democracies lost their democracies altogether. The question is whether the three elements were present or absent in these early 20th century democracies.

Because there are no detailed histories of impersonal rule provisions in any European country, including Britain, I proxy for the presence of impersonal rule provisions by counting the number of corporations per capita. General incorporation laws lead to a significant increase in the number of corporations (see NWW). Les Hannah compiled a census of corporations in 1910, covering 34 (+) countries with a mean of 120 corporations per million people. The top 14 countries are listed in the first column of Table 2. The break in the series seems to come after Finland, with 755 corporations per million population, then an intermediate group of Belgium, France, and Germany. The rest of the sample clearly did not have impersonal rules for forming corporations. I have added Spain, Italy, Austria, and Portugal to the top 14 to make a list of 18

countries.

All of the 18 countries on the list in Table 2 had some democratic elements in the late 19th century. Germany had universal male suffrage under its 1871 reforms. Spain had universal male suffrage in two 19th century constitutions, but the constitutions did not last, and for a time in the 1930s a democratic republic. Italy gradually broadened the suffrage until universal male suffrage and proportional representation was adopted in 1919. Cisleithanian Austria adopted a series of democratic reforms beginning in the 1890s; the estates system was abolished and replaced by universal male suffrage in 1907; Austria claimed its independence in 1919; and the Austrian republic wrote a constitution in 1920. Women gained the vote and the voting age was reduced to 20.

Table 2 brings together the 18 countries, ordered by corporations per million people in 1910, and notes whether the country adopted any of the three institutional reforms which led to durable parties before 1920. The countries in the upper panel all show evidence of impersonal rules provisions by 1910. The countries in second panel are on the cusp of impersonal rule provisions. Germany had corporations, but was not able to adopt any of the democratic elements and neither did the four countries in the lower panel.

The classification of the democratic elements are taken from the studies of the pluralists. Historically oriented, their general conclusions, as described by Dahl (1966 and other publications), were that factional societies riven by internal cleavages – religious, ethnic, or economic – which always included the possibility that the existing factions in power would

actively suppress competing factions.²⁶ Plural societies could escape factional politics by adopting party systems in which a small set of durable parties managed to accommodate one another. They did so by recognizing a set of electoral rules guaranteeing free and open elections, giving control of the government to the party or coalition (in proportional representation electoral systems) that wins elections, and requiring that the rules created by the government apply equally to everyone. The pluralists did not emphasize impersonal rules, however. In the pluralist literature these are outcomes of the democratic process. In the conceptual framework presented here, these institutional elements are inputs into the process of democratic development leading to mature democracies with party systems composed of competitive, durable political parties who exercise reciprocal control over governments. Voters choose between parties, but their choices are clearly limited to the small number of parties capable of winning elections.

Table 2 shows that all of the countries that show evidence of impersonal rule provisions, as proxied by the number of corporations per million residents, had adopted all three of the democratic elements necessary to support durable parties by 1920. Germany, Italy, Austria,

²⁶Robert Dahl opened the preface to his 1966 edited volume *Political Opposition in Western Democracies* this way: “Somewhere in the world, at this moment, a political group is probably engaged in the antique art of imprisoning, maiming, torturing, and killing its opponents. Somewhere, as you read these words, a government and its opponents are no doubt trying to coerce one another by violent means. For without much question the most commonplace way for a government to deal with its opponents is to employ violence.” He continued: “Throughout recorded history, it seems, stable institutions providing legal, orderly, peaceful modes of political opposition have been rare. If peaceful antagonism between factions is uncommon, peaceful opposition among organized, permanent political parties is an even more exotic historical phenomenon. Legal party opposition, in fact, *is a recent unplanned invention* that has been confined for the most part to a handful of countries in Western Europe and the English-speaking world. Even more recent are organized political parties that compete peacefully in elections for the votes of the great bulk of the adult population who can exercise the franchise under nearly universal suffrage.” (p. xi, both quotations, emphasis added).

Spain, and Portugal had not adopted the elements. Democracy did not survive the 1920s and 1930s in the later group. In every country with impersonal rule provisions, not only did mature democracies survive, the major parties in 1950 were very often the same parties that contended in elections in the 1920s.

4. An Organizational Theory of Development and a (brief) History

The 18 countries in Table 2 were not chosen at random, but neither were they chosen to reflect the belligerents in WWII or their division into alliances and coalitions. Fundamental conflicts over democracy were at issue in the war. The countries were included because, in 2022, with a few additions the countries are still the richest and most democratic on the planet (noting, of course, the wide variation in definitions of democracy).

This paper lays out a theoretical approach to organizations in general, then derives propositions about the interaction of rules and relationships within and between organizations from the basic assumption that all organizations adopt rules to increase the value of relationships within organizations and the basic definition that all *agreed upon rules* originate in organizations.

- Within organizations rules and relationships are fundamentally in tension.
- External rules are a way for interacting organizations to ease, but not eliminate the tension. This is sometimes done explicitly through a coordinating organization.
- External default rules are often more effective rules than external prescriptive rules.

Default rules enable more flexible and heterogeneous use of rules across organizations, because

behavior across organizations does not have to conform to the rule.²⁷

- Impersonal rules make default rules within organizations and external default rules more effective across organizations. To the extent that impersonal rule provisions include rules governing the formation of organizations the number of organizations increases. To the extent that impersonal rule provisions gives a wider share of the population access to impersonal external default rules organizations become more productive and heterogeneous. Heterogeneity of organizations is a first order source of economic growth, improved economic performance, and economic development.

The adoption of credible impersonal rules should lead to more organizations, more productive organizations, and more heterogenous organizations. That, in itself, is not a bad definition of economic development.

North defined institutions this way: “Institutions are the rules of the game in a society or, more formally, are the humanly devised constraints that shape human interaction.” (1990, p. 3) There is nothing in this theory of organizations and rules inconsistent with North’s definition. If we replaced “humanly devised constraints” with “collectively agreed upon rules” my definition and North’s modified definition would be identical.²⁸

But this is not North’s theory of institutions and economic development, nor is it Acemoglu and Robinson’s theory of institutions and economic development (in 2006, 2012, or

²⁷For the most part, the economics of institutions and political economy literatures have taken external prescriptive rules created by governments as the iconic type of rule and have missed the implications of default rules.

²⁸Of course, my definition would exclude norms, beliefs, values, and culture from institutions. All of those are constraints on human behavior, but none of them are “collectively agreed to rules.” How we should define institutions is a bigger than this paper can handle.

2020), nor is it Tilly's theory of institutions (the state) and economic and political development (1990), nor is it North, Wallis, and Weingast's (2009) theory of institutions and economic development. It does not build on the assumption that secure property rights, a state that credibly commits to its agreements and agrees to enforce the laws as written (identity or impersonal), and secure low cost contracting environment are the key elements of the institutions that support modern development. To be sure, those are all *outcomes* of political systems that are able to credibly create and enforce impersonal rules across broad spectrums of rules, organizations, and societies. But they do not tell us why those outcomes are sustained. At best we have tried to explain why the outcomes occur in some societies and not others, assuming that once adopted they are self-sustaining.

Instead, the theory of organizations developed here begins in a different place:

- Because the fundamental tension between rules and relationships exists in all organizations, all societies of any size have to devise ways to deal with the tension.

- In all societies that use external rules to coordinate across organizations and create coordinating organizations to provide the external rules, the tension between rules and relationships can be eased at lower levels of the rule and organization matrix. But in most societies that is accomplished at the cost of increasing the fundamental tension at higher levels of the matrix. At the highest levels, rules drive relationships to the extent that even basic rules are always subject to change if relationships between powerful organizations find the value of their relationships with each other is reduced by particular rules. In that situation rules either change or violence is a likely outcome. That is a more abstract and general statement of NWW's logic of the natural state.

- Since all societies face this problem, it is only by configuring the rules in such a way that powerful organizations that control access to governments have a strong interest in maintaining impersonal rules, that impersonal rule provisions can be made sustainable. Otherwise relationship will erode the rules. Relationships erode rules at all levels of the rule and organization matrix. The same logic applies at all levels of societies. Access to the control of governments in a mature democracy is a role played by mature political parties. The adoption of impersonal rule provisions in the countries that become mature democracies involves organizational innovation in both the economy and the polity. The fact that durable political parties control access to the government in a mature democracy is not the result of prescriptive rules that political parties rights to exercise reciprocal control. It is the result of the way rules and organizations dynamically interact in the rule and organization matrix. It is the rules governing elections, government administration, and impersonal rule provisions that create the incentives for mature political parties to form and behave in the way that they do.

In order to see how a society can adopt rules that organize its political process in a way that creates powerful organizations with the incentives to support impersonal rules, and so to support the impersonal external default rules that enable greater productivity in heterogeneous organizations as well as in the economy as a whole, we cannot begin in an intellectual sense with a Leviathan conception of governments or rules. A single actor rule giver *will always* find it in his or her best to adjust rules to relationships in changing circumstances in order to maintain their position of control. It is only if the Leviathan is sanctioned or created by force external to the society, e.g. God, would Leviathan not need to worry about losing control. In *Leviathan* the only

secondary rule is whatever Leviathan says is the rule has to be the rule, or Hobbes's logic fails.²⁹ North, Acemoglu and Robinson, Tilly, and NWW all start in a Hobbessian place intellectually and conceptually.

We need a theory of organizations and rules that understands how humans attempt to solve the fundamental tension between rules and relationships. Economic development is not about the disaggregated accomplishments of atomistic individuals that add up to higher economic performance. It is the result of changing the rule and organization matrix in ways that enables the organizations in a society to become more numerous, more productive, and more heterogeneous. The technological achievements of modern developed societies are the result of increased coordination, not atomistic invention and innovation.³⁰ Impersonal default rules enable freedom and liberty to flourish in an environment of security and peace. The expansion of government rules does not threaten freedom and liberty if the rules operate as default rules, but enhances it.

Economic's ambiguous treatment of organizations as both sources and obstacles of growth has predisposed us to not think about institutional innovation as working through organizational innovation (except in derivative ways), but through individual behavior alone.

²⁹Hobbes sets up his logic so that the only reason Leviathan would lose control is if he fails to provide peace. But Hobbes draws no distinction between identity rules and impersonal rules and he lived in a world of identity rules. One of Hobbes conditions that the Leviathan must hold to is that Leviathan has a monopoly over the creation and alteration of all rules. Leviathan would inevitably change the identity rules as a means of sustaining peace. Leviathan could not sustain impersonal rules, even by Hobbes's logic.

³⁰Coordination is the basic element of technological change in Joel Mokyr's "culture of growth" (2010, 2017). Economies begin to take-off technologically when coordination between people with skills and ideas increases.

Yet, even rational actor models of organizations produce organizational outcomes in which irrational behavior (in Selznick's sense) makes perfect sense. Relationships drive rules and we cannot, *ex ante*, conclude whether behavior is rational or irrational unless we understand all of the relationships at play. The value of relationships, however, is just as basically unobservable as utility is. Just as with utility theory, however, we can learn more about how the world works by beginning from the right theoretical spot and going on from there. Economic development is essentially an organizational accomplishment, not an individual accomplishment. We need a fuller organizational theory of economic development before we can understand the enormous changes that began in the mid-19th century and continues to shape the world that we live in.

Table 1
 The Organizational Ecology and Rule Environment of
 Laborers and Carpenters with respect to Driving Nails:
 The rule and organization matrix

Organizations:	Rules:
The State Safety Commission:	Rule I: Don't drive nails without wearing safety goggles
The Unions:	Rule II: Carpenters drive nails, laborers do not drive nails
The Construction Firm:	Rule III: Do what the carpenter says
The laborer/carpenter pairs	Rule IV: Whatever arrangement the carpenter and laborer work out between themselves determines who drives nails

Table 2
Corporations Per Million as Proxy for Impersonal Rules
and whether a society adopted the three reform elements of
Elections, Government Administration, and Expanded Impersonal Rules

		Adopted Three Elements Before 1920?			
	Corp per Million (1)	Electoral Reforms (2)	Govt. Administration (3)	Impersonal Rules (4)	
USA	2,913	Yes	Yes	Yes	
Norway	2,117	Yes	Yes	Yes	
Canada	2,032	Yes	Yes	Yes	
New Zealand	1,637	Yes	Yes	Yes	
Australia	1,545	Yes	Yes	Yes	
Netherlands	1,262	Yes	Yes	Yes	
UK	1,241	Yes	Yes	Yes	
Switzerland	1,060	Yes	Yes	Yes	
Sweden	1,055	Yes	Yes	Yes	
Denmark	998	Yes	Yes	Yes	
Finland	755	Yes	Yes	Yes	
Belgium	561	Yes	Yes	Yes	
France	306	Yes	Yes	Yes	
Germany	403	No	No	No	
Spain	106	No	No	No	
Italy	78	No	No	No	
Austria	70	No	No	No	
Portugal	196	No	No	No	

Note: the classifications of the three elements is based on my reading of the pluralist literature, including the case study chapters in Dahl, *Political Opposition in Western Democracies* (1966), the chapters in Lipset and Rokkan (1967) and LaPalombara and Weiner (1966); general histories of party development in Europe including Rokkan (1970) and Epstein (1967); individual case studies of the party systems in individual countries; and handbooks of electoral and governance institutions, including Carstairs (1980), Rokkan and Meyriat (1969), and Mackie and Rose (1991).

Glossary:

The following definitions define ideal types of rules and organizations. The definitions of rules are paired along dimensions, where the ideal definitions refer to either end of a continuum. In practice, rules lie along these continuous dimensions. I usually refer to the types of rules in the paper as discrete entities without “continuous” qualification.

Agreed Upon Rules: All agreed upon rules are deliberately created within organizations. These rules include:

Primary and Secondary rules: Primary rules apply to the behavior and relationships of individuals (or sub-units) with an organization. Secondary rules are the rules for forming new rules or amending existing rules within the organization. All organizations have secondary rules.

Internal and External rules: Internal rules are created by organizations and apply within the organization that created them. External rules are created and enforced by one organization, and used by other organizations. Governments are a key example of an organization that specializes in the creation and enforcement of external rules that are used by other organizations and individuals.

Identity and Impersonal rules: The form and/or the enforcement of identity rules depends upon the social identity of the individuals or organizations to whom the rule applies. Impersonal rules apply the same to everyone. Impersonal rules can also apply to categories of people. For example, all citizens, all subjects, all men, all women, all children, all cities over 100,000 population and the like. As a result, a rule’s form may be impersonal, but its application may be so specific that it in practice is an identity rule.

Prescriptive and Default rules: The form of prescriptive rules defines some behavior that is mandated or proscribed, and defines consequences for behavior that does not follow the rule. Organizations devote resources to enforcing prescriptive rules and applying sanctions to rule breakers. Default rules are enforced, but not followed. Default rules are enforced in case of a dispute between individuals or organizations, are brought to the appropriate third party, but actual behavior is not required to follow the form of the rule.

There is no category of “Not Agreed to Rules.” Within many definitions of institutions, however, there are norms, beliefs, values, conventions, customs, and cultures that are often referred to as “rules.” They are not referred to as rules in this paper, the term rules applies only to “agreed upon rules.”

Coordinating organizations are organizations whose primary purpose is to enforce rules for other organizations. Coordinating organizations are often created by groups of organizations in order to provide external rules that the members of the group can use.

Appendix Table A-1. Types of Laws Enacted by the Indiana Legislature, Select Years, 1830-1885

Year	Total Number of Laws	General Laws	General Laws as Percent of Total	Special Laws for Government	Special State Government as Percent of Total	Local Laws for Governments	Local Laws for Governments as Percent of Total	Private Laws	Private Laws as Percent of Total
Panel A: Legislative sessions held before the 1851 Constitution									
1830	118	2	0.02	8	0.07	83	0.70	25	0.21
1835	247	28	0.11	8	0.03	132	0.53	79	0.32
1840	307	39	0.13	31	0.10	156	0.51	81	0.26
1845	496	49	0.10	28	0.06	248	0.50	171	0.34
1850	550	43	0.08	16	0.03	278	0.51	213	0.39
Panel B: Legislative sessions held after the 1851 Constitution									
1855	114	74	0.65	23	0.20	12	0.11	5	0.04
1861	154	86	0.56	34	0.22	21	0.14	13	0.08
1865	156	97	0.62	28	0.18	26	0.17	5	0.03
1871	35	14	0.40	7	0.20	12	0.34	2	0.06
1875	158	104	0.66	22	0.14	28	0.18	4	0.03
1881	157	91	0.58	29	0.18	26	0.17	11	0.07
1885	159	85	0.53	32	0.20	36	0.23	6	0.04

Notes and Sources: The counts before 1855 include both the volumes for “General Laws” and the volumes for “Local Laws.” After 1851, there was only one volume per legislative session. The counts for 1861, 1865, 1875, 1881, and 1885 include both the regular session and special sessions held during those years. There was no special session in 1855 or 1871. Counts are from the Indiana session laws available on <https://heinonline.org/HOL/Index?index=ssl/ssin&collection=ss>

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