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# Limited Access Orders in the Developing World:

## A New Approach to the Problems of Development

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## Abstract

The upper-income, advanced industrial countries of the world today all have market economies with open competition, competitive multi-party democratic political systems, and a secure government monopoly over violence. Such open access orders, however, are not the only norm and equilibrium type of society. The middle and low-income developing countries today, like all countries before about 1800, can be understood as limited access orders that maintain their equilibrium in a fundamentally different way. In limited access orders, the state does not have a secure monopoly on violence, and society organizes itself to control violence among the

elite factions. A common feature of limited access orders is that political elites divide up control of the economy, each getting some share of the rents. Since outbreaks of violence reduce the rents, the elite factions have incentives to be peaceable most of the time. Adequate stability of the rents and thus of the social order requires limiting access and competition—hence a social order with a fundamentally different logic than the open access order. This paper lays out such a framework and explores some of its implications for the problems of development today.

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## **I. Introduction**

Most development policy today is based on models of the developed world and attempts to make developing countries look more like developed ones. However, the social dynamics of developed countries fundamentally differ from those of developing countries. Development practitioners therefore face a mismatch between the development problems they seek to address and the available tools. They aim to implement social, economic, and political institutions characteristic of the developed West in societies that often cannot even secure basic physical order. To improve state capacity they might, for example, administer donor funds conditional on improving government transparency through better financial auditing of public funds. But they do so in countries where potential leadership groups compete for control through violence, intimidation, and occasionally the ballot box, and where new groups replace old groups at regular intervals. Development practitioners face the futility of trying to solve a problem without knowing its cause and to build state capacity in societies that regularly dismember their governments. Development tools based on industrial country experiences are ill-suited to the development goals in developing countries.

The first step to more effective development policies is a more realistic understanding of how societies actually behave and, in particular, how developing societies are different from developed ones. This paper and the research it proposes build on a new conceptual framework for interpreting recorded human history (RHH), developed by North, Wallis, and Weingast (2006). By laying out the conceptual framework, we hope to initiate a new conversation within the World Bank and the larger scholarly and policy community about how developing societies structure their economies and politics in order to solve the universal problem of violence and disorder.

The problem of providing powerful individuals with an incentive to be peaceful motivates the entire framework. Systematic consideration of violence, and the role it plays in shaping societies, is fundamental to the problem of economic, political, and social development. All societies possess institutions, organizations, and beliefs that enable them to deal with violence with varying degrees of success. These social structures embody a fundamental logic, captured in the concept of a social order. Standard development advice fails all too frequently because it conflicts with the social logic that maintains order. This paper does not propose any concrete policies, but aims to stimulate a discussion of the implications of the framework for a new approach to development.

According to our framework, throughout all of history humans have devised just three *social orders*: ways of organizing societies that are self-sustaining and internally consistent. The *primitive order* consists of hunter-gatherer societies, and will concern us only in passing.

The *limited access order* creates limits on access to valuable political and economic functions as a way to generate rents. Rents are created both by limits on access to resources and functions – like worship, trade, education, and warfare – and by limiting access to forms of social organization that the larger society will support. Powerful individuals possess privileges and rents, and since violence threatens or reduces those rents, the risk of losing the rents can make it in the interests of powerful individuals and groups to cooperate with the coalition in power rather than to fight. Privileged individuals have privileged access to social tools enabling them, and only them, to form powerful organizations. In limited access orders the political system manipulates the economy to create rents as a means of solving the problem of violence. Acknowledging this direct link between the creation of rents and maintenance of order enables us to integrate economic and political theory in a new way.

The third order, the *open access order*, relies on competition, open access to organizations, and the rule of law to hold the society together. These societies use competition and institutions to make it in the interests of political officials to observe constitutional rules, including consolidated political control over all organizations with the potential for major violence.

The framework builds the logic of limited and open access social orders to explain why they differ fundamentally in their organization, behavior, and consequences, including freedom and economic growth. The framework also sheds light on how societies make the transition between the two social orders.

Limited access orders vary widely and include almost all of today's developing countries. Some are mired in poverty and violence. Others accumulate considerable productive assets, use them with at least modest efficiency, and allow most of the society to share in some of the resultant output growth. The framework distinguishes between two separate problems of development. The first development problem reflects the task of helping societies increase per capita incomes from \$400 to \$8,000. This problem requires understanding how limited access orders behave, since most of the development the World Bank wishes to promote occurs within the range of limited access orders. The second development problem is the *transition* from a limited access order to an open access order—from societies with per capita income of say \$8,000 to societies with per capita incomes of \$35,000. The two development problems are completely different, since one involves changes within the limited access order and the other involves the transformation of that social order into an open access order.

Our approach to the first development problem has two important implications. It suggests an explanation for the persistence of poverty and retarded development that explicitly

incorporates the role of endemic violence, rent-creation, and limited access in the structure of developing societies. It sheds light on why those structures hinder development and especially why they are so difficult to change. The framework also allows us to see why institutional changes persist only when they are compatible with the incentives and constraints of those in power. It explains why the larger society is often more concerned with enabling those in power to maintain order than with achieving a more open social system.

Taken together, these ideas suggest that development policies often fail because they try to transplant elements of the open access order -- such as competition, markets, and democracy -- directly into limited access orders. These reforms threaten the rent-creation that holds the society together and in many cases challenge the very logic on which the society is organized. Not surprisingly, the elite and many non-elite resist, sabotage, or subvert such reforms in limited access societies that are not ready for them. Limited access orders vary widely, as discussed below, and further analysis with this framework may help us understand the appropriateness of various reforms.

The RHH framework has many lessons for new democracies, post-conflict societies, and other low and middle-income countries today. Developing countries today are in a different situation from 200 years ago, and each country that has moved to open access has some unique features of its transition. While the basic logic of the limited access order is the same in today's developing world as it was in Europe of 1800 when the first countries began the transition to open access, the context has changed dramatically. The logic of the limited access order plays out differently in the modern world than it did 200 years ago.

Section II presents the RHH framework, and explains the logic of the two social orders. Section III discusses why institutions work differently in limited and open access orders and the

challenges that this difference presents for development policy. Section IV examines how the changes of the last two centuries in the international political system and technology (production, warfare, communication, and institutional organization) have altered the prospects for development in limited access orders. Section V discusses how the framework suggests new approaches to the development problem and to the question of why standard development advice often fails to achieve development.

## **II. Limited and Open Access Orders**

Most existing political and economic models of development posit a continuous path or process along which countries develop. In contrast, our framework has two distinct types of equilibria, each with a different mechanism to sustain itself. Those countries in the limited access order (LAO) have social, economic, and political systems based on limited entry and rent-creation. Elites in limited access orders use rents to maintain order and to hold the social order together.<sup>ii</sup> The political system manipulates the economy to generate rents that bind the interests of economic actors to support the current political system. The limited access order appears to be the means by which all but a handful of societies have secured order and limited violence for the last 10,000 years. We think of the limited access order as a *natural* state because it appears to be the natural way for societies to solve the problem of violence.

By contrast, a few countries in the past two centuries made the transition to a system based on open access and competition. An open access order (OAO) is defined as a country where access to economic, political, and social organizations, including the freedom to form them, is open to all individuals who qualify as citizens in the society and where citizens comprise most of the population. The ability to form organizations at will is necessary to sustain



thriving competition in both politics and economics. In politics, competition arises at several levels, including organized political parties that vie for political control and competition among groups, constituencies, and regions that vie for political influence. In economics, competition arises from organized firms. Competition in both the economic and political systems depends on the ability of people to form organizations and to utilize the state to support these organizations (for example, in contract enforcement).

## **II.1 The Logic of Limited Access Orders**

Almost all theories of the state explicitly or implicitly make two assumptions: first, the state can be modeled as a single actor and, second, the state has a monopoly on violence. Prominent examples include Olson's (1993) stationary bandit, North (1981, ch 3) and Levi's (1988) revenue maximizing monarch, and the standard theories of rent-seeking (Buchanan, Tollison and Tullock 1980).<sup>iii</sup> Normative economics, the principal component of the traditional approach to development, also falls in this category: it assumes a benevolent social planner that is a single actor (with no collective choice problems), has a monopoly on violence and, by virtue of benevolence, does not use violence for destruction or expropriation. These assumptions lead to misunderstandings of the problems of development. We begin in a different place.

In most societies, historical and contemporary, violence potential is spread throughout the population rather than concentrated. No one, including the state, has a monopoly on violence. Establishing a society that fosters peace, specialization, and exchange requires the creation of incentives for groups to compete peacefully rather than fight. LAOs are the natural response of societies to the threat (and sometimes the actuality) of internal or external violence.

An LAO reduces violence by forming a dominant coalition containing all individuals and groups with sufficient access to violence that can, if they act unilaterally, create disorder.

The dominant coalition creates cooperation and order by limiting access to valuable resources – land, labor, and capital – or access and control of valuable activities – such as contract enforcement, property right enforcement, trade, worship, and education – to elite groups. Restricting support for organizations to elite groups magnifies the rents that elite groups receive. Sophisticated social organizations require the ability to make agreements within and between organizations that rely on external, third party enforcement. Limiting access to organizational forms and contract enforcement is the key to the limited access order: it creates rents through exclusive privileges and directly enhances the value of the privileges by making elites more productive through their organizations.

Because violence reduces elites rents, the existence of the rents can motivate credible commitments among elites that they will not fight each other.<sup>iv</sup> Sometimes they fight anyway, but the cost of fighting makes it less likely. Maintaining the rents depends on the stability of the current coalition. The creation and distribution of rents therefore secures elite loyalty to the system, which in turn protects rents, limits violence, and prevents disorder most of the time. These causal links reflect the LAOs arrangements as a kind of social equilibrium: all the parts interact to sustain the social order. Rent-creation through the assignment of exclusive rights and privileges and the selective suppression of competition is at the heart of the LAO. Rent-creation provides the glue that holds the coalition together, enabling elite groups to make credible commitments to one another to support the regime and to perform their functions.<sup>v</sup>

Historically, LAOs were a great innovation over the previous primitive order of hunter-gatherer societies. They allowed the formation of complex civilizations with substantial

specialization, exchange, and wealth. Since the dawn of civilization, limited access orders have made it possible for people to live in large societies, pursue specialization, and develop economically. In comparison with a primitive social order, a well-functioning limited access order permits both personal security and positive growth of output and rents. Some limited access orders of the past and the present have been more successful than others. Some have failed. The great civilizations of the past were all successful limited access orders.

LAOs encompass a wide variety of societies – the Roman republic and empire, Mesopotamia in the third millennia BCE, Britain under the Tudors, and modern Nigeria, Bolivia, and Russia. The limited access order is a general strategy for organizing society, not a specific set of political, economic, or religious institutions. Some are vicious authoritarian regimes (Uganda under Idi Amin) while others have elections (Argentina); some are failed states (Central African Republic) while others exhibit long-term stability (Mexico); still others have been socialist states (the former Soviet Union). All share the basic principle of manipulating the economy to produce rents, stability, and prevent violence.

In comparison with an open access society, typical LAOs today have state-controlled industries, problematic business licensing regimes (for new entrants), and “corrupt” patron-client networks. All are manifestations of rent-creation. Many LAOs today have some institutional forms similar to those of OAOs—elections, corporations, etc.—but as discussed later, these institutions operate under a different logic and with different effects in the presence of limited vs. open access.

Limited access orders must carefully balance the distribution of elite interests within the dominant coalition. A shift in the incentives facing a major player that leads him to defect from the coalition and use violence or other means to forward his interests will produce instability, if

not civil war. Because many shocks – including demography, weather, economic cycles, new technology, threats from external sources – may affect the distribution of elite interests and violence potential, the internal structure of the dominant coalition and its distribution of rents is not robust. Any shock that changes the distribution of violence potential can force renegotiation of the distribution of rents; and actual violence is a constant possibility, because members of the dominant coalition may fail to reach a negotiated redistribution. For this reason, we say that LAOs are stable as a social order, but they are not static. They change frequently in the composition of the dominant coalition and the distribution of rents; but throughout, they remain limited access orders.

Persistence in the leadership of a LAO is also inherently uncertain. The LAO relies on personal relationships among the elites. The impermanence of individuals and their relationships produces ongoing adjustments within the coalition. External or internal shocks often cause regimes to collapse (wars, coups, civil wars, peasant revolts, ethnic violence, and succession crises). The violence and disorder associated with these collapses, however, usually motivates the establishment of another limited access order, as even the non-elites prefer a regime that maintains order. Thus the equilibrium forces in limited access societies usually block the transition of middle-income countries to open access orders.

## **II.2 The Spectrum of Limited Access Social Orders.**

LAOs differ widely. All low and middle-income countries are limited access orders, yet they have income levels that differ by a factor of 20. These differences suggest the importance of understanding the differences among LAOs. While all LAOs rely on the same mechanisms of sustaining stability, they differ in the density and kinds of organizations they support.

Limiting access to organizational forms is a key element of rent-creation for elites. All states are at once coalitions and organizations. The elemental organization in a limited access order is the state itself, or more accurately, the web of relationships that make up the credible commitments within the dominant coalition. Rent-creation is at the heart of a LAO, and one of the most potent sources of rent-creation is privileged limited access to organizational forms that the state supports. The sophistication of the state as an organization relates directly to the sophistication of elite organizations that the state and society can support. As a result, all LAOs have interlocking public and private networks of organizations.

We distinguish three broad types of LAOs along a spectrum -- fragile, basic, and mature limited access orders. Unlike the three social orders, which differ fundamentally in their own internal logic, the three types of LAOs are less distinct typologies that help us organize our thinking about differentiation and the process of change within limited access orders. The differentiation is mainly in terms of who has access to violence and of the sophistication and variety of organizations within the state and external to it.

In the *fragile* LAO, the state can barely sustain itself in the face of internal and external violence. Contemporary examples include Haiti, Iraq, Afghanistan, Somalia, and several other places in sub-Saharan Africa. The bottom billion, described by Paul Collier, live in fragile LAOs (Collier 2007). In a fragile LAO, each faction in the dominant coalition has direct access to violence, and violence potential is a principal determinant of the distribution of rents and resources. If the allocation of these rent-flows is out of alignment with the balance of military power, factions demand or fight for more. Because of their instability, fragile LAOs have simple institutional structures for the state, and they cannot support private elite organizations. Individuals in fragile LAOs perceive the potential benefits from institutional structures, but the

inability to maintain the coalition over long periods creates pervasive uncertainty about outcomes and prevents elite individuals from credibly committing to observe rules in a many possible circumstances. Fragile states attempt to create credible commitments among elites, but their fundamental instability means that as the dominant coalition changes, the attempted commitments are not credible *ex ante*. It is irrational for those elites to believe the commitments will be honored, and the commitments fall by the wayside. Only organizations outside the state are ones that enforce their own rules, since the state is struggling to enforce its own internal rules and has little credibility to do more.

In the *basic* LAO, the state is well established and, in comparison to a fragile LAO, generally able to reduce the outbreak of violence. In basic LAOs the only durable organization is the state itself, and elite rights and privileges are closely identified with it. Contemporary examples include Burma, Cuba, North Korea, and many Arab and Sub-Saharan African countries. In contrast to fragile LAOs, basic LAOs create and sustain a stable organizational structure for the state. An individual or group who wishes to pursue a complicated activity requiring a more sophisticated organizational structure must use the state itself as the vehicle for organization.

Sanctioned organizations in the basic LAO are essentially all elements of the state itself. For example, in twentieth century socialist countries every organization was usually embedded within the ruling party. As the state develops a more sophisticated internal institutional structure, it provides more organizational forms to citizens, but typically within the direct orbit of the state itself. Basic LAOs are not capable of supporting other organizations, even for elites, outside the orbit of the state's own organizational structure. Any private organization is a potential threat to the dominant coalition. As a result, all private elite organizations are closely tied to the state.<sup>vi</sup>

Basic LAOs cannot support a rich civil society, and the increasing sophistication of organizations develops primarily within the state.

This specialization and division of labor within the basic LAO state allows it to create organizations with specialized capacities that focus on particular public and private goods for the dominant coalition, such as managing trade, education, religion, tax collection, or infrastructure provision. Violence potential remains dispersed in most basic LAOs.<sup>vii</sup> Although not everyone is a violence specialist, every member of the elite has ties to a violence specialist: in case violence erupts, members of the elite need protection.

Basic LAO institutions are largely public law institutions, which structure the internal relations of the state and its relations with members of the dominant coalition. Public institutions also provide standard solutions to recurring problems, and basic LAOs may include institutions supporting the succession of the leader, succession of elites, determination of tax and tribute rates, dispute resolution among coalition members, and division of the spoils of conquest. All of these problems hold the potential for violence and renegotiation within the dominant coalition; institutionalizing decision-making facilitates negotiated settlements and limits the recourse to violence. Public organizations also help create common beliefs about behavior among elites. Widening the set of commonly held beliefs among elites broadens the range of credible commitments that the dominant coalition can sustain. Basic LAOs are therefore more stable and more resilient to shocks than fragile ones.

In the *mature* LAO, the government supports a large variety of organizations outside the government. As a limited access order, the mature LAO requires that each organization be sanctioned by the state. This allows the state to limit competition and create rents to maintain the dominant coalition. Mature LAO include most of Latin America, South Africa, and India.

Mature LAOs have durable institutional structures for the state and can support a wide range of elite organizations that exist apart from the state. In practice, this means that the institutions of the state must be readily identifiable by members of the dominant coalition. A mature LAO, therefore, has a well articulated body of public law that specifies the offices and functions of the state, the relationship between the offices and functions, and provides for methods of resolving conflicts within the state, and by extension, within the dominant coalition. The public law may be written or unwritten, but it must be embodied in a state organization, such as a court or bureaucracy, that is capable of articulating and enforcing the public law.

Mature LAOs cannot develop without more sophisticated private organizations. In order for more sophisticated limited access orders emerge, increasingly independent and sophisticated elite organizations are not only a source of development, but the presence of better organized private elite organizations allow more sophisticated institutions and organizations to mature within the state, because the private organizations will fight to protect the differentiation and autonomy of public institutions, such as courts and the central bank. The process plays a more visible role in open access orders, where sophisticated private organizations in a market economy serve as a counterbalance to political organizations. In a mature LAO, the government can credibly commit to a wider range of policies and institutions because elite private organizations can effectively punish the government if it deviates from its commitments. In this way, a double balance between the sophistication of public and private organizations emerges in mature LAOs that sustain a considerable level of political and economic development.

Mature LAOs are more resilient to shocks than fragile or basic LAOs. The durable public institutions of a mature LAO are capable, in normal circumstances, of lasting through changes in the make-up of the dominant coalition. Nonetheless, shocks always have the possibility for



breakdowns, and mature LAOs face intermittent crises. The extent to which mature LAOs have more durable state institutions than basic ones is a matter of degree rather than of kind.

In the mature LAO, some actors come to specialize in political or economic activities. Violence specialists will have more distinct and often separate organizations. The violence organizations, however, cannot be outside of the state structure and control. In contrast, it is difficult to differentiate political from economic actors in fragile and basic LAOs. All of the political and economic networks in these societies included violence specialists in their retinues or alliances. The integration of politics and economics is so complete, and the state relatively undifferentiated, that all actors are at once political and economic. In particular, in basic LAOs, organizations are at once public, political, and economic—the only sophisticated organizations are those of the state.

Although the different types of LAOs can be ordered in a progression from less to most developed, the progression is not a teleology: nothing inherent in any of these types impels them to move from fragile to basic or from basic to mature. States can regress as well as progress, and many states stagnate for decades or centuries. For example, Bolivia, Venezuela, and Russia all seem to be regressing as they nationalize, control, or outlaw once independent organizations. Similarly, states that fall into violence, such as Rwanda, Somalia and the former Yugoslavia, all regress. Germany in the 1920s and 1930s regressed from a mature LAO on the doorstep of OAO in 1913 to become more of a basic LAO under the Nazis.

Germany is good example of why fragile, basic, and mature LAOs are not ideal types but general categories. The spectrum of limited access orders do not translate neatly into ideal types. In a fragile LAO, the problem of endemic violence means that the dominant coalition directs its efforts primarily at sustaining the state itself. In general, fragile LAOs cannot support many, if

any, elite organizations, but to define an ideal fragile LAO precisely as a society with no private elite organizations would be too rigid. Likewise, in most basic LAOs elites find it difficult to sustain private organizations outside the framework of the state, but that does not mean that there are absolutely no private elite organizations. It does mean, however, that those organizations are closely tied to the state and will not be sophisticated private organizations.<sup>viii</sup> In the mature LAO, sophisticated private organizations begin to emerge and their independence from the formal state becomes more clearly defined.

An important aspect of the progression of LAOs is that the state and economy both exhibit more specialization and division of labor. The basic LAO sustains a range of organizations specializing in particular activities, such as exploiting natural resources, conducting inter-regional and international trade, collecting taxes, or providing various public goods. These organizations provide services and rents to particular elites, and as such must be protected by a set of state institutions that support these organizations and prevent other members of the coalition from expropriating their value. Basic LAOs therefore typically support greater levels of specialization and exchange and greater levels of investment than fragile LAOs. The mature LAO allows a range of non-state organizations, including (in modern mature LAOs) domestic business corporations. Here too sustaining private organizations requires that the state become more specialized. The state must create new institutions that provide services for these organizations, including enforcement of contracts; and the state must provide institutions that prevent expropriation of these organizations' assets by other members of the dominant coalition or by the state itself. Mature LAOs exhibit greater specialization and exchange and greater investment than basic LAOs.<sup>ix</sup>

### **II.3 The Logic of Open Access Orders**

Open access orders are sustained by competition. Specifically, political competition is necessary to maintain open access in the economy, and economic competition is necessary to maintain open access in the polity. Social scientists tend to overlook the deep and profound link between economic and political competition and thus have trouble explaining why modern developed societies do not appear more often.

Economists have long understood how competitive economic systems sustain themselves, but economic theory assumes the existence of a polity that enforces rule of law and property rights. There is no equivalent theory of competitive politics, but theories of democracy usually assume implicitly that a competitive market economy exists. Neither assumption is warranted. Almost all of the two dozen developed countries are developed politically as well as economically; they have open access and competition in both economic and political systems. The strong implication is that economic and political development are intrinsically linked. The question is how? The answer begins with core aspects of open access orders.

Open access is sustainable when a society is able to produce three outcomes: 1) entry into economic, political, religious, and educational activities is open to all citizens without restraint; 2) support for organizational forms in each of those activities that are open to all citizens; and 3) rule of law enforced impartially for all citizens. The portion of the population enjoying open access need not be 100 percent in order to sustain open entry in economic and political systems, which points to the importance of defining citizens: individuals who possess the right to engage fully in political and economic activities and organizations. A society where 5 percent of the population enjoys the rights of citizens is likely to be a limited access order; a society where a

third or more of the population enjoys the rights of citizens is likely to be an open access order that can sustain itself by intra-elite (intra-citizen) competition.<sup>x</sup>

Schumpeterian creative destruction ensues when entry into economic activities is open to all citizens and potential entrepreneurs enjoy basic support for organizational forms like partnerships, corporations, and contract law. When entry is open, economic actors create rents through innovation. Competition gradually erodes those rents as new firms and individuals enter into new lines of business or transform old activities. Economic actors would love to use the political process to restrict entry and maintain their rents. Symmetrically, political actors would love to use the political process to restrict entry, create rents, and bind economic actors to support a developing political coalition. That, of course, is precisely the logic of the LAO.

What prevents elites from transforming open access orders back to LAOs? It is certainly not lack of desire to create and enjoy rents. The persistent competition that results from open entry, however, frustrates the desires of economic and political actors to create **permanent** rents through limited access. This is the core logic of open access.

The creation of a privilege for one person or group necessarily involves the denial of opportunities and access to another individual or group. Because all citizens in an open access order possess the ability to form organizations, any action of the government that harms some individuals faces potential opposition by a well organized group. It does not matter whether the group was initially formed around a political, economic, religious, or other social function. If access to organizational forms is open, the state cannot prevent groups forming to oppose the state's action. More importantly, in open access orders one organization cannot prevent the formation of another organization with conflicting goals. This contrasts with the essence of a LAO, which involves the selective creation of elite organizations whose interests work in concert

to support the dominant coalition. An LAO exercises greater influence over the distribution of interests within both the elite and larger society through the systematic manipulation of rents. In contrast, a governing coalition in an OAO cannot prevent the formation of competing organizations that oppose privileges for others. Nor can the governing coalition prevent the process creative destruction from realigning interests in both economic and political dimensions.

Because the state, indeed the larger society, does not control the distribution and content of interests in an OAO, the political system cannot use manipulation of economic interests to order its internal arrangements. Open access orders maintain their equilibrium by allowing a wide range of economic and social interests to compete for control of the polity. Creative economic destruction produces a constantly shifting spectrum of competing economic interests. The inability of the state to manipulate economic interests sustains open political competition: politicians cannot cripple their opponents by denying them economic resources. The creation of rents by the political system will motivate the economic interests adversely affected by the rent-creation to organize politically. Because organizations mobilize and coordinate their members when their interests are threatened, open access to organizations of all types, especially economic, helps maintain political competition. Political competition in the presence of open access to organizations also provides opposition political parties with incentives to monitor the government and oppose proposals that threaten open access and competition. Access to organizational forms is thus critical to both political and economic activities.

Open access political and economic systems cannot sustain themselves independently of the other system. This is where the exogeneity assumptions of both economics and political science create fundamental problems. A competitive political system cannot sustain itself by its own internal structure and institutions if it is in the midst of a limited access economy. Several

mechanisms demonstrate the critical interaction of the two systems, in particular, how open access in the economy helps sustain open access in the polity. For instance, open access into the economy creates a wide range of organizations that can mobilize against a governing coalition that seeks to create privilege and limited access. The shifting pattern of economic interests that discipline political actors in an open access order seems necessary for sustaining political competition over time. Patterns of economic interests do not shift uncontrollably in a limited access order, because the logic of the LAO controls the pattern of economic interests. A symmetric situation holds with respect to shifting political interests.<sup>xi</sup>

All open access orders have sophisticated public *and* private organizations. Open entry in both economics and politics drives the formation of sophisticated groups and generates forces that provide balance in both systems. As with the limited access order, the logic of open access describes a self-sustaining social order where all of the parts interrelate to sustain the social order.

To sustain open entry, the state in an open access order must have significant specialized institutions both that provide these services and that make the necessary credible commitments to maintain them without expropriating the value they create. The state therefore exhibits considerable specialization and division of labor. It must also have institutions that create incentive compatible conditions so that those in power and their constituents have an incentive to abide by the rules of the game. In short, the state must have popularly supported constitutional rules, whether these are written or unwritten.

A great deal of political science focuses on formal constitutional rules. Our framework gives equal emphasis to informal rules. Without specific institutions that support open access to organizational forms in both the polity and economy, open access is not possible. The forms of

the specific institutions – democratic processes, legal rules, etc. – are critical to understanding how each society manages to maintain open access. On the other hand, simply adopting the institutional forms does not guarantee that open access will ensue.

Open access in politics *sustains* open access in economics and vice versa; neither *causes* the other. Both the limited and open access social orders comprise systems of economics, politics, religion, military organization, and education that reinforce one another. The mutually supporting logic of open access, like the logic of the LAO, arises because the component systems are embedded in a social order with its own distinct logic.

The deep integration of social orders poses two problems. How do societies make the transition from one social order to another, and how do we conceive of specific institutional forms working in the two social orders?

#### **II.4 The Doorstep Conditions and the Transition**

The movement from limited access orders to open access orders occurs through the transition process. Our framework builds on two parts. First, within LAOs it is possible, following the logic of the LAO, for a mature LAO to develop institutional arrangements that enable the beginnings of impersonal exchange within elites. Second, the transition process proper begins when the dominant coalition finds it in the interest of elites to expand impersonal exchange and, therefore, marginally increase access.

Based on historical experience in Europe and North America, we have identified three “doorstep conditions” that may evolve in a LAO and that enable impersonal exchange among elites: (1) rule of law for elites; (2) support for perpetually lived elite organizations;<sup>xii</sup> and (3) centralized and consolidated control of violence. Let us elaborate on each of these conditions.

Rule of law, property rights, and contract enforcement all provide a range of rights and services to elites. Perpetually lived organizations continue beyond the lives of those who create them, allowing people to create more powerful organizations that can, for example, more easily raise long-term financing and make long-term contracts. Logically, perpetually lived organizations require a perpetually lived state, because a mortal, temporal state (e.g., the king) cannot commit perpetual support to an organization. Consolidation of violence means that only specialized organizations (military and police) are violence specialists, and these organizations are controlled by the state and follow explicit constitutional rules about the use of violence against citizens.

Historically, societies that develop sustainable property rights and rule of law began by making credible commitments to sustain those rights for elites. Defining and enforcing elite rights often occurs as societies begin developing sophisticated public and private elite organizations in the process of becoming mature LAOs. Elite organizations can exert sufficient sway over the government to ensure that the government keeps its commitments. Stronger elite organizations simultaneously allow for more sophisticated state organizations, since the ability of elite organizations to punish the state increases the range of credible commitments the state can make.

In the transition, property rights and rule of law are transformed in two steps. First, rule of law for elites moves to define elite rights impersonally. That is, all elites possess the same rights, not a set of various rights that differ across individuals and groups depending on their power and their relationship to the ruling coalition. Once elite rights are defined impersonally, then it may be possible to extend those rights to a wider circle of society. For example, the creation of joint stock companies was originally a new organizational form to benefit elites. The



existence of tradable stock, which was only valuable to individuals who could count on unbiased enforcement of their property rights in the stock, created an incentive to extend the same legal protection to all stock holders. Because the value of stock holdings depended on transferability to new owners, stockholdings were more valuable *within the elite* if ownership was defined impersonally, rather than depending on the legal status – duke, earl, freeholder, etc. – of the individual owner. Thus the creation of a perpetually lived elite organization provided incentives to create impersonal legal protection of elite rights. Once elite rights were defined impersonally, new incentives to tap the wealth of non-elites arose. Since stock holding was limited to a very small portion of the population, the elites could see a benefit to themselves from marginally extending the new impersonal legal protections to non-elite stockholders, who were also wealthy and few in number. The rights of “stockholders” thus came to be defined impersonally.

In the transition, some areas of the economy and polity become marginally more open through the extension of impersonal forms, while access in the commanding heights remain dominated by limited access arrangements. The tipping point comes when open access in one dimension – economic or political – commands sufficient power to press successfully for open access to the commanding heights in the other dimension. For example, in the U.S., open access on the political side had progressed by the 1830s to the point of bringing universal white male suffrage in most states and Jacksonian Democrats to the national presidency. Then when the economic crisis of the 1840s came, they were able in the states of the North, which controlled access to the economic commanding heights (banks and transport companies), to bring about general incorporation laws (Wallis 2006). Clearly some features of open access were present in the US earlier, and many features of limited access persisted -- notably in the South for another

century -- but the tipping point came when opening access on the political side reached high enough to push through effective open access rules for the top of the economy.

When the tipping point is reached, the dominant coalition finds that its internal arrangements are better served by supporting intra-elite competition, rather than intra-elite cooperation to perpetuate existing mechanisms of rent-creation. That is, it makes sense for the elites to define themselves impersonally as citizens, rather than as kings, dukes, earls, etc. At this point in the transition, we expect to see rapid and fundamental changes that institutionalize “open access within the elite.” This sounds paradoxical, but remember that an open access order does not require universal open access. Once, however, the elite has created political, economic, legal, and social institutions that define elites as citizens and all citizens as equally and impersonally guaranteed to rights and privileges under the social arrangements, it is easy (non-revolutionary) to extend the access to larger segments of society.

A transition then, has two parts, at least in the historical cases that we have examined. The first part occurs when a mature LAO moves to the doorstep conditions. There is nothing, unfortunately, about being on the doorstep that impels societies into a transition. The doorstep conditions create the possibility for intra-elite impersonal exchange. The second part of the transition occurs when intra-elite relationships are put on the impersonal basis of “citizenship”: when each elite possesses his or her rights simply because they meet certain impersonally defined requirements. Further research is needed to see if transitions after 1950 have had or will have similar features.

### **III. Implications: Why the Behavior of Institutions Depends on the Social Order in which They Are Embedded**

The two social orders maintain themselves in very different ways: LAOs through limiting access, rent-creation, and the selective suppression of competition; OAOs through open access and competition. The same institutional forms therefore work differently in the two social orders. This makes the transition more difficult to understand, much less to implement or trigger by deliberate policy interventions, and deserves further discussion.

What is an institution? North (1991) defines an institution as the “rules of the game.” Institutions, however, involve more than explicit written rules. They also include informal norms behavior, the mechanisms by which the rules are enforced, and individual beliefs and expectations about how the institution, and other individuals, will behave. Greif (2005) identifies these separate elements that collectively make up institutions. If we use such an inclusive definition of institutions, then it is clear that every institution is unique, and it makes no sense at all to compare institutions in different societies or in different social orders.

Instead, we use the term “institutional form” to refer to explicit and formal institutional arrangements, like a written constitution, and “mechanisms” to represent the formal or informal way the institutional forms are implemented and sustained. An institutional form might specify that leaders are to be selected by majority-rule elections, and the mechanisms are the process by which the election is implemented.<sup>xiii</sup> Institutional forms and mechanisms explicitly do not include beliefs, cultures, or whether the institution is embedded in a limited or open access order. Along with loans or grants of funds, much of the assistance the World Bank offers to its clients come as recommendations and incentives to adopt specific institutional forms and mechanisms. Understanding why reform of institutional forms often fails to produce transformations in

developing countries requires recognizing that the same institutional forms work differently in limited and open access orders, even if the recipient country has the political will to implement the reform.

An important difference between the two social orders is the transformation from personal exchange to impersonal exchange in both economic and political systems. Open access orders have the ability to create and sustain impersonal exchange, in politics, economics, and in government administration: open access orders can issue driver's licenses and similar public goods to people based on relatively objective administrative criteria. In the LAO's personal exchange systems, the logic of the LAO creates incentives such that the delivery of government services always depends on whom the recipient is connected to. LAO bureaucracies and judiciaries find it difficult, if not impossible, to deliver services according to impersonal criteria. This is not necessarily because the bureaucrats or judges are personally corrupt, but because the system of incentives created by the social order offers them little or no opportunity to change.

The administration of welfare programs, business licenses, and judicial services all require personal exchange – and often bribes – in limited access orders. Ration cards in India, for example, often never reach the poor; instead they are sold informally to people who can afford them, generating income for those who distribute these cards.

On a more complicated and important level, consider legislatures. Many mature LAOs, including Argentina, Brazil, Chile, India, Mexico, and Russia, have elections, parties, and legislatures. The countries of Latin America have had US-style constitutions for two centuries without becoming OAOs. Competition for power works in LAOs differently than when citizens have open access to organizations that can represent their interests. First, LAOs restrict the number and types of organizations so that many constituencies and groups who might mobilize

to represent their interest cannot do so. Second, because limited access orders involve the systematic creation of privilege and rents, those powerful organizations that do exist are all part of the dominant coalition. To sustain the state, these groups must all exhibit a reciprocal respect for one another's privileges as part of the system of maintaining their own. In an open access order, the far richer array of organizations not only means the absence of reciprocity, but too many organizations fighting for privilege. The competition for privilege is part of the process that limits privilege. Third, the "tragic brilliance" mechanism hinders the operation of elections in LAOs (Diaz, Magaloni, and Weingast 2006). Because LAOs have many fewer limits on politics, political officials in these states can short-circuit electoral competition by making basic services depend on whom citizens vote for. When standard local services – such as water, electricity, and garbage – depend on supporting the incumbents, citizen electoral choice is highly proscribed and citizens have less ability to exercise choice. The logic is at once tragic and brilliant: Many citizens are forced to vote for the incumbents despite preferring the opposition simply because they want to maintain their services.

For Argentina, Spiller and Tommasi (2007) discuss how the legislature fails to produce members with long-term careers, and many legislators are beholden to regional bosses. In practice, this means that the legislature fails to be an arena for writing legislation, making compromises among contending groups and regions, overseeing the bureaucracy, or enforcing long-term bargains. In these LAOs, elections become a means of political control rather than a vehicle for citizen choice. In contrast, elections in the presence of open access to organizations and limits on government that prevent the wholesale manipulation of public benefits to supporters afford greater citizen choice. The delivery of benefits based on impersonal

characteristics helps to limit electoral manipulation in open access orders. The same institutional form operates in completely different ways in limited and open access orders.

Similarly, the judiciary works very differently in an LAO than in an OAO. Because delivery of services in limited access orders depends on personal connections, courts cannot dispense impartial justice. Instead, courts in LAOs appear to be corrupt: insiders and elites are treated differently from others. The courts solicit bribes from non-elites in order to move a case through the standard channels of justice. Indeed, many limited access order judicial systems are designed to have sufficient red tape so that they can collect numerous bribes that extract nearly the full value of each case.

Central banks are another example where research shows how formal legal independence does not always correspond to actual independence, as indicated by the ability to control inflation. Across a large sample of countries, the legal attributes of central bank independence do explain success in controlling inflation in the sub-sample of “industrial countries” -- almost all OAOs--but not in the sub-sample of “developing countries”, which are all LAOs. Many developing countries have laws specifying independence of the central bank, but that did not have the intended effect because there was not consistent rule of law, whereas there was in the industrial sub-sample (Cukierman, Webb and Neyapti 1992). As the LAO model would predict, the central banks could not have effective independence in the absence of independent private sector organizations to lobby on behalf of central bank independence.

We could multiply the examples, but the basic point should be clear. As they made the transition from limited to open access orders over the last two centuries, open access societies developed new institutional forms and mechanisms that allowed the delivery of public goods and services based on relatively objective, impersonal, and impartial criteria. It is tempting to

attribute the success of open access societies to the institutional forms because they are visible manifestations of development. But this view is too simple. Directly transferring the institutional forms and mechanisms of open access orders to LAOs will not produce development – *even if the LAO adopts the forms with good will and good intentions*. The institutional forms of open access societies differ in detail, and all the forms require an open access context in order to work in the way reformers intend.

The logic of the limited access order takes any institutional form or mechanism and bends it to the purpose of rent-creation to sustain the existing dominant coalition. Tackling the problem of development within LAOs, the first development problem, is unlikely to succeed simply by transplanting open access institutional forms and mechanisms.

#### **IV. Why Forces Operating in the Modern World May Not Produce Transitions in Limited Access Orders**

The world of 2007 differs substantially from that of 1800, in large part because open societies have developed, grown, and for much of the last two centuries controlled large parts of the planet. Many historians, economists and political scientists – including Lenin and Wallenstein – have discussed the effects that economically developed countries have on the less developed. The value added in our approach is that it allows us to examine the effects of the developed on the developing world in light of the logic of the limited access order. We focus on four dimensions of these effects that have changed fundamentally in the past two centuries – the availability of institutional forms in open access orders, the world political order, technology, and multinational firms.

The development community, both practical and academic, has at one time or another had hope that these new factors in the modern world will make it easier for limited access orders to make the transition. As we discuss in this section, it ain't necessarily so.

#### **IV.1 Institutional Forms**

Extensive experimentation with political and economic institutional technology has occurred in the past 400 years – constitutions for presidential and parliamentary systems, federal and unitary states, different types of socialist systems, and various forms of limited liability companies and financial institutions. The literatures in law, political science, and economics describe the outcomes associated with these institutional forms. In the past twenty-five years, substantial bodies of work have been compiled about how to design corporate institutions, legal systems, financial institutions, and labor markets. Decision-makers in developing countries – established elites or newly empowered leaders of the former opposition or the revolution – can and do look at this annotated menu when they consider changes in their systems.

In principle, these menus could allow a faster transition from a LAO to an open access order. In 1600, no one could conceive of an open access order, let alone specify the transition to it. The first movers had to use a trial and error process for several centuries to create the transition. In contrast, today's states making the transition do not need to invent most of their institutional technologies. Within broad parameters, the institutional forms of an open access order are well-understood, and elites can choose which institutional forms to bring in. Many elites in LAOs have been educated in the OAOs of Europe and North America, and many bring back ideals of the institutional models from where they have studied or from former colonial metropolises. Even well-understood institutions, however, such as joint-stock corporations and



proportional representation parliaments, operate differently when the surrounding economic and cultural situations are different.

What happens when the formal institutional forms of OAOs are set in LAO environments where the prevalence of violence and the lack of faith in formal institutions undercuts the OAO? If elites, old or new, are not ready for the transition to an OAO (for example, if they see it as a threat rather than a benefit, and they can see its effects better than elites in 1800), they will subvert formal OAO institutions, for example, by sabotaging the reforms through crippling institutional details or with informal practices to maintain limited access.

Many developing countries today have most of the formal institutions associated with OAOs – legislatures, formal executives, courts, bureaucracies and elections – but these institutions nonetheless sustain limited access rather than open access. Whereas limitations on access were often formal in earlier LAOs, such as European feudalism or imperial China, the limitations in LAOs today are frequently informal. Indeed, today the informal limitations on access often focus on effective utilization of the formal institutions associated with open access in the developed countries -- political parties, legalized property rights and corporate organization. Only the elites have full access to them. It is not obvious that these informal limits are deliberately imposed by the elite, for often they arise from the petty bureaucracy and petty corruption at lower levels of government. The elites tolerate the barriers, however (which do not much bind them) and benefit from their effect in limiting competition. Better local institutions are not created or are left dysfunctional, because the elites with international connections do not need the local institutions and because the lack of local institutions creates a barrier to entry that benefits incumbents.

## IV.2 The World Political Order

The world political order has changed fundamentally since 1600; including in the way that governments define themselves, their population, and their territory. The change started in Europe. In 1600 everyone with any status or property had a designated place in a hierarchy of interpersonal oaths and obligations made in return for specific privileges, often including some degree of land proprietorship. The state did not have a territory as such; rather for each king, one could in principle point to an array of territory to which he had direct claim or to which those with allegiance to him had claim (generally in return for that allegiance). Moreover, the boundaries of the state in this and earlier ages were not well-defined.

Between 1600 and the late nineteenth century, the institutions of the national state emerged, and almost all of the land and population of Western Europe came to be identified as the territory and citizens, respectively, of these national states. This process occurred simultaneously, in time and causation, with the development of the perpetually-lived state, property rights and perpetually lived organizations outside of the state. Initially these rights and organizations were only for the elite, but over time access to them became more widely available. This is the transition process described in RHH and summarized above.

Outside of Europe, similar concepts emerged in the half century after 1776 in the Western Hemisphere former colonies of Europe.<sup>xiv</sup> Africa and Asia, on the other hand either became colonies of Europe or in some cases continued as empires or kingdoms (Chinese, Ottoman, Ethiopian, Siamese, Russian) with their distinctive non-European features.

In the wake of the two world wars of the early twentieth century and subsequent decolonization, national states were set up for much of East and Central Europe, the Caribbean, the former Ottoman empire, Africa, and Asia. People in these places, especially the leaders who

had received higher education in Europe, wanted to follow the example of European national states. In Western Europe the national states of 1900 had developed the institutional strength to survive many internal and external challenges. Those without strength did not survive, and their populations and peoples were taken over by other states (Tilly 1990). A great many of the new national states of the twentieth century, on the other hand, were created by external fiat. Many such states in Eastern and Central Europe were taken over by the Germans and then the Russians in the 1930s and 40s. Since the breakup of the USSR and East Bloc, the newly emerged and sometimes redefined national states of central and near eastern Europe have rushed to join the European Union. The EU rules offer multilaterally guaranteed open economic and political access, and at the same time diminish the clarity of definition for member national states.

For national states in the rest of the world – the third world in its original sense of the places in neither NATO nor the Soviet bloc – the United Nations institutions (including World Bank and IMF) and rules of Cold War competition effectively guaranteed the external borders and provided access to emergency aid (e.g., Bates 2000). Some of these national states have developed institutions to maintain internal order and external autonomy, while others drifted in and out of failed status. An important difference in the modern world order is that failed states would have been taken over by powerful neighbors in the world order of 1600. Elites in failed or miserably performing states today can stay in power with financing from various combinations of foreign military and economic assistance and sales of natural resources – Bolivia, Venezuela, Surinam, Guyana, Nigeria, Zambia, Pakistan, and so on. Even states that fail to control major parts of their nominal territory, such as Congo, Somalia and Sudan, still obtain international backing and subsidies to maintain the guise if not reality of a national state. In comparison to 1600, states now face weaker negative sanctions that would pressure their

societies to develop institutions that make their domestic economies strong (e.g., Bates 2000).<sup>xv</sup> Only a few places on the front line of the cold war – Taiwan, South Korea, West Germany, and Finland – faced such pressures since the mid twentieth century. These places also needed an army to deal with external threats, requiring at the least an economy sufficient to support the army. Generally in Latin America and Africa, by contrast, the military has played mainly a domestic role. The change in the external environment seems to have made achievement of the third doorstep condition – centralized civilian control of the violence – more difficult. More research is needed to understand why.

The upside of the modern world order has been stability of external borders, so that countries had the opportunity in the second half of the twentieth century to focus on building up their domestic institutions. Not all of them used that opportunity.

We have developed the theory of limited and open access orders as a way to understand the variation among countries or societies. We take these countries as our given units of observations. Some commentators have noted, however, that the whole world order can be seen as a limited access order that assigns each area and population of the world to a different government, which is then allowed to manage or exploit its people and resources without outside interference. An important motivation for this international framework was to reduce the frequency and destructiveness of war. The Peace Treaty of Westphalia in 1648 was a deliberate attempt to reduce war among the major powers of Europe at the end of the 30-Years War, which had climaxed a long century of conflict about which branch of Christianity would dominate. The treaty held that the ruler of each principality could decide the religion of his people, and outsiders would not interfere. Similarly, to reduce conflict in their expansion to overseas empires, Portugal and Spain agreed around 1500 to divide their colonial rights in the Americas.

Three centuries later, the major powers of Europe met in Berlin in 1882 to agree on a division of colonization rights in Africa. The cold war division of 1945-90 can also be seen in part as an arrangement to avoid nuclear conflict between the Soviet Union and the United States (and its nuclear armed allies in Western Europe) by dividing the world. Each power recognized in practice the authority of the other to determine the economic organization and thus the allocation of rents in its sphere of influence. In all of these instances, at least some of the participants were limited access orders, so the governments had a direct stake in the allocation of rents.

In the European Union, we see a new phenomenon, where the criteria for membership essentially are the acceptance of open access rule for the economy and polity. The long-term effects of EU accession remain to be seen, but seem to herald an expansion of the OAO world.

### **IV.3 Technology**

Compared with 200 or 400 years ago, technology is the most eye-catching difference in the world today, both in the level and in the rapidity of change. Technology transfer has the promise of letting more backward economies catch-up quickly. Unfortunately, internationally available technology is not a panacea and in some cases may retard institutional development. Elites in LAOs can adopt technology in a selective way, without needing to enable the organizational density required for home-grown technology development. Without such institutions associated with OAOs, the LAOs can increase absolute levels of productivity and material welfare, but always remain behind the OAOs. Similarly the availability of weapons technology on the open market has mixed effects – sometimes letting elites in LAOs get a more secure hold on power, and sometimes allowing the non-elites to gain access to weapons and

power to challenge the elites. Rather than a more open social order, this usually leads to instability and more violence, moving society back toward basic or even fragile LAOs.

This point does not deny the productivity benefits to the elite in a country that has its own technology development; rather it recognizes that there is a cost to having the open access necessary for local technological progress – a cost not only in money but also (from the point of view of an LAO elite) in loosening the control on access to organizational forms. If elites can get most of the technology they want without allowing a flowering of potentially competing organizations, then they are less likely to allow such institutional change that threatens the stability of their situation.

Some scholars treat development as identical with productivity growth (Landes 1999; 1969; Mokyr 1990.), while others like Fogel and North see a distinction. The present framework allows us to examine the distinction more precisely. Development can be defined as movement along the spectrum of LAOs and the transition from an LAO to an OAO. This movement has generally led to increased productivity and incomes. Increases in income in and of themselves, however, rarely help states move along the spectrum of LAOs, much less to make the transition to an OAO. Growth due to technological change, therefore, does not necessarily produce either of these forms of development; so technological improvements do not necessarily contribute to development. So-called developing countries can adopt improved production technology (causing TFP growth) and to some extent even develop new technology themselves without becoming OAOs, achieving the doorstep conditions, or even becoming a mature LAO in the sense of supporting a wide array of organizations outside of the state.

Communications technology is particularly noteworthy, not only because it facilitates production and is itself an item of consumption, but because it is essential to forming and

sustaining organizations. Improvement in communications technology has multiple and contradictory effects on the two development problems and on the freedom of ordinary people. For example, enhancing the ability of people to form organizations and to coordinate can help a state move along the progression of LAOs. Freedom of speech and the press was critical to the historical emergence of OAOs. The introduction of radio and then TV in the early and mid twentieth century made it a lot easier for people in LAOs to get information, including about what was happening in the world and what other people were saying about it. This information allowed them to compare more readily their own circumstances and their leaders' performance relative to the alternatives.

These media have also made it easier for elites to disseminate their views to the masses. For much of the twentieth century, monopoly control over the radio and television media by the state allowed the dominant coalition to use these technologies to their advantage. Further, new technologies always provide a new potential source of rents, thereby potentially strengthening the dominant coalition by allowing them to add new members to the coalition without diminishing the benefits of the existing members. Privatization of Mexican telephones shows that this can be a tool of the LAO (See Haber et al. 2007).

More recent changes in communications technology seem to be undermining state control. Television and radio media did not do nearly as much to facilitate communications exchanges among non-state organizations because they lack the ability to support back and forth communication that is essential for organizations. The telephone did, although on a sequential one-on-one basis, with high costs for longer-range conversations (before the cell-phone).

The internet and cell phones on the other hand provide a significant increase in interactive communication, and we have yet to understand their full potential. Large groups of

people in geographically separated locations can now participate in the conversation at low cost. This form of communication potentially increases citizens' coordination in ways that can have big effects on governments in LAOs. This potential has made some governments nervous, and they have tried to restrict access to the internet and to keep track of (and often repress) those who use the internet to operate unapproved organizations. China is the best known but not the only example. Software and hardware companies – usually based in OAOs and nominally strong advocates of freedom – have sometimes cooperated, even to the extent of creating custom products by which governments can track who is doing what on the internet. We have yet to see whether these firms face sufficient market pressure to collaborate with authoritarian governments in designing technology that simultaneously allows limited access to the internet while affording government-controlled restrictions or monitoring. The public in the West reacted negatively when China arrested people on a user list released by Yahoo, and many IT companies signed onto a pledge in January 2007 that they would cease (or limit) such cooperation.<sup>xvi</sup>

#### **IV.4 Private Corporations from OAOs**

Private firms from OAO countries have a strong presence in most LAOs today – exceptions, such as Burma and North Korea, are rare. These organizations make manifest the most important economic institutional forms of the OAO world order, and thus potentially smooth the way to form similar organizations in LAOs. They do not need to replicate the trail-and-error process in Western Europe and the United States by which the form of limited liability corporations and their regulatory environment emerged. Indeed, most OAO firms operating in today's LAOs use the institutions of an open access order for their institutional and contractual support and therefore do not need to rely on the LAO's institutions to maintain



themselves. This gives these firms significant advantages over domestic firms in an LAO. In today's LAOs the private sector development activities of the international financial institutions and donors typically emphasize the formal steps to creating similar institutional forms. To some extent this happens, but a frequent frustration is the lack of dynamism in the process.

As described in North et al. (2006), the institutions of modern private firms emerged 100-400 years ago in today's OAOs (especially the first movers), when the elites had a material interest to have such organizations in order to expand the scope and profitability of their operations. To meet their needs, elites in OAOs had to develop domestic institutions to support these organizations, which later became accessible to wider circles of society. In LAOs today the elites have other options to make their commitment credible, such as to form an alliance or joint venture with a multinational firm. They can also invest their assets through a multinational firm, such as a bank or investment company in London, Tokyo, Zurich, New York or Miami rather than relying exclusively on riskier domestic instruments of investment.

This institutional retardation may inhibit not only achievement of the doorstep conditions and an eventual transition to OAO, but also the maturation of the basic LAO. The ability of elites to rely on multinational firms for profitable interaction with the global system lessens their incentive to have domestically established organizations and sometimes even to improve the organization of the government itself. Thus rulers of Equatorial Guinea and Mobutu's Congo (Zaire) can sell oil and other minerals to the world and have the profits sent to their personal bank accounts in the US or Europe; they have what they want without even getting a functioning ministry of finance, much less a domestic private financial sector.

The result is that many LAOs today have *dualistic economies*, with a domestic economy governed by domestic rules and institutions and international enclaves run by a separate set of

rules and institutions, modeled on and enforced by foreign OAOs. Other observers have remarked on the duality in terms of production efficiency and incomes; our analysis highlights the fundamental duality in access to security for contracts and organizations, which underlies the other dualities. Even in some places that are quite lawless from the point of view of the average citizen, international firms and their local partners enjoy relatively good protection of their contracts. In Surinam in the 1990s, for instance, the head of the central bank was wanted by Interpol for money laundering, but ALCOA operated securely there, producing the large majority of the country's legitimate export earnings and government revenue.

Observers and advisors from OAOs wonder why the duality persists. Seen within the logic of the LAO operating in a world dominated open access economies, elites in today's LAOs often gain substantially from this duality, which is now a central feature of many LAOs. Participation in the enclave of the global economy, with access to international capital and secure property rights, gives third world elites opportunities to prosper without having to alter their domestic LAO institutions that produce security and that sustain their rents. By allowing additional streams of rents without threatening the domestic order, enclaves allow elites greater rents and thus greater incentives to maintain the current system. Better local institutions (outside the enclave) are not created or remain dysfunctional because the elites with international connections do not need the local institutions and because the lack of local institutions creates a barrier to entry that benefits incumbent elites.

## **V. Conclusions: Why Existing Approaches to Development Often Fail and an Alternative Approach**

In the last 50 years, donor organizations have provided developing countries (and failed states) with policy and technical advice. In some places this has contributed to improvements both in material outcomes and in the quality of institutions – more mature LAOs and even movement toward OAOs in a few cases. In many places, however, the advice (and accompanying financing) has failed to promote systematic development or significant reductions in poverty. Why does such advice fail?

Existing approaches to development rely heavily on economics. They focus on market-oriented reform, such as “getting prices right,” and market-supporting institutions, such as property rights, rule of law, and democratic governance. According to this standard view, the extensive use of market controls and state intervention in LAOs reflects the negative influence of special interest groups and corrupt governments.

The problem with the standard approach to development is that the typical recommendations aim to introduce unmodified elements of open access orders into developing societies. These elements – property rights, the market, institutions of the rule of law, and democracy – can fail when inserted into limited access orders without taking account of the problem of the endemic distribution of the potential for violence. Some of them can work in LAOs, indeed they may help the movement toward a more mature LAO and the achievement of the doorstep conditions, but our model predicts that they will yield the expected benefits only if consistent with the logic of limited access in the actual country circumstance.

The foundation of the limited access order is its solution to the problem of violence. Reforms fail and lead to regression if they do not include arrangements to sustain this solution.

The LAO gains stability when a dominant coalition emerges that provides powerful individuals and groups with incentives to refrain from violence. By limiting access, the LAO creates rents that help maintain peace. Limiting access and rent-creation is more than just service to interest groups; it is a solution to the problem of violence. More competition, opening access, or freer markets can weaken the rent-creation system that holds the LAO together. These reforms therefore threaten the basis of order and hold the risk of violence. Similarly, attempts to remove corruption, create rule of law, and institute democracy with competitive parties can also destabilize an LAO and generate broad resistance. Groups who benefit directly from market distortions – firms that receive monopoly profits or groups that receive services at subsidized prices – will resist the reforms. Paradoxically, many who are exploited by these policies will hesitate to push for reform because they see disorder and violence as worse than being exploited economically.

Perhaps even more problematic is the possibility that the dominant coalition in a LAO can adopt the institutional forms proposed by an international donor without fundamentally changing the way the receiving society operates. Since institutional forms and mechanisms operated differently in different societies, recipient countries may be able to adopt the recommended institutional forms and co-opt those forms to sustain or strengthen their LAOs. In retrospect, donors evaluate these programs and complain that the reforms were mere window dressing or that the country lacked “political will.” We need to appreciate more deeply the logic and power of the LAO by which elites have incentives to subvert these reforms or, as they would see it, to adapt the institutional forms to local conditions.

Our approach remains in its beginnings and offers no magic solutions to problems of development. Nonetheless, it provides some insights suggesting a new approach to development

policies. Developing countries face two separate development problems, not one, and the policies necessary to foster development are different for each problem. The first development problem is the movement along the spectrum of LAOs – fragile, basic, mature – and the creation of the doorstep conditions. Historically, only the most sophisticated and, as it turns out, rich LAOs were ready for the transition (namely, those that meet the doorstep conditions). The first development problem is therefore more relevant for most of the World Bank’s clients, especially the poorest, most fragile, and most prone to violence. The second development problem is the transition from a limited access order to an open access order.

Making progress under the first development problem requires concentrating on steps that can help the state solidify itself, maintain or improve control of violence, and eventually to create a legal framework for non-state organizations. Fragile LAOs should focus on creating the possibilities for moving towards a basic LAO, including more specialized governmental agencies and services. Basic LAOs should focus on creating the conditions that can foster and sustain private organizations. Mature LAOs should focus on creating the doorstep conditions. Because LAOs are elite-controlled, many of reforms will have the most direct effect of improving the lives of elites or even helping elites solidify their rents. For example, in states with high violence, the important step in making the society better off is reducing violence. Failing states do not turn around by becoming OAOs. Our approach suggests that creating peace in violence-torn societies involves creating a basic LAO, not in creating an open access order with democracy and markets, nice as that is for a long-term goal.

Our approach does address the problem of poverty in that mature LAOs are significantly richer than fragile LAOs. Moving developing countries along the progression of types of LAOs typically expands the elite and at least some LAOs have thus made significant progress in

reducing poverty (Dollar 2005). Moving states along the LAO progression benefit for the poor as these states become more resilient to shocks and therefore suffer fewer debilitating crises that hurt everyone in the society.

These important issues deserve further investigation. Modern economics provides a good understanding of thriving markets and the competitive mechanisms that create them. Legal scholarship provides a good understanding of the legal systems required to sustain property rights, enforce contracts, and regulate certain types of externalities (as in torts). Missing is the equivalent knowledge in political science that affords an understanding of the political and constitutional institutions that can sustain these. Consider the mature LAO's sustaining of private organizations. We know something about the legal mechanisms necessary for sustaining these organizations, including contract enforcement between the organization and its members and among organizations. Yet we know too little about the mechanisms and institutions by which a mature LAO sustains these institutions and motivates members of the dominant coalition to respect these services. It is one thing to create courts and justices and another to ensure they can sustain the independence necessary to produce the impartial delivery of justice. Having given some reasons why existing development policy is inadequate, we can only point in the direction of what should replace it.

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## Endnotes

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i. The authors are affiliated, respectively, with Washington University (St. Louis), the University of Maryland (College Park), the World Bank, and Stanford University. The opinions in this paper are those of the authors and do not reflect official positions of the World Bank or the universities with which the authors are affiliated. For comments on earlier versions of this paper, we wish to thank Phil Keefer, Ali Khadr, Mushtaq Khan, Brian Levy and the participants at the May 2007 World Bank workshop on Limited Access Orders and the July 2007 SOAS/DFID workshop on Governance for Growth.

ii. The terms “order” and “social order” have different meanings. The former means peace and security -- the opposite of disorder; the latter means the organization of society and its component economic, political, and social systems. So as not to confuse the two meanings, we will always use the adjective “social” to indicate the latter, and “order” alone to indicate the former.

iii. Most other approaches to the state are also Weberian, e.g., Barzel (2000), Levi (1988), and Tilly (1993); see also Brennan and Buchanan’s (1980) leviathan model. More recent political economy models of policymaking also make the Weberian assumptions, including Bueno de Mesquita et. al. (2003) and Grossman and Helpman (2001).

<sup>iv</sup> Klein and Leffler (1981) make a similar argument in the context of rents and commitment to assure contractual performance.

v. Notice that this view of rent-creation differs from the more well-known approach to rent-seeking (e.g., Buchanan, Tollison and Tullock 1980). That approach is also Weberian: it assumes away the problem of violence and takes the state as given.

vi. The independence of private organizations is a continuous variable, not a zero/one condition.

vii. Soviet Russia, however, is a clear example where a basic LAO was able to obtain consolidated political control of violence, but could not sustain private elite organizations outside the framework of the state.

<sup>viii</sup> As discussed later, multinational corporations are important exceptions and generally operate in enclaves when they come to basic or fragile LAOs.

<sup>ix</sup> The fragile-basic-mature spectrum is only one possible way to differentiate LAOs. For instance Mushtaq Khan and coauthors have made insightful distinctions about forms of rent-creation—to explain they produce incentives that promote or inhibit productivity growth in the economy (Khan and Komo 2000; Khan 2007)

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x. The 5 percent example ignores the problem that in most limited access orders, elites are also differentiated from one another. Limited access orders do not contain a homogenous class of elites, but a group of elites who possess personal as well as general privileges. The one-third figure is also only suggestive. First, a third of what? The adult males? We do not propose that a quantitative figure has any predictive or explanatory power.

<sup>xi</sup> Open access orders tend to rely on broad taxes on economic activity, such as the income tax or a value added tax. Limited access orders rely less on these broad taxes, often raising considerable revenue from various rent-creation activities, state owned enterprises, and resources.

xii. A perpetually lived organization is an organization whose legal existence is independent of the identity of any specific individual members. In modern societies, business corporations enjoy perpetual live, business partnerships do not.

xiii. For example, in the United States there are detailed formal rules specifying how the President is to be elected, but there is no provision in the constitution for political parties, the actual mechanism by which potential candidates are selected.

xiv. Canada, Australia, and New Zealand became independent with these institutions a century later.

xv. Elites in some third world countries also face fewer positive incentives to develop domestic institutions for efficient finance, exchange and property rights, which is due to factors discussed later.

xvi. The next section discusses the general topic of how OAO-based firms behave when operating in LAOs.