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Edited by Douglass C. North, John Joseph Wallis, Steven B. Webb and Barry R. Weingast
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ONE

Limited Access Orders

An Introduction to the Conceptual Framework

Douglass C. North, John Joseph Wallis,
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1.1 The Problem of Economic and Political Development

Success in economic as well as political development depends primarily on improving institutions. This has become the consensus among economists over the last twenty years, as the world has witnessed many development failures in spite of abundant capital, natural resources, and educated populations, who emigrate or stagnate if institutions do not put them to good use. The question now is: What institutions are right? As elaborated later in this chapter, some argue that developing countries should emulate the institutions of the most successful, high-income economies of the OECD. We and others, however, see evidence that most low- and middle-income countries are not ready to utilize many Western European or North American institutions or that these institutions function very differently if transplanted into these low- and middle-income economies.

The purpose of this volume is to develop and apply an alternative framework for understanding the dynamic interaction of political, economic, and social forces in developing countries, which was first laid out by North, Wallis, and Weingast (2009, hereafter NWW). The standard approach begins with neoclassical assumptions that growth will occur whenever profitable opportunities present themselves unless the intervention of political or social impediments prevent markets from working. In contrast, the alternative perspective presented here begins with the recognition that all societies must deal with the problem of violence. In most developing countries, individuals and organizations actively use or threaten to use violence to gather wealth and resources, and violence has to be restrained for development to occur. In many societies the potential for violence is latent: organizations generally refrain from violence in most years, but occasionally find violence a useful tool for pursuing their

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ends. These societies live in the shadow of violence, and they account for most of human history and for most of today's world population. Social arrangements deter the use of violence by creating incentives for powerful individuals to coordinate rather than fight. The dynamics of these social arrangements differ from those described in neoclassical models, and this difference limits the value of the neoclassical tools for understanding the problems of development.

Our framework builds on the exciting work of a range of scholars studying the political economy of development. Some draw heavily on international contrasts of historical experience through detailed analysis of cases (Abernethy 2000; Bates 1981, 2001; Haber et al. 2003, 2008; Herbst 2000; Fukuyama 2011; La Porta et al. 1999; Landes 1998; Mokyr 1990; Spiller and Tommasi 2007; Tilly 1990). Our framework tries to take account of the events portrayed in those case studies. Other authors use econometric analysis to test for the historical origins of institutional differences (Acemoglu and Johnson 2005; Acemoglu and Robinson 2006; Engerman and Sokoloff 2008). Our framework aims to provide a new institutional explanation for why patterns of political economy have persisted for centuries. Another group of studies elaborates theoretical models of political interaction that give explanations for the dysfunction that plagues developing countries (for example, Buchanan et al. 1980; Bueno de Mesquita et al. 2003; Cox and McCubbins 2000; Levi 1988; North 1981; Olson 1993; Przeworski et al. 2000). Our framework takes more account of the issues of violence and of organizational structures within the elite. The studies closest to our approach not only look directly at institutions in developing countries today but also argue that no simple or linear relationship exists between institutional and economic development (Collier 2009; Easterly 2001; Grindle 2007; Khan 2004; Khan and Jomo 2000; Rodrik 2007; Shirley 2009). Our approach provides a more systematic explanation for some of the nonlinearities that they identify.

Others have also discussed how the institutions of developing countries differ qualitatively from those in developed economies. Marx, of course, noted how capitalist societies differed from their predecessors. Huntington (1968) and more recently Collier (2009) see the importance of the problem of violence in these societies, suggesting that they may not be ready for some of the institutions prevalent in more economically developed countries. Grindle (2007) and Rodrik (2007) see the need for developing countries to strive for "good enough governance," with the implication that the institutional needs in these places is qualitatively different from in developed countries. Alston et al. (2010), Khan (2004), Khan and Jomo (2000),

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Moore (2010), and Shirley (2009) also see an institutional agenda for developing countries that is not the same as an incremental and linear adoption of the institutions in developed countries. Compared to these earlier analyses, our integrated conceptual framework enables us to think about the interaction of economic and political behavior, explicitly considering the problem of violence as an entry point.

The problem of violence has increasingly become a concern of the World Bank. The central message of the 2011 World Development Report on *Conflict, Security, and Development* “is that strengthening legitimate institutions and governance to provide citizen security, justice and jobs is crucial to break cycles of violence” (World Bank 2011, p. 2). The report offers many dimensions of analysis within the theme that creating widespread trust in institutions and popular satisfaction with outcomes – like employment and rising living standards – are integral to reducing the threat of violence. Our approach puts more emphasis on the nature of organizations and the relations between their leaders – the elite, broadly defined. The WDR acknowledges a role for elite bargains, but sees them as a temporary solution at best for the problem of violence. Our framework sees elite bargains as the persistent core of developing societies and seeks to understand which types of elite bargains have contributed to positive economic and social development and which have not.

1.2 The Logic of Limited Access Orders

The conceptual framework emphasizes that developing societies limit violence through the manipulation of economic interests by the political system in order to create rents so that powerful groups and individuals find it in their interest to refrain from using violence. We call this way of organizing a society a *limited access order* (LAO), and this section explains the logic of these societies.

LAOs are social arrangements – simultaneously political and economic – that discourage the use of violence by organizations. Even in a world where violence is a viable option that cannot credibly be deterred by a third-party or central authority (like a government), some or all potential violence can be discouraged so that it remains latent, allowing individuals and organizations to have some confidence of peace in dealing with other organizations with violence potential. The LAO framework builds on the importance of organizations, both as a way of coordinating individuals and as a way of generating rents and shaping incentives consistent with individual behavior.

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We develop the underlying logic by starting with a simple example that focuses on two groups and two leaders. Real societies are much larger and more complicated. The story begins with self-organizing groups that are small and that have no way to develop trust between individuals beyond ongoing personal relationships. Members of one group trust others within their group but distrust members of the other groups. Because they recognize that disarming will lead the other group to destroy or enslave them, members of neither group will lay down their arms. To avoid an outcome with continual armed conflict, the leaders of the groups agree to divide the land, labor, capital, and opportunities in their world among themselves and agree to enforce each leader's privileged access to their resources. The privileges generate rents, and if the value of the rents the leaders earn from their privileges under conditions of peace exceeds that under violence, then each leader can credibly believe that the others will not fight. The leaders remain armed and dangerous and can credibly threaten the people around them to ensure each leader's privileges.

An important feature of the agreement between the leaders is the ability to call on one another to help organize and discipline the members of each leader's group. Especially they *limit* the possibility for others to start rival organizations. Limited access to opportunities for organization is the hallmark of LAOs. The arrangement is represented graphically in Figure 1.1, where individuals A and B are the two leaders and the horizontal ellipse represents the arrangement between them. The vertical ellipses represent the arrangements the leaders have with the labor, land, capital, and resources they control: their clients, the a's and b's. The horizontal arrangement between the leaders is made credible by the vertical arrangements. The rents leaders receive from controlling their client organizations enable them to credibly commit to one another, since those rents are reduced if cooperation fails and there is fighting. The rents from peace that are lost if violence occurs create incentives that curtail violence.

A reciprocal effect also exists. The agreement among the leaders enables each leader to structure their client organizations better, because they can call on each other for external support. In effect, the ability of the leaders to call on one another can make their individual organizations more productive. The rents the leaders enjoy, then, come not only from their privileged access to resources and activities, but from the leaders' ability to create and sustain more productive organizations.

We call the coalition among the leaders the *dominant coalition*. The dominant coalition provides third-party enforcement for each of the member organizations. The vertical organizations might be organized as political

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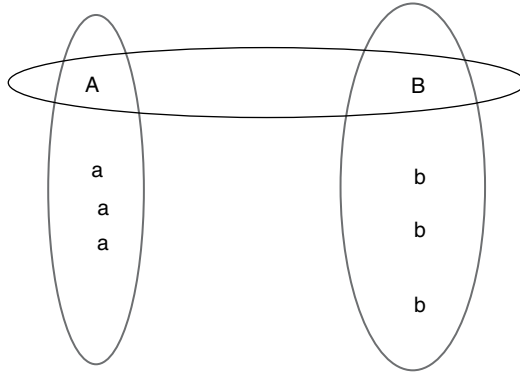


Figure 1.1 The logic of limited access.

parties, ethnic groups, patron-client networks, or crime families. The combination of multiple organizations, the organization of organizations, mitigates the problem of violence between the really dangerous people, creates credible commitments between the organizations with violence capacity by structuring their interests, and creates some belief that the leaders and their clients share common interests because they share in the value of rents.

The figure is a very simple representation. It portrays the dominant coalition as an organization of individuals, when the coalition in reality is usually an organization of organizations. They are often portrayed as patronage networks. The LAO framework calls attention to their function not only as the distributors of spoils but also as essential institutions to bring about cooperation rather than violence among organizations with violence capacity.

In a functioning limited access society, members of the dominant coalition include economic, political, religious, and educational leaders (elites) whose privileged positions create rents that ensure their cooperation with the dominant coalition and create the organizations through which the goods and services produced by the population can be mobilized and redistributed. Among the most valuable privileges members of the dominant coalition enjoy and the primary source of rents within the coalition is the ability to use the dominant coalition to enforce arrangements within the organizations of the coalition members. The rents created by those exclusive privileges are part of the glue holding together the agreements between the organizations. Limiting access to enforcement of rules by the coalition creates rents and shapes the interests of the players in the coalition.

The creation and structuring of rents are the heart of the logic of limited access. The framework focuses attention on rents to elucidate how a

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coalition of organizations provides order, but it differs in two ways from the uses of the term *rents* in recent economic literature. One difference is terminological, but the other difference illuminates how the LAO framework depicts the dynamic interaction between political and economic institutions.

Ricardo classically defined rents as a return to an asset or action higher than the return to the next best opportunity foregone. The neoclassical proposition is that individuals maximize net benefits: the difference between total benefits and total costs, where costs are defined as opportunity costs. Net benefits are rents, therefore rational individuals maximize rents. A smoothly operating market achieves the maximum amount of rents, the sum of consumer and producer surplus.

In the last few decades, a relatively narrow use of the term *rents* has come to dominate both academic and policy discussions about development. Krueger (1974) and Bhagwati (1982) extended the ideas of public choice economists like Buchanan, Tollison, and Tullock (1980) that individuals not only maximize rents, but that rational individuals are willing to devote resources to gain rents for themselves, an activity called *rent seeking*. The problem, from society's point of view, arises because individuals devote resources to pursuing rents that have no socially useful purpose. For example, suppose the government is deciding whether to impose a tariff on imports, which will create winners and losers. Both sides devote resources to gaining their desired end, spending up to their expected value of winning. The resources expended by winners and losers are directly unproductive rent-seeking activities (DUP), since the expenditure of resources creates no value for society as a whole. When rent seeking leads to outcomes that make society worse off, it creates DUP rents.

Common practice has dropped the *DUP* qualifier. A popular element of recent development policy, including the governance and anticorruption agenda, is the elimination of DUP rent seeking. Unfortunately that often is stated simply as eliminating rent seeking. Defined in the classical way, however, rent seeking is a ubiquitous characteristic of human behavior. Adam Smith pointed out how individual rent seeking could benefit society. We want to be explicit that the LAO framework uses the term *rents* to mean classical rents, not just DUP rents.

Our thinking about elites and dominant coalitions emphasizes that rents make people's behavior more predictable. An individual willing to work for ten dollars an hour but is paid fifteen dollars an hour receives a rent of five dollars an hour. A small change in circumstance will not lead that person to quit his or her job. In contrast, if the worker is paid \$10.05 an hour, he or

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she receives a rent of only \$.05 an hour and may quit the job if even a small change in circumstances raises the value of his or her alternatives or reduces his or her benefits from working.¹

Following the logic of limited access, rents are critical to coordinating powerful members of the dominant coalition because rents make their behavior predictable. But not all rents make behavior with respect to violence more predictable. The rents can limit violence within the coalition only if rents are reduced when violence breaks out. The logic of limited access therefore emphasizes a kind of rent creation effected by violence that can serve to coordinate members of the dominant coalition.

This logic also shows why organizations are so important to the dominant coalition. In Figure 1.1, A and B enjoy rents that will be reduced if they are violent, creating a credible incentive for both of them to be peaceful. But A and B also receive rents from their organizations that depend on their continued cooperation. If A and B serve as credible third parties for each other, then their vertical organizations become more productive. The gains from making their organizations more productive are the rents from cooperation. If A and B do not coordinate, the rents from their organizations are reduced.

This understanding of rents distinguishes the LAO framework from other schemes that focus simply on the maximization of elite rents from any source.² The DUP approach ignores violence and implicitly assumes that the creation of rents is unrelated to the underlying nature of the society in which the rents appear. The LAO focus on violence and instability highlights the trade-off between stability and efficient growth. Specifically, when is it better to allow some costs to the economy, and perhaps to civil or political rights, in order to maintain or strengthen stability? The conceptual framework shows that the appropriate counterfactual about eliminating rents is not a competitive market economy (as the DUP perspective suggests), but a society in disorder and violence. To the extent that rent creation in LAOs is the means of creating stability, rents are a symptom of the development

¹ This is the logic of “efficiency wages” laid out by Akerlof and Yellen (1990).

² In a stable LAO (effectively motivating restraint of violence), everyone in the dominant coalition is getting a efficiency wage, which means that they are dividing the pie so that no one individual or group is maximizing its rent. If someone were maximizing in the neoclassical sense, it would mean pushing someone else close to the edge and ready to change loyalties if there were a marginal change in prices. Limited access allows all the members of the dominant coalition to enjoy extra rents and not be at their lower margin. Of course, sometimes a big change in relative prices precipitates discontinuous changes in the LAO dominant coalition. But the more robust LAOs have enough excess rents in the system to avoid this most of the time.

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problem, not the cause of it. Attempts to remove institutions and policies that support economically unproductive rent creation and corruption need to be done in ways that avoid recurrence of instability and violence, which derails development in a LAO.

Combining the dynamics of rent allocation within the dominant coalition with the neoclassical idea that individuals seek to maximize rents allows us to understand the uncertain dynamics of limited access orders. One important implication is that limited access orders do not have a strong tendency to adopt arrangements that increase rents in the aggregate by making social organizations more productive. Individual elites usually have a complicated mix of rents, and their interests in maximizing rents through the dominant coalition is not wholly predictable. As a result, limited access societies are not characterized by steadily increasing stability or productivity. Rather, they have periods of rapid growth and periods of stagnation or collapse.³

LAOs are not static. When a crisis hits a limited access society, the dynamics of the dominant coalition lead it to focus on the rents – old or new – that sustain coordination and limit violence, and the creation of new rents that do sustain coordination and limit violence, as in the cases of Mexico in the 1930s, Chile in the 1970s, Korea in the 1960s, and Zambia in the 1980s. Or a crisis may lead to a free-for-all, as in Mozambique in the 1980s or in the DR Congo since the 1990s. A lot depends on the personality of the leaders in these times of crisis (Alston et al. 2010). Whether the new rents are good or bad for economic growth is not predictable. In some cases, new rents seem to cause social decline, as in Marcos's crony capitalism in the Philippines. In other cases, the new rents move societies forward, as when privileges were granted to conservatives in the 1980 Chilean constitution. The mixed role of rents in limited access orders explains why these societies do not inevitably improve over time.

Another implication of the framework is that limited access to organizations and economic rights necessarily limits competition and economic productivity. In other words, the solution to the problem of violence may become an impediment to long-term economic development, although it does not set an absolute limit to economic growth.

To summarize, LAOs constrain violence by limiting the ability of groups to form political, economic, social, military, and other organizations to engage in social activities. The rents created from those limits on access form the incentive structure that controls violence: powerful groups and individuals understand that their rents will fall if violence erupts, so they

³ See NWW, chapter 1.

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are more likely to be peaceful. At the center of all but the most fragmented LAOs is the dominant coalition, an organization held together by the interlocking interests of its members. A valuable privilege for members of the dominant coalition is that it provides exclusive third-party services to enforce arrangements between and within the organizations in the coalition. The rents created by those exclusive privileges are part of the incentives holding together the agreements between the organizations and their leaders. Limiting access to enforcement by the coalition creates rents and shapes the interests of the players in the coalition.

The logic of how LAOs solve the problem of violence has striking implications for economic development. Limits on the rights to form organizations and numerous privileges for rent creation necessarily mean extensive political constraints on the economy. Local monopolies and restrictions on economic entry hinder competitive markets and long-term economic growth. Put simply, the means by which limited access orders solve the problem of violence is part of the development problem.

Before the twentieth century, the problem of development was really the problem of human history. For roughly ten thousand years after the first large societies emerged in the Middle East, the long-run growth in the material standard of living of most of the population was essentially zero. The field of economic development largely ignores the long expanse of human history, focusing almost exclusively on the last century of relatively slow or zero per capita economic growth of societies outside the twenty-five or so countries that achieved high incomes by the late twentieth century. Viewed in the context of long-run history, the developed world was decidedly abnormal while the slow or nondeveloping world appeared normal.

By the end of the twentieth century, however, the LAOs of the world, including many newly liberated former colonies, were in a world economic and political system dominated by OAO economies and organizations. This has had many effects (North et al. 2007), but an important one for long-term growth was that the LAOs could access technology, markets, and even institutions from the OAO part of the world, especially Western Europe and the United States. This has allowed many developing countries to have significant per capita GDP growth over several decades while maintaining LAO institutions to restrain domestic violence as well as to benefit the elite in the dominant coalition. While some countries have had major reversals of growth, taking productivity and living standards temporarily back to levels of past centuries (like the DRC and Mozambique in our sample), other LAOs do not seem likely to have huge reversals and could plausibly keep growing. Even without making the transition to open access they are growing in the wake

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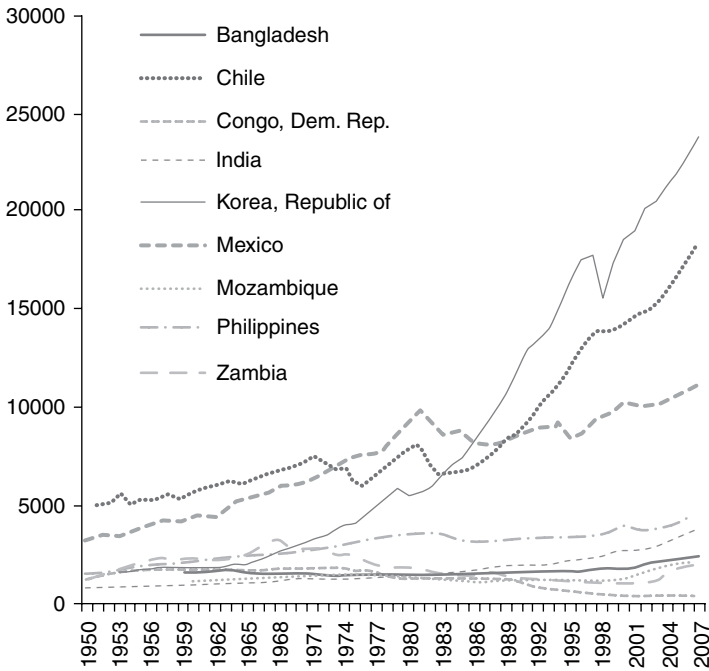
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Figure 1.2 GDP per capita in nine countries (2007 prices).

Source: Heston et al. 2009.

of the OAOs – Mexico, India, and Zambia in our sample, along with Brazil, China, Indonesia, Malaysia, Vietnam, and South Africa.

Figure 1.2 shows the last half century of per capita GDP in our sample countries – usually but not always growing. There is a lot of room for most developing nations to grow economically and improve their institutions while remaining LAOs. To properly advise developing countries, we need to understand better how the LAOs work.

1.3 The Spectrum of Limited Access Orders

How do LAOs improve or regress? Although all low- and middle-income countries today are limited access orders, they have per capita income levels that differ by a factor of twenty or more, reflecting wide differences in the quality of institutions. To differentiate limited access orders and to think about the process of change within them, we developed a spectrum (not categories!) of fragile, basic, and mature LAOs. The three labels are not distinct stages, but variants of an ideal type: points on a continuous spectrum of