

I. Constitutional Political Economy and Organizations

- A. Constitutional Political Economy analyzes how "the rules of the game" affect decisionmaking by persons inside and outside the institutions of interests and how such effects, in turn, affect the the design and evolution of institutions.
- i. In its broadest sense, CPE can be used to as a framework for thinking about private norms, informal and formal organizations, civil law, and constitutional governance.
 - ii. This mini course analyzes some general properties of formal organizations, and explores how decisions tend to be made in the very short and very long run.
- B. This analysis is based on elementary game theory and microeconomics, which are used to analyze the origins of organizations and their standing organizational decisionmaking procedures.
- i. It uses that analysis to analyze governmental decisions in the short (crisis management) and long run (constitutional reform).
 - ii. These subjects are **beyond the scope of most economic and political economy courses**, which tend to focus on "medium run" choices in which decisionmakers operate within preexisting institutions and confront well understood choice settings.
- C. The course begins with some general ideas about organizations that generalize across a wide variety of organizations including national governments and treaty organizations.
- i. Essentially all organizations confront a variety of coordination, team production and decision problems.
 - Most meet at particular times and places.
 - All produce services that are more effectively produced as a team than as independent individuals.
 - These may take the form of pure public goods or private goods produced with economies of scale over some range of interest.
 - ii. Thus all organizations have to decide when to meet, what to produce, and how to produce it.
 - iii. In this sense, all organizations have collective decision making procedures.
- D. To the extent that those decision making procedures are stable, they may be said--as argued below--to have a constitution.
- Constitutions in this sense are not social contracts.
 - Nor are they carved in stone.

- They are adjusted from time to time as circumstances change.
- E. This short course attempts to provide a framework for thinking about constitutional design in this general sense and about the manner in which they are likely to be adjusted through time.
- i. The constitutions of national governments are special cases of this approach, as are the constitutions of treaty organizations.
 - ii. This is not to say that governments are exactly the same as any other organization--there are important differences--but in many respects they are similar.
 - iii. The course analyzes medium, short, and long run decisionmaking--with a bit more focus on the short and medium run than typical in economic courses.
 - The material for the first week of the course is drawn from my forthcoming book on the rise of Western democracy.
 - The material for the second week of the course is drawn from published work that will be the basis for another book on the political economy of crisis management.
 - Two case studies are used to illustrate the manner in which "crises" may emerge in settings that look well organized.
 - The course ends by examining long term decisions: e.g. constitutional amendment.
- F. In the days before histories were recorded, there were few distinctions between governments and other organizations.
- i. Both were evidently largely familial and clan based.
 - ii. As agriculture emerged and people settled in particular places, the variety and size of organizations and governments tended to increase, and distinctions began to emerge between organizations that could impose rules only on their own members and those that could impose rules on persons outside their organizations.
 - iii. That more activities took place within formal organizations and within territories ruled by governments does not imply that all activities were organized from the top down, as in totalitarian states, nor do the distinctions between governments and other organizations imply that the procedures used by territorial governments had become completely different from those used in other organizations.
 - iv. More people were simply being organized to engage in more tasks, because the advantages of formal organizations with artificial incentive systems had increased for both the leaders and members of organizations.

- G. With such distant beginnings in mind, this course begins with an analysis of the emergence and evolution of formal organizations.
- i. All organizations share the property that they are formed to advance goals that can best be achieved by coordinating the efforts of more than one person.
 - ii. All organizations make decisions that focus the organization's resources on particular activities and induce their members to function as more or less productive teams, rather than as unproductive assemblies of individual shirkers and rent seekers.
 - iii. It is these effects that make them "organizations," rather than simply groups of unrelated persons, each doing their own thing. Hunting clubs, farm cooperatives, churches, commercial enterprises, pirate ships, and governments all select projects to undertake and provide internal incentives for undertaking them.

II. The use of analytical histories as a device for understanding institutions and civiliation has been used by scholars and theorists at least far back as Aristotle's *Politics*.

- A. Aristotle, for example, includes a very tightly written theory of the emergence of trade and markets:
- " For the members of the family originally had all things in common; later, when the family divided into parts, the parts shared in many things, and different parts in different things, which they had to give in exchange for what they wanted, a kind of barter which is still practiced among barbarous nations who exchange with one another the necessaries of life and nothing more; giving and receiving wine, for example, in exchange for coin, and the like. This sort of barter is not part of the wealth-getting art and is not contrary to nature, but is needed for the satisfaction of men's natural wants. The other or more complex form of exchange grew, as might have been inferred, out of the simpler. When the inhabitants of one country became more dependent on those of another, and they imported what they needed, and exported what they had too much of, money necessarily came into use. For the various necessaries of life are not easily carried about, and hence men agreed to employ in their dealings with each other something which was intrinsically useful and easily applicable to the purposes of life, for example, iron, silver, and the like. Of this the value was at first measured simply by size and weight, but in process of time they put a stamp upon it, to save the trouble of weighing and to mark the value." (Book 1, part 9)
- B. The modern use of "anarchy" as an initial state has been used as a normative analytical technique at least since Thomas Hobbes in 1651 and John Locke in 1690, but has

since been used as an analytical tool by many constitutional theorists--especially those who are referred to as contractarians.

On the nature of anarchy: from Thomas Hobbes, *Leviathan* (1651)

"Whatsoever therefore is consequent to time of Warre, where every man is Enemy to every man; the same is consequent to the time wherein men live without other security than what their own strength, and invention shall furnish them withal. In such condition .. the live of man [will be] solitary, poor, nasty, brutish and short.

From John Locke, *First Tract on Government* (1660)

"'Tis not without reason that tyranny and anarchy are judged the smartest scourges [that] can fall upon mankind, the plea of authority usually backing the one, and of liberty inducing the other...All the remedy that can be found is when the prince makes the good of the people the measure of his injunctions, and the people...pay a ready and entire obedience."

From Mancur Olson, "Anarchy, Autocracy and Democracy" (1991)

Olson argues that it is roving bandits that create a Hobbesian jungle, rather than individuals. Better forms of government may emerge from the jungle, not because of contracts, but because "The conqueror of a well defined territory has an encompassing interest in that domain given by the share of any increase in the territorial income that he collects in taxes. This encompassing interest gives him an incentive to maintain law and order and to encourage creativity and production in his domain. Much of the economic progress since the discovery of settled agriculture is explained by this "incentive."

From James Buchanan, *Limits to Liberty*, 1975.

"The state serves a double role, that of enforcing constitutional order and that of providing "public goods." This duality generates its own confusions and misunderstandings. "Law," in itself, is a "public good," with all the familiar problems in securing voluntary compliance. Enforcement is essential, but the unwillingness of those who abide by law to punish those who violate it, and to do so effectively, must portend erosion and ultimate destruction of the order that we observe. These problems emerge in modern society even when government is ideally responsive to the demands of citizens. When government takes on an

independent life of its own, when Leviathan lives and breathes, a whole set of additional control issues cone into being.

"Ordered anarchy" remains the objective, but ordered by whom? Neither the state nor the savage is noble, and this reality must be squarely faced.

III. This course begins with an analytical history: an abstract and general discussion of the nature of governance and the decisions making institutions of government, but it does not end there. It also attempts to apply the models and logic developed to understand Western democracy.

- A. Essentially all organizations have to solve a variety of coordination, team production and decision problems, because most organizations meet at particular places and times
 - Most meet at particular times and places.
 - All produce services that are more effectively produced as a team than as independent individuals.
 - These may take the form of pure public goods or private goods produced with economies of scale over some range of interest.
 - Thus all organizations have to decide when to meet, what to produce, and how to produce it.
- B. For the purposes of this course, it is the latter--the decision making process--that is of most interest, but we begin by examining the team production problem.
 - This allows us to illustrate some fairly general principles of reward systems.
 - Some of these will apply to decision making as well as to the production of "ordinary" goods and services.
 - It also allows an internally consistent theory of the origins of organizations and the state that avoids the free rider problems noted by Mancur Olson.
- C. An Illustration of the team production problem

Table 1

The Shirking Dilemma Game for Natural Cooperatives			Organizational Solution to the Shirking Dilemma		
	Team Member B			Team Member B	
	Work	Shirk		Work	Shirk
Work (A)	3, 3	1, 4	Work (A)	R, R	R, P
Shirk (A)	4, 1	2, 2	Shirk (A)	P, R	P, P
Exit (A)	1.5	1.5	Exit (A)	1.5	1.5

The cell entries are utilities, the rank order of subjective payoffs for the team members (A, B). The dilemma in the "natural case" is that both team members shirk rather than work.

- i. Note that the upper four cells of the left hand game is a normal PD (prisoner's dilemma) game interpreted here as a team production problem.
- ii. The upper four cells of the righthand game is that game with a reward system introduced. Here is assumed that the organization (its leaders) can change the payoffs of the game by adding rewards for working and penalties for shirking.
 - The new supplemental reward for work be R and the new penalty for shirking be P .
- iii. Note that both players work to advance team goals if $R > P > 1.5$ and $R > 2$. Note that any system of rewards with $R=2.1$ and $P =1.6$ will solve the team production problem.
 - If costs increase with rewards and penalties, "organizers" will choose to set R just a bit above 2 and set P a bit greater than 1.5.
 - If punishments are less costly than rewards, the formateur will be inclined to use penalties rather than rewards to encourage productive effort.
- iv. However, if team members are "volunteers" in the sense that they are free to exit and join other organizations or work alone, the formateur faces a PDE (prisoner dilemma with exist) rather than PD problem.

- In this case, the exit option limits the extent to which penalties can be imposed on team members. In the example, exit implies that the formateur cannot use penalties greater than 0.5 without risking exit by some or all team members.
 - In this case, a combination such as $P=0.5$, $R = 0.5$ might well be the best solution for the formateur, a mixture of “sticks and carrots.”
- v. In general, the least cost pattern of rewards and penalties will include nonpecuniary rewards (approval, status, etc.) as well as pecuniary ones (wages, bonuses, and promotions).
- In some cases, the "organizer" (or "formateur") can partially rely upon incentives provided by the culture in which he or she operates.
 - For example, the culture may include a work ethic.
 - In others, the formateur may attempt to create an organizational culture if that will solve the incentive problems at lower cost.
 - The formateur may also attempt to attract members that are easier to motivate, more skilled, or already demonstrating an "internalized" work ethic.

IV. Formateurs, Culture, and Organizational Opportunities

- A. In Schumpeter's (1934) and Kirzner's (1978) terms, a formateur has, creates, or recognizes organizational opportunities that others do not have or cannot see.
- i. Consequently, “innovation,” “foresight,” and “boldness” are often associated with organizational leadership along with exceptional ability to recruit and motivate a team. Formateurs may also be said to be less risk averse than others (Knight 1921) insofar as they are more willing to accept the risks associated with launching new enterprises.
 - ii. Formateurs, however, differ from the entrepreneurs of classic economic analysis, because they form organizations, rather than engage in price arbitrage or product innovation alone. **Formateurs cannot be “loners,” although they tend to have unusual motivational skills and organizational insight.**
 - iii. When designing a decision making procedure for the organization, "formateurs" may also use a combination of money, status, and selection to create an effective system of organizational governance.

- Note that this tends to be true of small voluntary groups as well as larger coercive groups such as pirates and some forms of government.
 - It also tends to be true of governments formed via social contract insofar as those outside government have an interest in minimizing the overhead cost of governance.
- B. Overall, the analysis above demonstrates that reward systems are complex, which provides a good reason for formateurs to adopt “off the shelf” reward and recruiting systems.
- i. Both the templates chosen for reward systems and the teams assembled reflect the aims and constraints of their founders, rather than history or broad collective objectives, per se.
 - ii. The constraints include technological and cultural factors, which are not entirely predictable.
 - iii. Although formateurs can influence both technological and cultural developments, neither is completely within their control, because both are consequences of complex networks of social relationships and dynamics that are beyond the complete understanding or control of any single person or organization.
- C. Acknowledgement of the partly “spontaneous” and unintentional nature of productive internal and external cultures has implications for the formateur's choice of organizational design.
- i. It implies, for example, that new pecuniary reward systems and new recruiting methods may have unintended consequences on an organization's ability to attract and retain productive team members.
 - ii. The evidence surveyed by Frey and Jegen (2001) suggests that increases in explicitly conditional forms of motivation often reduce (crowd out) self-motivation.
 - iii. In principle, the unintended effects of changes in reward systems on internal culture can be positive or negative, but even if the unintended effects (prediction errors) are symmetrically distributed around zero, rather than biased toward undermining the organization's supporting culture, risk aversion on the part of formateurs implies that fewer organizational experiments take place.
- D. “Institutional conservatism” in such cases is an entirely rational response to the problem of “unanticipated consequences” by risk-averse formateurs (and their successors). “If it ain't broke, don't fix it.”

It should be acknowledged that many new organizations fail, which implies that formateur insight tends to be quite imperfect.

V. Economic Support for Institutional Conservatism

- A. Rational institutional conservatism is further supported by advantages associated with being “conventional.”
- i. Stable internal routines, theories, and norms can be passed on to successive generations of team members at a relatively low cost, as current team members teach new members the methods for getting along and succeeding within the organization.
 - ii. The use of routine “off the shelf” methods of reward and assignments of responsibility within an organization allows personnel to be easily shifted among teams within large organizations.
 - iii. The use of commonplace reward systems allows new team members to be recruited from other organizations and employed with lower training and acculturation costs than is possible when differences among internal reward systems are large.
- B. In settings in which a number of organizations compete to attract the services of team members, team members will naturally tend to join the teams offering the highest (risk-adjusted) rewards and exit from those providing the lowest (risk-adjusted) rewards.
- i. Organizations that offer too little to current and potential team members will not be viable, because they will not be able to retain or attract team members. Conversely, teams cannot promise to pay too much, because the system of rewards cannot be greater than the team’s total production without reducing the viability of the organization.
 - ii. Competitive pressures, thus, reinforce other practical advantages associated with the use of conventional reward systems. The greater is the competition for team members, the narrower is the range of feasible reward systems.
- C. Such economies of conventionalism reinforce tendencies for convergence of internal incentive regimes and provide additional support for institutional conservatism and stability.
- D. Together, the common interests of formateurs and competitive pressures imply that very similar solutions to intra-firm incentive and governance problems tend to be widely used in culturally linked regions and applied for long periods of time.
- i. The convergence and stability of reward systems do not, however, imply that every formateur regards his or her organizational form to be the best that can be imagined or that formateurs are extremely risk averse.
 - ii. Nor do they imply that the results are socially optimal in some sense. For example, excessive conservatism may be induced by a prisoner’s dilemma–like social dilemma

that increases the stability of prevailing practices beyond optimal levels. Individual formateurs may not be able adopt more “efficient” practices without losing team members or customers to their more conventional rivals, even though all formateurs and team members would be better off with revised practices.

- iii. With or without such social dilemmas, however, it remains the case that the formateurs adopt the most cost-effective reward systems that are feasible for them, and that considerable convergence among reward systems tends to take place.
- A. Stable patterns of rewards simply imply that the anticipated cost of significant reforms exceed their benefits for formateurs, given prevailing practices and norms in the communities in which the organizations operate.
- i. Fishing clubs will use similar nets to catch similar fish in similar places. Pear harvesting coops will use similar ladders and baskets.
 - ii. Cherry picking firms will use similar harvesting techniques and pay similar wages to their employees based on similar performance criteria.

VI. That an organization’s rules (laws) are for the most part purposely adopted have a number of implications.

- A. The laws adopted generally advance the aims of the formateurs and their successors, be they a ceo or dictator, board of directors or aristocracy, or cooperative or representative body of the citizenry (a majority in well-functioning democracies).
- i. Laws will be revised as those interests change through time.
 - ii. They will also be revised as mistakes are discovered, or new better theories of the effects of law come to be widely accepted.
- B. Insofar as the interests served remain constant, laws and institutions *tend* to “**improve**” through time.
- i. As legal experiments are made, new laws may be found superior to old laws.
 - ii. The laws in place are the **most efficient** ones that the “rulers” **know of**.
 - Old laws will be replaced by new laws whenever new laws are expected to better serve the interests of those in power.
 - Thus, changes in information can lead to new legislation and improvement.
 - Laws in general and laws governing governance (constitutions), thus, have an evolutionary character that reflects accepted historical experiences.

- C. For example, the optimal size and complexity of the organization and the optimal conditional reward system to solve internal principal-agent, coordination, and free-riding problems may change through time as the technology of production changes or as various economic resources become more or less scarce.
- i. For example, as new economies of scale are discovered, an organization may organize larger teams and purchase (or rent) more capital goods.
 - ii. As the production process becomes more complex, specialization among team members and managers may increase.
 - iii. Again the reforms adopted are not necessarily socially optimal for the organization as a whole, but will tend to advance the interests of the persons with authority to adopt reforms.
- D. Organizational history is thus "peice-wise" rational, but not necessarily globally so.
- i. Generally, the choice is among a subset of possible laws, namely those that other organizations (and/or societies) have already tried out.
 - This body of experimental evidence is increased by new experiments and new results through time
 - Revisions to rules (and laws) tend to more effectively promote the interests of the persons occupying seats in the rule making bodies of organizations, whoever they might be.
 - ii. To say that laws are purposely adopted and/or left in place, however, is not the same as claiming that "the law" is fully understood by those controlling government.
 - iii. Although, in this sense organizations may be said to improve through time, the best of all possible laws or institutions is unlikely to be in place.
 - The set of rules considered by reformers tends to be a subset of laws and institutions that already exist, rather than all possible laws and institutions.
 - Since only a subset of the set of all possible laws is evaluated by rulers (and their staffs), the law will not be the "most" effective laws possible, only the most effective laws that are known.
- E. Moreover, if the interests of the ruler change through times, laws will change for reasons having nothing to do with increased effectiveness or efficiency.
- It also bears noting that the interest of "the government" may differ from the general interest of its citizenry.

- Thus, increased governmental efficiency *may actually make the average citizen worse off* rather than better off in cases in which the interests of rulers differ from those of its citizens.

VII. In the next lecture, we'll take up organizational governance and national governance.

- A. There are two quite different meanings of the term government in English.
- i. On the one hand, it describes standing rules for making rules, which all durable organizations tend to have.
 - ii. On the other, it refers to a specific subset of organizations that have the authority to impose rules on persons outside their organization within a given territory.
 - iii. We will begin with the former and use the results to characterize the latter.
- B. Purposeful behavior has some clear implications for the types governments that survive in the long run.
- i. There is a general tendency toward more effective governance in the sense that the "rents" (social surplus) should tend to be more and more concentrated in the hands of those that have the power to write new laws (to govern).
 - ii. There should be a general tendency toward more security, in the sense that those in power are increasingly likely to retain power through time.
 - iii. The first of these implications suggests that wealthy "elites" should emerge under dictatorships and aristocratic organizational forms, but less so within well-functioning cooperatives and democracies.
 - Evidence of this can be seen in the physical architecture, music, and art of aristocratic-royal Europe as opposed to modern Europe or the contemporary republican and more representative governments of the Netherlands (1600-1800) and USA (1700-present).
 - However, unfortunately for future tourists and historians, not every elite spends its "rents" on durable forms of amusement (architecture, music and art).
- C. The enterprise of governance is broadly similar in all organizations.
- i. All types of government create and enforce laws through threats of one kind or another.

- ii. Most governments also adopt systems of reward and punishment that govern the behavior of those employed by governments itself (within its "organization" or bureaucracy).
 - iii. All governments have routines for making policy decisions.
 - In a democracy, those inside and outside of government are subject to the same laws.
 - In an aristocracy, members of the ruling elite are not normally above the law, but often subject to a somewhat different law than others.
 - In dictatorships, the dictator may be formally placed "above" the law of governance.
 - iv. Laws that determine how decisions are to be made, what decisions have to be made, and which cannot be made are **a nation's constitution**.
- D. The standing procedures for making policy decisions within organizations have attracted far less attention by economists and other rational choice analysts than have the internal incentive systems analyzed in the first half of the chapter.
- i. For example, Williamson's widely read books and articles on corporate governance (1967, 1996, 2002) implicitly assumes that the institutions for choosing policies are already in place, essentially automatic, and well-functioning.
 - ii. The same can be said about Alchian and Demsetz' (1972) analysis of team production, Vicker's (1985) analysis of delegation, and Laffont and Tirole's (1993) game-theoretic analysis of relationships among firms and between government regulators and firms.
- E. A partial defense of that neglect is that an organization's government is often an instance of team production and delegation.
- i. In most cases an organization's standing policies are jointly produced by several team members that have been delegated authority to make various policy decisions. Information is collected about internal and external circumstances, the information analyzed, alternatives evaluated, and decisions made.
 - ii. In only the simplest of organizations and circumstances is all this done by a single individual.
 - iii. As a consequence, those participating in organizational governance normally have "artificial" incentives that are largely determined by the organization's standing system of rewards, because the usual problems of team production have to be overcome to create an effective organizational government.
- F. However, just as an organization is more than an incentive system, its government is more than just another team.
- i. The "outputs" of an organization's government are very different from those of other teams. Its outputs are decisions that substantially create the organization itself and revise it through time. It determines whether teams will be organized to pick cherries, pears, or apples.
 - ii. Once teams are organized and production is underway, it determines whether to continue or not; and whether to change direction or not. A pear harvesting cooperative may switch to grapes or olives.
 - iii. A fishing firm may shift from fishing to shipping, and, if it does so, the policy choices of its governing body will substantially determine which ships head to which port cities, and who and what is on board its ships.
 - iv. The decisions of the ruling body of a regional government determine what will be taxed, who will collect the taxes, and also how future decisions about taxation will be made.
- G. As a consequence, there are informational, bargaining, and collective choice aspects to organizational governance that are absent or much smaller for other teams within large organizations.
- H. Regional governments differ from most organizations because they can impose more rules on more people, and because their members and their citizens are not as free to leave as in smaller less encompassing organizations.
- i. This allows government to produce some kinds of activities that voluntary clubs, firms, and religious organizations will find difficult or impossible to undertake.
 - ii. It also allows them to use greater use of coercion (significant penalties) to control the game because exit tends to be unavailable or a less attractive alternative.
 - Because of the latter, governments will be able to exercise more control over their members and over those "served" than other organizational forms.
 - None the less, it remains the case that someone (the formateur?) benefits from governmental organizations