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## Better Rules or Stronger Communities? On the Social Foundations of Institutional Change and Its Economic Effects

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**Abstract:** Much of the literature on the impact of institutions on economic development has focused on the tradeoffs between society and community as mutually opposed forms of institutional coordination. On the one hand, sociologists, geographers, and some economists have stressed the positive economic externalities that are associated with the development of associational or group life. Most economists, in contrast, hold that the development of communities may be a second-best solution to the development of formal institutions or even have negative effects, such as the promotion of rent-seeking behavior and principal-agent problems. Societal institutions—such as clear, transparent rules and enforcement mechanisms—are held to be universally positive for development. But there are no real-world cases in which only one of the two exists; society and community are always and everywhere in interaction. This interaction, however, has attracted little attention. In this article, society and community are conceived of as complementary forms of organization whose relative balance and interaction shape the economic potential of every territory. Changes in the balance between community and society take place constantly and affect the medium- and long-run development prospects of every territory. The depth and the speed of change depend on a series of factors, such as starting points in the interaction of society and community, the sources and dynamics of change, and the conflict-solving capacities of the preexisting situation.

**Key words:** institutions, society, community, economic development, institutional change.

In recent years, there has been a lively debate in the social sciences on the role of groups or “communities” in economic development and growth (North 1990). The debate stems from the classical notions, from European sociology, of *Gemeinschaft* and “mechanical solidarity” (Tönnies 1957 [1887]; Weber 1921; Durkheim 1984 [1893]). The contemporary terminology for these debates includes labels like *social*

*capital* (Coleman 1990; Putnam 2000; Putnam, with Leonardi and Nanetti 1993; Fukuyama 1999) and *civil society* (Pérez Díaz 1993; Douglass and Friedmann 1998). *Communities* refers variously to features of group life, such as norms, traditions and social conventions, interpersonal contacts, relationships, and informal networks. Although there are many dimensions of

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community, the analytical core of the concept for our purposes is that access to membership in communities that are nontrivial (in the sense that they are capable of sustained collective action) is costly, cognitively complex (requiring a lot of “local” and complex information), and hence subject to high and “personalized” entry barriers. At the same time, membership confers coordination advantages with other members at a low cost. Communities have specific types of enforcement mechanisms, which are both *ex ante* and *ex post*, but also involve interpersonal “positional” sanctions for an individual.

*Society*, by contrast, generally refers to institutions that are defined by more transparent and codified rules. Although these rules may also be costly to learn, they are not transmitted principally through informal and interpersonal means, but instead operate under conditions of anonymity. Coordination with other members tends to be at a higher initial cost than does coordination within communities and involves formal and costly *ex post* enforcement mechanisms, in which sanctions are individual in nature.<sup>1</sup>

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<sup>1</sup> Society and community are increasingly operationalized in the scholarly literature. The operationalization of *society* attracts more of a consensus than does that of *community*. Society is generally operationalized using such indicators as the rule of law, property rights and other market-shaping rules, the stability of constitutional or regime rules, the type of legal system and its everyday operational institutions, the nature of bureaucracy and its rule-boundedness, and so on. Many different data sets are used by scholars who operationalize what we are labeling “societal” forces. Community is more complicated to operationalize. On the one hand, there are indicators that measure the degree of bondedness, usually concentrating on the density, extent, and depth of membership in civic, economic, social, and professional associations. The objective is to capture group life. On the other hand, there are indicators of division, such as ethnic, racial, or other forms of fragmentation, which are assumed to be the “flip side” of bonds within those groups. In addition to these objective indicators, subjective feelings of membership, affinity,

We tend to think of society as having a greater spatial extent than community, but upon closer inspection, this is not necessarily true. The Catalan “community” is bigger than the Danish “society.” Moreover, “Danishness” is both communitarian and societal in its operational reality. Spatial extent tends to be most clearly differentiated at the empirical extremes of our conceptual continuum—neighborhood civic groups (a small spatial extent) versus “United States” (a large territorial extent). This points out that an inquiry into the relationships between society and community may, under some circumstances, be about local versus regional, national, or global, but it is not so as a matter of theoretical necessity. Rather, its interest to economic geographers and others who study territorial development is that—at whatever territorial scale the relations between society and community play out—they do play out at *some* territorial scale. Society and community are territorially differentiated, albeit at a potentially large variety of different scales, depending on the concrete problem to which we apply them as analytical categories. Hence, the inquiry into society and community is inherently about the territorial patterning and differentiation of economic development.

We argue that these two ways of binding people together correspond to two fundamentally different—but mutually necessary and complementary—types of relationships between individuals and collective action in the economy. In the real world, they then shape one another, and it is precisely this mutual influence in constructing complex institutional realities that is the subject of this article.

For students of economic development, the question is why certain institutional arrangements of community and society facilitate the economic process while

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bonding, and so forth are also measured. The literature on social capital has attempted various combinations of these types of indicators, as has an older sociological literature on community itself (see Durlauf and Fafchamps 2004).

others seem to hinder it. This consideration of group life is part of a more general turn toward examining the role of institutions and underlying social forces in economic development. It has been stimulated by increasing evidence that traditional growth theories, based on physical and human resource endowments, trade, technology transfers, or governmental structure, cannot adequately explain development, as reflected in the stubbornly high residuals in growth regressions (Solow 1994).

Granovetter (1985) and Coleman (1990) pioneered concepts—such as “embeddedness” and social capital—that emphasize the potentially beneficial effects of group life on economic development.<sup>2</sup> The prevailing view among geographers and sociologists and, to a much lesser extent, among economists, is that the development of the institutions of community—sometimes coupled with the use of temporary organizations, such as development coalitions (Asheim 2002)—improves the provision of public goods (Coleman 1990; North 1990) and market organization (Granovetter 1985) through the embedding of firms in efficiency-enhancing networks of relationships (Grabher 1993). Communities are said to have such beneficial effects by generating trust (Fukuyama 1999; Putnam 2000; Bowles and Gintis 2002), reducing transaction costs between economic agents (Storper 1997), limiting moral hazards—or the risk of opportunistic behavior by raising the costs or lowering the benefits for the group—and free riding (Streeck 1992; Putnam 2000), mitigating asymmetries in information (Granovetter 1985; Wade 1987), and enabling the matching of individual to aggregate interests (Rodríguez-

Pose 1999). Thus, community is said to provide an “institutional exoskeleton” for behavior that is conducive to development (Streeck 1991).<sup>3</sup>

A positive relationship between community and economic performance has been strongly suggested by numerous qualitative case studies of industrial districts and clusters (Piore and Sabel 1984; Kristensen 1992; Semlinger 1993; Burroni 2001; Becattini and Sforzi 2002; Bellandi 2002), “learning regions” (Morgan 1997; Gertler, Wolfe, and Garkut 2000; Henry and Pinch 2000; Bathelt 2001), and regional systems of innovation (Cooke and Morgan 1998). Many quantitative analyses have reached similar results. For example, the pioneering statistical analysis of Putnam et al. (1993) showed that differences in levels of community institutions between northern and southern Italy were at the base of their sizable income inequalities. Later research has found that proxies of community, such as group participation, are correlated with better economic performance (Knack and Keefer 1997; Zak and Knack 2001; Beugelsdijk, de Groot, and van Schaik 2004; Guiso, Sapienza, and Zingales 2004), or that, conversely, deep divisions between groups limit an economy’s overall potential for growth (Easterly and Levine 1997; Aghion, Alesina, and Trebbi 2004).

Yet the claim that community facilitates economic performance has also been strongly challenged in empirical research. Drawing on the classical work of Banfield (1958) on southern Italy, Trigilia (1992) showed that the lack of institutional density was not at the root of the Mezzogiorno’s chronic development problems, but rather the negative externalities associated with the prevalence of “primitive” forms of commu-

<sup>2</sup> Granovetter, building on his notion of the “weakness of strong ties,” also held that communities can be damaging to prospects for economic development under some conditions, calling attention to the possibility of excessive embeddedness. We discuss the disadvantages of community later in this article and how institutional forms can check and balance strong communities.

<sup>3</sup> Along the same lines, “institutional thickness” is seen as a favorable condition for economic development (Amin and Thrift 1995). The greater the density of community institutions within a given territory, the greater the potential for higher economic growth and development (Amin and Thomas 1996; Morgan 1997; Cooke and Morgan 1998).

nity. The dominance of such groups leads to pervasive rent seeking (or the determination of certain individuals to seek benefits at the expense of all others in the community), insider-outsider problems (or the pernicious conflicts of interest between insiders to a community and outsiders), clientelism, and nepotistic practices. All of these factors have negative effects on overall development and on the distribution of income. Rodríguez-Pose (2001) and Martin and Sunley (2003) argued that there is relatively little evidence to support the notion of the superior economic performance of closely knit clusters and communities.

There is also theoretical uneasiness with the claim that communities generate positive externalities. As North (1990) and Durlauf and Fafchamps (2004) argued, community may merely be a second-best solution to economic coordination when reliable formal institutions to address market failures and protect property rights are underdeveloped. From this perspective, even when societal rules are well developed, strong communities may lead to greater social polarization by hampering equal opportunity and may exacerbate problems of imperfect competition, impacted information (or the cost of unequal information across parties to a contract), and principal-agent problems<sup>4</sup> (Durlauf 1999; Durlauf and Fafchamps 2004). In concert with this skepticism about groups or communities, the contemporary consensus in economics and political science is that societal institutions that are based on transparent rules—such as property rights and the rule of law—are universally good for economic development because they promote individual choice (preference realization) and factor mobility (adjustment) (Schleifer 2002).

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<sup>4</sup> Principal-agent problems arise when an individual or organization has to rely on another party, the agent, to perform an action or a service on her behalf and is unable to verify or evaluate the agent's actions, thus creating the opportunity for the agent to pursue his own interest at the expense of the principal's interest.

It has frequently been considered that, under some circumstances, such societal institutions may also have detrimental effects on development. For example, sometimes low levels of interpersonal confidence—which may be due to the weakness of group life, itself abetted by some societal institutions—cannot be compensated by societal rules and laws in ensuring against opportunistic defection from contracts (Streeck 1991); hence, low levels of community could potentially leave the door open to a confrontational society that is characterized by high transaction costs and costly conflict resolution (Storper 2005). A society with weak groups would also likely suffer from the inadequate production of public goods in the fields of education and training, environmental management, or technological innovation because the pursuit of strictly individual maximization strategies would lead to attempts at self-provision by a limited number of people. But positive scale economies would not be attained, and negative externalities would be generated; by contrast, widespread group organization widens the constituencies for such goods and reduces these problems. In labor markets, it has been shown that the less skilled depend more on networks and groups than do the highly skilled to secure them a proportionate return to their skills; it follows that societal institutions alone may promote long-term increases in inequality, which, beyond a certain level, can discourage effort and lead to overall productivity losses for the economy (Aghion 1998; Sen 2002).

Thus, the debate over the relationship among community, society, and economic development remains sharply polarized. If for some, communities generate positive externalities that assist economic activity, for others, communitarian bonds are second best to the formal institutions of society (Durlauf and Fafchamps 2004), and for still others who work in contemporary institutionalist theory, groups are generally bad for long-term development because of the pervasive agency problems that they generate (Buchanan and Tullock 1962; Olson 1965; North 1981).

This debate, however rich and insightful, remains incomplete. As we have argued elsewhere (Storper 2005), it has focused almost entirely on the tradeoffs between society and community, seeing them as inherently mutually opposed forms of institutional coordination. It has rarely considered their interactions. All real economies, however, operate in a context that consists not only of individuals and society, but of groups as well. Individuals bond together into groups, and societal rules then enable these groups to interact—or bridge—more or less successfully. Missing from the standard debate is that under certain circumstances, both society and community can possess qualities that can offset the potentially negative qualities of the other. Community can lower transactions costs and raise interpersonal confidence, while society can ensure competition and hence minimize rent seeking, free riding, and sclerosis. By contrast, the relative scarcity of either society or community can result in misaligned incentives and agency problems, which can ultimately have negative effects on the quality and quantity of long-term economic development (Table 1). Hence, society and community can be complements in potentiating economic development, not simply contradictory forces, as is claimed in much of the literature.

This polarization is evident as well in the analysis of changes in group life or societal rules, which is the standard fare of institutionalist social science. Changes are considered in isolation from one another. Does a move toward stronger groups favor economic performance? Or is it the

other way around? The answer to this question about the potential effect of “stronger rules” on economic development can, in our view, be discovered only by considering what simultaneously occurs to the strength of groups or communities in the economy because it determines how such rules are actually used. By the same token, the effects of the increasing or decreasing strength of groups can be ascertained only by considering the context of their societal rules. Toward this end, this article provides a framework for understanding the changes in the interaction of the two that affect medium-term economic performance.

Institutions are at the heart of a number of other literatures whose concern is comparative economic development, including “varieties of capitalism,” national business systems, and national innovation systems (Lundvall 1992; Nelson 1992; Christopherson 2002; Hall and Soskice 2002). They focus, variously, on labor market laws and the relationships among business, government, research and development (R&D), and unions; relationships among banking, capital markets, and corporate governance; and relationships among R&D, education, entrepreneurship, and workplace dynamics and cultures. Although the mix of factors considered is different from one approach to another, all try to find different but internally coherent institutional architectures (at the national or regional level) and to link them to differences in economic performance, such as growth, specialization, innovation, and corporate form. Although in all these literatures, occasional references can be found to such microdimensions of behavior as “trust” or its lack, cultures, and sometimes to the effects of “small” rules on the behavior of individual agents, for the most part, they are mesolevel theories, which seek effects of history in defining institutions that, in turn, define collective action and pathways of economic adjustment and problem solving (or lock-in). They tend to use descriptive or typological comparisons; as such, the comparisons ultimately are limited by the ability to strip away some

**Table 1**

The Economic Outcomes of the Interaction Between Community and Society

Society	Community	
	Low	High
High	Suboptimal	Optimal
Low	Worst-case scenario	Suboptimal

of their complexity and determine whether institutions that appear different are somehow similar in some deeper underlying way. Many development economists are starting to do just this: they argue that there are many functionally equivalent but different ways to ensure that markets work properly, so we need to compare them not on the basis of whether the instruments are precisely identical, but on whether the incentives and outcomes that they generate are similar. This is what we propose in this article for institutions and institutional change: society and community are concepts that seek to describe not all the complexity of how institutions appear, but what gives them underlying structure in terms of the kinds of incentives for action that they generate and how these incentives change. These underlying forces can take many different concrete observable forms.

We begin by considering the external and internal sources of change in society and community as the underlying sources of changing interactions between them (second section). We then develop a descriptive model of possible trajectories of change in the overall balance of society and community (second section). Next, we consider the process of change in greater detail, distinguishing those starting points that offer the possibility of rapid (positive or negative) change from those whose existing institutional structures are likely to produce only slow or gradual change (third section). Finally, we reexamine these change processes in light of the specific behaviors that are often considered in the wider institutionalist literature—such as agency, free riding, and rent seeking—arguing that an increase or decrease in these behaviors is conditioned by society-community interactions (fourth section). At the end, we return to resituate what we have done in relationship to the wider field of institutionalist social science and economic geography.

## Society and Community in Interaction

Before we can consider change, we need to see more generally how society-community

interactions shape the institutional foundations of economic development. Groups and rules interact to shape the basic ways that individuals can participate in the economy, creating incentives for them to do some things and not to do others.<sup>5</sup> What are these incentives? The first column of Table 2 lists three main areas in which certain first-order conditions for economic growth must be satisfied: those that ensure microeconomic efficiency, those that define the social policy underpinnings of such efficiency, and those that encourage effective problem solving. In other words, these are basic underlying conditions that have been identified as necessary to successful economic development, but—as was noted earlier—they take many different functionally equivalent institutional forms (Rodrik 2003).<sup>6</sup>

To take the first such feature, any set of forces that systematically reduces transaction costs and moral hazards creates a microeconomic environment that comes across to individual actors as a reason to have confidence in the economic process. The economic consequences are both static and dynamic. On the static side, improving the efficiency of economic transactions raises output, but what is more important, on the dynamic side, it encourages growth by stimulating the further development of the economy-wide division of labor (Young 1928; Stigler 1951). The reduction of moral hazards allows us to estimate better future rewards, which, in turn, are reflected in discount rates, perceptions of risk,<sup>7</sup> and positively affecting expectations and effort levels. Both encourage

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<sup>5</sup> The remainder of this section is a synthesis of a more detailed argument that may be found in Storper (2005).

<sup>6</sup> There is, of course, a fourth area, macroeconomics, but that area is beyond the scope of this article.

<sup>7</sup> We are reminded here of the fundamental distinction between risk and uncertainty, introduced by Frank Knight (1921). When confidence is weak or absent, the problem is that risks can no longer be estimated and hence minimized, and actors must face true uncertainty, with strongly negative effects on many of the foundations of long-term growth.

**Table 2**

Society-Community Interactions and Incentives

Incentives Necessary for Long-Term Development	Principal Microeconomic Effects of Each Incentive	Operational Institutions: Behavior, Routines, Regularities	Role of Communitarian “Bonding” in Bringing About Each Incentive	Role of Societal “Bridging” in Bringing About Each Incentive
Microeconomic: Confidence ↓	<ul style="list-style-type: none"> <li>• Reduces transactions costs</li> <li>• Reduces moral hazards</li> <li>• Raises expectations and efforts ↓</li> </ul>	<ul style="list-style-type: none"> <li>• Encourages Schumpeterian entrepreneur</li> <li>• Improves the coordination of firm-firm transactions</li> <li>• Raises investment levels ↓ →</li> </ul>	<ul style="list-style-type: none"> <li>• Reputational effects, shared conventions, identities (depends on the process of group formation)</li> <li>• Overcomes certain information problems in a low-cost way (but can encourage rent seeking) →</li> </ul>	<ul style="list-style-type: none"> <li>• Overarching rules promote transparency and limit rent seeking, help to complete markets ←</li> </ul>
Social Policy: Effective and acceptable distributional trade-offs ↓↓	<ul style="list-style-type: none"> <li>• Precedent encourages ongoing “sacrifices” in face of shocks (Rodrik 1999)</li> <li>• Overcomes disincentive to participate and make effort (Aghion 1998) ↓↓</li> </ul>	<ul style="list-style-type: none"> <li>• Raises investments in skills</li> <li>• Raises work and entrepreneurial participation rates</li> <li>• Improves the willingness to pay taxes (investment) ↓↓ →</li> </ul>	<ul style="list-style-type: none"> <li>• Voice and loyalty</li> <li>• Being in the same boat enhances acceptability</li> <li>• Membership may involve real forms of intragroup redistribution →</li> </ul>	<ul style="list-style-type: none"> <li>• Counters corporatism and distributional holdups</li> <li>• Standards of fairness and efficiency constrain group demands</li> <li>• Intergroup mobility (exit), disciplines groups ←</li> </ul>
Problem Solving: Successful ongoing conflict resolution	<ul style="list-style-type: none"> <li>• Participation of groups is enhanced</li> <li>• Minimize rent seeking from corporatism</li> </ul>	<ul style="list-style-type: none"> <li>• Better adjustment of rules governing entrepreneurship and labor markets</li> <li>• Intelligent ideas are more likely to receive support as public policy</li> <li>• Coalitions can form, avoiding chaotic instability →</li> </ul>	<ul style="list-style-type: none"> <li>• Secure groups encourage coalition formation: voice that gets heard (but risk of principal-agent problems) →</li> </ul>	<ul style="list-style-type: none"> <li>• Limits to group power encourage compromise</li> <li>• Exit options, defection, make other coalitions possible, hence dynamically limit principal-agent problems ←</li> </ul>

Note: → ↓: cumulative and/or one-way causal effect; → ←: two-way interactions and feedbacks.

entrepreneurship, particularly the innovative “Schumpeterian” brand (Kirzner 1973; Swedberg 1991; Casson 1995). In addition, confidence encourages governments to be

less myopic in their policies, and myopic governmental policies have been shown to be harmful to growth (Persson and Tabellini 2002).



Confidence is also directly related to the central mechanism of contemporary growth theory, which is the development and application of knowledge (Romer 1986, 1987, 1990; Lucas 1988; Grossman and Helpman 1991; Aghion and Howitt 1992; Jones 2004). Knowledge is different from other factors of production, in that it can have endlessly increasing returns because knowledge is nonrivalrous; hence it can be reused at no additional cost, applied in many different ways, and recombined into different uses. Communities facilitate these processes of knowledge sharing by promoting selective affinities among economic agents (Easterly 2001). At the same time, if knowledge stays too much inside such bounded communities—when communities mistrust each other—then knowledge will have a limited and uneven spread. Bridging between communities gives the more knowledgeable communities confidence that their knowledge will be used by members of other communities to their mutual benefit.

The second feature of successful development is an effective social policy environment, as reflected in distributional arrangements, which include both the distribution of income and the processes (markets, rules, and groups) by which incomes are determined. Such arrangements have an important dynamic effect. The analysis of development transitions has shown that acceptable distributional arrangements help economies to adjust successfully to the inevitable shocks and setbacks of the development process because they encourage compromise and sacrifice (Rodrik 1999).

Standard models of the factor prices, and thus the distribution of income, call attention to the incentive effects of appropriate prices. Empirically, this means that some degree of income inequality corresponds to an equilibrium level. A long tradition of reflection, mostly from outside economics, suggests that there can be social costs or externalities from inequalities, even in equilibrium. Within economics, recent models have shown that some levels of inequality

are not equilibria. Too much inequality simply leads to the withdrawal of effort by potentially productive actors; formally, it amounts to a capital market imperfection (Aghion 1998).<sup>8</sup> Alesina and Rodrik (1994) and Persson and Tabellini (2002) argued theoretically that less inequality has a positive relationship to growth, which is consistent with the empirical evidence that shows that the highly performing Asian economies have all been characterized by limited inequality, in contrast to the poorly performing Latin American economies. Appropriate distributional arrangements encourage participation and discourage the withdrawal of effort—whether between or within groups. One way in which they do so is by providing incentives for those who are not the greatest beneficiaries of new technologies to support (or, at least, not block) innovations, which are generally most strongly pushed by those who stand to benefit the most from them (Mokyr 1990). Moderation in inequality improves overall investments in the creation of skill, raises the incentives to participate fully in the formal economy and to become an entrepreneur (hence, participation rates and levels), and improves the willingness to pay taxes and to invest.

Thorstein Veblen and other precursors of evolutionary thinking in economics gave us the basic notion that an economy's institutions would allow the economy (if successful) to select itself in an ongoing way into the things it could do well and hence to sustain the development process over time (Hodgson 2004). In such a dynamic process, no institutional arrangements resolve all problems for good: what are good institutional forms at one stage are no longer appro-

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<sup>8</sup> These models have an indirect link to Sen's (1999) notion that extreme inequality expresses the lack of, but also impedes the construction of, the social bonds that are crucial to development because it discourages the provision of certain necessary social goods and deprives the poorest of the preconditions (basic resources) that would enable them to contribute to their own, and society's, development.

appropriate at others (Bremer and Kasarda 2002).<sup>9</sup> Ongoing problem-solving adjustment of the rules governing investment, entrepreneurship, and the regulation of labor markets becomes necessary as an economy undergoes structural change. Communities, regions, and nations “like companies, need to innovate and adapt to remain competitive” (Gertler and Wolfe 2004, 46). This is one of the biggest differences between countries that succeeded in the second half of the twentieth century and those that stagnated (e.g., East Asia versus sub-Saharan Africa), but also between countries that initially did well (as in Latin America) but subsequently did not continue to move up the world distribution of income. In the East Asian cases, for example, institutions were adjusted to limit rent seeking as the potential rents from development increased, thus continuing to expose domestic firms to internal and international competition and generating a steady catch-up with the factor productivity of the developed countries. By contrast, in Latin America, labor productivity is at the same level or lower as a percentage of the developed countries as it was in 1950, even after adjustments for human capital levels. Elites have preferred policies that are oriented to rent earning (in both the productive and financial sectors), and income distributions became more unequal through rent accrual at the top (Cole, Ohanian, Riascos, and Schmitz 2004). Thus, the lack of problem solving was, in turn, linked to unsatisfactory distributional arrangements, which, in turn, has generated stagnation, instability, and insufficient confidence for more than half a century in most of Latin America.

These three broad features and their associated economic behaviors characterize a wide variety of successful long-term economic development experiences. By

contrast, cases of stagnation or long-term developmental regress manifest failure to achieve these features and to enjoy the microeconomic and aggregate effects described in the first three columns of Table 2. The fourth and fifth columns of Table 2 then show how each of these types of incentives is shaped and given concrete institutional form by society-community interactions (horizontal). Generalized confidence can emerge when the pervasive information problems, attendant moral hazards, and market failures of economies are attenuated. Communities are low-cost ways of resolving these problems, by creating interpersonal trust, reputational effects, and shared conventions. No fully “societal” system—whether markets or administered, centralized bureaucracies—has ever succeeded in doing everything that communities can do in this regard. But communities can reduce generalized confidence if they lead to rent seeking, clannism, or corruption; hence, it is best when they exist in a delicate and dynamic relationship with the forces that promote transparency, entry, and exit, thereby limiting rent seeking and helping to complete markets where communities may stifle them. Generalized confidence, in other words, requires both society and community. Lundvall (2005) highlighted precisely this kind of relationship in analyzing the “Danish model” of economic success. On the one hand, he noted that much confidence comes from the “village economy” basis of cooperation; but on the other hand, he signaled the central importance of an educational system that teaches personal responsibility and integrity, and labor market institutions that expose individuals to competition through easy hiring and firing. And he noted the extreme contrasts between these features of the Danish model and the continental corporatist and statist systems, as in France and Germany.

The same is true of the achievement of effective and acceptable distributional arrangements. These arrangements can neither be administered by a societal over-

<sup>9</sup> Similarly, what are good institutional forms for one locality, region, or nation may not be appropriate for others. The diversity of institutional systems requires approaches that are sensitive to the institutional conditions of each location (Peck 1996; Christopherson 2002).

seer,<sup>10</sup> nor come about from the spontaneous interaction of individual agents. For one thing, only some such agents have the capacity to make their preferences heard (Sen 2002). Communities can give voice to agents whose claims would otherwise go unheard by markets.<sup>11</sup> Moreover, group membership has the virtue of diffusing a sense of “being in the same boat,” and those who are in the boat can contribute to a mutual sense that fairness has been achieved (as well as injustice and anger). In the former case, the acceptability of any distributional tradeoff is enhanced. In addition, communities—even in the most modern economies—often have big roles in distributional matters. Families in some economies carry out income redistribution and smoothing, mobilize savings at low interest rates, and share work. But society is necessary as well if undesirable forms of cronyism or enduring hierarchy are to be avoided. Competition and political interaction between groups counteract corporatism and distributional holdups, common standards of efficiency and fairness can constrain certain group demands and privileges, and intergroup mobility (the possibility of exit) has a disciplining effect on what groups do to obtain their piece of the pie. It is their interaction that generates acceptable and efficient distributional arrangements.

As was noted earlier, any developmental process requires ongoing adjustment of the rules that govern its vital center: entrepreneurship, labor markets, and investment. This adjustment, however, inevitably generates the potential for conflict. Effective problem solving and institutional adaptation come about when it is difficult

for groups to practice excessive corporatism and rent seeking and when problem-solving bridges are built between the relevant groups. On the one hand, the community-based social bonds referred to earlier provide groups with a certain degree of security, allowing them to be “at the table” so that their voices can be heard, whether formally or in a more diffused manner. On the other hand, societal forces create limits to group power, so that the position of groups is not so secure that other coalitions are impossible. The participation of many different groups prevents them from practicing negative forms of exit (resignation or winner-take-all) from the problem-solving process. This participation helps avoid the twin dangers of “bad” stability in the form of interest-based but nondevelopmentalist (rent seeking) coalitions, on the one hand, and extreme instability, on the other (Alesina, Ozler, Roubini, and Swagel 1996). Thus, there is less danger that intelligent ideas will be blocked out because the principal interest groups have less ability and incentives to bind themselves to rigid, exclusively self-serving positions. This makes institutional learning more probable (Haggard 1990) and may even allow ongoing revision of the most basic institutional infrastructure, such as legal principles, the system of political power sharing, and other factors that influence political opportunity structures and hence the possibility for competing ideas to be heard (Evans 1995; Aghion, Alesina, and Trebbi 2004).

Table 3 considers these three types of incentives together, showing schematically how different overall levels of society and community in interaction will shape economies. A favorable interaction of society and community allows the potentially positive effects of each—respectively, responsibility (agency) and autonomy (voice, capacities) to emerge, while each also acts as a check on the possible negative effects of the other were it to exist in an environment that lacked the other. Thus, stated in the most standard terms, the

<sup>10</sup> Because the overseer, by the very act of making decisions about distribution in advance, encourages rent seeking or laziness, even without the inevitable tendency for lobbying to try and determine which schema of rewards is used.

<sup>11</sup> In the formal sense, scale lowers transactions costs and raises the payoffs to addressing preferences that are shared on a large scale.

**Table 3**

## Society and Community in Interaction

Society	Community	
	Low	High
High	Responsibility without autonomy: individual agency but an insufficient voice <ul style="list-style-type: none"> <li>• Dominance of arm's-length transactions</li> <li>• Moral hazards contained when information transparent only</li> <li>• Asymmetrical strength of individual agents</li> <li>• Certain interests have no voice/no autonomy (effort and reward markets are imperfect)</li> <li>• Costly conflict resolution and confrontational society</li> <li>• Insufficient public goods</li> <li>• Tendency toward inequality</li> </ul>	Autonomy with responsibility: a good balance of voice and agency <ul style="list-style-type: none"> <li>• Costs for all kinds of transactions minimized</li> <li>• Moral hazards contained for both transparent and specific information</li> <li>• Autonomy strong and participation high (strong community reduces losses due to anonymity, fragmentation)</li> <li>• Rent seeking contained through competition, entry, and exit (a strong society modernizes communities)</li> </ul>
Low	Neither autonomy nor responsibility: chaos and the law of the jungle (voice of the powerful, ubiquitous agency problems) <ul style="list-style-type: none"> <li>• High costs for all types of transactions</li> <li>• Generalized instability: weak societal rules, weak local bonding</li> <li>• High moral hazards, generalized opportunism, low sanctions for defection and cheating</li> <li>• Public goods destroyed, stolen, or appropriated</li> </ul>	Autonomy without responsibility: collective voice, but with agency problems <ul style="list-style-type: none"> <li>• High transactions costs for arm's-length transactions</li> <li>• Prevalence of primitive, nonmodern communities</li> <li>• Rent seeking widespread</li> <li>• Individual voice subjugated to groups (insufficient competition and mobility)</li> <li>• Insufficient generalized trust and confidence</li> <li>• Skewed distribution of public goods</li> </ul>

possible positive effect of community—permitting actors to reduce transactions costs and hence to enhance the autonomy or scope of action of principals—is realized when the potential moral hazards and rent seeking of agents are held in check by rules that enforce responsibility. The potentially positive effects of society—such as reducing the exercise of absolute power by any individual or group and hence encouraging responsibility through competition and innovation—are realized when groups are present who can act as collective agents so as to give voice and autonomy to principals who otherwise would not be heard. Autonomy and responsibility are the doubles of society and community, and each depends on the checks and balances offered by the other.

### Changes in the Interaction of Society and Community and Their Effects on Economic Performance

Most studies of institutions and social capital have held that their effects on development are the outcome of long-run processes with deep structural roots. This is, for example, the case with Putnam et al.'s (1993) *Making Democracy Work*, in which the civic involvement that is said to be at the root of the economic dynamism of northern Italian regions is traced back to the Middle Ages. A glacial pace of change thus leaves little room for maneuver (or, for that matter, for hope) in those areas of the country that have been unable to develop the “right” mix of communitarian and societal institutions

over the past few centuries, as is the case of the Mezzogiorno. Although the speed of change of communitarian values takes place at a faster rate in Putnam's (2000) study of American society, the pace is still slow, extending over several decades. Various schools of comparative institutionalism have argued that founding moments in the remote past (such as constitutions or legal systems) are the roots of institutional form and economic performance today (Glaeser and Schleifer 2001). In contrast, we argue that although some bonding and bridging processes are shaped by long-term forces, certain short- and medium-term changes are also vital to economic performance. Specifically, we contend that changes in the relative strength of community and society are constantly taking place; the sources of change are both internal to societies and communities and due to exogenous events; directions of change are defined not by individual elements, but by society and community in interaction; starting points, as defined by particular checks and balances between societal and community forces, strongly affect the potential speed of change and modify the effect of the speed of change in either of these two forces individually; and economic outcomes are caused by the process of interaction as much as by changes in either of the two sources of change taken separately.

### **Sources of Change in the Relative Strengths of Community and Society: A Typology**

Changes in the forces of community and society can have exogenous or endogenous origins. Exogenous change is the outcome of events that are independent of the internal dynamics of the groups involved. Factors such as war, natural disasters, globalization, technological change, or the insertion of new groups into preexisting contexts are often outside the control of the inhabitants of a territory and are likely to upset previous problem-solving equilibria or arrangements. Their effects can be favorable (new civic contributions) or unfavorable (e.g., new

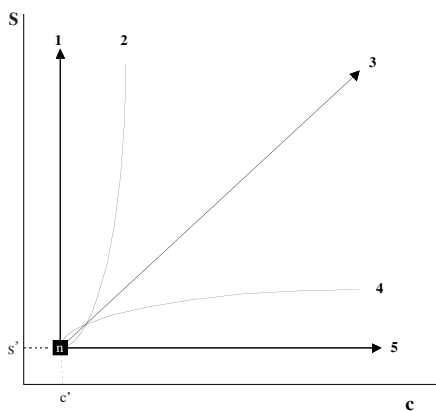
moral hazards or power imbalances). Endogenous change, in contrast, stems from developments within and between the groups that inhabit a certain territory. The internal evolution of groups often leads to the alteration of, or a break with, previous configurations of networks, power, and compromise. Revolutions, the seizing of power by a certain group or party with a new political agenda, the implementation of major changes in societal rules (such as the major devolution of powers), or the emergence of internal conflicts (ethnic, religious, or political) may significantly alter the balance of community and society forces. Under certain circumstances (e.g., war combined with revolution, as in the case of Russia in 1917, or capital market integration combined with a sudden economic collapse, as in the case of Argentina in 2002), changes in the community/society relationship may be the combined outcome of both exogenous and endogenous factors. To take again the case of Russia, many scholars now believe that the collapse of the Soviet system left a societal void, and rapid liberalization hence permitted preexisting communities (former Soviet officials, notably) to emerge and transform many sectors into clannish oligopolies. In contrast, the Baltic republics are widely considered—thanks partially to ethnic cleavages and the exclusion of Russians from power in state institutions (Steen 1997)—to have constructed orderly societal structures in the wake of the Soviet collapse—and with them, market rules—which successfully prevented communities of *nomenklatura* from appropriating the process of economic transition. Other parts of eastern Europe, however, are said to suffer from deficits of communities that are capable of ensuring innovation, entrepreneurship, and business networks, so that even relatively orderly societal transitions are not yet generating any real economic takeoff (Steen 1997; Geishecker and Haisken-DeNew 2004).

The alteration in the relative strength of the forces of community and society generates what can be termed a process of “institutional migration,” whose dimensions,

scope, and outcome will depend on factors such as the starting point (whether the existing situation was optimal, suboptimal, worst-case scenario), the relative weight of change in each of the forces, and the conflict-solving capacities of the preexisting situation. We now inventory the major possible pathways of change.

Suppose that a territory  $n$  has a starting point of community and society forces represented by point  $(c', s')$  in Figure 1. The  $x$ -axis represents the strength of communitarian forces, and the  $y$ -axis, that of societal forces. In this case, both bridging and bonding are weak; an example of the worst-case scenario depicted in Tables 1 and 3. Suppose in addition that some exogenous or endogenous event or process alters the relative strength of these societal and communitarian forces, which results in a change of position of point  $n$  (Figure 1). The direction of change in the starting point  $n$  will be determined by the interplay of both forces. Several scenarios can be envisaged:

1. If society is strengthened but not community, the displacement will follow vector 1, possibly leading to an oversupply of society, featuring strong rules and an emphasis on individual agency, but where weak individuals will tend to have insufficient voice because of the weakness of communities. Territory  $n$  would then



**Figure 1.** The dynamics of the interaction between community and society (1).

migrate from a worst-case scenario to a better, though suboptimal, institutional situation, in which the stronger societal order would reduce certain kinds of transactions costs, raise confidence and the enforceability of contracts, and generate powerful incentives for certain kinds of human and physical capital investments. However, some of the potential negative externalities of society, including higher transactions costs that are due to anonymity and moral hazards or enhanced inequality, could emerge because communities would not be strong enough to check them. This is, in fact, the classic dilemma of many rich countries and regions: managing the tensions generated by the long-term strengthening of societal order with respect to the weaker agents in the system. It is such a powerful tendency that most such countries and regions now deliberately assist groups of all sorts in organizing themselves and participating in “governance” processes of various types, hoping that these “civil society” groups will be able to help smooth economic and social processes in ways that official bureaucracies cannot.

2. If the outcome is an increase in both the forces of society and community, but with the former strengthening more than the latter, institutional arrangements  $n$  will migrate to a new steady state along vector 2 (Figure 1). Under this scenario, societal and communitarian forces may initially develop in parallel, but in the medium-run societal forces come to prevail. This may be as a result of inherent or ensuing weaknesses in the buildup of communities or because of the greater development of the institutions of the state after a certain point. In this case, communities may nonetheless be able to exert some checks on the potentially negative externalities generated by societal forces taken alone, resulting in better economic outcomes than under scenario (1).

3. If change in both forces is of equal strength, the institutional arrangements in territory  $n$  will move along vector 3, eventually resulting in something close to an “optimal” institutional arrangement, characterized by autonomy with responsibility

and a good balance between voice and agency (hence significantly reducing agency problems). In the end, a new configuration will emerge, featuring the optimal tradeoff between transaction costs, rent seeking, and moral hazards. It bears repeating that such underlying strengths can take many different concrete institutional forms.

4. If the increase in communitarian forces is greater than those of society, the trajectory of change will follow vector 4, leading to a situation in which community prevails, but moderate reinforcement of societal arrangements succeeds in instilling some checks on the potentially negative aspects of communities. This was probably the situation of many small- and medium-sized cities in the Third Italy in the post-World War II period and underlay the success of these cities' small-firm industrial clusters. In recent years, however, this situation has come under strain from both internal forces (generational succession in entrepreneurship) and external forces (the globalization of competition).

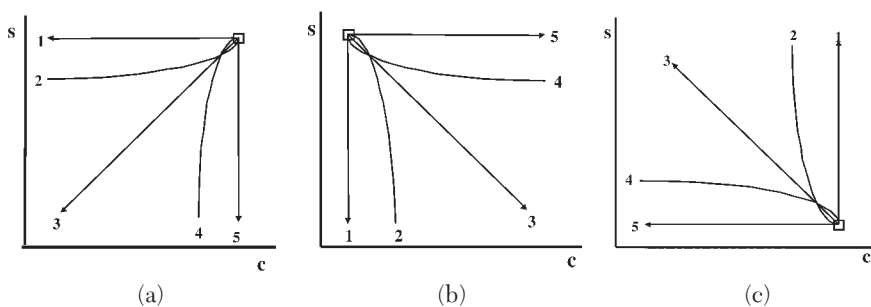
5. Finally, an increase in community but not society is described by vector 5. A stronger community will generate greater autonomy for actors to exercise a collective voice and facilitate their joint action. However, there is likely as well to be a strong increase in agency problems, such as high transaction costs, widespread rent seeking, inequality, and lack of trust. The example of post-Soviet Russia is the "poster child" of this unfortunate trajectory.

This exercise in mapping possible pathways of change can be straightforwardly extended to other starting points, as is depicted in Figures 2a–2c. In particular, Figure 2a highlights the potential determinants of institutional arrangements in a territory that has, in the past, developed an effective set of checks and balances between a strong society and strong communities. Figures 2b and 2c present the potential migration trajectories of territories with institutional arrangements initially characterized by strong societal (Figure 2b) or communitarian forces (Figure 2c). The former characterizes the case of metropolitan Los Angeles, a highly successful region that based

its dynamism during much of the post-World War II era on the pillar of a strong society with relatively weakly organized social and ethnic groups. Until the 1990s, Los Angeles behaved much like a city-state in which powerful, semi-autonomous development bureaucracies and a cohesive business class provided far-sighted strategic planning. But community and environmental resistance has grown significantly in recent years. As groups have become better organized, political institutions have not kept up with them, leaving what is widely thought to be an increasingly conflictual situation in place, with growing problems of governance and negative externalities (Erie 2004). In terms of Figure 2b, metropolitan Los Angeles may have been on vector 3 or 4 in recent years, but in a highly uncertain and changing context. By contrast, Taiwan—a successful developer—started out at independence in a situation of relatively strong underlying community forces (a starting point represented by Figure 2c). A societal (in this case, state) apparatus had to be constructed, and it was done in a way that community forces (notably represented by the strong economy of small- and medium-sized enterprises) were able to participate and to interact successfully with state bureaucrats, while the latter were able to guide overall economic policy (Wu 2005).

### The Speed of Change

In addition to whether change is endogenous or exogenous, the relationship between community and society may be understood according to the speed of change. Rapid changes are the consequence of traumatic events, such as war, revolution, natural disaster, or sudden economic collapse, disrupting the social forces underlying institutional arrangements in the short term. Gradual changes are the result of processes that operate over the medium to long term so as to transform the balance of forces incrementally; they can be set in motion by processes such as globalization, technological change, the evolution of social norms



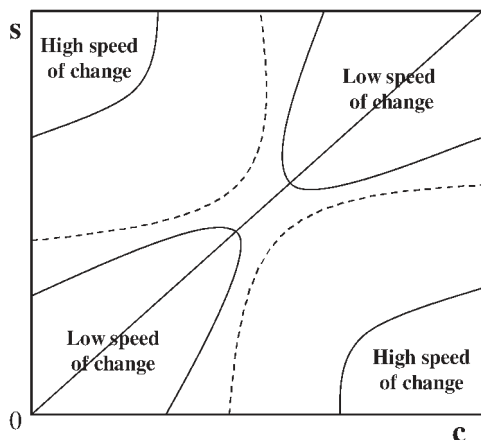
**Figure 2a, b, c.** The dynamics of the interaction between community and society (2).

and lifestyles, or comprehensive reform of public administration, or, for that matter, virtually anything that has major impacts on transactions costs within or between groups.

The speed is not determined solely by each force (bonding or bridging), but by the starting point defined by their joint interactions. Figure 3 graphically represents these two types of dynamics. Where the balance between community and society starts out optimal or close to optimal—and thus the problem-solving capacity of a territory is strong—or when they are close to the worst-case scenario of Table 1, the speed of change is likely to be low. By contrast, where the starting point is far from the optimum, the speed of change—irrespective of whether

the direction of change is positive or negative—is likely to be much greater.

Places with strong groups and strong societies will be characterized by institutional arrangements with problem-solving mechanisms that help to resolve tensions and agency problems, even in the face of strong endogenous or exogenous pressures to change. The presence of a high density of cross-cutting and overlapping community groups within a strong societal framework, allowing for easy entry and exit, will not only restrict moral hazards and principal-agent problems and reduce transaction costs, but also will reduce the possibility for endogenous conflict and minimize the potentially negative impact of exogenous forces. This is the case of countries like the Netherlands, Denmark, Finland, Norway, and Sweden, where deeply rooted societal and community institutional arrangements have helped to prevent serious internal conflict for long periods (Lundvall 2002). When exogenous challenges have emerged—such as the transition to a more globalized economy, with the loss of manufacturing to cheaper areas and the need to respecialize and adapt to new business conditions—the institutional arrangements have addressed its sources in a pragmatic way that generates widely shared adherence to the solutions that are adopted (i.e., a partial reform of the welfare system in Denmark, the Netherlands, and Sweden and the sweeping labor market reforms in Denmark and the Netherlands). In turn, confidence in and support for underlying institutional arrangements has been



**Figure 3.** The speed of change in the community/society relationship.



preserved, which then facilitates further problem solving.

At the time of this writing, change also seems slow in a number of the big continental European economies, such as France, Italy, and Germany, all of which have suffered slow growth and high unemployment for a considerable time. Our framework predicts that change will be slow in these places, characterized by strong groups and strong societies, even in the face of strong problems, because they are—in the long-run—strong and well institutionalized. These cases allow us to bring out another essential point: the time horizons of change. Our framework addresses medium-term processes. On this basis, it is probable that France, Italy, and Germany will find solutions that restore growth and generate employment, but that this could take considerable time. In each of these countries, group forces have steadily strengthened over the past two decades, and societal solutions for reform have yet to command political majorities, leading to severe insider/outsider dynamics (e.g., employed/unemployed) (Esping-Andersen and Regini 2000). Thus, they are all arguably not at an optimum, but nor are they so far from it that reform is unlikely. However, if stability becomes blockage, the process of institutional change has the potential to gather pace and—beyond a certain threshold—to generate a significant overall transformation in a relatively short time. The history of the Thatcher years in Britain can be interpreted in the same light: a period of standoff and accumulating problems, followed by strong change in a fundamentally stable developed country.

The United States is a case of a country with strong societal and communitarian institutions, albeit in a different configuration from those of typical continental European countries. Putnam (2000) and other “communitarian” theorists in the United States have deplored what they see as a slow, incremental but palpably increasing asymmetry between traditional civic association (declining) and strong corporate groups, as well as the strengthening of market forces

to the detriment of group life (Etzioni 1996). Accordingly, there is some evidence of increased polarization and rejection of compromise between the groups in different political camps in the United States.<sup>12</sup> Under these circumstances, rent seeking and corruption can spread, raising the cost of transactions, creating a skewed distribution of public goods. In an economy as vast as that of the United States, the economic effects are subtle. For example, many of the difficulties of big “traditional” American firms are in their “legacy” health care costs, which are much higher than those of their foreign competitors because of the absence of a political compromise on health care policy. On the other hand, the recent American economic success, based significantly on highly flexible labor and capital markets, may be able to continue for a considerable time if the associated social costs can be externalized or otherwise avoided. This, in turn, depends on the ways in which societal frameworks and communities interact over these issues. On the basis of the amount of change that has thus far occurred in the United States, it is impossible to predict whether it will lead significant reform movements (such as occurred in the late nineteenth and early twentieth centuries in the United States), to accumulating costs and declining growth, or to other forms of problem solving that sustain growth in novel ways. These examples thus allow us to observe that common distinctions between “coordinated” European economies and more “liberal” Anglo-Saxon economies<sup>13</sup> do not capture the underlying forces of coordi-

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<sup>12</sup> Shortly after the 2004 American presidential elections, Grover Norquist, the head of major Republican lobbying groups and close to the White House, was asked about the promise of bipartisan cooperation made by the newly reelected president. He replied, “There’s no need to cooperate anymore; we have all the power we need” (AlterNet, 10 November 2004: [www.alternet.org](http://www.alternet.org)).

<sup>13</sup>As in the “varieties of capitalism” literature (Hall and Soskice 2002), the implication is also that coordinated economies are somehow more stable than are liberal economies. This is not a

nation, stability, and change that are at the heart of our heuristic.

A slow pace of change is also common in the polar opposite situation of weak institutional arrangements. If societal forces are primitive and group life is unstable and/or clannish, weak institutional arrangements resembling our worst-case scenario are likely to prevail. It is extremely difficult to transform them in the short and medium term. Where societal institutions have largely collapsed and community has been reduced to its most primitive expressions—that is, family and clan, even more than ethnicity—the prevalence of individual over collective interest, coupled with the absence of sanctions for defection and cheating, rife opportunism and corruption, and weak local bonding, is likely to make any improvement in the quality of institutional arrangements highly improbable. Such improvement is impeded by pervasive moral hazards and high transaction costs within and between groups because of low confidence, which, in turn, is due to the absence of enforceable rules and sanctions and nothing that encourages compromise. Positive change will be slow and require massive and sustained efforts under these circumstances, often with substantial outside help. These conditions characterize the present-day situations of countries like the Democratic Republic of Congo, Somalia, and Afghanistan. Another example of blockages to change is the communitarian drift that has traditionally prevailed in parts of the Italian South, taking the form of mafias in such regions as Calabria and Sicily (Bottazzi 1990; Trigilia 1992). It is also found in poorer areas of Latin America, such as northeast Brazil, where elite groups hijack societal rules to their advantage and simultaneously disorganize nonelite groups, thus obstructing the emergence of checks and balances (Storper, Lavinás, and Mercado

forthcoming). Similarly, under certain circumstances, bottom-up devolutionary processes can undermine societal rules and reinforce specific interests that are not interested in positive change. The case of the drafting of the 1988 Constitution in Brazil is an example. The dominance of subnational interests over the center during the drafting process tilted the balance of power in favor of regional groups, weakening the leverage of the federal government, undermining its legitimacy, and eventually exacerbating the problems of debt and inequality (Rodríguez-Pose and Gill 2004, 836–37).

The potential for rapid institutional change—positive or negative—exists when there is a severe imbalance between community and society. Two such situations can be identified. The first is when an already uneven balance between community and society is tilted in favor of the stronger of the two forces. In some cases, exogenous shocks or endogenous processes may weaken some communities, groups, and associations, leading to the reinforcement of other groups or the society. The remaining groups may then be able to hijack societal rules in a winner-take-all way. The consequence of this process will be a rise in noncooperative games because of a fundamental shift in power relations, and the likely outcome will be a reinforcement of the asymmetrical strength of individual agents, an increasingly confrontational society, and growing inequality.

Alternatively, institutional migration may generate a society-only situation, with a similar outcome as in the previous case. In the years following the French Revolution, for example, the “Le Chapellier” laws banning groups (*corporations*) were passed, creating a legal culture of dealing with social and economic issues in a way that delegitimized groups in favor of individuals, on the one hand, and the state, on the other hand (Rosenvallon 2004).<sup>14</sup> Even though

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prediction that follows from the framework presented here. Underlying each of these visible institutional forms may be more or less stable configurations of societal and communitarian forces, and this is precisely the reason to search for more cross-cutting analytical categories.

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<sup>14</sup> This refers to the French notion of “culture de généralité” (something equivalent to a preference for abstract, universal categories for policies).

groups were never widely destroyed in France, over much of the nineteenth and early twentieth centuries, they were marginalized from the political scene and hence little able to be involved in problem solving in that country.

Rapid institutional change may also be strongly positive. In this case, exogenous or endogenous forces help correct a preexisting imbalance between community and society. This positive evolution may stem from internal processes or be imposed by external actors. "Bribing through incentives" is a strategy that is often used by international organizations to get communities to accept stronger societal rules, with an aim to making them more responsible, transparent, and efficient. The World Bank, for instance, has, in recent years, helped to promote decentralization processes in many of the countries in which it has intervened, as a means of reducing the power of certain local individuals, groups, or clans in states, thus improving growth and service delivery and minimizing corruption (Litvack, Ahmad, and Bird 1998). Similarly—although for different reasons—the strengthening of European regional policy has *de facto* helped to encourage decentralization in many European Union countries, with the ostensibly paradoxical effect of strengthening societal rules at lower territorial scales. In other circumstances, such a change may be set into motion by endogenous processes that internally weaken rent seeking communities and open up space for more effective societal rules or allow other communities to become more powerful and balance the situation. Increasingly widespread autonomy and hence more responsibility, through competition between groups, is the likely outcome.

External pressure from globalization and technological and societal change, often in combination with strong internal political and economic crises, has played a key part in the weakening of the stronghold that Latin American elites have had on certain regions of their countries, allowing a stronger civil society and democracy to develop. In the case of the São Paulo region of Brazil, the process of economic restructuring triggered

by globalization—together with the advent of democracy—has played a key role in the adoption of more proactive attitudes and policies by trade unions and industrial groups, as well as by local and state governments (Rodríguez-Pose, Tomaney, and Klink 2001). In a similar vein, the improvement of the society/community balance in certain regions of the Italian Mezzogiorno, such as Campania and Puglia, or in southern and western Spain may be related to external factors that are linked to the increased integration of these areas in the European Union, with its society-reinforcing effects, as well as the Spanish transition from a centralized dictatorship to a modern and decentralized state (Aja 2001).

Thus, as the community and society come into greater balance—in contrast to the previously described situation of deterioration of the balance—the pace of change will tend to decelerate as the balance between both forces approaches the optimum (see Table 1). It does so because as autonomous but responsible participation in the economy widens, there is less and less incentive for rapid change, and the checks and balances on any agents that would be tempted to try and break up these arrangements are stronger. Nonetheless, no institutional system is perfect, and in the face of exogenous changes in the basis of economic success, even a relatively balanced system may prefer compromises whose latent effects are negative and hence give rise to pressures for more radical reforms.

Finally, in situations of community/society imbalances, the stronger of the two forces may deteriorate. This migration from a suboptimal to a worst-case scenario situation would be at first characterized by a rapid speed of change, decelerating progressively as a territory descends into a situation of chaos, from which the potential of escape is low. This is likely to be the trajectory of present-day Iraq, where a relatively strong society established by Saddam Hussein's regime—although tightly regimented, built on fear, and characterized by the merciless repression of any community beyond that of the ruling party, religion, and

clan—was profoundly disrupted by military intervention that swept away existing institutional arrangements without successfully managing to build bridges across ethnic and religious communities. A similar migration from suboptimal to worst-case scenario was witnessed in post-Soviet Russia, as was noted earlier. In both cases, collapse—abetted in the Russian case by misguided liberalization strategies—undermined the bases of preexisting societal arrangements and rules, without managing to generate bridges between communities. This process has contributed to the passage from what were by any measure bad but relatively stable economic (but not political) conditions to unstable and relatively chaotic ones. In this light, positive change is likely to be slow and difficult, unless other types of sustained positive forces for change are set into motion.

### **Causal Processes: The Mutual Transformation of Society and Community**

Proponents of institutionalist and comparative economics would agree that starting points for community or society matter (Schleifer 2002). Yet there are important differences between our approach and these others. Comparative economics asks why certain institutional forms come about under different exogenous conditions, concluding that the latter set up a wide variety of bargaining or choice situations. Thus, for example, the existence of different communities (regional, ethnic, or feudal) set up bargaining games between such groups, whose outcome is the construction of institutional forms of property rights and the type of legal system. The rules or institutions that emerge from this then have long-term effects on economic development because of the ways they affect individual incentives and collective problem-solving. Much of the recent work on constitutional frameworks has found, for example, that societies with strongly contested and fragmented power bases, such that successful bargaining

is impossible, may lead to attempts to centralize power (successful in the French case from 1500 to 1650). In other cases, strong local power leads to “peaceful” decentralized power sharing among central elites and local or regional elites (Glaeser and Schleifer 2001; Aghion, Alesina, and Trebbi 2004). Legal systems reflect the issues that were contested in the bargaining; thus, centralization in France was accompanied by a legal system that left little autonomy to local interpretation, whereas in England the common law system reflected the more distributed power sharing of that country. The resulting societal rules thus reflect, to a certain extent, the ways in which existing communities act upon their interests and are then bridged by new rules.

We argue that it is not only the starting points, but also the strength and direction of endogenous and exogenous forces for change in both the community and society spheres, that influence the potential evolution of each one of them. The paradox is that comparative economics sees societal rules as being generated almost entirely by communities in interaction with each other. Thus, societal institutions (as in public choice theory as well) have no independent existence. In our view, however, societal institutions are “institutionalizing” because like all institutions, they are materialized in the form of networks of real actors. Such networks legitimate themselves formally through rules and material power and sanctions and diffuse cognitive frameworks across other groups of actors, which influence what these latter do and how they define their interests and the possibilities of acting upon them (Dobbin 2004). This idea is shared by a number of other nonmainstream schools of institutionalism, such as varieties of capitalism, and certain scholars of national business systems and national innovation systems.

This view of institutions, whether societal or communitarian, also involves a certain number of additional, crucial differences from the approaches that are now current in standard theory. For example, that theory relies in the end on restricted notions of

rational choice: a narrow definition of the interests of the parties, bargaining situations defined by transactions costs and principal-agent dynamics, and how much rent extraction the different parties can therefore get away with. This is a problem because, of course, groups are not individuals, and even when principal-agent dynamics are taken into account, their "action" in a wider context of other groups, individuals, and societal institutions is unlikely to conform to the coherent-actor model used for individuals (and which, in any case, is strongly questioned even for individuals by many theorists) (Sen 2002).

Different limitations may be identified in some of the other schools of institutionalism (varieties of capitalism, business systems, and innovation systems). These schools emphasize the strong effects of history on institutions and of institutions on actors. Some of them are more rational choice oriented than are others in describing what individuals then do or what small groups or informal groups do within these institutional systems, but for the most part, the level of individual choice is not at the center of the theorizing exercise. When it is, it is often invoked in an ad hoc way—"trust," "cultures of cooperation," and other such devices are assumed to operate for individuals at some level of aggregation—but the result is that they do not really theorize what individuals do.

The theoretical framework put forth here thus leads to different predictions about the potential outcomes of processes of change from those extant in the literature in two principal respects. First, we hold that what happens in the "other" form of collective action can have big effects on the outcome of a given direction of change in either the society or community. For example, stronger societal institutions—for whatever reason—are likely to have different overall effects if they occur in a context of weakening communities from when they unfold in a context of strengthening groups. In the former, distributional inequalities will likely widen because a smaller number of agents will be organized in a way in which they

can use the rules effectively, and certain kinds of transactions costs will rise. Whether formal corruption declines or not, moreover, will depend on the starting point for society and community: initially weak societal institutions that strengthen in a context of weakening communities tend to create spaces for corruption as winner-take-all opportunities arise; initially strong societal institutions that strengthen in the same context of weakening communities give rise to competent state rule-enforcing elites who prevent corruption. Thus, both *mutual* starting points and *respective* directions of change shape the overall direction of change. Some of these outcomes would be seen as perverse or impossible in comparative economics, for the reasons discussed earlier.

The second major difference is the view of the process itself. Standard theories have richly modeled how groups can block or twist societal rules, including both economic and political losers as potential obstacles to development, on the one hand, and political and economic winners whose interests do not coincide with optimal development outcomes (Acemoglu and Robinson 1999). But as we depict in Figures 1–3, this is an overly restricted view of how groups may affect societal institutions and economic development. In the same way that groups can block or distort societal institutions, they can also construct and positively shape them. This positive contribution may be the (perhaps unintended) result of their deliberate choices, in the sense that the pursuit of their interests leads to configurations of competition, entry, and exit that check tendencies toward rent seeking, for example, and that lead them to support societal rules in that sense. Or it may be "fully unintentional," as when groups attempt to use societal rules and procedures to advance their interests and, in the course of doing so, reinforce the networks of actors and cognitive frameworks of those rules and procedures (Friedberg 1993). By the same token, societal institutions (their actors at least) may construct or destruct themselves, whether as a result of deliberate choices or fully unintentional

consequences. These are examples of the ways in which institutions—whether societal or communitarian—are made up of institutionalizing actors, not merely “bargaining” or “choosing” actors, and in which institutionalization is inherently interactive in nature. This force is certainly present in the nonmainstream institutionalist theories, but it is not theorized in any consistent way, and, in particular, there is no consistent notion of countervailing forces in the organization of collective action (e.g., minimizing transactions costs but limiting rents), which we are convinced is one of the principal confirmed findings of standard microeconomic institutionalist theory.

This view of the process introduces another element that tends to be eliminated from more standard approaches: uncertainty along the way. Of course, much of the literature on political processes uses advanced game theory and introduces uncertainty or opacity at different steps, so that actors do not know what is being done until the next round when action is complete and they reevaluate (Grossman and Helpman 2001; Persson and Tabellini 2002). But if society and community are internally complex and in interaction, and if each is composed of complex networks of actors and involves such things as cognitive frameworks, as well as all the standard features, like principal-agent dynamics, information costs, and transactions costs, then it can readily be seen that the uncertainty involved at each step is of a different order of magnitude from what is dealt with in most standard theory.

Even in a simplified account of the interactions between society and community, the changes under way in each will meet up with institutionalizing counterforces (or strategies) in the other, such that starting points and directions of change in each are still not sufficient to tell us exactly where change will end up. The pathways that are traced in Figures 1–3, however suggestive, may be subject to “twisting” at intermediate points in the process because of the uncertainty that is introduced by society-community interaction. Rather than the relatively

direct pathways we trace for heuristic purposes, there may be S-shapes, J-shapes, and even U-shapes.

This is not a call for abandoning theory because the world is complex (we do not abandon climate theory because the weather is a complex process) but, rather, to introduce additional refinements in the ways in which we understand that process can affect outcomes. Although introducing such refinements is beyond the scope of this article, there is a strong suggestion in our initial conception of society-community relations about how it could ultimately be done: the process consists of intermediate steps in the definition and redefinition of the checks and balances that society and community define for each other. These checks and balances redefine the possibility sets for the actor networks in society and community spheres at each step in the process and allows a more realistic view of process than merely the recalculation of interests in the context of limited information, followed by new rounds of bargaining, as is the case in standard game theory models. The evolving checks and balances should be visible in rules, networks, sanctions, power and cognitive frameworks along the way.

## Conclusion

The vast bulk of the literature on institutions and social capital has been concerned with the question of whether the presence of strong communities or strong societies in any given territory is good or bad for economic performance. The emergence of durably contrasting positions about the respective merits and demerits of the dominance of strong communities or strong societies has left relatively little room for theoretical progress. More important, it has left almost no space for the analysis of real-world circumstances of interaction between communitarian and societal forces, even though the circumstances under which one of these forces would eliminate the other entirely are almost impossible to imagine. Such interactions include not only the theoretical “standard” case of mutual blockage

between society and community, but many in which the two complement each other to generate institutional arrangements that are beneficial for economic development. The goal of this article has been to chart the diversity of possible pathways of change in these interactions and their effects on development.

The advantage of this theoretical approach is that it allows a consideration of a wide variety of complex institutional contexts, rather than merely emphasizing one principal form of collective organization. Hence, it cuts a middle ground between the extreme parsimony of standard theory and the descriptive empiricism of many heterodox forms of institutionalism. We believe that standard theory's elegance is achieved at too great a price in terms of behavioral realism and institutional richness. Various alternative forms of institutionalism, by contrast, risk becoming so complex and ad hoc that they lose theoretical power. When applied to problems of economic geography, they tend to yield thickly descriptive geographies of development that make it impossible to generalize and falsify. The present approach allows us to see the common forces that lie beneath the many complex forms of institutions and does so in relation to their micro-economic properties. It does so in a reasonably, but not excessively, parsimonious way that can therefore yield general insights into institutional change and its economic effects.

In this article, we have been able to offer only the fundamentals of an approach to analyzing changes in these foundations of institutions. Future work requires better specification of operational versions of society and community as variables, in relation to both institutional arrangements and mesoeconomic and microeconomic outcomes. With such variables, rigorous comparative case studies could be carried out, as well as quantitative comparative analysis. Finally, additional progress on specifying and analyzing the intermediate steps in processes of change, through measurement of the unfolding checks and balances that are defined by society and community and their relationship to defining further

changes, would enable us to capture greater complexity and diversity in ultimate outcomes of change.

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