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"Climbing the hierarchical ladders of rules": A life-cycle theory of institutional evolution☆

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ABSTRACT

This paper proposes an analysis of the emergence and evolution of institutional frameworks. It explains the causes, process, and outcome of institutional evolution. We first describe the institutional framework as a multilevel system at the bottom of which several "local and flexible" institutions apply to subsets of the society while, at the top, a single "generic and rigid" institution applies to all. Dissatisfied with generic order, promoters of local orders try to design collective governance solutions that are better suited to their needs. If agents are heterogeneous (as we assume), then coordination needs differ and a competitive process begins among sponsors of alternative orders. To benefit from efficiency gains, promoters of local orders encourage adherence to their preferred system of rules. The resulting competition for adherents explains why "local and voluntary" institutions might progressively turn into "generic and mandatory" ones. We thus establish a logical continuum between contractual governance mechanisms and institutions. We then analyze the strategic interplay among sponsors of alternative institutional orders by considering not only the "horizontal" competition among institutions emerging in the same time but also the "vertical" competition between promoters of new rules and sponsors of the established, more generic rules.

1. Introduction

This paper is a contribution to the analysis of institutional dynamics. Building on selected ideas from New Institutional Economics (NIE), we provide a framework in which "local and voluntary" institutions endogenously turn into more "generic and mandatory" ones. A now classical distinction (at least among NIE scholars), introduced by North (1990), disentangles the institutional environment from institutional arrangements. The former refers to the general institutions of societies that set the "rules of the game" and make them mandatory, either because these rules are enforced by a coercive power of last resort (i.e., the state) or because they represent the beliefs and conventions (religion, customs, language, etc.) that create a

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society's identity. This *institutional environment* frames the interactions among an extensive set of agents, so in this sense it is generic. In contrast, the notion of *institutional arrangements* applies to mutual (and most often bilateral) commitments voluntarily established by contracts between agents, as analyzed by Williamson (1985, 2000) and many other scholars (for an overview, see Brousseau and Glachant, 2002). There is a significant difference between the nature of governance devices, which reflect the will of agents, and the institutional environment, which are beyond the control of agents (at least in the short run). The literature contrasts the logic of rule-making in these two cases. The design of local orders is driven by efficiency considerations (along the lines of Williamson), whereas the design of institutional systems is dominated by compromise among political forces (following North, 1990).

While recognizing their different natures, we view institutional arrangements and the institutional environment as distinct phases of a developing institutional framework. Our general theory runs as follows. Local agreements emerge through negotiations and the voluntary acceptance of common rules. With the passage of time, some rules may be adopted by a wider community; this makes such rules both decreasingly negotiable and increasingly mandatory. The resulting order may then become rigid (no longer negotiable) and mandatory (no longer based on voluntary adhesion) and so become "generic". We therefore view generic institutions as the consequence of the spreading and solidification of *some* local arrangements, and thus we establish a temporal and logical continuum between contractual governance mechanisms and institutional ones.

The driver of this endogenous transformation of (some) local institutions into generic ones is a competitive process among institutional arrangements. A common order yields a collective benefit because it favors the division of labor. However, because agents are heterogeneous, they have different preferences with respect to alternative arrangements and so will not unanimously prefer the same order. Agents therefore tend to sponsor the creation and adoption of their preferred common order. This results in a competition for "members" among order setters. In a context of the simultaneous emergence of alternative orders, path dependence and networks effects play a role because (1) adhesion to a system of rules is influenced by the number of early adopters and (2) the ability of order setters to attract new adopters affects their bargaining power vis-à-vis sponsors of alternative systems of rules.

We start by providing some historical examples of the process just described (Section 2) and then point out how self-interest shapes the design of institutional settings (Section 3). This leads us to analyze how a competitive process is automatically launched when institutions are decentrally created by agents, which leads to a "race for generalization" whereby promoters of a local order are led to sponsor adhesion to their preferred rules (Section 4). We then examine the incentives of institutional promoters to cooperate with other sponsors on the same playing field, which leads us to describe patterns of competition and cooperation among order setters in various circumstances of horizontal and vertical competition (Section 5). Our approach is based on the hypothesis that an institutional architecture results from the forward-looking strategy of institutional sponsors. We can thus establish a link between the intensity of competition among institutions and the necessity of organizing them formally by establishing a clear delegation of authority. Moreover, we show that the competition among institutions leads to explicit negotiation among "institutional entrepreneurs" that entails their mutual recognition. Section 6 briefly concludes by proposing testable predictions.

2. Empirical examples: from local to generic institutional frameworks

Several historical examples show how generic institutions might be the result of a progressive adoption and institutionalization of local experiments. Before going into the details of two specific examples, it is worth noting that the idea of a "bottom-up" creation of collective rules, such as the law, has already been raised in the literature. For instance, both Benson (1989) and Cooter (1996) analyze the evolution of commercial legislation in the common law system; these authors emphasize that current formal laws are the result of decentralized experiences, some of which progressively became institutionalized. In particular, merchants' conventional practices had a strong influence on the design of commercial and contract laws. The medieval "law merchant" (*lex mercatoria*) in Europe emerged to ease transactions across various boundaries (political, cultural, and geographic). Significant elements of these rules ended up as components of the formal body of common law. Kingston (2007) provides a detailed study of institutional evolution in the marine insurance business in England and the United States during the seventeenth and eighteenth centuries. He shows how rules originally designed almost "from scratch" by a set of private insurers in Lloyd's coffee house—the "underwriters"—were progressively adopted by most market participants and ended up as the general rules structuring that industry. Most recent examples show that, today, "private" initiatives continue to influence the design of future formal laws despite a well-established process of formal lawmaking. For instance, the regulation of the Internet provides interesting examples of new, locally established rules that might become part of future global regulation of the information society (Brousseau, 2004; Hadfield, 2004). More generally, contractual practices and self-regulation influence the regulation of many industries.

These movements of generalization and formalization are not due to "spontaneous" processes of the diffusion of new practices. Rather, there is a competition among (private) rulers to favor the adoption of their rules by the greatest possible number. This is illustrated by Banner's (1998) analysis of the emergence of the New York Stock Exchange. Trying to understand how "a handful of stockbrokers in New York in the early nineteenth century [could] build from scratch an organization that would become, by the second half of the century, one of the most powerful non-governmental bodies in the world" (pp. 113–114), Banner documents the progressive adoption of local rules by market participants and their implementation in the legal framework. At the beginning of the nineteenth century, a small number of "dealers" agreed to follow a set of common and informal rules binding (some of) their decisions. This "club" progressively grew by attracting additional members,