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Beyond Institutions: Beliefs and Leadership

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Beliefs shape the choices of institutions. Beliefs are generally stable, but shocks that cause sufficiently unexpected economic and political outcomes make beliefs malleable. Within these windows of opportunity, leadership can play a role in shaping a new belief among the dominant organizations that in turn generates new institutions and over time a possible transition to a new developmental trajectory.

Douglass North gave his presidential address titled "Beyond the New Economic History" to the Economic History Association in September 1973 (North 1974). North's address raised three issues: (1) the limitations of applying standard neoclassical theory to economic history, (2) the addition of theoretical tools to extend neoclassical theory, and (3) a future research agenda. One of the major limitations of neoclassical theory was that it was not meant to understand or predict long-run development, which for North was at the heart of economic history. North explicitly encouraged the use of transaction costs and property rights as tools for illuminating increases in productivity (p. 4). For the future agenda, North encouraged research on the period before the Industrial Revolution and embraced a political economy approach to understanding failures or regress as well as success stories. "It is only when we introduce

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an economic theory of the family, transaction costs, and a theory of political decision making that we can explain decline or stagnation" (p. 6).[1]

As we know, North embraced his research agenda and moved beyond it with *Institutions, Institutional Change and Economic Performance* (1990). By the 1990s, North understood that property rights and transaction costs were embedded in institutions, and so we needed more work on institutions. A decade later, North still found a full understanding of long-run change elusive. It was like peeling an onion, layer by layer. Transaction costs and property rights are embedded in institutions, but institutional choice was embedded in beliefs (North 2005). I pick up the ball from North and encourage more work to understand the belief structures that undergird institutions as well as the leadership that at times is required to move from one set of beliefs to another with accompanying institutional change. By institutions, I mean the rules that incentivize behavior. Rules are both formal and informal, and both matter for behavior.

I start with the observation that there has been remarkable stability in the developmental trajectories of most countries. Over the past hundred-plus years, countries can be categorized as low-, middle-, or upper-income countries. Although there has been overall growth within categories, very few countries have changed categories.[2]

There is a consensus that institutions are critical for development. Yet, despite the trillions of dollars in aid for development, we have learned that there is no recipe for implementing institutional change to produce better economic and political outcomes. In the 1990s, many at the multilateral development agencies believed that applying the Washington Consensus was all that was needed. In 1989, John Williamson (2004) set out what he saw as the defining set of reforms that he maintained permeated policy prescriptions coming out of the World Bank and the IMF and hence the "Washington Consensus."[3] In principle, it was a fine recipe, but it was not politically feasible. In part because of the rents that organizations receive from the status quo, most institutional change occurs on the margin. The status quo has a heavy hand. For institutional reform to succeed, it has to fit a country's political and economic endowment; institutional reform must be contextual. The Washington Consensus did not take into account

[1] As background, North and Thomas's *The Rise of the Western World: A New Economic History* (1973) had just been published with Cambridge.

[2] For elaboration, see the Introduction in Alston et al. (2016).

[3] The reforms included fiscal discipline, reordering public expenditures, tax reform, liberalizing interest rates, competitive exchange rate, liberalizing trade, liberalization of foreign direct investment, privatization, deregulation, and secure property rights (Willamson 2004, p. 3)

social norms, nor could it overcome the resistance from those that would lose rents from its implementation.

To better understand development, I propose a set of concepts that, when wedded together, form a dynamic for understanding development. The set of concepts forming the dynamic include: dominant network, beliefs, institutions, economic and political outcomes, shocks, windows of opportunity, critical transitions, and leadership.[4] Many of these concepts are familiar, but tying them together allows us to better understand development over time. The dominant network consists of the set of organizations that have the power to change and implement formal institutions. These will be specific to a given country, but include not just the government actors (e.g., the legislature, the executive, the bureaucracy, and the courts) but other business and social organizations, often by sector (e.g., financial, industrial, educational, export, and import). In many societies, the military plays a huge role.

The dominant network through coordination establishes the formal rules of the game based on their expectation of how rules will affect outcomes.[5] To do so, they need a mental map of the process.[6] Beliefs are the mental map that translates perceived impacts of formal rules on economic and political outcomes. Beliefs are typically multidimensional because the dominant network has a variety of outcomes that they would like to achieve, for example, economic growth, less income inequality, more or less political competition, open or closed elections, more or less inclusion for minority groups. Organizations within the dominant network have differing or competing beliefs, but some subset will win the day. If the rules put in place produce the expected outcome for the organizations in charge, it will become reinforcing and tend to convert other organizations as long as they share in the rents. An example of differing beliefs is the appropriate role for state versus federal power in determining economic, political, and social policies. Beliefs are based on both a normative and positive component. I am interested in the positive component. In principle, one could test for the causal impact of

[4] For the use of dominant network, see North, Wallis, and Weingast (2009); for beliefs, see North (2005) and Greif (2006); for institutions, see North (1990); for leadership, see Riker (1996). Alston et al. (2016) define the remaining concepts—economic and political outcomes, shocks, windows of opportunity, and critical transitions.

[5] The dominant network cannot directly shape norms.

[6] My definition of beliefs is similar to that of "core beliefs" expressed by Greif (2006) and Schofield (2006). It is also similar to the "mental maps" of Eggertsson (2005). I am most interested in the beliefs in the dominant network that over time generally become internalized by the population. Beliefs in the dominant network differ from behavioral beliefs made familiar by game theory.

top-down versus more decentralized rule making, but such econometric tests are difficult across countries and I have not seen any convincing natural experiments. The subjective view of the world comes down to a belief based in part on the contextual nature of the society, including its mapping of past policies on outcomes that are also contextual.

To the extent that outcomes match expectations, members of the dominant network will stick with their belief, perhaps changing it on the margin, for example, more or less state intervention. When beliefs only change on the margin, the dominant network will put in place institutions that only change on the margin. Countries are always passing laws so there is change, but most legislation tends to simply maintain the country on its same economic, political, or social trajectory. To the extent that a country has a binding constitution, the dominant network passes laws under the shadow of the court. The dominant network generally will try to pass legislation that will not be rejected by the courts because this has reputational effects.[7] Economic, political, and social trajectories measure different aspects of development and contain a normative component. But it is fair to say that there is a great deal of collinearity across different indexes that measure economic versus political openness (Acemoglu and Robinson 2012; Alston et al. forthcoming). Social indexes such as the Human Development Index are highly correlated with economic and political openness. In Figure 1, I depict the process of a dominant network under the umbrella of a belief and under the shadow of a binding constitution. The dominant network enacts institutions (formal laws and regulations) that result in more or less the predicted economic and political outcomes that in turn loop back, reinforcing the belief and more institutional deepening consistent with the belief.

Core beliefs have many facets: economic, political, and social. One aspect of a belief can change without changing the overall trajectory of an economy. More advanced countries are more resilient to a single belief changing because of the number of organizations and the set of relationships in the dominant network is large.[8] Core beliefs are quite stable, so it takes a significant shock to the system to change them. A shock occurs when the outcomes for powerful organizations in the dominant network are considerably different from expectations.[9] Shocks can be economic,

[7] The length and darkness of this shadow varies considerably from country to country. In some countries, the dominant network is much less concerned with their rules being overturned simply because there is a much lower ex-ante likelihood of that ever happening from interference from the judiciary.

[8] On resilience and economic development, see Wallis (2016).

[9] On the importance of shocks in U.S. economic history, see Higgs (1987). See also Neal (2000).

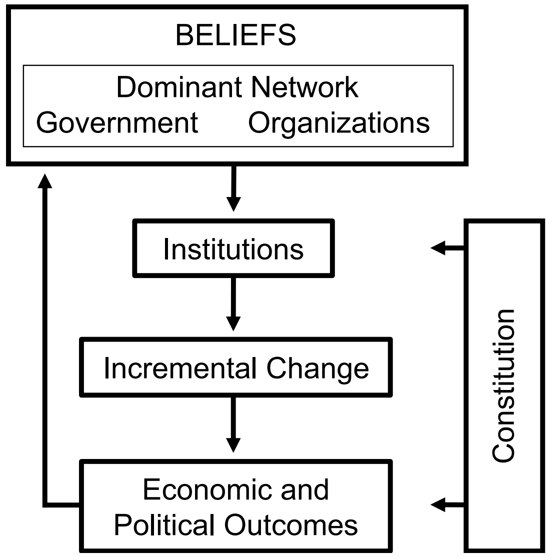

FIGURE 1
INSTITUTIONAL DEEPENING ON THE SAME DEVELOPMENTAL TRAJECTORY

Source: Alston et al. (forthcoming).

for example, a huge spike or fall in the price of oil wreaking havoc or creating a bonus in wealth, or they can be political, for example, Brexit. Shocks make beliefs less firmly held because the outcomes that transpired were unanticipated, so it is only natural some of those in power begin to question their beliefs: Something is not working as we anticipated; what did we get wrong? Economic, political, or social shocks change the rental streams to those in power and may also change who is in power. Subsequent changes in beliefs can be a result of differing beliefs of the organizations in the dominant network as well as a compositional effect coming from new entrants and exits. I define a "critical transition" as a change in the beliefs of the powerful organizations in the dominant network.

Shocks create a "window of opportunity" for changes in beliefs. During windows of opportunity, beliefs are uncertain and malleable. Whose beliefs will carry the day? There is a collective-action problem and leadership can play a role. By "leadership," I do not mean that great people and events make history. But individuals or groups of individuals have played critical roles in initiating a change in beliefs and institutions. To the extent there is institutional deepening that reinforces belief deepening, you have a nascent critical transition. If this were not the case, then there would be little value in discussing the roles of the "founding fathers" in the United States, Nelson Mandela in South Africa, Juan Perón in Argentina, and others who coordinated a change in the trajectory of their countries.

Leadership for countries differs from leadership for firms. For firms, it is more of a principal-agent problem because of the residual claimancy of owners. For countries, given that decisions get made within a dominant network, different attributes for leadership are at play. Important attributes of leadership include: cognition, coordination, adaptability, imagination, and moral authority.[10] Cognition entails an understanding of the problems associated with the current belief given the shock and the recognition of a window of opportunity along with a nascent belief that will solve the problem(s). Coordination is framing the belief and setting the agenda so as to persuade other organizations to adopt your belief. At the bargaining table, a leader will try to frame the issue such that her belief is the focal point over which debate transpires. Adaptability is the willingness and ability to respond to downstream unforeseen contingencies. Generally, this will entail political or economic side payments to achieve a consensus. Ex-ante, one can never see with complete precision all the downstream moves by the various organizations in the network. Imagination means seeing further down the decision tree than others at the table. It also entails a certain amount of risk-taking and entrepreneurship. Moral authority means that organizations are much less likely to suspect your motives. Moral authority can be earned over time, or a leader can come to the situation with moral authority from past actions, for example, war heroes or ex-prisoners fit this category.

A critical transition becomes possible through a shock that makes beliefs malleable, in turn creating a window of opportunity. If a leader seizes the window of opportunity and coordinates other organizations, a belief change within the dominant network is possible.[11] Frequently, an event encapsulates the belief change, often a new constitution or a constitutional amendment. I call such events a constitutional moment. Institutions change, and if outcomes are as expected, the belief deepens and more institutional deepening occurs. A critical transition is an iterative process that starts with a change in beliefs by a sufficient number of organizations in the dominant network to agree to new institutions that are embodied in the constitutional moment. Though there are always bumps

[10] My views on leadership have been influenced by Ellis (2015), Greif (2006), Riker (1984, 1996), Schofield (2006), and Shepsle (2017) as well as discussions with Avner Greif, Ken Shepsle, and Barry Weingast.

[11] The change leads to positive or negative development outcomes. In my case studies, I focus on positive outcomes.

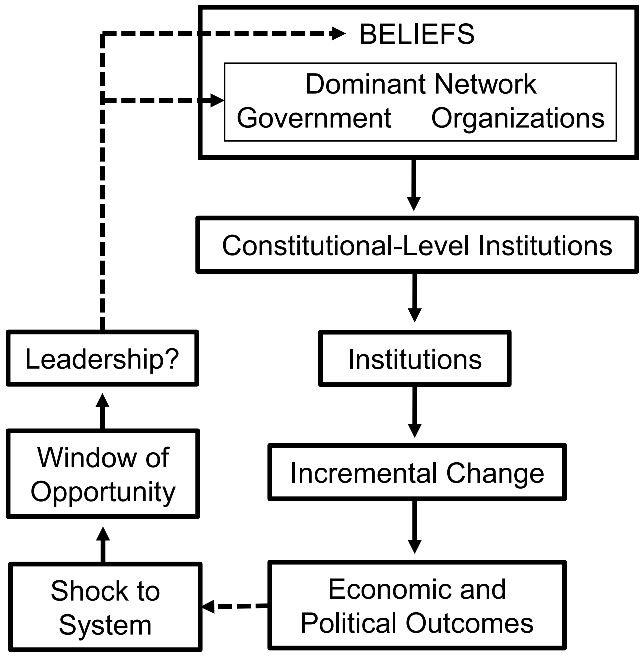

FIGURE 2
INSTITUTIONAL DEEPENING AND CRITICAL TRANSITIONS

Source: Alston et al. (forthcoming).

in the road, a critical transition entails a temporal period of belief and institutional deepening. Of course, not all organizations adopt the new belief, but what matters is that a sufficient number of powerful players do adopt the belief over time. I depict the process in Figure 2.

By construction, concepts in frameworks need to be defined and appear relatively black and white, whereas the developmental process is much fuzzier and messy. For this reason, I advocate case studies to see to what extent the framework helps us better understand the development process.[12] Groups of case studies utilizing the same framework will help us judge the degree to which the framework has general applicability for understanding development. With enough case studies, one can see patterns and begin to form testable hypotheses. But at this stage of our

[12] Here I focus on the United States and Brazil. For additional case studies on Argentina and Ecuador, see Alston et al. (forthcoming). For a case study not explicitly using this framework, though consistent with it, see Alston and Gallo (2010). In the case of Argentina, the belief change led to deterioration over time in overall economic development, though like all change, it created winners and losers. The hope is that more scholars familiar with particular histories of countries would utilize the framework. Two candidates for analysis of countries who jumped to the top income trajectory are Singapore and South Korea. China changed its developmental trajectory under the leadership of Deng Xioping (Vogel 2011).

knowledge, we need to first better understand before we can formally test the processes involved with development. Case studies take the form of analytical narratives that embody some theory, as well as quantitative and qualitative evidence (Bates et al. 1998). Thick historical description is necessary to understand context, which can be in the form of circumstantial evidence. Circumstantial evidence is used when there is no smoking gun or significant *t*-statistic. But, it can be very powerful when the evidence presented is independent and points in the same direction (Fogel 1982).

APPLYING THE DYNAMIC: CASE STUDIES FROM THE UNITED STATES AND BRAZIL

United States, 1783–1789: Transitioning from "States Rule" to the United States of America

In November 1777, more than a year after the Declaration of Independence, the colonies passed the Articles of Confederation.[13] With these Articles, the colonies became states united under a Confederation in which all states were equal, each having one vote. The prevailing view among the powerful forces in the Continental Congress and in the states was that the proper sovereign unit of governance was the state. The Confederation lacked the central power to tax. Throughout the Revolutionary War, George Washington requested more funding from the Continental Congress, but the funding fell woefully short of his requests. Washington—along with Alexander Hamilton, his aide de camp through most of the war—recognized early on in the conflict that the strict belief in the states as the sovereign unit of governance hampered their ability to defend the union of states. The colonies won the war with few resources, largely by not directly confronting the better-funded British army, a strategy set out by Washington.[14] The fighting of the Revolutionary War ended in 1781. The official ending of the war was the Treaty of Paris in 1783. Washington resigned his commission in December 1783 and retired to Mount Vernon, with the intention of not returning to politics.

With the war behind them, many states—in particular, the governors of states—favored the continued lack of centralized authority and primacy

[13] I rely heavily on Ellis (2015) as well as comments from Jeremy Atack, Larry Neal, Richard Sylla, and John Wallis.

[14] The colonies benefited from aid from the French. Without the belief that the French would subsidize our effort, we might not have declared our independence from Great Britain. Franklin sent word to the colonists that the French would provide assistance (Ellis 2015).

of states in the Confederation. The Continental Congress met but accomplished little because all substantive changes required unanimity. Yet, some early Federalists came to believe that sharing power with a central government could overcome some of the glaring issues that faced the Continental Congress: How should the debts for waging the war be funded? Was it fair that states that raised funds to fight the British be solely responsible for the debts? How can a young country issue debt without a central authority to tax? How should interstate trade be managed? How should foreign affairs be conducted? How could a loose confederation rally should another conflict emerge? Should the United States rely on state militias or should it have a standing army? The one issue that remained unresolved and little discussed was slavery. As a confederation, states clearly could determine their own policies regarding slave-holding (slavery).

As stated earlier, the status quo has a heavy hand, and despite its problems, change did not seem imminent for a new constitution in which states would share power with a central authority. A federal system had its proponents. Washington, and particularly Hamilton, voiced their support for federalism. Washington was retired at Mount Vernon and not directly involved with politics, but Hamilton was a vocal advocate for change in the Continental Congress. John Jay, the president of the Congress, voiced his support for federalist ideas. Jay was the primary negotiator of the Treaty of Paris and believed that the United States lacked credibility as a country without a stronger central authority that could negotiate with foreign nations. James Madison, though a relative latecomer to advancing federalism, did so with a fervor once converted to the cause.[15] Of course, others were also involved, but I will focus primarily on Hamilton, Jay, Madison, and Washington as the critical players.[16] Collectively, this group led the transition from a loose confederation to a belief in federalism and the *United States*. The nascent belief became codified with passage of the Constitution in 1787 followed by the Bill of Rights in 1789, which strengthened the belief. More institutional and belief deepening ensued. Of course, the majority of the power in the country would still rest with the states for well over the next one hundred years.[17]

What are the counterfactual scenarios had the quartet not brought about the Constitution? First and foremost, without a standing army and

[15] Madison recognized the flaws of the Articles of Confederation and the need for a Constitution granting the federal government certain *limited* powers. Once the Constitution passed and Madison became a representative for Virginia, he became a proponent of limited federal government and, for many, is best remembered as devoted to states' rights.

[16] I follow Ellis (2015), who singles out these four actors as the "Quartet," the title of his book.

[17] The Great Depression saw a relative shift in power to the federal government.

no explicit ability to tax, the United States would have had difficulty defending its real estate from outside intrusion. So, war with a foreign nation sooner rather than later is a possibility. The states could also have gone their own ways, though more likely there would have been regional blocs. There would have been less interstate trade unless they somehow could have prevented tariffs across state lines. Indeed, the trade issue started the process toward the Constitution.

In September of 1786, Congress agreed to meet in Annapolis to discuss the issue of interstate trade. The meeting was a non-starter as not enough states sent delegates to the meeting. In a brilliant and lucky imaginative moment, Hamilton rose to the floor at the end of the convention and announced boldly that there was a consensus to meet and discuss all the weaknesses of the Confederation in hopes of forming a new *constitution*. The venue would be Philadelphia in May 1787. Most thought this a rash pipe dream of Hamilton, who was known for his boldness. Ellis (2015, p. 100) captures the audacity of Hamilton:

> This was Hamilton's out-front brand of leadership in its most flamboyant form. A convention called to address the modest mandate of commercial reform had just failed to attract even a quorum, and now Hamilton was using this grim occasion to announce a new date for another convention to address all the problems affecting the Confederation at once. It was as if a prizefighter, having just been knocked out by a journeyman boxer, declared his intention to challenge the heavyweight champion of the world. Given the overwhelming indifference that had suffocated all previous attempts at comprehensive reform of the Articles, no one with any semblance of sanity could possibly believe that Hamilton's proposal enjoyed even the slightest chance of success.

Given the abysmal failure in Annapolis, we might have expected Hamilton's call to go unheeded. Instead, Congress endorsed and encouraged states to send delegates. The Federalists recognized the importance of having Washington attend. At this stage of his life, Washington had been retired for three years. Jay, Hamilton, Madison, and others recognized the moral authority that Washington would bring to the cause of the Constitution. Washington approved of a stronger central authority, but in his retirement was not as outspoken as he had been during the war. The argument that was most often made was that a new Constitution with a stronger central government might succeed if Washington attended, but that it was doomed if he stayed at home. Henry Knox, in whom Washington confided, advanced the argument that tipped Washington into coming to the convention. He argued that a stronger Constitution of the United States would ensure Washington the epithet of "Father of our Country" (Ellis 2015, p. 112).

Filled with hope, now that Washington would be in Philadelphia, the Federalists prepared. Madison, in particular, did his homework by reading the works of the leading lights in political economy as well as the classics. He then played the devil's advocate and readied responses to proposed criticisms of a stronger central core. He also convinced the other delegates from Virginia to coalesce around the Virginia Plan, which was a new constitution (Ellis 2015). The first order of business was to approve a chair for the convention. Washington was the unanimous choice. Though he said little at the convention, Washington's gravitas and moral authority lent incredible weight to the cause of the Federalists.

Prior to the convention, Madison also won over Gouverneur Morris of Pennsylvania to the outlines of the Virginia Plan. On 30 May, Morris proposed to the delegates that they approve a central government along the lines of the Virginia Plan. Madison displayed coordinative leadership at its best by controlling the agenda. Instead of debating the merits and demerits of the Articles of Confederation, the delegates debated the Virginia Plan as the focal point. Though the delegates made many changes to Madison's ideal vision of a national government, his overall vision of a tripartite system held and won approval by the delegates (Farrand [1911] 1966, p. 57).

The congressional stamp of approval for the Constitution was simply the first step in creating a stronger union. Nine of the 13 states needed to ratify the Constitution for it to become law. This was not a foregone conclusion, and many states and their governors, who would lose power, opposed the Constitution. Governor Clinton of New York was the strongest opponent to the greater centralization of power. Hamilton, Jay, and Madison recognized this and set about to win the vote for ratification with their publication of 83 essays in six months espousing the benefits of the Constitution. The trio published under the pseudonym Publius. Hamilton was a *tour de force* and wrote 51 of the 83 papers. Madison wrote 27 and Jay contributed 5. More than half of the papers cited the need for national defense as a reason for a stronger union.[18] Despite the pressure and haste in which they were produced, the Federalist Papers did the job. We will never know the counterfactual of a world without the Federalist Papers, but New York voted for ratification in July 1788. Unanimity took more than a year, with Rhode Island ratifying in 1789.

[18] I thank Timothy Larsen for his research on the Federalist Papers. Hamilton and Jay, more so than Madison, brought up the importance of national defense. For Hamilton, it was clearly coming from his experiences of financing the Revolutionary War. In debates on the Constitution during the ratification conventions, those siding with the Federalists brought up the issue of financing and coordinating national defense (Edling 2003).

The Constitution was an important focal point and codification of the nascent belief in a stronger nation, but more was needed. Despite being an up-or-down vote, most states submitted amendments. New York proposed 30 amendments and Virginia 20 amendments. States voiced approval but also clamored for more changes. The original Constitution is primarily about the workings of government, for example, three branches of government with enumerated powers, equal number of senators per states, representatives on a population basis, *inter alia*. Most of the amendments enumerated personal freedoms. Hamilton and Madison did not think that amendments were necessary because states already had the personal freedoms guaranteed in their state constitutions. Jay convinced Madison in particular that passing amendments would fully bring states on board with the U.S. Constitution. Madison seized the opportunity and wrote a draft from the various amendments, picking and choosing, and submitted it when Congress reopened. The end result became known as the Bill of Rights. It is another example of Madisonian leadership in the form of agenda control. The debate in Congress was not over each state's amendments but rather the bill that Madison proposed. Importantly, Madison excised any amendments ceding taxation or veto over taxation to the states. Congress passed the Bill of Rights quickly in 1789, helping to solidify the belief in the United States as the sovereign unit.

As discussed earlier, belief and institutional deepening is an iterative process. There was and always will be a tension between the rights of states and the power of the central government.[19] The Constitution can be seen as a commitment mechanism to ensure credibility as a nation and self-defense. Importantly, under the leadership of Hamilton, the United States funded the Revolutionary War debts, whereas Jefferson, among others, opposed. Hamilton believed that the nation should pay for the war even though individual states had debts. In addition, if successfully funded, it would establish the United States as a good creditor. Rhetoric alone was not sufficient to seal the deal over the debt. In exchange for votes, the Federalists agreed to move the capitol from Philadelphia to Washington, DC. This shows the continued use of imagination and adaptability on the part of Hamilton.

The ability of the United States to tax was put to a test beginning in 1791. Hamilton, as Secretary of Treasury, proposed and Congress approved an excise tax on whiskey. Opposition to the tax increased to "rebellion" in western Pennsylvania, where interests involved with producing and

[19] Until the twentieth century, the majority of innovative institutional change leading to development came from states (Lamoreaux and Wallis 2015).

selling whiskey maintained the tax was an abuse of federal authority. Washington tried to resolve the issue peacefully, but violence broke out in 1794 over a refusal to pay the excise tax. Hamilton convinced Washington that troops should be sent to enforce the tax and, moreover, that Washington should lead the troops. This was a powerful signal to the rebels in western Pennsylvania who backed down before Washington arrived. This was another sign of the continued leadership of Washington and Hamilton in strengthening the belief in the Union.

Institutional and belief deepening continued. Congress agreed to a national bank in 1791 chartered for 20 years. Four years prior, this would have been unimaginable. More deepening continued after Washington, Jay, Madison, and Hamilton left the stage. The judiciary strengthened its role under the leadership of John Marshall, who was Chief Justice of the Supreme Court from 1801 to 1835. In the famous decision of Madison v. Marbury (1803), the Court ruled that they had the authority of judicial review over legislation that they viewed as potentially unconstitutional.[20] Judicial review took time to be accepted, but it solidified over time, as did beliefs in the right of the Supreme Court regarding its power of review over legislation by Congress and states.

Somewhat ironically, Jefferson strengthened the role of the central government with the Louisiana Purchase in 1803. The purchase nearly doubled the land area that the United States had to defend. For this reason, it remained paramount that the states not divide over slavery. To help ensure that slavery was not on the legislative agenda and limit sectional frictions, Congress agreed to the Missouri Compromise in 1820 and subsequently agreed to the balance rule whereby slaves and free states would be admitted in pairs. As long as the number of senators was equal in the North and the South, the South would have a veto. As a result, the most contentious legislative issues for most of the early nineteenth century entailed the tariff and internal transportation (Weingast 1998).

The balance rule was fragile, and eventually slavery divided the nation. Lincoln maintained that the slave issue was first and foremost a matter of preserving the Union:

> If there be those who would not save the Union, unless they could at the same time *save* slavery, I do not agree with them. If there be those who would not save the Union unless they could at the same time *destroy* slavery, I do not agree with them. My paramount object in this struggle *is* to save the Union, and is *not* either to save or to destroy slavery. If I could save the Union without freeing *any* slave

[20] For a discussion of the importance of Madison v. Marbury, see discussion on the judiciary in Alston et al. (forthcoming).

> I would do it, and if I could save it by freeing *all* the slaves I would do it; and if I could save it by freeing some and leaving others alone I would also do that. What I do about slavery, and the colored race, I do because I believe it helps to save the Union; and what I forbear, I forbear because I do *not* believe it would help to save the Union. (Letter to Horace Greeley, 22 August 1862)

The Civil War was incredibly divisive, and it is conceivable that belief in the United States might have never rebounded. But of course it did, though with continued tensions as to the proper divide between states' rights and federal power.

Brazil: Transitioning from Social Inclusion to Fiscally Sound Social Inclusion, 1985–2015

After a military dictatorship from 1964 to 1984, Brazil opened up to democracy.[21] Usually, military regimes are toppled, but in Brazil, the military announced when it would redemocratize. The military operated under a belief of developmentalism that entailed top-down economic planning and curtailment of civil liberties. After a rocky start from 1964 to 1967, developmentalism produced considerable growth from 1968 to 1973 (the Miracle Years). After the oil shock of 1973, growth declined and political repression grew. Given the exclusionary nature of economic, political, and social life under the military regime, the new belief that emerged quickly under the new democracy was "social inclusion." In practice, this meant that all interest groups had a seat at the table. As an example, the resulting Constitution of 1988—known as the Citizen Constitution—is among the longest and most detailed in the world. It is also known as the "Christmas tree" constitution because all interest groups got to hang their ornaments on the tree. Two of the more significant changes having large downstream consequences included illiterates receiving the right to the franchise, and unions the right to strike. Business groups maintained their tariff barriers.

The numerous demands on government spending without an independent central bank resulted in hyperinflation as the norm. From 1988 until 1994, inflation was in the hundreds and thousands percent. Between 1986 and 1993, the government initiated five major stabilization plans, but all failed. Hyperinflation destroys rents and creates chaos. In addition to a prolonged economic crisis, Brazil faced a political crisis of impeachment

[21] This draws heavily on Alston et al. (2016). I thank Gustavo Franco for insights into the *Real Plan* and stabilization policies during the Cardoso years. Gustavo Franco was a keynote speaker at the 2016 EHA annual meeting.

proceedings in 1992 against President Fernando Collor de Mello, the first directly elected president since redemocratization. President Collor resigned in December 1992 and Itamar Franco took over as president. The most pressing issue was stabilizing the economy. Fortunately, Franco had the good judgment (or luck) to move Fernando Henrique Cardoso from being foreign minister to finance minister. Cardoso seized the window of opportunity and quickly demonstrated his leadership skills. Cardoso was a former professor of sociology who had written on dependency theory in his earlier career. By the time that he was a senator in the administration of Collor, Cardoso had moved to the center politically. Cardoso came to the position with moral authority from being self-exiled during the military regime, which had prohibited him from teaching. Given his past, Cardoso was trusted more than most politicians to act in the public interest.

Cardoso knew that stabilization was the first order of business. He sought advice and had the wisdom to select for his economic team a group of economists mostly from PUC-Rio (Pontifical Catholic University of Rio de Janeiro). The group was well trained in economics from prestigious graduate schools in the United States. The group devised the *Plano Real* to stabilize the economy. It drew lessons from the economic history of the German hyperinflation and its ultimate cure.[22] Neither the market nor the International Monetary Fund, which promoted a currency peg, welcomed the *Real Plan*. Despite its critics, the *Real Plan* succeeded.

On the success of the *Real Plan*, Cardoso ran for the presidency in 1994 and won. Taming inflation was a first step in transitioning from a belief in social inclusion to a belief in fiscally sound social inclusion. Development does not happen with a big bang. It is an iterative process of belief and institutional deepening. We can point to certain events, like the *Real Plan*, as the window of opportunity that was seized, but a transition needs time and deepening. The difference between social inclusion and fiscally sound social inclusion is the recognition of trade-offs and opportunity costs. Brazil pursued social inclusion if the budget allowed it. It also had other goals, first and foremost to stabilize the overall economy, not simply prices.

Cardoso once again chose wisely with his economic team. Pedro Malan became finance minister. Gustavo Franco followed Malan as interim president of the Central Bank early on during the crucial days of the *Real Plan*, and then, with a hiatus, Cardoso appointed Franco

[22] Gustavo Franco, one of the plan's architects, had written his Ph.D. dissertation on the German hyperinflation experience.

president of the Central Bank in 1997. Stabilization meant controlling the budget and most importantly pension reform. Bank reform was also needed at the state level. It had been common for state governments to overspend and then get loans from their state banks, which the Central Bank subsequently monetized. Tariffs also needed to be reduced along with some privatization of state companies. Cardoso's economic team knew the economics, but Cardoso had to follow through with the coordinative skills and adaptability. Over time, Cardoso increased the size of the dominant network inside and outside of the government. Within the government, he was a superb coalition manager. Outside the government, he coordinated most of the major business groups by convincing them that a stable economy with clear rules would bring more benefits than the tariffs and subsidies to which they had been accustomed.

On the strength of his economic record as well as concern for inclusion, Cardoso was reelected in 1998 for four more years. This enabled Cardoso to continue to stabilize the economy, promote transparency, and adhere to the rule of law. The landmark legislation controlling spending by states and signaling a transfer of power to the federal government over fiscal control was the Fiscal Responsibility Law in 2000. The World Bank lauded this achievement.

Despite the state of the economy, Cardoso had his critics on the left led by Lula (Luiz Inácio Lula da Silva). Cardoso's chosen successor was his Finance Minister Pedro Malan, who was viewed as a technocrat. Lula was charismatic and promised more transfers to the poor. His message resonated with the electorate but not with the markets. On news that Lula would win the election, the *real* plummeted. Between the election and the beginning of his term, Lula became convinced of the merits of fiscally sound social inclusion. Lula's priorities differed from those of Cardoso, but he did not abandon fiscally sound social inclusion. He calmed markets by naming orthodox economists as finance minister and president of the Central Bank. Cardoso was partially responsible because he was open with advice during the transition. Cardoso wanted Lula to succeed in part because it would ensure his legacy as initiating the transition of Brazil. Lula maintained and solidified the belief in fiscally sound social inclusion by running budget surpluses while still expanding social programs, especially his flagship program *Bolsa Família*, which paid mothers to keep their children in school.[23] The actions of Lula illustrate the iterative nature of institutional and belief deepening.

[23] Lula is given credit for *Bolsa Família*, but it was an expansion of a program started by Cardoso.

With the economy booming, in part due to the stable economy inherited from Cardoso, as well as high commodity prices, Lula was resoundingly elected for a second term. It appeared to the world that there may be a "Brazilian" model of development because Brazil emerged relatively unscathed by the financial crisis that rocked the G20 countries in 2008. Lula's anointed successor, Dilma Rousseff, won the election in 2010 and vowed to stick to the belief in fiscally sound social inclusion: "the Brazilian people do not accept that governments spend more than is sustainable" (Presidential Acceptance Speech, November 2010).

Rousseff's first term started off well, but her actions did not match her rhetoric. She expanded social programs and state-run enterprises despite declining revenues due to a fall in commodity prices. In the election of 2014, she narrowly won. In 2015, Rousseff was hit by the perfect storm of bad luck: the Petrobrás scandal (one of the most costly in world history),[24] a continued decline in commodity prices, and a continued decline in growth. Her popularity plummeted and the Senate impeached her in August 2016 on grounds of violating the Fiscal Responsibility Law for overstating her budgets during the 2014 election year. A reasonable counterfactual is that if the electorate had known the true state of the economy, she would not have won the election. During her first term, Rousseff veered off the path of fiscally sound social inclusion.

Did the impeachment of Rousseff signal the end of a belief in fiscally sound social inclusion? Or, has the short run been consistent with a return to fiscally sound social inclusion that also supports the rule of law? The impeachment surely opened up a window of opportunity for a new belief. As the Petrobrás scandal continues to unfold, it is clear that no one is above the law. Former President Lula is now set to go to trial, and some of the nation's wealthiest businessmen are in prison and engaged in plea bargaining over further allegations. The country applauds that the rule of law is being enforced. This would have been unimaginable in a world prior to Cardoso.

Though rumors abound about whether Michel Temer will become ensnared in the corruption probe and indicted or impeached, so far his actions have moved Brazil back toward institutions consistent with fiscally sound social inclusion. Temer appointed orthodox economists to the Finance Ministry and Central Bank. He has called for independence of the Central Bank and stricter budget controls to tie his hands and those of Congress

[24] Petrobrás is Brazil's publicly owned oil company. Initially, the scandal entailed the diversion of funds from Petrobrás to the Workers Party and its coalition partners. At the time of this writing, the scandal has escalated and at the heart of it is Brazil's largest construction company with bribes paid for construction projects around the globe (*Financial Times* 2016).

over spending. The *real* has appreciated more than any other currency in 2016 (up to the election of Donald Trump). Foreign direct investment has also surged over the past few years. What does the future hold? Uncertainty for sure. With the government held in low regard, this has the appearances of a window of opportunity for a new belief under leadership to seize the moment. Yet, there is no visible potential belief to replace the status quo nor is there a visible leader to seize the current opportunity.

CONCLUDING REMARKS

Douglass North was a pioneer in advocating institutions as the key to understanding economic and political development. Scores of economic historians have followed North's lead. North also advocated that we need to understand beliefs in order to understand institutions and development. Fewer economic historians have analyzed the relationship between beliefs and institutions. Leadership is also not well understood in economic history and scarcely studied. In this address, I developed and linked a set of concepts that form an analytic framework for understanding critical transitions. A critical transition entails the dominant network embracing a new belief with new institutions. Transitioning to a new belief results from a shock to society, and a perceived economic or political shortcoming that needs to be addressed during a window of opportunity. During the window of opportunity, there are competing beliefs. Leadership can be essential to orchestrate a sufficient number of organizations to adopt a new belief over the heavy hand of the status quo. Under the new belief, new institutions follow. With sufficient institutional and belief deepening, the result can be a movement to a new developmental trajectory.

Does this simply mean that great people and great events are all that is needed to change developmental trajectories? Important people and events are part of the story, but not sufficient. Development does not happen with a grand event and a great leader. To move to a new trajectory, a society needs: belief changes in the dominant network, orchestrated by leaders; institutional changes that produce outcomes consistent with new beliefs; and an iterative process of belief and institutional deepening over time.

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