

A Conceptual Framework: Beliefs, Leadership and Critical Transitions: Brazil 1964-2014*

I. Introduction

Economic and political development is contextual.¹ Persistence or incremental changes are more common than countries making big changes in their economic and political trajectories. The early achievers, Great Britain, France and the U.S. broke with the past by accident not design. Other countries, e.g. the G-20 followed suit, but most countries remained either middle income or lower income despite knowing the attributes of the success stories. But, some countries have broken away from their past and Brazil is one such country in the midst of transition. Our framework allows us to better understand the evolution of Brazilian development over the past 50 years. We focus on Brazil because as we argued in the introduction, it has moved down the developmental road considerably in the past 50 years. It is one of the middle income countries, where at first blush, it is a puzzle that a greater number have not transitioned

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¹ By contextual we mean that there are many multiple paths to economic and political openness. We do not believe that it is best to first open up economically and then politically or vice versa. History has examples of either path as well as a relative balanced path between economic and political openness. Our book provides a detailed case study of Brazil from 1964-2012 which allows us to establish the importance of context and the heavy hand of historical institutional dependence. Our book complements and augments the recent literature on development and institutions by proposing a framework for understanding Brazilian development along with a detailed case study. In this regard we are following in the footsteps of many: Acemoglu and Robinson (2006, 2012); Eggertsson (2005), Greif (2006, 2012); Mokyr (2009); North, Wallis and Weingast (2009); North, Wallis, Webb and Weingast (2012) and Schofield (2006). There are also scores of articles on institutions and development. We differ from much of the literature which relies on historical examples of today's developed countries.

to more open economic and political societies, given that there are role models they could emulate.² By emulate, we do not mean that institutions can be directly imported but only that the leaders of countries have a good idea of some of the key ingredients that today's open societies possess: e.g. rule of law; clear, secure and impersonally enforced property rights; competent and honest bureaucracies; and open and competitive economic and political systems.³ Our framework consists of several interconnected key concepts that we will first define in a static context and then utilize to show how they produce a dynamic of institutional change or persistence.⁴ The key concepts include: windows of opportunity; beliefs and leadership. Our major contribution is wedding the concepts of windows of opportunity, beliefs and leadership to institutions, and economic and political outcomes.

II. Understanding Economic and Political Transitions

Today the primary role of institutions as defining countries that are on a sustainable trajectory of economic and political openness is now widely accepted in the literature (North, Wallis and Weingast, 2009; or Acemoglu and Robinson, 2012). But, though we know the differences in institutions between the most developed and the rest, we do not have a recipe for countries on how to transition from less open to more open economic and political institutions. We have analytical narratives on how the pioneer countries like France, the U.K. and the U.S. made their transitions.⁵ But, the developmental paths of these countries differed even though they ended up with more or less the same set of institutions. In short, we maintain that transitional paths are contextual and institutional change is embedded in different belief structures that define and limit the feasible set of institutions that any country can implement at a

² We return to the issue of role models when we discuss leadership. Greif (2006: 195-196) recognizes the importance of role models: "Such comprehensive changes are more likely to be attempted if there is a "role model, a known alternative institution with better outcomes..."

³ We are not arguing that there is recipe for development. There is not; the institutions of open societies emerged out of a process of changing beliefs over time and each country transitioned in a different way depending on their historical antecedents and political and economic endowments at the time.

⁴ Eggertsson (2005) analyzes the factors that can account for "imperfect institutions," by which he means that actors are aware of alternative institutions that would produce more economic growth. He lays the major blame on social models. We will return to this in our section on beliefs. Eggertsson (2005: p.151), Greif (2006); and Schofield (2006) are closest to us in arguing that experience and shocks shape beliefs/mental models.

⁵ North, Wallis, Webb and Weingast (2012) present an analysis of the developmental paths of countries that have not yet transitioned (with the possible exceptions of Chile and South Korea). The paths taken by all countries vary enormously.

certain time. But, if beliefs define and limit institutional changes what changes beliefs in ways that allow a country to embark on a new trajectory? In our framework we maintain that when economic and political outcomes differ from expectations, it creates a window of opportunity for changing institutions because the beliefs about institutions and outcomes become malleable. Moreover, it creates an opportunity for leadership to coordinate institutional change. Why? Because beliefs about how the world works changes when outcomes deviate from expectations. In such situations, coordination amongst the dominant organizations in society is critical for moving to a new trajectory because the dominant organizations actors may differ in their beliefs on how to change or maintain institutions to get desired outcomes. The dominant network may become fragile and porous and leadership during such window of opportunities could be decisive for whether a country embarks on a new path and, moreover, whether it can stay on the path.⁶ It is one thing to “give it a go” and quite another to sticking to it.

Our framework enables us to understand the fundamental transition that has been underway in Brazil from a closed, corrupt, clientalistic society to one that is driven by a belief in fiscally sound social inclusion. Generally, social inclusion ends up in populism with the “kids in charge of the candy shop.” This was Brazil from 1985 to 1994. On the other hand, fiscally sound policies (the Washington Consensus) are not politically sustainable in a democracy that has not yet transitioned to the list of developed countries. Brazil embarked on its trajectory towards a more sustainable open economic and political society by wedding social inclusion with orthodox monetary and physical policies. This belief has driven institutional change since 1994.

How Does our Framework fit in the Literature?

We want to explain why and how Brazil has embarked on a more virtuous trajectory. Our dependent variable is the process or dynamic of institutional change that produces more economic and political openness. Our framework relies on windows of opportunity as a crucial part of its dynamics. Although endogenous incremental change is an important part of those dynamics, punctuated endogenous or exogenous shocks are the central feature that sets into motion important changes in all the other elements of the framework. Equally important

⁶ Our use of the terms organization and particularly dominant network builds on the work on Wallis and North (2014) whose purpose differs from our analysis. They are interested in explaining the existence of government(s) and the role of impersonal rules.

continual supporting institutional changes must follow in the wake of the window of opportunity in order to be on the road to openness.⁷

The major goal of our book is to propose a framework for understanding the transition in Brazil, though we believe that the framework has greater applicability. Compared to the pioneer countries that have transitioned to open societies, there is a greater comprehension today of what is going on and a wider offering of tried and tested institutional alternatives. To stress this difference we use the term ‘window of opportunity’ rather than ‘critical junctures’ to refer to the large shocks that initiate a process of change.⁸ Although the difference may sometimes be subtle, ‘window of opportunity’ suggests that there is a chance for leaders and policymakers to purposefully react to the new circumstances to change institutions by coordinating competing beliefs to a focal core belief which forms an umbrella over institutions.⁹ In addition, most decision makers in the past acted to solve current problems without seeing that solving a particular problem, e.g., corruption in banking in the 19th Century U.S., could have downstream positive (or negative) effects. In our framework decision makers are both backward looking (in the sense of solving a current problem) and forward looking - they can foresee (never perfectly) downstream consequences.¹⁰ We view the inability to foresee downstream events not as probabilistic but as uncertainty in the downstream consequences in the way that Frank Knight viewed uncertainty, i.e., unknowable.

A critical juncture, on the other hand, conveys the notion of a shock in the more distant past to which rulers and citizens reacted with less understanding of all that was involved and a weaker notion of what could possibly be done. This does not mean that windows of opportunity will always be seized or that they will lead to the efficient changes, as leadership may be absent and the configuration of power is often such that growth-enhancing change is blocked. Also, whereas it is relatively easy to look back at history and recognize a critical juncture, it is not

⁷ Our focus on the importance of repeated supporting institutional changes has much in common with the formal model of Bidner and Francois (2013) who stress the role of repeated virtuous actions by leaders in order to transition to a democracy. We come back to this point in our sections on beliefs and leadership.

⁸ Acemoglu and Robinson (2012) use the term critical juncture to describe a discrete change in a country’s trajectory.

⁹ On core beliefs see Greif (2006) and Schofield (2006).

¹⁰ Eggertsson (2005); Greif (2006); and North, Wallis and Weingast (2011) are closest to our concept of window of opportunity in that the process is not a ‘big bang’ and must be sustained over a period of time sufficiently long to affect beliefs in the general population about how the ‘new’ world works. We differ in our stress on the forward looking ability of today’s decision makers because of the role models played by the pioneer countries.

straightforward to sort out which of the myriad events in a country's current life are consequential and may turn out to be realized windows of opportunity, and which are just full of sound and fury but will signify nothing tomorrow. The difference is the combination of a decisive action taken at time t when the window is recognized and the necessary downstream supporting institutional changes taken to affect outcomes and in turn beliefs. We maintain that all societies face numerous windows of opportunity, some big and some fall, and most are not seized. As social scientists we can look back and identify missed windows of opportunity. In the empirical sections of the book we will highlight missed windows of opportunity for Brazil.

Given that windows of opportunity are a chance that can be seized, who will do the seizing? In many instances realizing the opportunity requires leadership to perceive the situation, to propose what must be done, coordinate the effort and persuade the country to take the leap of faith. Many windows of opportunity go by undetected or unrealized due to the lack of leadership (which might be an individual or a group) to provide the necessary elements of change. The role of leaders is typically absent in the literature on institutions, but is often overplayed by historians and business scholars. We see a circumscribed, yet often crucial role for leaders as the catalysts during windows of opportunity.

The final distinguishing characteristic of our framework is the central role played by beliefs in the dynamics between institutions and outcomes. A central question in the literature on institutions has always been why all countries don't put in place good institutions given that they are widely recognized as the key to long-term growth. The standard answer is: new institutions have redistributive consequences that cannot be renegotiated due to transaction costs and commitment problems, such that those in power prefer to block the change and retain a larger expected share of a smaller pie. We agree that such social conflict issues are essential for understanding the process of development. However, this explanation requires that all economic agents can calculate without cost or mistakes the impact of each set of new institutions and rationally pick that which maximizes the discounted present value of the inherent rental streams. In the absence of such unrealistic powers of rationality, beliefs arise out of the need to interpret the way the world works. When assessing whether to pursue or block changes in institutions, those in power have to have a map in their heads of how each set of institutions leads to different outcomes. Beliefs are those maps or instructions, though they lack the specifics of a technical

manual. They provide an interpretation of cause and effect between how different institutions translate into economic and political outcomes. If the world were such that those maps varied little across different groups and circumstances, and that beliefs had a natural tendency to reflect reality very closely (when there even is a ‘true’ relationship between institutions and outcomes), then beliefs would not be very consequential. However, the diversity of human experience shows that interpretations of how the world works has varied dramatically across societies, so that understanding why particular institutions have emerged and persisted in specific countries requires careful and explicit attempts at understanding the country- specific core beliefs of those who are in power. In many societies there is not a widely held consensus across all organizations on core beliefs. But what matters for the establishment of formal institutions are the core beliefs of those in power. Whether there becomes a consensus depends in large part on the outcomes that the institutions produce, e.g. in democracies if the institutions produce outcomes that benefit more organizations they will gravitate towards the belief of those in power. Even in autocratic societies, organizations may not like the outcomes but those in power have the power to maintain the formal institutions and organizations in society come to realize that this is how their world works.

The Building Blocks of Our Conceptual Framework

Windows of Opportunity

Windows of opportunity are historical occasions when there is a chance to change the trajectory of a country’s economic and political outcomes by changing beliefs and institutions. We stress that windows of opportunity are decisive moments but rather a series beginning with an opportunity and ending with a change in the dominant core belief held by the dominant network and most citizens. Windows of opportunity begin when: 1) the rental streams fall short or exceed the expectations of members of the configuration of power; 2) a new member or organization enters the configuration of power because of an unanticipated economic and political shock; and 3) the beliefs of some members in the configuration of power change either because of the change in the economic and political outcomes or because of an exogenous event.¹¹ All crises are windows of opportunity but windows of opportunity do not require a

¹¹ For example, the recent financial crisis has affected the beliefs of many actors in the sanctity of the existing relative prices of securities or housing to reflect long run values. In short, many economists now believe that bubbles

crisis.¹² There are undoubtedly many windows of opportunity but it is the interaction among windows of opportunity, beliefs and leadership that matters. Windows of opportunity are not only “windows” for changing institutions; they are windows through which leaders can change institutions to make societies **more** or **less** open, economically or politically.¹³

Configuration of Power

In our framework political power means the ability to change formal institutions, e.g. the laws of a society, and during windows of opportunity, the potential to change informal institutions by influencing beliefs. We are interested in explaining the transition in Brazil to a more open but sustainable trajectory. Brazil fits the doorstep conditions for making the transition societies: it has solved the violence problem¹⁴; has rule of law for elites; and has numerous perpetually lived organizations. In Figure 1, we show how the nature of the configuration of power becomes more complex as development progresses. Panel A depicts an early stage of development, when there are few organizations (X, Y and Z) headed by elites (superscript E) and their clients (superscript C).¹⁵ The elites in each organization possess some form of violence potential, which they use to control their clients and possibly to assault and appropriate wealth from other organizations. A group of kingdoms is an example of this scenario.

can and do happen. This is no surprise to economic historians, several of whom have stressed financial bubbles. See in particular Kindleberger and Aliber (2011); and Neal (1993)

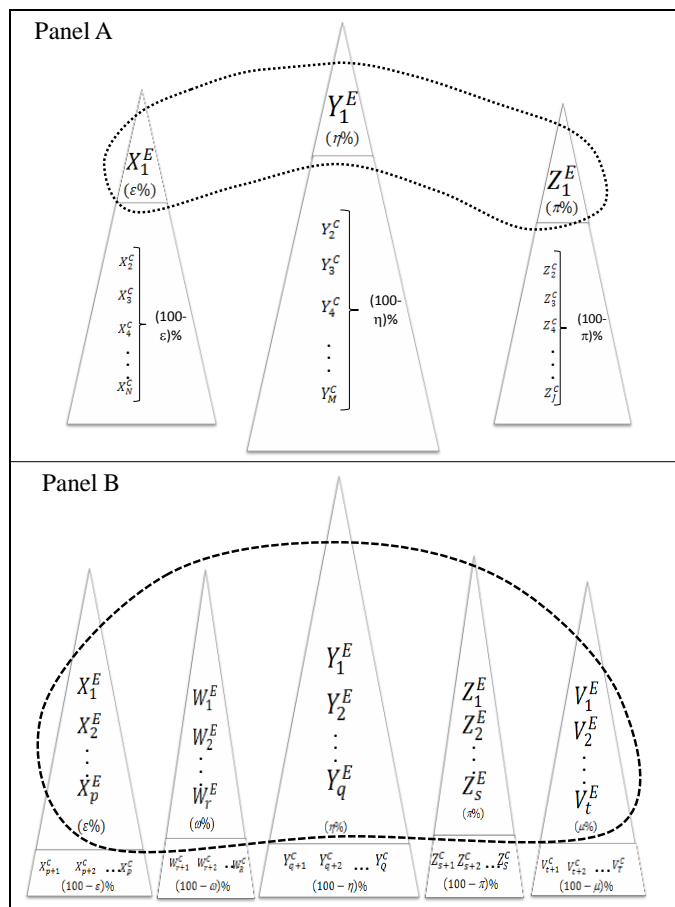
¹² The window of opportunity may be open for some time and awaiting a leader to seize the moment. This was the case of hyperinflation in Brazil which we discuss in Chapter 5. This also appears to have been the case in the dramatic changes in institutions put in place by President Rafael Correa in Ecuador (meetings of Alston with Correa and his ministers in July 2013). Bidner and Francois (2013) similarly do not rely on a crisis for a transition to democracy to begin. See Higgs (1987) for a convincing discussion of the important role of crises in the U.S. prompting and sustaining the growth of government.

¹³ This is consistent with Eggertsson (2005:151): “...opportunities for reform are created by real factors that upset the political balance, by real shocks and exogenous impulses that induce actors to revise their models..”

¹⁴ This is slightly different than North, Wallis and Weingast (2009) who argue that there is consolidated control over the military. In our view, the military can be leading a government but they simultaneously can be an agent of other organizations in the society. To this extent, there is control over the military.

¹⁵ Panel A is an adaptation and extension of Figure 1 in Wallis (2011). We also borrow some terms, such as ‘violence specialists’ and ‘adherent and contractual organizations’, from Wallis (2011). We borrow the terms dominant network from Wallis and North (2014). Network rather coalition stresses the multitude of relationships amongst those in the network. Not all of the members of the network are directly connected but they have a stake in sustaining the network to sustain their rents.

Figure 1 –Configuration of Power



The potential for increased productivity and economic gain from peace might prompt the organizations to establish a pact where each refrains from violence. The dotted line demarcates the dominant network formed by the organizations' elites. By refraining from violence each is able to reap greater rents than would accrue when violence was endemic. The dominant network is an adherent organization that will function only as long as the rents make compliance incentive compatible. Each individual organization, on the other hand, is a contractual organization that benefits from the third party enforcement provided by the dominant network, making it easier for each organization to control their own clients. The third party enforcement also allows for anonymous exchange among members of different organizations. The gains in specialization and productivity that can be achieved are limited, however, by the fact that the creation of rents which keeps the dominant network together requires entry into economic and political markets to be restricted. The barriers to creation of new organizations restrict

investment and innovation with deleterious consequences for long term economic growth. Furthermore, periods of peace and cooperation are often precarious as shocks that change the violence potential of any of the organizations may cause peace to breakdown until a new network can be formed through a new configuration of rents. Many countries remain endlessly stuck in cycles of this nature.

While some countries have been able to achieve considerable progress under limited access, historical experience suggests that there is a limit to how much growth can be achieved under such arrangements. A few countries, however, are able to develop an increasingly complex social organization that expands access into the dominant network, allowing for even further specialization and trade. This situation is represented in Panel B of Figure 1. Note that not only have new (economic, political, religious, and educational) organizations emerged, including a central government, but access to the rents in each organization has become more widespread.

While in Panel A the proportion of the population that is in the elite (parameters ε , η and π) is extremely small, in Panel B greater numbers have been granted access to rents and to the creation of new organizations. This incorporation can take place as a strategic decision by current elites during times of upheaval as a mean to preempt unrest and revolution (as in Acemoglu and Robinson, 2000 and 2006). Alternatively, greater access may take place when the creation of new organizations increases productivity and growth in ways that expand the rents that the current elites appropriate (as in North, Wallis and Weingast, 2009). In this process the rule of law and impersonal exchange may emerge within the elite network, creating a society where rents and privilege, while still present, are increasingly dissipated by economic and political competition among this extended elite. We will argue that Brazil is at this stage in the development process. By granting open access to the creation of new organizations to increasing proportions of its population Brazil has created circumstances for the Schumpeterian process of creative destruction that underlies the success of most developed nations' growth trajectory.

Brazil's configuration of power is now a complex network composed of myriad powerful organizations that influence formal institutions. Because of the plethora of organizations 'at the table,' our view of power is expansive; it includes all of the organizations that can influence the outcomes of the political process. It consists of both economic and political interests. Together the economic and political actors/organizations determine the formal rules of the game. In

today's world there are myriad of interest groups including environmental, health, economic, business and many other NGOs. For now we are not concerned with the factors determining what is in an individual or groups 'interest' but simply that some interests have power and others do not; power is a matter of the access to influence or shape institutions.¹⁶

In Brazil, citizens also matter because they vote. Politicians listen to public opinion because disregarding it could mean being voted out of office. But, the demands of interest groups get filtered through the political process in Brazil which includes a number of active parties, two legislative chambers, a President, with strong powers, an independent Supreme Court a relatively honest and competent bureaucracy and electoral competition. All of these forces combine to produce a *de jure* and *de facto* configuration of political power. It is this set of actors and their relative power that defines and enforces the formal institutions in a society. The institutions in a society are shaped by those with political power and their preferences, i.e., the outcomes that they would like to see but there is uncertainty about the precise impact of laws on outcomes. The actors/organizations differ in their beliefs about the cause and effect relationships between institutions and economic and political outcomes. It is the beliefs of the players, rather than their preferences that ultimately constrain and shape the institutions of societies.

Beliefs¹⁷

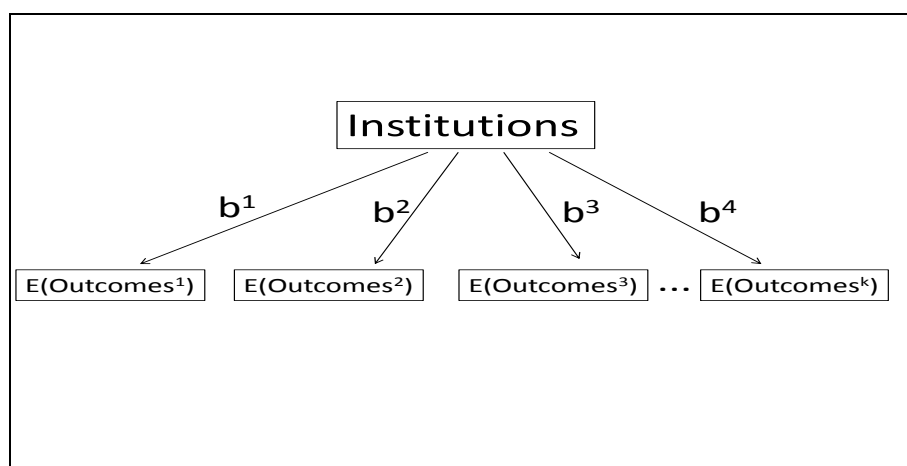
By beliefs we follow North (2005) who defines beliefs as the subjective views of actors about the way the world works. Beliefs are very different from preferences which are views about what organizations would like to see transpire whereas beliefs are about perceived outcomes from institutional change, though because the world is non-ergodic there will also be some degree of unintended consequences. Ultimately, beliefs about how the world works will shape the institutions that those leaders/organizations implement to achieve a desired expected

¹⁶ Wallis (2011) argues cogently that preferences; the range of choices; relative prices; and beliefs determine 'interests.

¹⁷ Greif (2006) has analyzed the role of beliefs and institutions in detail in a deductive game theoretic fashion. In equilibrium institutions must be consistent with beliefs but we are interested in beliefs during windows of opportunity. Similarly Schofield argues that most of the time, societies operate on a "core" set of beliefs but during "constitutional quandaries" core beliefs become fragile. It is the fragile moments that enable societies to change their trajectories.

set of political and economic outcomes.¹⁸ But it is not obvious which institutions will lead to the outcomes they want, given the constraint of beliefs about how others will act. This is important in the transition from one set of core beliefs to another. If there were some comprehensive manual mapping institutions to outcomes, those in power could look it up and see exactly which institutions they need to put in place to get the outcomes they want. But there is no manual; there is uncertainty about how things work and about the causal mechanisms between institutions and outcomes. As shown in Figure 2 a given set of institutions can lead to many different expected political and economic outcomes. The outcomes which are expected to emerge from a given set of institutions will depend on the beliefs of how institutions affect outcomes.

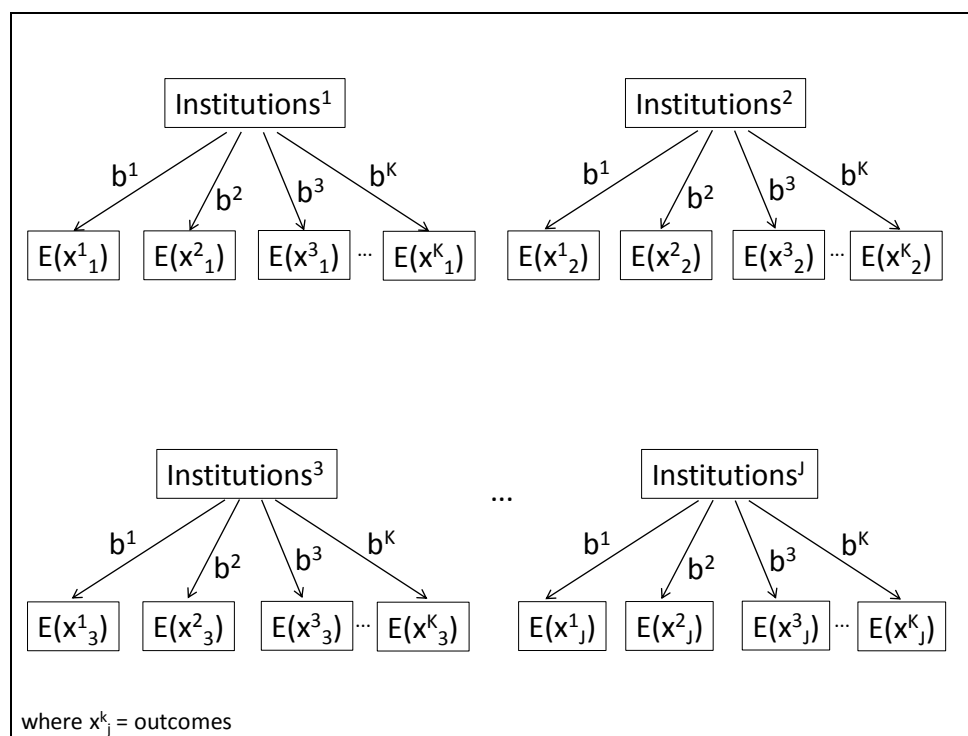
Figure 2 – Expected Outcomes given a set of Formal Institutions.



For the leader(s)/organizations in power formal institutions are a choice variable during windows of opportunities, although the choice process is quite complicated. In addition during some windows of opportunity beliefs can also be somewhat endogenous to those in power. It depends on the size of the window of opportunity and the fragility of the ex-ante beliefs. Figure 3 shows the full set of expected outcomes that can emerge from the full set of conceivable institutions.

Figure 3 – Expected Outcomes from all possible Formal Institutions.

¹⁸ This is consistent with Greif's definition of "internalized beliefs." He argues that internalized beliefs of those with power can motivate them to change institutions consistent with their beliefs.



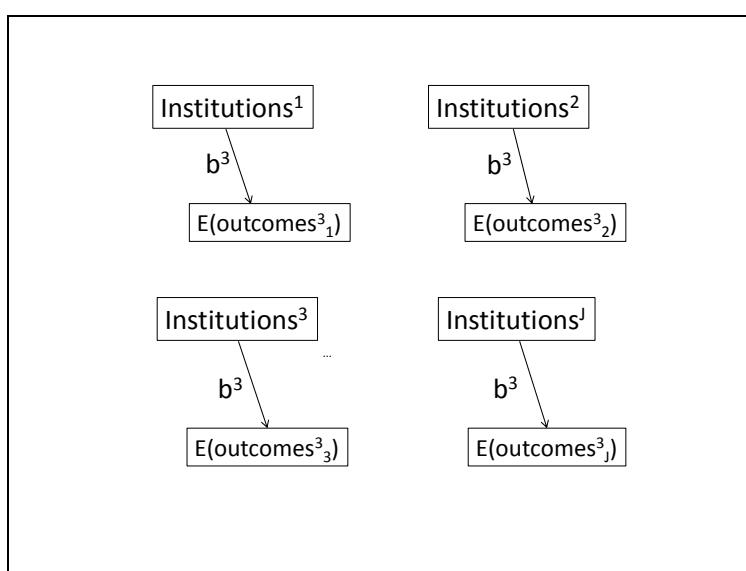
There are $j=1, \dots, J$ possible set of institutions, $k=1, \dots, K$ different sets of beliefs and expected outcomes x^k_j for each combination of institutions and beliefs. If it were clear how the world worked, then it would be easy to choose the institutions that lead to the best outcomes. But given the uncertainty it is not clear which branch b^k society is on. So those in power need some way to map –even though always imperfectly –from institutions to outcomes. Institutions shape choices that people make because they influence incentives. But, formal institutions are not the only influence on the choices that people make that determine outcomes. In addition to the unintended consequences from changing formal institutions, there are unintended consequences from informal institutions; and internal and external shocks which all play a role in the ultimate outcomes.

Beliefs emerge from history, experience, interaction and serendipity, though those in power have a greater scope to act on their beliefs.¹⁹ Once beliefs emerge the choice in institutions becomes tractable. Given belief b^k emerges, the group in power will choose Institutions^j , where j is the set of institutions that leads to the best expected outcome for them. If,

¹⁹ When outcomes are very different from expectations, beliefs change, at least for those in power, and a window of opportunity emerges for leadership. Schofield (2006) argues that Benjamin Franklin, acting on news that the French would support the colonies in their independence struggle with Great Britain, convinced the elite in the colonies to draft and sign the Declaration of Independence.

for example, given beliefs b^3 , $E(\text{outcomes}^3_3) > E(\text{outcomes}^3_i)$ for every $i \neq 3$, then the leader/organization in power would choose institutions that best fit their preferences. In Figure 4 beliefs b^3 have arisen and the choice of institutions is then a matter of picking those institutions which maximize the **expected** outcomes for the group in power. We stress that institutions never map directly into outcomes but rather those in power can choose the institutions that they believe will give the best expected outcomes.

Figure 4 – Choice of Formal Institutions given Beliefs.



Once those leaders/organizations with power choose and implement institutions, the outcomes that emerge have to match their expectations at least approximately or it will change the configuration of power, or the beliefs of those in power or both. The degree to which new formal institutions change outcomes depends on the extent to which they are compatible with the beliefs and norms of the economic and political organizations in society. If the beliefs of a sufficient number of organizations are firmly held, and inconsistent with the new incentives, the expected outcome for those in power will not materialize. Greif (2006) argues that the incompatibility of possible new institutions with the extant beliefs held by actors is a large part of the explanation for institutional persistence. We agree; but, if beliefs are malleable during windows of opportunity institutions will have a bigger impact on outcomes because norms may also change.

When expected outcomes do not materialize, there will eventually be a revision of the beliefs of those in power, or the dissatisfaction with the outcomes might, given a window of opportunity, lead to a punctuated change in the configuration of power, beliefs and institutions. We argue that experiences (political and economic outcomes) are the main factor shaping and changing beliefs of leaders/organizations in power as well as shaking the beliefs of citizens at large.²⁰

We are not proposing a full theory of the determinants of beliefs. Our goal is more modest. Like, North Wallis and Weingast, we argue that “the cultural environment- the political, economic, social context- fundamentally influences beliefs” (NWW: 262). It is the beliefs of those in power that matter the most because those in power face windows of opportunity and make the laws. Nevertheless, the beliefs of citizens do matter in Brazil and in many other countries. Indeed, the beliefs held by the citizens are a constraint on those in power. Those in power have preferences over outcomes but it is their beliefs that determine their actions. Our view on the role of beliefs in Brazil matches Mokyr’s view of the role of enlightenment in enabling the British Industrial Revolution:

To sum up: Britain became the leader of the Industrial Revolution ... thanks to the synergy of the Enlightenment: the combination of the Baconian program in useful knowledge and the recognition that better institutions created better incentives (Mokyr, 2009: 122).

According to Mokyr (2009: 40): “Enlightenment beliefs followed in the footsteps of Bacon’s idea of understanding nature in order to control her...” It was a belief that with the application of useful knowledge, a country could progress over the status quo. The application of knowledge in turn needed institutions that promoted ‘progress.’ At the time this was a new belief and, a belief not shared by all powerful actors at the time. It is the very nature of subjectivity of beliefs that gives rise to different views about the impact of institutions on outcomes. For a modern example, following the financial crisis of 2008, there is a lively debate amongst economists, politicians, and other interest groups about the impact of a stimulus plan versus an austerity plan for

²⁰ Our view is very similar to Eggertsson’s definition of a policy model: “Policy models are the operational models that guide decision makers, whether in the private or public sphere. Policy models define for the actor his or her choice set, rank the elements in the choice set, and describe relationships between means and ends (instruments and targets)” (Eggertsson, 2005: 26).

promoting recovery.²¹ The actions that get taken result from the relative power of the actors and beliefs of those with the power, as well as the role of leadership.

In today's modern world the political and economic actors can have a more forward looking view of beliefs because there are role models. Whereas the pioneer countries were trying to solve problems in light of their past experiences, today's countries can draw on the experiences of the already developed world for some of their beliefs. Not only can those in power draw from these experiences, but in some instances they do so inappropriately for a particular country. This was the problem with blindly relying on the "Washington Consensus." The failure of the consensus to work in certain countries most likely was a result of the incompatibility of the rules/incentives with the beliefs held by citizens. We stress that learning from other countries does not mean that the implementation will have the same effect, but nevertheless, it can affect not only their "belief" but the depth of their belief, which determines how long those in power will hold on to the cause and effect relationship. For example, if those in power want to control inflation there is a consensus that this is easier to accomplish if the central bank has independence from political pressure. So far, we have simply posited that beliefs shape actions, but if beliefs shape institutions it is paramount to posit how beliefs change, at least on the margin. We will do so later in this paper when we discuss the dynamics of the framework. For now we posit that belief-deepening depends on outcomes and the actions taken by others, including the support of citizens.²² Belief deepening is also iterative between the institutions established by those in power and the perception of the outcomes by organizations and citizens.²³

²¹ This is written in 2014 in the shadow of the 'euro crisis' and persistent high unemployment in the U.S. and across many countries in Europe.

²² For examples of how belief deepening depends on the outcomes being consistent with the prediction of those in power, who first held the belief see Bates, de Figueiredo, Jr. and Weingast (1998), who examine Zambia and the former Yugoslavia; Eggertsson (2005) who analyzes the persistence and eventual change in beliefs in Iceland; Rakove, Rutten and Weingast (2000), who examine beliefs in the colonies leading to the Revolutionary War between the North American colonies (U.S.) and Great Britain; and Greif (2006) who examines beliefs in the context of Medieval trade.

²³ On the importance of the dynamics for belief deepening we are consistent with Bidner and Francois (2013).

Leadership²⁴

Leadership is a relatively absent concept in frameworks of institutional change.²⁵ By leadership we mean that certain individuals at certain moments in a country's history make a difference because of their actions. The counterfactual is that if someone else or another group of people were in the same position of power with the same beliefs, the forthcoming institutions could have been different. Our view is akin to the 'structural theories' of leadership and most similar to leadership as espoused by Schofield (2006). Ahlquist and Levi (2011:8) cogently describes Schofield's concept of leadership:

For Schofield, pivotal moments in history—what he calls “constitutional quandaries”—occur when core beliefs no longer conform to reality or, slightly more formally, when there is extreme variation in individual assessments of the appropriate action relative to the common, shared understanding. When these moments occur, small shifts in the beliefs of a few may trigger a cascade that results in an entirely different configuration of beliefs. A leader is the agent most likely to trigger such a cascade. According to Schofield, “architects of change” must do two things: (a) communicate a model of the world in which there are specific outcomes associated with differing courses of action and (b) convincingly advocate a specific outcome.

We differ from Schofield in that we do not believe that beliefs change in a “cascade” but rather deepen depending on outcomes consistent with the beliefs initially held by a “few.” We agree that leaders start the process because they hold beliefs about institutional changes that can set the country on a new trajectory. This change in trajectory is just a start and must be reinforced over time. We are not arguing that leaders simply impose beliefs from the top down but rather leaders sense and articulate what is likely a latent belief held by many.

²⁴ We thank Avner Greif, Patrick Francois and Barry Weingast for discussions on the roles of leadership and beliefs. For an excellent analytical survey of recent contributions to literature on leadership, see Ahlquist and Levi (2011).

²⁵ Exceptions include Bidner and Francois (2013) who model the interaction of leaders and citizens in transitioning to democracy; Greif (2006: 201-202) who discusses the importance of “institutional entrepreneurs,”; Harberger (1993) who strongly argues that leadership mattered enormously for the economic reforms in Latin America; Higgs (1987) and North (1981) who discuss “ideological entrepreneurs (for Higgs in times of crisis); Jones and Olken (2005) who use deaths of leaders as an exogenous change in leadership and find that leaders matter for economic growth; and Schofield (2006) who argues that during “constitutional quandaries” leaders can influence the shift to a new core belief. Schofield posits that Benjamin Franklin, James Madison, Thomas Jefferson, Abraham Lincoln and Lyndon Johnson were “architects of change” (leaders). Leadership has been recognized by the “Austrian” school as entrepreneurship but for the most part has been applied to business organizations not political organizations. See Wagner (1966) and Frohlich, Oppenheimer and Young (1971) for a role for political entrepreneurship. Political scientists have elaborated on leadership but mostly in the context of principal/agent models. See Fiorina and Shepsle (1989) for a discussion of formal theories of leadership in which they discuss the strengths and weaknesses of principal/agent models.

The fact that history is replete with the mention of individuals lends considerable anecdotal weight and circumstantial evidence to our argument that certain individuals *did* make a difference. Leadership comprises several non-mutually exclusive concepts: 1) Cognition; 2) *Heresthetics* or Coordination; and 3) Moral Authority.²⁶ Before one can be a leader, he has to cognitively be aware that a window of opportunity exists. In addition he must know how to take advantage of the window of opportunity. In short, cognition entails being able to address two questions: What is the problem or opportunity that we face? How can we solve the problem or take advantage of the situation? This should not be construed that we have leaders who can perfectly foresee all downstream consequences but only that they see the problem and have a provisional ‘game plan’ on how to both correct the problem at time *t* and understand that they will have to react to downstream consequences in unforeseen ways to sustain the solution to the problem at time *t + n*. Indeed, without downstream institutional deepening the initial ‘big bang’ would not produce long run benefits. It is the combination of the initial institutional change which, if successful, affects beliefs in a way that will enable later institutional changes. Leaders also never act alone; it is the orchestration of other powerful organizations that allows the initial change to take place and subsequent institutional deepening. Another way of putting it is: if the initial institutional changes produce outcomes that benefit extant organizations or create new organizations that win, the beneficiary organizations now have a stake in sustaining and deepening the new institutions.

An example from business is Amazon.com.²⁷ Jeff Bezos founded Amazon and went online as a bookseller in 1995. This was a very different way for consumers to purchase books and many pundits at the time did not envision the success of Amazon. Did Amazon succeed and become the world’s largest on-line company by one change –selling books on-line? No, they got their start with a big idea; selling books on line because they could offer consumers a larger inventory than any bookstore. But, they succeeded because they moved into selling a myriad of goods and even services: electronics, apparel, beauty supplies, clothing, jewelry, groceries, ‘cloud’ storage for data, *inter alia*. Moreover, a large percentage of what Amazon sells is produced by other companies who find it in their interest to use Amazon as their intermediary.

²⁶ See Greif (2012) for the leadership roles of cognition, moral authority and coordination, especially chapter 3.

²⁷ Most of the information in this paragraph comes from a series of daily articles in the *Financial Times* July 9-13, 2013.

Other retailers find that they can make more money, even after paying Amazon, by listing their products on Amazon and using Amazon's web platform. Why? Because Amazon receives more 'hits' and sells more products in terms of value than any other on line merchant. Indeed, the value of Amazon's sales is slightly larger than the next ten biggest on line merchants. So, the success of Amazon can be credited to the initial and continued leadership of Jeff Bezos and others at Amazon. First, the big change of selling books on line and then by the downstream changes into other products and most importantly an efficient web platform such that it became in the interest of other retailers to sustain the growth of Amazon. Jeff Bezos in 1995 did not have a vision of the huge platform that sustained his success but he did have the cognition to recognize the opportunity to successfully sell books on line in 1995 and the downstream cognition to sustain further changes in his company that importantly increased the number of other retailers that now had a stake in Amazon.

But, cognition is not sufficient. As recognized by Wagner (1966) political entrepreneurship is needed to overcome the free rider problem associated with collective action.²⁸ We refer to entrepreneurship, following William Riker (1996: 9), as *heresthetics* which Riker defined as: "the art of setting up situations –composing the alternatives among which political actors must choose- in such a way that even those who do not wish to do so are compelled by the structure of the situation to support the heresthetician's purpose." *Heresthetics* involves strategy especially dynamically in the course of decision-making.²⁹ There are two aspects of "dynamic": 1) the art of compromise in the interest of getting most of what you want; and 2) staying the course temporally in order to solidify beliefs. *Heresthetics* is the "**art**" of policymaking and is not justified by ex-post rational choice and could certainly not be designed ex-ante by a mechanism design approach. Successful leadership entails cognitive ability of knowing what to do along with the coordinative ability of getting others in power to go along.

Leadership can be in a leader's and his supporters' narrowly construed self-interest but leaders at times can take reputation or 'moral' rents into account (Greif 2008). Some leaders try to do 'the right thing' for their country by 'playing for the history books. Harberger (1993) argues that several Latin American leaders from 1960s to the 1990s took courageous steps to

²⁸ Indeed as we argue in Chapter 4, President Collor recognized the problem of inflation but did not possess the coordinative ability to quell inflation.

²⁹ Riker (1983 and 1996) applies *heresthetics* it to the establishment of the electoral college and the ratification of the U.S. constitution.

help their economies with unselfish motives driving them. In addition to seeking ‘moral’ rents, some leaders have moral authority either because of their past or because they earned it. Moral authority does not necessarily make heads of state ‘leaders’ but it gives them legitimacy which in turn can induce a public to trust their motives which may lead more readily to accepting new beliefs during windows of opportunity.³⁰

Leadership can change the trajectory of a society for better or worse. Leadership is only an important concept when there are windows of opportunity. For much of the time, countries are on “auto-pilot” such that the rental streams are within a tolerable band to those in power so that there is no reason to rock the boat by changing institutions in a big way. We are not arguing that all you need for development are ‘great’ leaders but rather, that individuals and certain organizations at times make a difference. For example, if this was not the case, there would be no need to discuss France without Napoleon; the U.S. without George Washington; Great Britain absent Churchill; China after Mao and with Deng; Argentina after Peron or in our case Brazil after Cardoso. We believe that these individuals along with their allies made a difference. Similarly there are today discussions about Cuba after Castro; Venezuela after Chavez; Korea after Kim Jong I; and Egypt after Mubarak. If individuals did not matter then these discussions are pointless.³¹

Institutions

We follow in the now standard tradition of North (1990) by defining institutions as the formal and informal “rules of the game,” along with enforcement for non-compliance, that shape behavior. Formal institutions include the laws of society and how they are enforced. In Brazil laws are passed by Congress and approved or vetoed by the President. In Brazil laws are passed under the shadow of the Supreme Court.³² Together formal institutions and informal norms

³⁰ Nelson Mandela in South Africa or Vaclav Havel in the Czech Republic commanded moral authority because of their time spent in prison. On the role of legitimacy in England of Kings to use parliament for legitimacy see Greif and Ruben (

³¹ We recognize that the exit of certain individuals may simply be a tipping point and that many other underlying economic and political organizations may have already changed. This appears to be the case for Cuba which has now embarked on reforms. As of this writing, the exit of Mubarak has not produced significant changes in the powerful economic or political organizations.

³² The size of the shadow of the court varies from country to country. For example, in Argentina, from 1946 to 2010, every administration but one (de la Rúa) has either impeached Supreme Court Justices, forced resignations or added

provide the incentive structure for economic, political and social actions. Norms are also institutions but they differ from formal institutions in that there is not an explicit sanction for norm non-compliance.³³ By the incentive structure we mean the perceived reward structure faced by all individuals in political activity, in market activities, and within firms and other internal organizations. The perceived rewards vary enormously across individuals in political and economic activities. The perceived rewards, and the actions undertaken produce economic and political outcomes some of which may be consistent with the underlying beliefs of cause and effect as expected by those in power and others inconsistent with the beliefs of the designers of the formal institutions.³⁴

The laws that countries pass will frequently entail political or economic side-payments. When the side-payments are transparent we call the process lobbying or ‘pork.’ When the process is not transparent we label the process ‘corrupt.’ Whether it is pork or bribes, many policy makers condemn these practices but, as North, Wallis and Weingast (2009) point out, they are the glue that prevents the entire system from unraveling into violence in less mature societies. For advanced societies, the ‘pork’ may enable welfare enhancing measures and eliminating pork may make policy change impossible (Alston and Mueller, 2006). In the process of institutional change in Brazil, we need to recognize the important developmental role of “pork” and in some instances ‘corruption.’

Economic and Political Outcomes

The institutions of societies generate incentives for economic and political activity which in turn produce economic and political outcomes. Again we recognize that it is not simply formal institutions that determine the full set of incentives; norms matter as well as the differing relative prices or costs of taking certain actions – which in turn depend on institutions -and the perception

Justices (Alston and Gallo, 2010). This has led to little if no constraints on the executive and legislative branches. Informal institutions include the norms of behavior within a society.

³³ For norms to affect behavior either: a majority of people follow the norm because other people also follow the norm, e.g. a norm of reciprocity; for the minority who do not follow the norm there can be social sanctions, e.g. some form of ostracism. For more on the distinction between norms and formal institutions see Alston, Mueller and Nonnemacher (2014).

³⁴ Deep seated behavioral and internalized beliefs (as defined by Greif 2006) may often be the cause for why the outcomes deviate from policymakers’ belief. In short the set of beliefs held by those in power about how a new institutional change will affect expected outcomes deviates from the actual outcome because the actors in society hold onto their set of beliefs which differs from those in power who can change the rules.

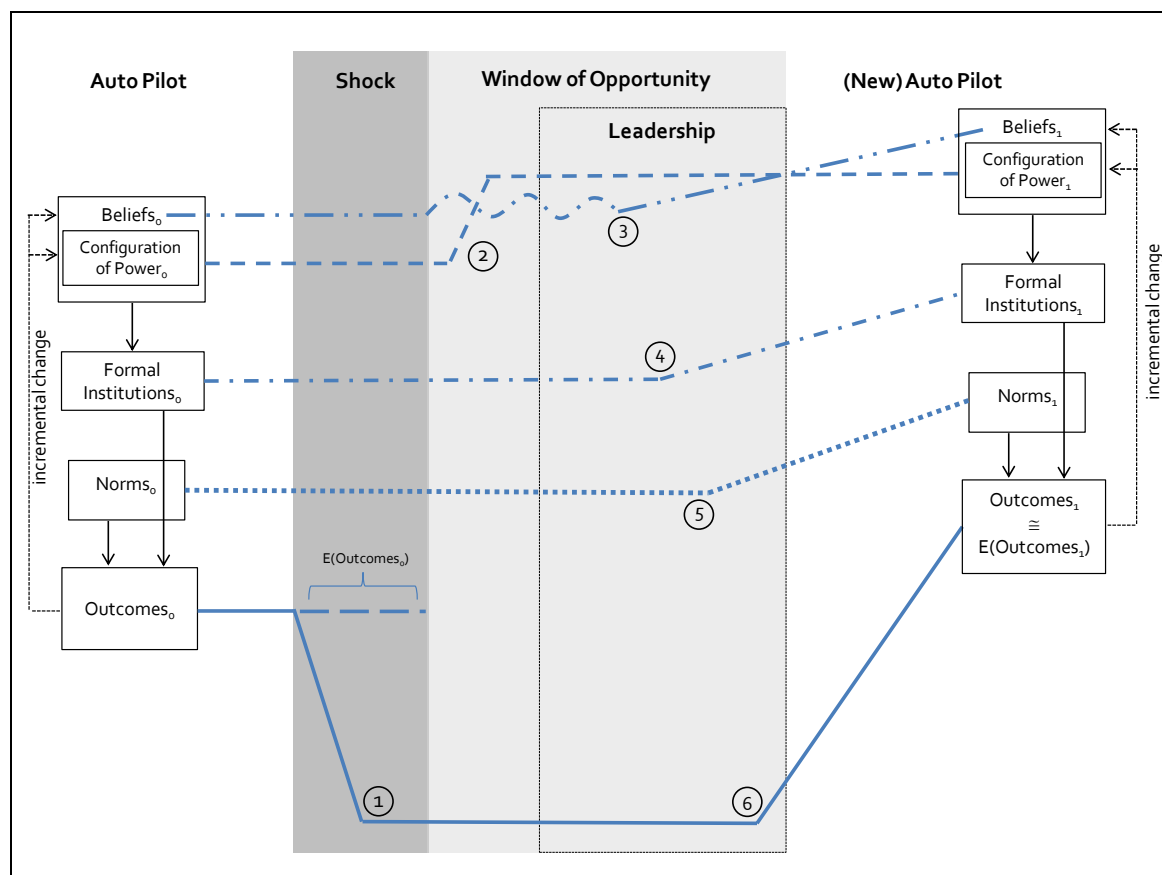
of actors of the outcomes from choices. It matters for those in power if the outcomes are consistent with their beliefs because they enact institutions to change incentives which in turn will produce outcomes that they perceived as beneficial for their goals. Political outcomes include narrow outcomes, e.g., politicians want to get re-elected, and broad outcomes, e.g., the degree of personal freedoms in a society. Economic outcomes, as well, are narrow and broad, e.g. did import protection increase the profits of a particular industry? Or, broad, e.g., how did policies impact unemployment levels, economic growth per capita and income inequality? The economic and political outcomes can have two effects. If they are sufficiently different from expectations or repeatedly different from the expectations they can affect the beliefs of those in power.³⁵ In addition to affecting beliefs, the political and economic returns can change the relative power of the economic and political actors. It is the change in beliefs or the change in power that generates the *dynamics* in our framework, producing either incremental institutional changes or more discrete large institutional changes when a window of opportunity opens along with the necessary leadership.

Dynamics

Now that we have the elements we can discuss in broad terms the dynamics of the framework, which is summarized in Figure 5. The left-hand side of the figure represents a society at some moment in time when there is relative stability in terms of the configuration of power, beliefs, institutions, and outcomes. This situation is labeled as being in “auto-pilot” to indicate that during this period there is generally no role for leadership as we defined it. There are people in charge of government and organizations, but they do not affect beliefs except in indirect and incremental ways. The world that the players face is never static so they always take some actions to change some institutions on the margin, though others they leave as fixed. The x-axis represents time and the y-axis represents changes in the components of our framework, i.e., beliefs, power, formal institutions, norms and outcomes.

³⁵ This is consistent with Eggertsson’s (2005) argument that experiences affect social/policy models.

Figure 5 – The Dynamics of Development



Many institutions remain fixed because the incentives that the institutions produce generate outcomes that produce a sufficient rental stream to the organizations such that they see no reason to “rock the boat.”³⁶ For other institutions they tinker on the margin. They make decisions, e.g. pass laws, issue decrees, and render judicial decisions, *inter alia*. All of these institutional modifications change incentives on the margin but do fundamentally affect beliefs. We are in a world which Greif (2006) argues the institutions are consistent with the beliefs of economic and political organizations.

Beliefs about the impact that the institutional changes will have on incentives and in turn outcomes determine the institutions put in place, though the institutions also produce some

³⁶ Eggertsson (2005) argues that for centuries Iceland held on to “imperfect institutions” because they benefited the agricultural elite. He argues that they held a misguided partial equilibrium social model. The landed elite feared that fostering fishing would drive agricultural wages up. They neglected to see that ‘a rising tide, raises all boats’ i.e. reaping the benefits from fisheries would foster economic growth sufficiently to increase the rent for landowners as well.

unintended consequences, sometimes small and sometimes large.³⁷ To the extent that the overall outcomes produce adequate rents to the players in the configuration of power we will not see ‘big’ institutional changes and societies may cruise along in this “auto-pilot” mode for decades.³⁸ Societies function and operate under a belief system of: “this is the way our world works.” The system is meeting the expectations of those in power as well as citizens; it is like a tide that washes over society. The belief system is predictable and is sustained by the social fabric of society, i.e., familial, religious, social and cultural relationships. In such a world, outcomes are consistent with expectations so there is no one in a position of power to push for big changes nor do actors outside the configuration of power question the legitimacy of the extant institutions.³⁹

But, at some historical moment, the cumulative effect of small changes reaches a tipping point, or there is an exogenous shock, either internal or external to a country, which creates a window of opportunity. The shock is shown in Figure 5 with time moving from left to right. The lines that emanate from each concept represents change when it moves either up or down, and stability when it remains flat. At this level of generality we are not interested if the change was positive or negative, but simply whether something has changed or not. When a shock takes place the only thing that changes in a first moment are the outcomes, which now no longer match expectations (see (1) in Figure 5).

If this effect is large enough it may create pressure for change, leading to a window of opportunity. As shown in Figure 5 in a window of opportunity there are changes in outcomes that produce changes in the organizations in power, beliefs, leadership and ultimately institutions. The way these changes take place depends on the country and the situation and there are infinite possibilities. As drawn in Figure 5 the first element to change is the configuration of power with some (or all in extreme cases) of the previous organizations/individuals being substituted. This can take place through riots, revolution, impeachment, elections or any other

³⁷ Unintended outcomes result from a myriad of forces: formal institutions alone do not feed directly into outcomes; norms matter as well as the relative prices of choices faced by organizations. See Wallis (2011).

³⁸ This is analogous to how most of us live our lives. Most of us operate according to certain routines and it takes something out of the ordinary, e.g. a heart attack, to cause us to fundamentally change our way of life, though again we tinker on the margin.

³⁹ The rents are sometimes termed ‘corruption’ but they are necessary to sustain the social order. In advanced countries legitimate ‘pork’ plays the same role. For example, many pundits bemoan the use of earmarks in the U.S. or ‘pork’ in Brazil yet they are part of the political and economic process that produces institutional changes and allows the society to make some other wealth enhancing gains. We recognize that pork and corruption do not always produce institutional change; frequently pork and corruption sustain a redistributive function.

means (see (2) in Figure 5). Tipping points seem most likely in the case of mass movements, e.g. the demise of the Soviet Union and successful tipping point transitions are not common.⁴⁰ The economic/political system no longer meets the expectations of those organizations in power or citizens for a variety of reasons, some endogenous to the system and other external shocks.

In these moments the beliefs of some of those organizations in power about the cause and effect relationships of policies may change. This represents a window of opportunity to begin a transition though transition may take years or decades to complete and may need to be affirmed by successor to the administration in power.⁴¹ As the previous understanding of how things work decays and is not substituted by a new set of beliefs, there is uncertainty about which new institutions should be put in place to achieve the desired outcomes. The wavy line at point (3) in Figure 5 represents the uncertainty in the beliefs of those in power and or the citizens in general.

It is in such situations that leadership may become relevant. In Figure 5 leadership comes into play within the window of opportunity when beliefs have become uncertain. After point (3) a new set of beliefs is in place. Change happens ultimately because beliefs about the way the world works have changed. In rare cases the new beliefs simply emerge as a result of the shock, but in others they can be purposefully influenced by leaders.⁴² Not everyone changes their set of beliefs simultaneously and some organizations in power may never change their beliefs. But if leaders can exercise cognitive and coordinative roles, a big institutional change affecting the trajectory of a country is possible. Schofield (2006) argues that Madison and Hamilton played this role in the ratification of the U.S. Constitution in writing the majority of the Federalist Papers which swayed voters in their belief for a larger role for the federal government at the expense of the power of states. In Figure 5 the change in beliefs leads to new formal institutions (point (4)) and also to new norms or informal institutions (point (5)). These changes in turn affect the incentives faced by individuals and organizations affecting in turn their choices. All of this leads to new outcomes (point (6)), which now once again match expectations. In the right-hand side of the figure the society is once again in “auto-pilot”, which means that leadership or

⁴⁰ On tipping points in the former Soviet Union see Kuran (1995).

⁴¹ We argue in Chapter 6 that Lula being from the opposition party sustained the transition to the new set of beliefs set in motion by Cardoso. Bidner and Francois also stress that changes in beliefs require a change in the configuration of power to affirm that governments are now different.

⁴² In some situations the shock was sufficiently large that no matter who was in power the actions taken would have been similar. As an example, after 9/11, every conceivable President in the U.S. would have vowed to “hunt down” Bin Laden.

changes in beliefs are no longer a major source of incremental institutional change. Compared to the situation before the window of opportunity there are new beliefs, new organizations in power, new institutions, new norms and new outcomes. The outcomes might be better or worse than before but are stable in the sense that they accord with what is expected. The outcomes will naturally vary over time as they are affected by small internal and external shocks, leading to incremental changes in beliefs and organizations in power (see feedback loops from outcomes to beliefs and configuration of power in Figure 5). Occasionally large shocks or endogenous tipping points might lead to new windows of opportunity and the process may repeat, though usually within a different context and with different details. Note, however, that there is no reason to expect that with each new cycle the country will be more open and developed. On the contrary, the historical experience suggests that such trajectories are rare, and countries are more likely to shift from one underperforming state to another or to cycle forward and back without much overall long-term improvement.

The key element in the dynamic is the change in beliefs. When beliefs become uncertain, some leaders can sway which beliefs get acted upon in terms of the institutions that get established. This can come about through the “art of policymaking.” If the new institutions produce incentives that in turn generate outcomes that are viewed as ‘good’ or consistent with the subjective view of the way the world works as expounded by the organizations that implemented the institutional change, then beliefs about the causal role of institutions on incentives and on outcomes deepens.⁴³

For example, in Brazil, during their initial ‘miracle’ years, there was a belief in the mid-1960s until the late 1970s held by the majority of the business elites and the political elite in power (the military government) that ‘developmentalism’ increased the size of the economic pie for Brazil.⁴⁴ Increasing the size of the pie was more important than the distribution of the pie; concerns over distribution would come later. Consistent with this belief was the central planning role of the military along with some degree of authoritarianism and censorship. Of course not all

⁴³ For example, Rakove, Rutten and Weingast (2000) argue that prior to the Revolutionary War between Britain and her North American colonies, only a minority of those in power in the New England colonies “believed” that Britain would take away the liberties of the colonists. Actions taken by British, including the quartering of troops in New England and the disbandment of the Massachusetts legislature, gave credence to the beliefs of the New Englanders and overtime this belief in ‘the British will take away our freedoms’ propelled the colonists to take up arms against the British.

⁴⁴ In Brazil ‘developmentalism’ meant state run technocratic planning.

elite groups held this belief. The intellectual left and the unions did not hold this belief but these individuals and organizations did not have sufficient power to change the prevailing *de facto* belief in the face of a system that produced double digit economic growth. Only when growth slowed down in the late 1970s did the majority of economic organizations begin to question their belief in ‘developmentalism’. This change in beliefs by the business organizations proved crucial for bringing down the military, and bringing in its wake a belief in social inclusion, i.e., a more open and participatory political system. With a lag the economic system became more open which we discuss in Chapter 5.

The beliefs of the benefits from change do not happen in a vacuum: those in power (and at times, citizens at large) can view the impact of institutions (and their resulting incentive structure) around the globe, e.g., an independent judiciary, secure property rights or less trade protection. In addition many of the economic and political elites acquired part of their education in wealthy countries which shaped their beliefs and their perceived benefits of importing institutions, though with modifications to suit their needs. Knowledge of institutions from the outside world also allows leaders more conviction “to stay the course” when there are upfront costs for downstream benefits from institutional change.

During a window of opportunity it is the competing and incompatible beliefs amongst organizations within the configuration of power, either the new players or old players with new beliefs, that brings about the potential for new institutions that change incentives and (at times beliefs) and move a society towards a more open political and economic society.⁴⁵ In such a situation, competing powerful organizations are constrained by the beliefs of each other and their relative power. A new set of institutions emerges through leadership (which could be a consensual group of organizations) in the Riker sense of coordinative activity that enables a new belief system to take hold amongst a winning network of organizations. In the case of Brazil, the winning network following the military government consisted of business organizations, who were disappointed in the slow rate of growth, some centrist politicians at the state and local level,

⁴⁵ Competition only brings about the “potential” for moving to a more open society. It depends on the beliefs of those who win the competition for power. Our concept of “windows of opportunity is similar to that of Acemoglu, Johnson, Robinson and Yared (2008) who argue that economic growth does not necessarily lead to democracy and whether it does they label a critical juncture. They reach this conclusion after an econometric exercise which convincingly demonstrates that country specific effects make the difference. The difference between a critical juncture and a window of opportunity is that in a window of opportunity the actors realize the potential and are forward looking.

and the “social reformers,” consisting of the union leadership and “intellectuals” (academics, artists and others who opposed the censorship of the military).⁴⁶

Leadership entails orchestrating powerful groups to react to the perception of a problem and that the perceived solution to the problem is shaped by the beliefs of leaders about the likely consequences of the new incentives emerging from the new institutions. In this sense our actors are both forward and backward looking.⁴⁷ Here is where today’s threshold countries, like Brazil, can learn from the experiences of countries that have already transitioned to open societies. Of course those in power can’t perfectly foresee the outcomes of their actions but they can make an educated prediction.⁴⁸ In addition today’s leaders recognize that a ‘big bang,’ e.g., the dissolution of the former Soviet Union, is not sufficient for development but it was necessary. As we stressed earlier, the ‘big bang’ must be sustained with complementary changes in beliefs along with further downstream institutional deepening. All leaders can foresee is that putting in place certain incentives – through institutional change – will have some likely foreseen outcomes and some unforeseen outcomes. Leaders must be responsive to downstream unanticipated consequences. North (1990) referred to this process as ‘adaptive efficiency.’⁴⁹ Of course knowing what to do differs from the incentive to change. In many countries it is in the economic and political interests of the dominant network in power not to open up. Not everyone wins with creative destruction from open markets. But, our point is that it is not a cognition issue as it may have been 150 years ago when the belief in protecting ‘infant industries’ still undergirded many policies.

Opening up either politically or economically is problematic because the future has uncertainty. Some groups will lose, e.g. the military elite in Brazil in the mid-1980s. Moreover, generally opening up the economy entails considerable upfront costs, e.g., stabilization policies typically have short-run costs with long run benefits. This means giving up political and

⁴⁶ In the empirical chapters, we discuss the leadership roles played by different individuals and organizations.

⁴⁷ This differs from the North, Wallis, Weingast (2009) view where the actors are primarily solving extant problems and not as forward looking as today’s leaders/organizations can be. But, we agree with North, Wallis, Weingast that actors are solving current problems, the difference is that today’s leaders can be more forward looking because of the experiences of other countries.

⁴⁸ Of course this does not dismiss the role for unintended consequences of which history redounds.

⁴⁹ In this sense our actors are forward looking, similar to the Acemoglu, Johnson, Robinson (2005) versions of England and Spain responding differentially to oceanic trade. In other versions of Acemoglu and Robinson (2006; 2012), the elites are forced by citizens to give up rents. We believe that citizens have a greater role to play in the developmental process in proportion to the extent that the rule of law pertains to a greater percentage of citizens.

economic rents in the short run for some unknowable but perceived ex-ante increase in rents in the future for society as a whole, though with unforeseen distributional consequences. Part of the solution to development is recognition that a winning political network of organizations foresees more advantages from promoting openness than the extant status quo. This is why windows of opportunity are so important. As we will see, the *Plano Real* (the stabilization plan of 1993) succeeded in part because after a series of hyperinflationary periods and failed stabilization plans, those in the winning network in Brazil believed that taming inflation was the number one priority for Brazil in the early 1990s. Enacting political and economic institutional changes requires some risks to those in power and this is where the leadership of Cardoso and his economic team mattered. Opportunities present themselves but not all potential leaders take advantage of the opportunity, either because: they lack the perception to see the opportunity; they perceive an opportunity but lack the knowledge of what to do; or they lack the art of policymaking in the dynamic sense expounded by Riker (1984, 1996).

Recognizing a role for leadership is a departure from the standard economic and political rational choice models consisting of “representative agents.” We recognize that this leads to a certain degree of arbitrariness which is why analytical narratives entail thick description in the same way that courtrooms need to rely on circumstantial evidence when there is not a ‘smoking gun.’⁵⁰ Windows of opportunity allow leaders to affect institutional changes that can lead to incentives that produce less or more political or economic openness than the previous order. Windows of opportunity are not unidirectional in proceeding from less to more openness; the reverse is equally likely. For example the revolution in Cuba was a window of opportunity that did not bring about greater political or economic openness but rather led to the sustained power of Fidel Castro, a leader of the revolution and subsequent President of Cuba.

At times, leaders enact ‘big’ institutional changes that lead to incentives producing outcomes consistent with expectations and also lead to greater economic or political openness because a greater number of organizations see a higher expected gain from the new institutions. This requires a complementary change in the way the world now works. For example, in the political arena, if the electorate rewards politicians for increasing political and economic openness within a framework of rule of law there is a tendency for the dynamic to become

⁵⁰ On the role of circumstantial evidence in history see Fogel (1982).

virtuous with institutional deepening, i.e. successive smaller institutional changes buttress the initial “big” institutional change. Belief deepening must accompany institutional deepening (Greif 2006; Bidner and Francois 2013). Institutional deepening is necessary for countries to transition to a sustained path of economic and political openness – the big institutional change is not sufficient. Moreover, many seemingly ‘big’ institutional changes never are sustained because they are not buttressed with other supporting smaller institutional changes and not accompanied by changing beliefs amongst the general actors in society. In short whether institutional changes are really ‘big’ can only be judged ex-post.

We will argue later in the book that the *Plano Real* led to taming inflation but it was the subsequent smaller institutional changes from 1994 through today that have produced a very different Brazil from the one in 1994, or 1985, the end of the military regime. Politicians find it in their interest over time to provide public goods to secure votes, and citizens in a competitive political system tolerate less corruption in society. Increasingly, the rule of law applies to political rulers in the sense that they are not above the law; impeachments are a sign that leaders are not above the law.⁵¹ In the economic system, regulation and loans can be used preferentially or in patron-client fashion but politicians come to realize that such treatment no longer delivers the same political support nor generates economic growth for consumers. The virtuous dynamic produces a more impersonal society but a more open society, though progress is neither continuous nor always towards more openness.

From the lenses of history we know that reaching a sustainable virtuous dynamic is not an easy task and is not inevitable. Indeed those countries who have achieved relatively sustainable open societies are the exception rather than the rule (North, Wallis, Weingast, 2009; Acemoglu and Robinson 2012). The answer appears to be so highly country specific that generalizations can only take the form of very broad frameworks such as the one we presented here for Brazil. Nevertheless, by applying the framework to Brazil, which we claim to be one of

⁵¹ In Chapter 4 on the early years of democratization, Collor, the first elected President in Brazil, was impeached for corruption and yet the transition of the Vice-President to the Presidency was peaceful, and the process evolved according to the formal institutions put in place in the constitution. There was never a hint that the military would take over government.

the few countries currently making the transition, we can both explain the real ‘Brazilian miracle’ and gain insights for understanding the general process.⁵²

III. Brazil 1964-2012

Figure 6 presents our interpretation of the three periods through which Brazil has passed from 1964 to the present. The figure provides information on a series of central elements from our framework along a timeline: 1964 to 1985, 1985 to 1994 and post-1994. The top portion of the figure shows three periods and the key beliefs that prevailed in each period. Below the beliefs are the institutions that beliefs produced and then the subsequent illustrative political and economic outcomes.

Figure 6- Brazilian Development: 1964-2014

Period	1964-1985	1985-1994	1994-2014
Belief	Developmentalism	Social Inclusion	Sustainable Social Inclusion
Institutions	Economic – Technocratic Social Planning, import substitution. Political – Curtailment of civil liberties.	Economic – Subsidies to business elites and import substitution. Political – ‘Christmas tree’ constitution, franchise for illiterate.	Economic – Fiscal and monetary orthodoxy. Political – Restraints on state govts with power shifting to the federal government.
Economic & Political Outcomes	Economic – Initially high growth, ‘Brazilian Miracle’ followed by slower growth. Political – Authoritarian rule with exclusion, censorship and oppression.	Economic – hyperinflation and uncertainty. Political – democracy w/o checks and balances, e.g. populist land reform, judiciary siding for labor.	Economic – price stability with mediocre growth. Political – Increasing social inclusion if fiscally sound.

Clearly different groups will evaluate outcomes differently as there are many distributive consequences of each situation. Our goal is to depict the beliefs of those in power. Although subjective, in most cases our classification will not be controversial. In some cases the classification hinges on a comparison with the previous period, so outcomes may not be ideal but

⁵² In the 1960s some development economists referred to the period as the ‘Brazilian Miracle,’ though with hindsight they narrowly focused on economic outcomes and not the sustainability of the economic and political processes that brought about the unsustainable period of growth.

interpreted relative to the outcomes from a previous period. We give details and the connections between each of the elements as we discuss each of the periods in turn.

We begin our analysis of Brazil's move towards an ultimate virtuous path of development with the 1964 military coup. Here we will not to give a detailed account of the history, but analyze each period in light of our framework and to show the forces leading to change. In order to do so we need to establish: What were the windows of opportunity? Who were the leaders during the transitions? Who held power? And, what beliefs prevailed?

We will not enter into the pre-1964 period except to note that the coup came about due to the dissatisfaction with both the economic and political outcomes. Recurring periods of high inflation and low growth mired in populism and political volatility set the stage for the overthrow of democracy with significant approval, or at least a lack of resistance, by most of the elites and the population in general (Bresser Pereira, 1994: 193; McDonough, 1981b; Von Mettenheim, 1990; Skidmore, 2003: 244). McDonough (1981a) underscores how the failed policies of the past shaped the perceptions of the actors in the subsequent period:

Among Brazilian elites, the judgment that a trade-off must occur in favor of economic over social development derives not only from academic principle or from the casual observation that resources are limited and the time to catch up is short but also from their recollections of the populist era immediately preceding the 1964 coup. However short-lived, the experience of double-digit inflation and of stagnation in real growth during the last year of democratic rule left many of the elites with a deep skepticism about the feasibility of equitable development. (McDonough, 1981a: 537)

Similarly, on the political side McDonough (1982: 90) traces the lack of enthusiasm in defending democracy after the coup to "bitter recollections of the electoral frauds - the double voting and voting by citizens long buried - practiced by local bosses in pre-authoritarian days." But who were the elites that emerged in the early military period? Identifying those in power is not always an easy task as it involves disaggregating 'the elites' into separate groups that have distinct sources of power as well as distinct objectives. These distinctions can arise from *de jure* versus *de facto* sources of power, as in Acemoglu and Robinson (2006), or can be thought of as differences between political versus economic elites. In any case, given its authoritarian nature, identifying the elites during the military period in Brazil is not terribly controversial.

The authoritarian period consisted of two sub-periods, with a clear inflection in the direction of economic growth and the subsequent political support for the regime after 1974. In both sub-periods political power was clearly in the hands of the military as well as the technocrats to

whom they delegated the running of the governmental machine. As for the economic elites, for the early sub-period Frieden (1987: 100), identifies the following ‘new growth network’:

A powerful grouping of economic actors was especially important to national development after 1964. The domestic banking system grew institutionally and financially stronger. The state firms expanded continually, bringing along with them networks of suppliers, especially in the capital goods industries, where the parastatals accounted for two-thirds to three-quarters of domestic orders. The multinationals, which dominated the consumer durables sector, had the opportunity to tap a rapidly growing national market of middle-class consumers, many of whose purchases were financed by the vibrant financial system. (Frieden, 1987: 100)

Who was left out of the elite, besides the masses? According to McDonough (1981: ???) “... many formerly well-entrenched groups were also marginalized: politicians as a class, labor leaders, many intellectuals, some members of the business community and, gradually, the church.”

But what were the beliefs of the new groups with power? It is axiomatic that each group prefers policies that promote their own welfare but under the shadow of what belief? Beyond that consideration we can identify different prescriptions for how the country should be organized. McDonough (1981a) conducted 250 interviews in Brazil in 1972 and 1973, the height of the ‘Brazilian miracle,’ in a study of the elites. He identified three broad trends. The first is preference for prioritizing quick economic growth above all other goals, epitomized in the saying that first you should make the pie grow so that you can divide it later. The second priority preferential goal was the establishment of democratic values that promote inclusion and participation of all members of society. The third preference as stated by the interviewees was to reduce poverty, inequality and other social ills. By far and away the dominant view was clear according to McDonough (1981a: 542): “Most Brazilian elites rank national priorities along a hierarchy of needs, the foundation of which is the nation's economic might, with the luxury of politics in last place.”

Although the views in the previous paragraph sound like beliefs they are preferences as they refer to how the agents would like the country to be if it were in their power to make it happen. Our conception of beliefs refers instead to the perceptions of organizations about how things actually work, given the configuration of power in place. As indicated in Figure 6, the key belief we identify for the authoritarian period is based on the notion of ‘developmentalism’. ‘Developmentalism prioritizes fast industrial growth through state-led investment in large infrastructure projects and protection of selected private industries. It includes heavy doses of

nationalism and the quest for national champions. As a belief, 'developmentalism' was the recognition that given the military regime's hegemonic power and their preference for strong and orderly economic growth, policy would necessarily pursue those objectives whatever the costs in terms of other goals such as equity, democracy, justice, and environment. The belief in developmentalism grew initially over time and then declined in its latter years. Austerity and restrictive measures to combat inflation marked the first three years of the period. In the subsequent years, peaking in 1974 and then only gradually declining, the belief in developmentalism was at its height, underlying and being confirmed by what became known as the 'Brazilian miracle':

From 1967 until 1980, the growth coalition succeeded extraordinarily well in utilizing previously installed productive capacity, a reorganized financial system, and foreign finance to obtain impressive rates of industrial growth. The booming international trading and financial systems helped accelerate the economy's upward trend, and it was not difficult to maintain a level of political agreement among major economic interests so long as the world and local economies were growing. (Frieden, 1987: 100)

In the period 1964 to 1974, inflation averaged 24% per annum and yearly real GDP growth averaged almost 9%. This contrasts with the previous period (1960-1964) where the averages were, respectively, 60% and 5.7%.⁵³ These positive economic outcomes brought about relative prosperity to many, and thus approval or at least acquiescence of the regime's performance (Frieden, 1987: 101). Yet on the political margin the level of dissatisfaction gradually increased, especially after the hardening of the regime in 1968. The sentiment against the military started with those former powerful members that found themselves excluded but progressively spread as repression, torture and censorship became increasingly routine. Although it is generally accepted that the level of repression in Brazil was milder than in most other Latin American military dictatorships, it came to have an extremely profound impact on the country's beliefs. Skidmore (2003: 246-247) stresses the subtle way in which the perception by many in the elite changed regarding the legitimacy of strong-handed methods to maintain order and pursue the policies that so benefited that same elite. The military regime's methods of social control disturbed not only the Church, lawyers and intellectuals but, according to Skidmore (2003: 247), even factions within the military evinced dissension.

⁵³ The GDP differences become even starker if one considers only the years after 1967.

While the economic performance continued to improve, dissatisfaction with repression was only enough to induce very subdued pressure for change. In 1974 the regime announced a ‘slow and gradual’ process of opening whereby command of the country would be returned to civilians in a controlled and orderly manner, maintaining the rights and prerogatives of the current political elites. However as the economic situation took a downturn with the economic crises of the late seventies and early eighties this orderly process became increasingly hard to control. In our framework we stress the role of endogenous and exogenous events in producing pressure for change through their impact on outcomes. The deterioration of the economy in this period was a result of such interplay, with external factors (oil prices) triggering and amplifying the internal dysfunctions of the economy. With the now negative economic outcomes adding to the already negative political outcomes the pressure for change increased. Frieden (1987) describes how the magnitude of discontentment destroyed any hope the regime had of closely dictating the nature and pace of the process of redemocratization:

By 1981 the cycle had ended. Foreign finance, parastatal orders, and domestic finance all dried up. The "miracle" was definitely over, and its end spelled the collapse of the coalition of economic interests that it had supported. ... (T)he Brazilian economy began a downward spiral that drove increasingly influential social groups into opposition and culminated in a new civilian opposition government assuming power in March 1985. ... By 1982 business discontent with the regime was widespread; by 1984 it was nearly universal. The regime had lost most of its popular and elite support. (Frieden, 1987: 115-116)

In light of our framework, the transition to civilian rule in 1985 was a window of opportunity with new leadership, new elites in the power structure and a new set of prevailing beliefs. In this case the window of opportunity took place over an extended period of time and there was no single ‘big bang’ event as in the ‘revolutionary’ transition of 1964. The framework does not assume that all shifts in ‘status quo’ take the same general form; on the contrary, each case will have its own specificities. Importantly the window of opportunity brings with it new configurations of power, and beliefs.

The elites which came to power with democratization were led by the nation’s modern industrial sector which had precipitated the fall of the previous regime as it abandoned the ruling military coalition. They included industrial workers and the urban middle classes, including technicians, bureaucrats and intellectuals. According to Frieden (1987: 121) “... in the simplest terms, the national industrial bourgeoisie had both come of age and come to power.” Domestic bankers had been among the last to abandon the previous regime and only gradually transitioned

to the new network. Politically the opposition candidates who had been elected as governors in the 1982 election became particularly powerful, especially those of the industrial southeast, as the vote legitimized their position *vis-à-vis* the indirect route to power by President Sarney.

What were the beliefs of this new and expanded network? Politically, the new network rejected the exclusionary practice of the previous regime. The long experience without voice or vote, subject to repression, censorship and torture, led to a strong reaction against those practices and instilled high regard for democratic values of participation and citizenship, that quickly overturned any attempt to limit the pace and scope of the opening. Rochon and Mitchell (1989: 318) note that although the Brazilian middle class had historically supported an elite-centered democracy instead of one based on mass participation:

... as the transition to a civilian government unfolded it proved impossible to maintain the carefully circumscribed electoral democracy envisioned by the outgoing authoritarian rulers. Within months after the inauguration of President José Sarney, the government enfranchised illiterates (25 percent of the population) and ended campaign restrictions, the ban on cooperation between parties, and the prohibition of split ticket voting. The Sarney administration also made plans for the first direct presidential elections. Both the partisans of civilian control and the partisans of mass democracy, both the democratic legalists and the populists got what they wanted. (Rochon and Mitchell, 1989: 318)

Economically the preferences that prevailed were centered on anti-austerity measures that moved radically away from the financial conservatism of the last years of the previous regime. The hardships of the previous crisis and resentment against foreign indebtedness instilled preferences for growth-oriented policies, strong industrial growth and abhorrence to foreign dependence.

Out of these preferences and the new structure of power emerged the first of two beliefs that played a crucial role in setting Brazil on its current path. The essence of this belief is that inclusion, participation, citizenship and equality should permeate the behavior of governments, firms and individuals.⁵⁴ Remnants from the authoritarian past such as censorship, top down decision-making and lack of accountability and transparency would not be tolerated. We call this a belief in ‘social inclusion.’ It does not mean that from one moment to the other there was equal access to political and economic resources to all and that social justice would always prevail, but rather that there came to rule a presumption that behavior and policies would, if not actually

⁵⁴ Many on the left including the intellectual elites and the union leadership always held this belief but these groups never had power. Now the belief became shared by the business elites.

progress towards these values, at least not explicitly contradict them. Often times this belief would be counterproductive, other times innocuous as it would simply affect the packaging and not the content. Nevertheless we argue that the existence of this lens through which those in power perceived the world did and still does have profound impacts in the path Brazil has followed.

An anecdotal indication of this belief is the way in which after 1985 practically no politician admits to being on the political right, opting instead for terms such as ‘center’. According to Powers (2000: 206-207) this phenomenon of an ‘abashed right’ could be seen in the way “conservative public figures were continually uncomfortable, apologetic, and generally squirming in the presence of journalists and intellectuals.”

Two other early manifestations of the belief in social inclusion was the extraordinary rise in social movements and the surprisingly powerful role assumed by the *Ministério Público* as a truly independent and effective defender of the diffuse and collective interest against government ineffectiveness and incompetence. Similarly the proliferation of councils as a means of policy-making in the most diverse areas, from education to health, from river basins to the environment, at municipal, state and federal level, are all expression of the social inclusion belief.

We have not made any claims about the desirability or the nature of the impact of the mode of governance that emerged under this belief. We will elaborate on the consequences of the belief in social inclusion below. For now we simply provide a clear notion of what the belief encompasses to convince the reader of its importance. Land reform is an area in which the belief in social inclusion is particularly evident. Land reform played a key symbolic role in both the 1964 and the 1985 transitions. Rural unrest, land invasions and the growing demand for land reform were one of the major issues that prompted the military coup in 1964. Ironically the military regime nevertheless actively pursued a redistributive land reform as it recognized the need for a modern agricultural sector as a crucial input in their quest for economic might. Similarly, in 1985 one of the flagship policies of the new civilian government, and a regular staple in the new democratic discourse, was the realization of a massive and widespread land reform. It seems contradictory that a new government that was intent on severing any resemblance to the previous regime would put such emphasis on a policy that had previously been championed by its predecessor. The explanation of this paradox is in the beliefs that

justified the policy in each period. Whereas the early land reform effort was sanctioned by the belief of developmentalism, in the New Republic it was advanced as a case of social justice.

The clearest manifestations of the belief in social inclusion is the 1988 Constitution, as Constitutions by definition are places where powerful groups delineate guiding principles, general rules and the accepted outlook on how things should be setup and operated.⁵⁵ The fundamental spirit of the new Constitution was exactly to make a break with the past, abandoning the development-at-any-cost nature of the previous regime and embracing values of equality, social justice, human rights, inclusiveness, citizenship, and participation. These values not only oriented the content and tone of much of the text, but several were explicitly highlighted as fundamental principles. Article 1 establishes at the outset ‘citizenship,’ ‘dignity to the human person,’ and ‘political pluralism’ as fundamental principles. Article 3 proclaims it a fundamental objective, among others, to ‘build a society that is free, just and has solidarity.’ Similarly, Title 5 of the Constitution, dedicated to Fundamental Rights and Guarantees has 78 items, assuring things such as the ‘inviolability of the right to life, liberty, equality, security and prosperity (Article 5). Clearly much of this is the regular window dressing that tends to ornate many Constitutions throughout the world, and certainly many articles privileging specific groups at the expense of the collective found its way into the 1988 Constitution, given the way it was drafted by the elected members of Congress. Nevertheless this inclination of the Constitution has not been innocuous, as its content has frequently been exploited by politicians, parties, social movements, judges, district attorneys and even individuals to significantly affect governmental policies and decisions. This has become increasingly the case in Brazil given the independence of the judiciary and the extreme ‘constitutionalization’ that has evolved in Brazilian Law.⁵⁶ The fact that the judiciary has become a major locus of policymaking in Brazil implies that the social inclusion bent of the Constitution does in fact have palpable consequences.

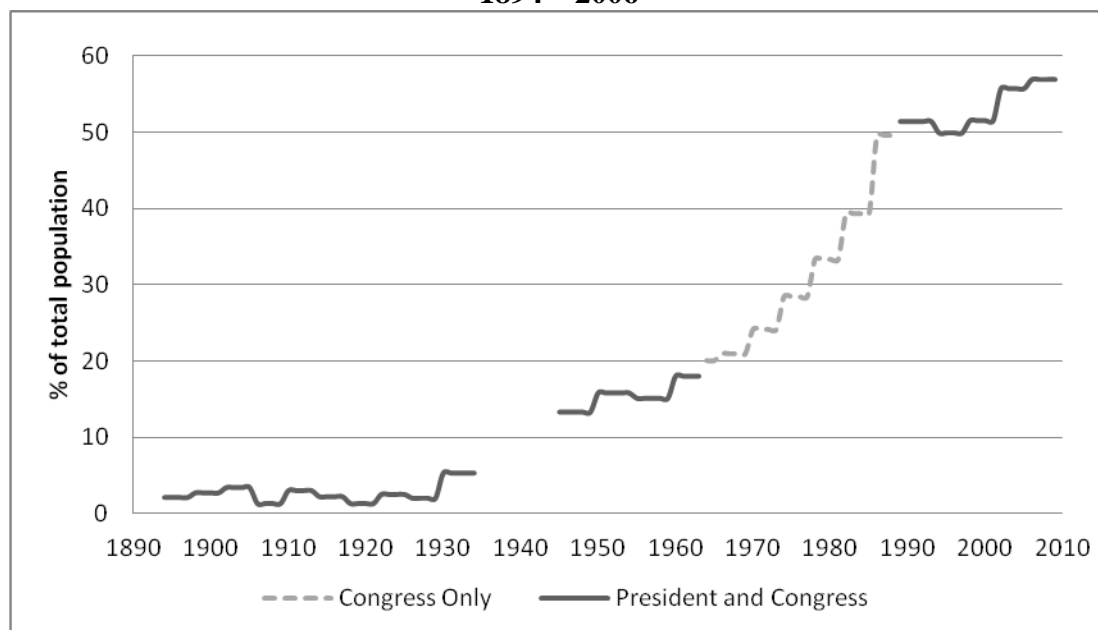
A key change that was squarely compatible with the new belief and that would corroborate the above mentioned impact of the new Constitution was the extension of the franchise that took place with re-democratization. Figure 7 shows the evolution of the proportion

⁵⁵ Here we refer to “true” constitutions rather than the numerous sham constitutions that are window dressing but are not statements of guiding beliefs.

⁵⁶ Increasingly over time Brazil tied the hands of politicians by making a ‘law,’ a constitutional amendment. In addition after the Constitution many parts had to be excised as constraining the ability of the government to meet its fiscal target.

of total population that effectively voted for President and Congress from 1894 to 2006. Only in 1985 did Brazil authorize the right to vote to illiterates, so the first time that a majority of the Brazilian population voted for President occurred in the 1989 election. The previous presidential election had been almost 30 years earlier and less than 20% of the population voted in that election.

Figure 7 – Percent of total population that voted for President and Congress, 1894 – 2006



Source: Nicolau (2003) and Tribunal Superior Eleitoral for the elections of 2002 and 2006. The data is for the total number of voters that actually voted and not the number eligible to vote. Data for Congressional elections is for the period after 1933 and is very close but not identical to that for Presidential elections.

Although Congressional elections took place during the 1964-1985 period, these were clearly of a less significant nature. This implies that the political scenario initiated in the 1990s was remarkably different than anything that the country had ever experienced. The incentives of politicians were thus of a very different nature than those of previous periods. This is particularly true and relevant for the case of the President given the strong presidentialism that prevailed after the 1988 Constitution.⁵⁷

More than in any other time in Brazilian history there were strong electoral incentives for policy to pursue the public good rather than private interests. This effect has probably grown over time becoming stronger in each subsequent election as voters and politicians have come to understand and believe in the new rules of the game. Similarly, candidates in electoral races are clearly shedding bad electoral practices which were the norm in the past, such as clientelism,

⁵⁷ Brazil authorized very strong powers to the executive branch relative to most Presidential systems. The executive in Chile has similarly very strong powers of agenda control.

vote buying and the use of public office by incumbents in the electoral race.⁵⁸ The inception of greater political openness, equality and inclusiveness changed the negative approval along the political dimension which had prevailed throughout the authoritarian period.

Along the economic dimension, however, dissatisfaction was not eliminated. Although the new civilian government radically altered fundamental economic policies, economic outcomes deteriorated. In Figure 8 we show that average yearly inflation increased from 98% in 1974-1985 to over 1000% in the 1985-1994 period.

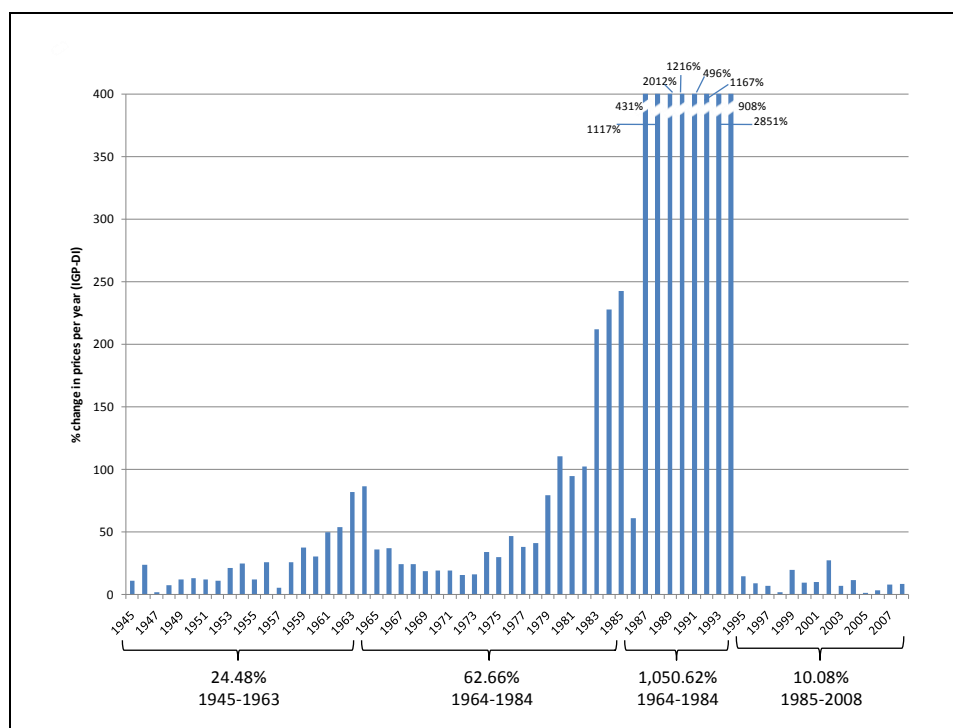
Over the same period, GDP growth fell from 4% to 2.8%. The new levels of inflation are so high that they could not be shown proportionally in Figure 8. In order to provide more detail, Figure 8 shows the yearly inflation levels from 1945 to 2007, yet even here it was not possible to fit the 1985-1994 period in the graph at actual scale without making the other years indiscernible to the eye. This was not simply another bout of high inflation that had been recurrent in Brazilian history. This was in fact a Weimar Germany-style hyperinflation with all the associated pain and disruptiveness.

The adoption of new economic measures caused the hyper-inflation bouts. The belief in social inclusion that undergirded the choice of policies was a natural reaction by the new network seeking to redress what it saw as the errors and injustices of the previous government. This belief led to a strong presumption that policy would thereafter be inclusive and promote social justice. The 1988 Constitution epitomized this process not only in terms of political rights, as noted above, but also by distributing economic benefits to large arrays of the population. An example of this is the extension of social security and pensions to non-contributing rural workers. This has had an important redistributive effect but at the same time added considerable pressure to the system's precarious fiscal balance. Other examples include the universal education and health benefits, and the guarantee of job stability to civil servants. Together with these social and universalistic transfers in the Constitution, interest groups also managed to

⁵⁸ Today elections in Brazil are widely recognized as fair and well run, with a competent Electoral Tribunal in charge and, since 2000, 100% computerized voting which increases the speed of the process and reduces the possibility of fraud (Kinzo, 2004; Sadek, 1995). The fact that the Electoral Tribunal has removed from office since 2000 more than 460 mayors and vice-mayors and 5 governors shows that there are still abuses of electoral practice. More importantly, it shows that contrary to previous periods in Brazilian history effective enforcement mechanisms have started to evolve that dissuade those practices.

embed their own particularistic transfers and so insulate them from future alterations. The result of this unmitigated inclusiveness was naturally a sharp jump in public expenditure.

Figure 8 – Inflation in Brazil 1945 – 2008, % per year

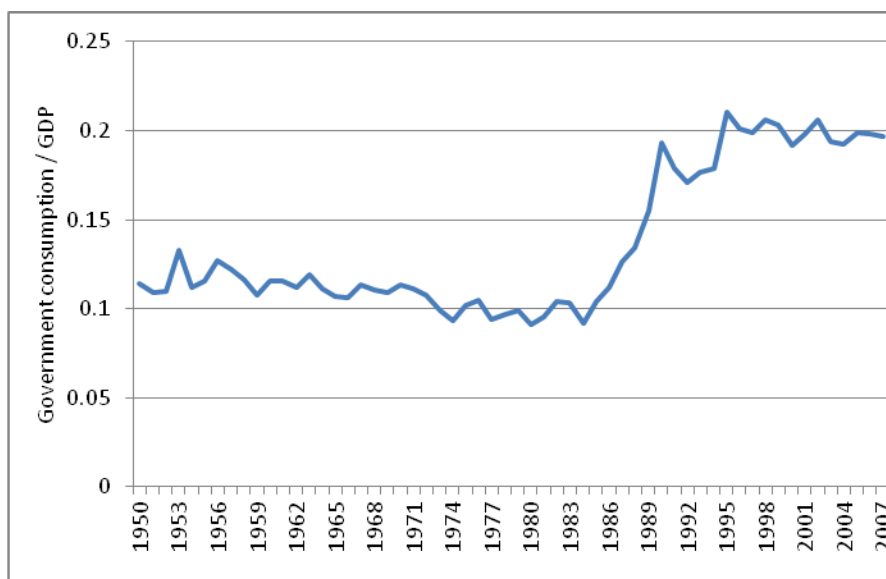


Source: Fundação Getúlio Vargas, IGP-DI

Figure 9 shows the distinct upward shift of government expenditures as a percentage of GDP that resulted from re-democratization and the 1988 Constitution. Clearly this abrupt doubling of government expenditure is causally connected to the surge in inflation that was observed at the same time.

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Figure 9 - Government Expenditure / GDP, 1950 – 2007



Source: Central Bank of Brazil in IPEADATA.

The ten years of hyperinflation that followed re-democratization produced a time of economic distress and uncertainty. Inflation at this level systematically reduces real incomes, drains government effort from other policy domains, and wreaks havoc on any attempt at planning for the future by individuals, firms and government. It is a tax that falls disproportionately on the poor, quickly wiping out the gains achieved through the new inclusive policies. Even for those who had access to financial instruments that afforded protection from rising price levels, unanticipated inflation posed substantial transaction costs and uncertainty.

When salaries have to be corrected almost monthly to keep their value, labor relations become strained and strikes endemic. Similarly, when delaying a payment by even one day can yield a significant gain in the overnight market and at the same time a significant loss to the creditor as prices will rise in the meantime, the probability of conflict and litigation over contracts increased greatly. These ten years witnessed several economic plans devised to end inflation. In the few cases where the plans managed to stem the rise in prices, the effect was fragile and temporary, eventually reverting to even greater inflation. Repeated failures undermined the hope that stabilization was possible. To many it came to seem that inflation, with the accompanying pain and disruption, had become an inherent and unavoidable characteristic of Brazilian life.

By the early 1990s the situation was arguably becoming set for some sort of coup, as public opinion became increasingly disillusioned with the merits of the new institutional arrangements. Instead, what took place was the *Plano Real* in 1994 and the sudden demise of inflation. How this window of opportunity arose, why it was successful and what resulted will be analyzed below. First we need to describe the second belief that we contend has been crucial in the recent transformation in Brazil. At the heart of the belief is the notion that inflation is perverse, impending and to be avoided at all costs.⁵⁹ The ‘fear of inflation’ is still very strong today and underlies the entire policymaking process constraining choices and actions. The collective strife of the hyperinflationary decade created an implicit understanding of the kind of policy that translates into inflation and a tacit consensus that such behavior must be curtailed. This does not mean that the ‘fear of inflation’ eliminated political opportunism or the pressure for redistribution by various interest groups. It does mean that there were now countervailing forces to those natural instincts. When voters instinctively understand the link between the price level and fiscal and monetary discipline, politicians, and in particular the President, have greater incentives to pursue better macro-economic policies. In this sense the combination of increased franchise and the inflation-aversion belief had an important impact having set the tone of all presidential administrations, independent of party affiliation, establishing a clear precedence of fiscal and monetary discipline over other demands.

In many instances the social inclusion belief and the inflation-aversion belief are in direct opposition to each other. In such cases which one prevails? When Lula came to office in 2003 his flagship project was the Zero Hunger Program, which had the noble goal of eliminating hunger and sub-nutrition throughout the country. Although the program proved to be popular from the outset, with individuals, firms and celebrities vowing to help, it was eventually sidelined and ostracized by the President himself, who quickly perceived the greater importance of consolidating and maintaining monetary stability and fiscal discipline. As with this example most policy choices since 1994 have shown that the ‘fear of inflation’ belief takes precedence over the social inclusion belief. This does not mean that inclusiveness and citizenship are no longer important policy objectives, but rather that they depend lexographically on monetary stability before they can be directly pursued. With inflation in check both Presidents Cardoso and

⁵⁹ Germany today still holds this belief.

Lula pursued policies of greater social inclusion. With increased economic growth, Lula could expand social inclusive policies to a greater extent than Cardoso and in turn deepen beliefs in fiscally sustainable social inclusion

Brazil tackled inflation with the *Plano Real* in 1994 which we see as a window of opportunity. Here the interest is to continue the analysis of Brazilian development through the lens of our framework. The period after 1994 can be seen as a one with a new set of beliefs, which succeeded the set of prior set of beliefs, unsustainably anchored on solely social inclusion. As we have seen, the previous situation had led to substantial political openness but displayed the poorest economic performance in several decades, with average GDP growth of only 2.8% and quadruple digit inflation. As a result, there was widespread dissatisfaction and pressure for change. The success of the *Plano Real* resulted in both positive political and economic outcomes, the first time we see such a result in our period of Brazilian history starting in 1964. Average inflation fell by two orders of magnitude and GDP started to grow at a moderately higher pace with significantly less variation and uncertainty.⁶⁰

The post 1994 ‘status quo’ dynamic has lead the country along a virtuous path of development in which both political and economic competition and openness have taken root and evolved. Policymakers significantly extended the rule of law to greater portions of the population and political and economic institutions have gradually evolved to increasingly sustain impersonal economic and political exchange. The implication is that this new ‘status quo’ set of beliefs will continue to lead to greater institutional strengthening and economic growth. Because both the economic and political dimensions have reached stable positive outcomes, positive feedback will tend to reinforce the beliefs in place though there is always the possibility that a big enough exogenous shock can knock the country off that path.

This is not a trivial claim. It goes against much of the received wisdom that highlights the deep structural, social and cultural problems inherited from the past and sees the recent changes stressed above as merely superficial and not addressing the deep-rooted causes, such as inequality, corruption, and a flawed political system. The claim also flies in the face of most Brazilians, who in our experience often counter it with a list of the recent scandals, negative

⁶⁰ The standard deviation of GDP growth from 1985 to 1994 was 3.82 while the figure for 1995-2008 was 1.95. Whereas Brazil exhibited slower growth than many other countries in the same period, such as Argentina, the process proved to be more sustainable over the long run.

statistics and examples of the daily absurdity from the morning paper; “How can you make this claim, the reasoning goes, in a country where such things can happen?” We will not attempt to defend our claim in this section.. Given that this is an issue where there is no ‘smoking gun’, the verdict must be reached through a preponderance of circumstantial evidence.

The purpose here is to understand the process that led to the transition from the previous configuration of power and beliefs to the new set of power and beliefs. If we are correct that this transition has led the country to a virtuous path of development, then it is important to understand how and why this has happened as it is clearly an exceptional achievement in the modern world and, in the light of only a few years ago, in the most unlikely of countries. The idea is not that the process can be replicated directly elsewhere, but rather to understand the more basic elements that operate in the developmental process. In particular we stress the roles of windows of opportunity; leadership; and beliefs.

To understand the shift in power and beliefs that took place in the mid-1990s it is important not to be fooled by the benefit of hindsight into perceiving as inevitable the changes that ended inflation and started reforming the country’s institutions. By the time of the *Plano Real* the country had been mired in hyperinflation for nearly a decade and a large number of explicit economic plans and other assorted policies had been tried, yielding only temporary reprieve and collapsing back to what increasingly seemed an inescapable order. Given the cumulative experience of previous failures each new attempt at dealing with inflation and associated macroeconomic problems elicited less and less hope of success. In contrast to the public elation generated by the first few months of the *Plano Cruzado* in 1986, the public greeted the *Plano Real* with resignation and skepticism.

The protracted cost of inflation on firms and individuals made the likelihood of some form of political upheaval ever more likely: if this was what democracy had to offer, then many might be less resistant to some other form of government that might offer less suffering and hopelessness. Although this could come about through a military coup, given the social inclusion belief and the experience of other Latin American countries in the same period, it could also come about in the form of a Chavez-like government in Venezuela. Alternatively the series of stabilization plans could have continued indefinitely and even have been successful, following the general trend in Latin America, yet without initiating a process of deeper institutional change.

The question is then: why did the *Plano Real* succeed and why did institutional deepening transpire in its wake? Once again, in this overview, we want to answer this question not in its specific details, but more generally in the light of our framework. As discussed earlier, the *Plano Real* is interpreted as a window of opportunity in which a jump was made to a new configuration of power with new beliefs. Because the change took place when it did, it may seem with hindsight to have been obvious or preordained. This is because we are most aware of successful policies during a window of opportunity. Many other windows of opportunity that open are not perceived or realized and therefore leave no legacy. In this sense windows of opportunity have a strong element of serendipity in that they are unpredictable and unexpected. This does not mean that they are simply happenstance. Although windows of opportunity come about unplanned and often by surprise, they require that someone be able to recognize and act upon the opportunity. This is why leadership is so important. A leader must: recognize the window of opportunity; know what to do; and either persuade or coordinate others into going along with the new belief, awaiting outcomes that will deepen or truncate the new belief.

It is quite possible that other events prior to the *Plano Real* had presented windows of opportunity for change, such as the Constitution of 1988 and its failed revision of 1993, or the impeachment of Collor in 1992, or even some other instance of which history books are now unaware. During those periods the dissatisfaction with the economy was sufficiently large to generate a demand for change. Yet it was only with the *Plano Real* that the shift to a new set of beliefs took hold.. Several key elements contributed to allow such a shift. The first was the fact that the prolonged hardships of life under hyperinflation made society more willing to accept sacrifices that held the promise to lead to a solution to those problems, though as noted before past failures made each new attempt seem increasingly futile. In 1990 the Collor Plan revealed this willingness to sacrifice when the government announced a surprise freeze for 18 months of all but a small margin of the populations' bank deposits and savings accounts. This is a measure that in other circumstances might lead to despair or rebellion. Yet, in a situation of 80% inflation per month, the population accepted the Collor Plan with passive resignation. The second contributing element was the lack of a coherent game plan by the opposition, due to scandals and other political events that we detail elsewhere. In addition, the cumulative experience with failed plans as well as lessons from other countries that were undergoing similar problems had

increased the knowledge of the kinds of policies that work and especially the kind of policies to avoid.

Yet even with all these elements in place there was nothing inevitable about the way things turned out. Realizing that the elements were there, and could be exploited in a very precise way to reach an envisioned outcome required leadership in the form of an individual or a group that was serendipitously at the right place at the right time with the right powers so as to coordinate the necessary actions. Despite the facilitating circumstances noted above, change of this magnitude requires persuasion and strategy to overcome disperse and specific resistance, actions which were all the more difficult in Brazil given the limits imposed by the social inclusion belief.

We view the leadership roles played by Fernando Henrique Cardoso as an essential element in the shift to a new set of beliefs that resulted in the end of inflation and the start of a long period of reform that dramatically changed the nature of the Brazilian economy, polity and society. Cardoso's role started as finance minister with the coordination of the team that devised and implemented the *Plano Real* in 1994, so as to realize the window of opportunity that had presented itself. More importantly, Cardoso's leadership continued with the capitalization of the popularity that arose from the success of the plan. Following stabilization Cardoso initiated a process of long term structural reform that not only modernized and liberalized the economy in many important ways, but more importantly established political institutions that locked-in and reinforced that direction of change by affecting the constraints and incentives of individuals, organizations and especially politicians. The institutions created an evolving set of property rights, checks & balances, and rule of law that we see as the foundation of the virtuous developmental path that Brazil has since pursued.

Many alternative networks could have emerged. Actors faced high uncertainty and looked backwards in a problem solving fashion. There were upfront costs and coordination problems that required Cardoso's leadership due to the high uncertainty. Crucial for the success of Cardoso's strategy was that the new economic actors developed a stake in the reform process and formed a constituency which did not exist before: firms redeployed their assets in new profitable ways. In addition, citizens as consumers updated their beliefs in the benefits of liberalization and price stability. Citizens' aversion to inflation and economic elites' failure

fatigue following six failed economic stabilization programs set the stage for the exercise of leadership.

A number of factors helped making the reforms of Cardoso credible, particularly the *Real* Plan. They included a number of contextual factors – Itamar Franco’s weakness as president, a national front government in the wake of the impeachment of President Collor, a congress in crisis because its leadership was implicated in a corruption scandal - and in particular the approval of the constitutional amendment allowing the reelection of presidents. A stronger president rather than a lame duck was able to engage in necessary amendments to the Constitution in order to sustain a fiscal balance. The second term of Cardoso articulated a pattern of network management and a host of compensatory measures that did not compromise the overarching lexicographic goals of maintaining the stability of the currency and fiscal stability.

With institutional deepening during Cardoso’s second term, the role of leadership took a quantitative change. Although the decisions of the leader are still important in navigating the country forward, they are nevertheless decisions within the prevailing bands of the new status quo of beliefs; and not decisions that impel a jump to a new set of beliefs. In this sense the leadership of Cardoso lies mainly in the recognition of the latent belief in the priority of macro stabilization and the establishment of an institutional environment where the government pursued all other objectives subject to this preponderant macro stability constraint, as well as the secondary, sometimes conflicting social inclusion constraint. Once society accepted this dynamic path and elected Cardoso to a second term, his leadership role receded to the background. The country was by then on ‘auto-pilot’ in the sense that changes became incremental within the prevailing configuration of power and set of beliefs. The strongest evidence of this interpretation is the unexpected conversion of President Lula to the macro stability constraint and further institutional deepening along the same lines initiated by Cardoso, culminating with Brazil becoming investment grade and poised for higher rates of economic growth and political openness. President Dilma Rousseff’s economic team remains committed to a belief in macro-stability as its top priority: ‘Inflation is my permanent preoccupation’ Guido Mantega, Finance Minister of Brazil (Financial Times July 13 2011:8). Since taking office, inflation has remained under control despite an initial upsurge in foreign investment and an increase in the value of the *Real*.

IV. Conclusion

Most countries in the world remain on a trajectory of economic and political development where changes are marginal. This explains why so few countries have broken into the world of the high GDP per capita countries whose inhabitants live in a world where economic growth is almost always positive. The reason for only marginal changes is because the returns to those in power are sufficient to sustain them in power. Economic and political power are often goals of those in power. It is not in the interest of those in power to make discontinuous changes; but, once in awhile, a country breaks from its past. The necessary conditions to break from one's past include a window of opportunity and leadership. Successful leadership towards sustained economic and political openness entails: a leader who knows what should be done; and a leader who knows how to coordinate activity to achieve his goals, i.e., the art of policymaking. At times leadership occurs through the motive of a leader having a long run perspective of 'playing for the history books' and wanting to make his country great. Knowing what to do entails causal beliefs about how institutions will affect outcomes in ways that will lead to a virtuous path of economic and political development.

During windows of opportunity leaders shape beliefs when their actions achieve results that most citizens perceive as positive. This also enables leaders to engage in institutional deepening which is part and parcel of economic and political development. In the early 1990s Brazil seized a window of opportunity with the leadership of President Cardoso and others in his administration. Over time, beliefs changed about how Brazil functions and subsequent administrations have deepened institutions that created a more open Brazil, both economically and politically. This in turn created a virtuous dynamic because an increasingly large number of players have a stake in the new open system. Will the virtuous dynamic persist? Only history will tell, but for now Brazil has embarked for twenty years on a trajectory analogous to other nations that have succeeded.

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