

Institutions, Institutional Change and Economic Performance, by Douglass C. North, pp. 1-35, 83-104

(Devarati Ghosh)

pp. 1-35 *Definitions and Logic*

- Institutions are “the rules of the game in a society, or, more formally, are the humanly devised constraints that shape human interaction,” (3). In his definition, North includes both formal constraints (e.g., rules) and informal constraints (such as conventions, customs, traditions, and codes of behavior—herein lies his incorporation of culture). Institutions are different from organizations, insofar as organizations are created by groups of people for specific purposes, that can themselves be agents of institutional change.
- Having abandoned efficiency theories of institutions on account of empirically persistent inefficient institutions, North seeks to explain divergence and institutional change. He identifies the “lock-in that comes from the symbiotic relationship between institutions and the organizations that have evolved as a consequence of the incentive structure provided by those institutions,” and “the feedback process by which human beings perceive and react to changes in the opportunity set,” (7).
- North asserts that institutions provide a stable structure of human interaction, and that change is largely incremental. Change is the result of alterations in the perceptions of political and economic entrepreneurs of the best institutional framework. North emphasizes that incomplete information and cognitive factors that undermine the rational choice model of individual behavior, although he does believe that institutions are the result of short-term individual choices.
- North is interested in cooperation under the more difficult circumstances of non-repeated interactions, incomplete information, and a large number of players, especially from the perspective of the increased costs of transaction. He focuses upon contractual arrangements rather than coercive ones, although he concedes that most formal institutions are created to serve the interests of those with the power to enact new structures of interactions.
- Turning to theories of individual behavior, North acknowledges the success of choice theoretic assumptions, but asserts that they do not always accurately account for the individual’s motivation, and the manner in which he/she understands the environment. Where the costs of expressing ideology, norms, etc. is low, they will have a significant impact upon action. Additionally, the disparity between the individual’s subjective processing of the environment and material reality is a consequence of incomplete information.
- North believes that reducing the costliness of information would facilitate contractual arrangements. He therefore attempts to construct a theory of exchange based on transaction costs, which he divides into measurement costs and enforcement costs. In studying measurement costs, he addresses the utility of any given unit of exchange. He points out that any such unit will have several attributes that contribute to utility, that its standardized value may not reflect. The standardized value generally reflects the degree to which the flow of an asset is immune to costless control by someone else. Enforcement costs, on the other hand, reflect the risk of defection, and the cost of the sucker’s payoff.
- North believes that institutions (patterns of measurement and enforcement, which depend in turn on perceptions of attributes that contribute to utility and on patterns of rights and adherence to them) structure the transaction costs of exchange. Greater specialization and higher numbers and variability of valuable attributes lead to greater reliance on institutions as structures for less costly exchange. North offers three types of exchange (personalized exchange involving small-scale production and local trade; impersonal exchange where the parties are constrained by kinship, hostage exchanges, or merchant codes of conduct; and impersonal exchange with third-party enforcement), and uses them to draw a picture of costs.

pp. 83-104 *Stability and Change*

- The individual entrepreneur is the agent of change, who responds to perceived changes in incentives, brought on by changes in relative prices or preferences (tastes). Stability is facilitated by informal constraints, which often complement formal constraints as more specific patterns of routinized exchange. Informal constraints often persist even in the face of changes in formal constraints and relative prices. However, North believes that material reality and the changing costs of adhering to some informal constraints ultimately causes an incremental change in those informal constraints. Changes in formal constraints (including those brought on revolution) are only meaningful if informal constraints bolster them.
- North believes that institutions provide a mechanism for incremental change, because they provide opportunities for new bargains and compromises. Newly empowered players have to believe that the benefits of change override the costs of enacting the change itself, in the short term (since they would have to absorb the costs).
- North takes up the twofold question of divergence among institutional frameworks, and the persistence of “inefficient” institutions, as critiques of evolutionary theories which hold that the institutions that most reflect material reality will outlast those that do not. He argues that in a world lacking perfect competition (and hence characterized by incomplete information) and increasing returns to scale, “not only can both divergent paths and persistently poor performance prevail, the historically derived perceptions of the actors shape the choices that they make, (95-96).
- Essentially, political and economic entrepreneurs are left to their subjective preferences and cognitive devices when interpreting the world and the best course of action to maximize utility within it. The choices that they make may be “inefficient,” but they also initiate a course whose best directional predictor is the most recent step. This course is reinforced by “network externalities, the learning process of organizations, and the historically-derived subjective modelling of the issues,” (99). Taking this one step further, divergence is caused by the existence of different bargaining groups in different states and the varying distributions of power among them. Even the adoption of the same formal constraints will yield different results (example—Latin American constitutions based on the US model).
- North emphasizes that while his story of increasing returns and path dependence does yield predictions about short-term choices, it does give a causal story for the direction of long-term change.