

Douglass C. North
Institutions, Institutional Change, and Economic Performance

A central theme of this study is the problem of achieving cooperative solutions to problems.(p. 134)

Part I: Institutions

Chap 1: An Introduction

Definition of institutions:

“the **rules of the game** in a society or more formally, the **humanely devised constraints** that shape human interaction”(p. 3)

“the **framework** within which human interaction takes place”(p. 4)

“regularized interactions we call institutions”(p. 23)

Kinds of institutions:

“Institutions include any form of constraints that human beings devise to shape human interaction. Institutions can be either formal or informal. **Formal constraints** include rules (constitutions, laws, and property rights), while **informal constraints** include conventions and codes of conduct. Institutions may be created, as was the US Constitution; or they may simply evolve over time, as does the common law” (p. 4)

“Institutions consist of a set of constraints on behavior in the form of the rules and regulations; a set of procedures to detect deviations from the rules and regulation; and finally, a set of moral, ethical behavioral norms which define the contours and that constrain the way in which the rules and regulations are specified and enforcement is carried out”(1984: 8)

North makes a **critical distinction** between institutions and organizations.

Institutions = the underlying rules of the game

Organizations = players

- 1) group of individuals bound by some common purpose to achieve objectives;
- 2) Like institutions they provide a structure to human interaction,
- 3) They are influenced by institutional framework,
- 4) But they are also agents of institutional change.

“Organizations are created with purposive intent *in consequence of the opportunity set resulting from the existing set of constraints* (institutional ones as well as the traditional

ones of economic theory) and in the course of attempts to accomplish their objectives are a *major agent of institutional change*.” (p. 5).

North places emphasis on the interaction (**symbiotic relationship**) between institutions and organizations.

Roles of Institutions:

“Institutions **reduce uncertainty** by providing a structure to everyday life. They are a guide to human interaction”(p. 3)

“Institutions define and limit the set of choices of individuals.” (p. 4)

“Institutions reduces uncertainty by **establishing a stable**(but not necessarily efficient) **structure** to human interaction”(p. 6)

“Institutions determine the opportunities in a society”(p. 7)

“ Institutions define and **limit the set of choices of individuals**. (p. 4)

“Institutions **provide the structure for exchange**...allow individuals to engage in complex contracting with a minimum of uncertainty about whether the terms of contract can be realized.” (p. 34)

“Institutions provide the basic structure by which human beings throughout history have **created order** and attempted to reduce the uncertainty in exchange. (p. 118)”

“Institutions basically alter the price individuals pay (for one’s convictions) and hence lead to ideas, ideologies, and dogmas frequently playing a major role in the choices individuals make.”(p. 21, 26)

“From this capacity of the mind to process, organize, and utilize information taken in conjunction with uncertainties involved in deciphering the environment, **rules and procedures evolve to simplify the process**. The consequent institutional framework, by structuring human interaction, **limits the choice set of the actors**.”(p. 25)

“When it is costly to transact, institutions matter.”(p. 12)—quoted as the most important message of Coase.

“Under conditions of limited information and limited computational ability, **constraints reduce the costs of human interaction** as compared to a world of no institutions.”(p. 36) (for everybody?)

“Institutions assure cooperation.”(p. 57)

Nature of Institutions?

“Institutions are **not necessarily or even usually created to be socially efficient**; rather they, or at least the formal rules, are created to serve the interests of those with the bargaining power to devise new rules.(p. 16)

Institutions alter the price paid for one’s convictions and hence play a critical role in the extent to which non-wealth-maximizing motivations influence choices...Under certain circumstances institutions [devised as such may] turn out to be or evolve into socially efficient ones.”(p. 16, 26)

♣ The term **efficient** is being used in this study to indicate a condition where the existing set of constraints will produce economic growth. (p. 92)

North’s interest in/questions regarding institutions:

To argue that the **limitations of human organization** (p. 132) is the fundamental problem, (rather than technology) and thus concentrate on the **institutional origins of transaction and transformation costs**, and tries to draw its implication for human economic history

Institutions → incentives → choices → outcomes/performance (p. 134)

“Institutional change and the divergent economic performance resulting from it “(p. 7)

Why wouldn’t competitive pressures lead to the elimination of inefficient institutions? Wouldn’t the political entrepreneurs in stagnant economies quickly emulate the policies of more successful ones?

How can we explain the radically differential performance of economies over long periods of time?

North’s answer to these questions hinges on the **difference** between institutions and organizations and the **interaction (symbiotic relationship)** between them that shape the direction of institutional change. Institutions determine the opportunities in a society. Organizations are created to take advantage of those opportunities, and, as the organizations evolve, they alter the institutions.

Chap. 2: Cooperation: the theoretical problem

*Smith's Wealth of the Nations, chap. 2 (Of the principles which give occasion to the division of labor)

In contrast to Western countries, why many countries remain underdeveloped?
The theory employed by development economists is not up to the task.
Due to the **persistence of inefficient forms of exchange**

What has been missing in the studies thus far is an understanding of the **nature of human coordination and cooperation, that is, institutions**

Issue (the focus of this study): Under what conditions can voluntary cooperation exist without the Hobbesian solution of the imposition of a coercive state to create cooperative solutions?

A neat, definitive answer to 1) **why**, both throughout history and in most of the present world economies, the potential gain from trade have **not** been realized? 2) as well as to **why the modern Western world has realized (at least partially) this economic potential**, would not only solve the issues of economic development but point toward resolving the larger issues of human conflict.(p. 13)

To make cooperation possible, it is necessary to know others' beliefs, wants, etc. and for others to know of me. That means it is necessary to overcome uncertainty. This is an informational problem, which brings about transaction costs, in its essence.

Criticism on game theory

- It does not provide us with a theory of the underlying costs of transacting and how those costs are altered by different institutional structures.

Coase's (and North's) argument:

Neo-classical economics explains the world well when it is costless to transact.

They assume that

1) competition, if strong enough, eliminates the incomplete, asymmetrical information that rewards defection in the game theory models. (p. 15)

(But is it achievable? No.)

2) when there are significant transaction costs, the consequent institutions of the market will be designed to induce the actors to acquire the information that will lead them to the correct models to achieve their ends.

* **Think about this issue hard.**(I myself sometimes argue so in the defense of competitive-market model.)

Implication of these assumptions:

- 1) Institutions are designed to achieve the efficient outcomes.
- 2) They can be ignored in economic analysis because they play no independent role in economic performance.

Critique:

None of these stringent requirements can survive critical scrutiny.

- 1) Individuals act on incomplete information and with subjectively derived models that are frequently erroneous.
- 2) The information feedback is typically insufficient to correct these subjective models.

“Institutions are **not necessarily or even usually created to be socially efficient**; rather they, or at least the formal rules, are created to serve the interests of those with the bargaining power to devise new rules. In a zero-transaction-cost world, bargaining strength does not affect the efficiency of outcomes, but in a world of positive transaction costs it does, and given the lumpy indivisibilities that characterize institutions, it shapes the direction of long-run economic change.”(p. 16)

Creating relatively efficient institutions is only possible

- 1) under certain circumstances, the **private** objectives of those with bargaining strength to alter institutions produce institutional solutions that turn out to be or evolve **socially** efficient ones.:
- 2) These circumstances are determined by 1) the subjective models of the actors, 2) the effectiveness of the institutions at reducing transaction costs, and 3) the degree to which the institutions are malleable and respond to changing preferences and relative prices.

Chap. 3: The behavioral assumptions in a theory of institutions

The traditional behavioral/rational choice assumptions have prevented economists from coming to grips with some very fundamental issues; And a modification of these assumptions is essential to further progress in the social sciences.(p. 17)

Deficiencies of the rational choice approach as it relates to institutions
(two particular aspects of human behavior)

1) motivation

Not simply wealth maximization

North tries to build more elaborate models of complex human behavior (within the expected utility model), incorporating certain aspects of altruism (issues of free-riding, fairness, and justice).

Altruistic motives and self-imposed constraints influence human behavior (enter the choice set).

“Institutions basically alter the price individuals pay for one’s convictions (that is, one’s own ideology, or norms, or preferences) and hence lead to ideas, ideologies, and dogmas frequently playing a major role in the choices individuals make.”(p. 22)

--This aspect helps to understand a great deal about institutions and about the way in which they influence decision making.

*** ideology: **subjective perceptions (models, theories)** all people possess to explain the world around them; these theories individuals construct are colored by normative views of how the world should be organized.(p. 23)

[or one’s sense of the way the world ought to be; p. 21]

2) deciphering the environment

90% of our actions in a day do not require much reflection (choices).

It is the existence of an **imbedded set of institutions** that has made it possible for us not to think about problems or make such choices. **We take them for granted, because the structure of exchange has been institutionalized in such a way as to reduce uncertainty.** 22

Herbert Simon:

...If on the other hand, we accept the proposition that both the knowledge and the computational power of the decisionmaker are severely limited, then we must distinguish between the real world and the actor’s perception of it and reasoning about it. That is to say, we must construct a theory (and test it empirically) of the process of decision. Out

theory must include not only the reasoning processes but also the processes that generate the actor's subjective representation of the decision problem, his or her frame.

The rational person in neo-classical economics always reaches the decision that is objectively, or substantively, best in terms of the given utility function. The rational person of cognitive psychology goes about making his or her decisions in a way that is procedurally reasonable in the light of the available knowledge and means of computation. (Simon, 1986, pp. S210-11)

In the face of complexities and the computational, problem-solving limitations (and necessary fumbling efforts), **human beings need to develop regularized patterns of human interaction.** These regularized interactions we call institutions may be very inadequate or very far from optimal in any sense of the term. In short, **Simon's way of looking at how human beings proceed (that is, subjective and incomplete processing of information) is consistent with the arguments about the formation of institutions.**(p. 23)

Ronald Heiner: **Uncertainty not only produces predictable behavior, but is the underlying source of institutions.**(p.24) :**relationship among uncertainty, behavior, and institutions**

North's Reformulation of Sydney Winter's summary:

1. For some purposes the concept of equilibrium is a valuable tool of analysis, but for most of the issues that we are concerned with there is not one equilibrium, but **multiple equilibria** that arise because "there is a continuum of theories that agents can hold and act on without ever encountering events which lead them to change their theories" (Hahn, 1987, p.324).
2. Although individual actors face many repetitious situations and, as noted above, can act rationally in such situations, they also are confronted with many unique and **non-repetitive choices** where the information is incomplete and where outcomes are uncertain.
3. Although Becker and Stigler have made an impressive case(1977) for relative price changes accounting for many apparent changes in preferences, the **stability issue** is not so easily dismissed. Not only do anomalies show up at the disaggregated level at which psychological research has been conducted, but certainly historical evidence suggests that **preferences over time change.** (eg., the demise of slavery in the nineteenth century).
4. Actors would certainly like to improve outcomes, but the **information feedback may be so poor** that the actor cannot identify better alternatives.

5. Competition may be so muted and the signals so confused that adjustment may be slow or misguided and the **classic evolutionary consequences may not obtain** for very long periods of time.
6. The condition of the world throughout history provides overwhelming evidence of **much more than simple rational non-cooperative behavior**.
7. **The behavioral assumptions of economists** are useful for solving certain problems. They are inadequate to deal with many issues confronting social scientists and the **fundamental stumbling block** preventing an understanding of the existence, formation, and evolution for institutions.

Conclusion:

We have made progress toward building a precise and tidy behavior model.

That will allow us to explain why institutions are a **necessary extension of the way human beings process information; and to predict the complex mix of motivations that shape choices..**

Not yet. But the **current model is enough to explain** the existence of institutions and (less precisely) the motivations of the actors that helps to shape institutions and provides the means by which altruism and other non-wealth maximizing values enter the choice set.

- 1) Institutions exist to reduce the uncertainties involved in human interaction (or in deciphering the environment).
- 2) Rules and procedures evolve to simplify the process (of processing, organizing, and utilizing information).
- 3) The consequent institutional framework, by structuring human interaction, limit the choice set of the actors.

Chap. 4: A transaction cost theory of exchange

(North's approach: **University of Washington approach**, contrasted with Williamson's)

My theory of institutions: theory of human behavior + theory of the costs of transacting

North's central concern: define precisely what it is about transacting that is so costly
(Neither Coase nor many of subsequent studies of transaction costs have attempted to do it.)

Why important? behavioral assumptions → understanding need for institutions, roles of institution

I.

The Costliness of exchange, which has been disregarded ever since Adam Smith, is the key.

The costliness of economic exchange distinguishes the transaction costs approach from the traditional theory economists have inherited from Adam Smith, who built their theory... without regard to the costliness of this exchange process. [Which is dependent on institutions; they simple-mindedly assumed this away as if they did not exist or they did not matter.]

(Total) production cost = **transactions costs** + production (transformation) costs
(former accounts for more than 45% of national income, and growing)

TC = resource inputs of land, labor, and capital involved in defining, protecting, and enforcing the **property rights** to goods
the right to use,
the right to derive income from the use of,
the right to exclude,
and the right to exchange (p. 28)

Two components of TC:

“These measurement and enforcement costs are the sources of social, political, and economic institutions”(p. 27)

- 1) costs of measuring the valuable attributes of what is being exchanged (**measurement costs**)
- 2) costs of protecting rights and policing and enforcing agreements (**enforcement costs**)

1) measurement costs

costs of measuring the **valued attributes** of goods and services and the varying characteristics of the performance of agents

The information costs in ascertaining the level of individual attributes of each unit exchanged underlie the costliness of this aspect of transacting.

And additional resources needed to define and the measure rights that are transferred.
29

Asymmetries of information exacerbate the difficulty of transacting:

→ adverse selection dilemma

→ moral hazard problem

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II.

The relationship between the magnitude of TC on either party and the ownership structure

예를 들면 왜 슈퍼마켓에서 사과를 open sale (소비자가 골라가도록)하면서 다른 물건에 대해서는 안하는가

Eg. (mine) lease, rental, child-rearing, road pricing, restaurants (p. 31-2)

III.

2) enforcement costs (and risk premium)

From the need to police agents arise the **principal-agent relationship and the monitoring problem**. (Agency issue in general)

Enforcement is (and always has been) the **critical obstacle** to increasing specialization and division of labor.

The net gains from exchange = the (standard) gross gains
 minus the costs of measuring and policing the agreement
 minus the losses that result because monitoring is not perfect

IV.

Relationship among the behavioral assumptions, the characteristics of transacting and the institutional structure of a society:

“**Property rights** are the rights individuals appropriate over their own labor and the goods and services they possess. **Appropriation is a function of** legal rules, organizational forms, enforcement, and norms of behavior—that is, **the institutional framework**. Because with any property rights structure transaction costs are positive, rights are never perfectly specified and enforced; some valued attributes are in the public domain and it pays individuals to devote resources to their capture. Because the costs of transacting have changed radically throughout history and vary equally radically in different contemporary economies, the **mix** between the formal protection of rights and individual protection of their own rights varies enormously.”(p. 33)

♣ **institutional framework is defined as the sum of** legal rules(formal), organizational forms, enforcement, and norms of behavior (informal)

- Institutions determine the way property rights are appropriated.

“Institutions provide the structure for exchange that (together with the technology employed) determines the costs of transacting and the cost of transformation. How well institutions solve the problems of **coordination** and **production** is determined by the motivation of the players (**their utility function**), the **complexity of the environment**, and the ability of the players to decipher and order the environment (**measurement and enforcement**)” (p. 34)

General evolutionary pattern of exchange:

- 1) Personal exchange
(limited specialization, hence transaction costs low, but transformation costs high) →
- 2) impersonal exchange
(constrained by kinship ties, bonding, exchanging hostages, or merchant code of conduct; or supported by the state (but often the source of insecurity and higher transaction costs))→
- 3) impersonal exchange with third-party enforcement
(via an effective judicial system)

Immense resources are devoted to attempting to promulgate codes of conduct. Equally, however, the returns to opportunism, cheating, and shirking rise in complex societies...Indeed, effective third-party enforcement is best realized by creating a set of rules that then make a variety of informal constraints effective.

Thus the need to look at the evolutionary relationship between formal and informal institutions, and enforcement

Chap. 5: Informal Constraints

- Examples: conventions, customs, norms of behavior, codes of conduct
(* general purpose institution?)

The **pervasiveness** of informal constraints
(formal rules make up only a small part of the sum.) 36

Underlying these informal constraints are formal rules, but these are seldom the obvious and immediate source of choice in daily interactions.

In spite of total change in the (formal) rules, so many aspects of a society persist due to the existence of informal constraints. (Japanese culture after US occupation; Russian Revolution, etc.)

Where do informal constraints come from?

They come from socially transmitted information and are a part of **culture** (=transmission from one generation to the next, via teaching and imitation, of knowledge, values, and other factors that influence behavior)...Culture provides a language-based conceptual framework for encoding and interpreting the information.

Cultural filter provides continuity so that the informal solution to exchange problems in the past carries over into the present and makes those informal constraints important sources of continuity in long-run societal change (p. 37)

In chap. 3, the emphasis is on the incompleteness of information and the consequent need for institutions to structure human interaction.

Here it is on the way in which cultural filter makes those informal constraints important sources of continuity in the long-run societal change. 37

See the human interaction when there are no formal rules (no state)

Anthropological studies of **Primitive societies** says that a dense social network leads to the development of informal structures with substantial stability.

“they operate with a set of rules or standards which define appropriate action under a variety of circumstances. The rules, by and large, operate to eliminate conflict of interests by defining what it is people can expect from certain of their fellows...Rules do not solve all problems; they only simplify life. They also give a framework for organizing activities. Standards and some means of applying sanctions are necessary complements to the rules...”(in Elisabeth Colson’s words; p. 38)

Common Message:

Order in the societies is the result of dense social network where people have an intimate understanding of each other and the threat of violence is a continuous force for preserving order because of its implications for other members of society. Deviant behavior cannot be tolerated in such a situation.

II.

Informal constraints are **pervasive** features of **modern economies** as well.

Arising to coordinate repeated human interaction, informal constraints are

- 1) extensions, elaboration, and modifications of formal rules;
 - informal constraints evolve from the formal rules to deal with specific problems of exchange and become established as recognized institutional constraints
 - example: congressional committee power and committee chairs (Shepsle and Weingast)
- 2) socially sanctioned norms of behavior, and
 - example: duel as an accepted way of settling disputes among gentlemen
- 3) internally enforced standards of conduct that modify behavior.(p. 40)
 - only pursuant to informal constraints; altering choices
 - example: legislators' voting behavior (reflect their ideas, ideologies, and convictions)

III.

How do we explain the emergence and persistence of informal constraints?

Conventions solve coordination problems efficiently; These are the rules that have never been consciously designed and that it is in everyone's interest to keep (Sugden)

typical example: **the rules of the road** (p. 41)

—It is not only minimizing the measurement costs but **self-enforcing**.

“Informal constraints can take the form of **agreed upon lower cost forms of measurement** (standardized weights and measures, for example) and make second- and third-party enforcement effective by specific sanctioning devices or information networks that acquaint third parties with exchange performance (credit ratings, better business bureaus, etc.).”(p. 41)

- examples: codes of merchant conduct in later medieval and early modern Europe

Why informal institutions exist and what roles they play?

- provides the way by which the mind processes and utilizes information; hence the **cultural processing of information**
- Because of the costliness of measurement, **most contracts are incomplete; hence informal constraints play a major roles in the actual agreement.**(p. 61)
- A major role of informal constraints is to **modify, supplement, or extend formal rules**(p. 87)

Summary:

“The way by which the mind processes information not only is the basis for the existence of institutions, but is the key to understanding the way informal constraints play an important role in the makeup of the choice set both in the short-run and in the long-run evolution of societies.”(p. 42)

What is it that makes norms evolve or disappear?

alternative models: game theory vs transaction costs framework

Both are deficient

subjective perceptions of the actors in the context of formal institutional structures that alter the price individuals pay for their convictions

For example, voting, hierarchies that produce slacks in the principal/agent relationship in legislatures, and life time tenure for judges are formal institutional constraints that lower the cost of acting on one’s convictions

The long-run implication of the cultural processing of information that underlies informal constraints:

(is that) It plays an important role in the **incremental** way by which institutions evolve and hence is a **source of path dependence**.”..Cultural traits have tenacious survival ability and most cultural changes are incremental. (p. 44)

“Equally important is the fact that the informal constraints that are culturally derived will not change immediately in reaction to changes in the formal rules. As a result the **tension between altered formal rules and the persisting informal constraints** produces outcomes that have important implications for the way economies change.”(p. 45)

Chap. 6: Formal constraints

Kinds of formal rules (Elinor Ostrom, 1986)

- 1) position rules specify a set of rules and how many participants hold each position,
- 2) boundary rules specify how participants are chosen to hold these positions and leave these positions,
- 3) scope rules specify the set of outcomes that may be affected and the external inducements and/or costs assigned to each of these outcomes,
- 4) authority rules specify the set of actions assigned to a position at a particular node,
- 5) aggregate rules specify the decision functions to be used at a particular node to map action into intermediate or final outcomes,
- 6) information rules that authorize channels of communication among participants in positions and specify the language and form in which communication will take place.

Relationship between informal and formal rules:

- The move from the former to the latter has been unidirectional, as we have moved from less to more complex societies.

- 1) Formal rules can complement and increase effectiveness of informal constraints. They may lower information, monitoring, and enforcement costs and hence make informal constraints possible solutions to more complex exchange.

전자상거래의 등장 → new rules 의 추가 필요성 + informal constraints

- 2) Formal rules also may be enacted to modify, revise, or replace informal constraints. (But informal constraints may stand in the way.)
- 3) Sometimes (but not always) it is possible to supercede the existing informal constraints with new formal rules.

II. Generalizations

- Formal rules include political (and judicial) rules, economic rules, and contracts. And they have a hierarchy: constitutions to statutes and common laws to specific bylaws and finally to individual contracts(p. 47). **The rules descend from politics to property rights and to individual contracts.**(p. 52)
- Function of formal rules is to facilitate exchange, political and economic(, by altering the initial bargaining strengths of the d-m parties). It, however, promotes certain kinds of exchange, **but not all** exchange (for example, factional struggle). For example, patent laws, and trade secret laws are designed to raise the costs of exchange deemed to inhibit innovation.
- Rules are devised in the interests of private well-being, rather than social well-being. (Certainly ideas and norms matter, but) **Rules are derived from self-interest. Hence no necessary implication for efficiency.**

Examples: denying franchise, restricting entry, or preventing factor mobility

- Rules are generally devised with compliance* costs in mind. In many cases, however, the costs of measurement, given technology of the time, exceed the gains, and rules are not worth devising and ownership rights are not delineated.(p. 48)

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*Costs are incurred by the parties to contracts to enforce and make their rights effective respectively

1) political rules

- Political rules broadly define the hierarchical structure of the polity, its basic decision structure, and the explicit characteristics of agenda control.
- Broadly speaking, political rules in place lead to economic rules, though the causality runs both ways (the **priority of political rules**).
- Credible commitment evolve to enable agreements to be reached: self-enforcement, reputation are important;
- Political institutions **constitute ex ante agreements about cooperation** among politicians. They reduce uncertainty by creating a stable structure of exchange: complicated system of committee structure
- Formal political rules, like formal economic rules, are designed to facilitate exchange but democracy in the polity is not to be equated with competitive markets in the economy.
- Efficient markets are scarce enough in the economic world and even scarcer in the political world.
- The distinction is important with respect to the efficiency of property rights.

2) property rights [=economic rules?; yes, in most cases]

- Economic rules define property rights, that is the bundle of rights over the use and the income to be derived from property and the ability to alienate an asset or a resource.
- **Obvious persistence of inefficient property rights** reflecting that they are the outcome of political bargaining and compromise (between the ruler and strong interests); In this sense, the **efficiency of the political market is the key to the issue**: If political transaction costs are low and the political actors have accurate models to guide them, then efficient property rights will result. But this has not usually been the case in reality and the consequent organizations have had no incentive to create more productive economic rules (p. 52).

3) contracts

- Contracts reflect the incentive-disincentive structure imbedded in the property rights structure (and the enforcement characteristics); thus the opportunity set of the players and the forms of organization they devise in specific contracts will be derived from the property rights structure.

- typically incomplete, thus requiring the intervention of the courts or some third party for the settlement of disputes over the life of the contract.

A word of warning:

A mixture of informal constraints, rules, and enforcement characteristics together defines the choice set and results in outcomes. Looking only at the formal rules themselves, therefore, gives us an inadequate and frequently misleading notion that the relationship between formal constraints and performance.

Chap. 7: Enforcement (+ compliance costs, p. 48)

Enforcement is seldom either perfect or constantly imperfect. And the structure of enforcement mechanisms and the frequency and severity of imperfection play a major role in the costs of transacting and in the forms that contracts take.

The inability of societies to develop effective, low-cost enforcement of contracts is the most important source of both historical stagnation and contemporary underdevelopment in the Third World.

(Cf. This understanding constitutes another major difference between Oliver Williamson's approach to transaction costs and North's; **Williamson** assumes enforcement to be imperfect (otherwise opportunism would not pay), but does not make it an explicit variable in his analysis. Such an approach simply does not lead Williamson to deal with the problems of historical evolution, where the key problems of institutional change, of contracting, and of performance turn on the degree to which contracts can be enforced between parties at low cost.) (p. 54n)

- Enforcement is **typically imperfect**; and the structure of enforcement mechanisms and the frequency and severity of imperfection play a major role in the costs of transacting and in the forms that contracts take.
- Two reasons for imperfect enforcement:
 - 1) costs of measuring multifaceted contract performance is high,
 - 2) enforcement is undertaken by agents whose own utility functions influence outcomes. (**asymmetry of information**)

“No institutions are necessary in a world of complete information. With incomplete information, however, cooperative solutions break down unless institutions are created that provide sufficient information for individuals to police deviations.”(p. 57)

Institutions assure cooperation; there are two parts to it:

- 1) Institutions make possible the policing of defections, by making available, through a communications mechanism formed by institutions, the relevant information necessary to know when punishment is required.
- 2) Institutions must also provide incentives for those individuals to carry out punishment when called on to do so (punishment is often a public good)

Creating an institutional environment that induces **credible commitment** entails the complex institutional framework of formal rules, informal constraints, and enforcement that together make possible low-cost transacting. (p. 58)... Viable impersonal exchange in technologically complex world requires institutions that can enforce agreements by the threat of coercion... There are immense scale economies in policing and enforcing

agreements by a **polity that acts as a third party** and uses coercion to enforce agreements...

But therein lies the fundamental dilemma of economic development. *If we cannot do without the state, we cannot do with it either.* **How does one get the state to behave like an impartial third party?** (p. 58)...No one knows at this stage how to create such an entity. Put simply, if the state has coercive force, then those who run the state will use that force in their own interest at the expense of the rest of the society...

Will the correct constitutional forms restrain the tyrannical exercise of political power (as argued by Riker)? Skeptical. (p. 59)...

How does one create such self-enforcing constraints? Part of the answer is that creating a system of effective enforcement and of moral constraints on behavior is a long, slow process that requires time to develop if it is to evolve—a condition markedly absent in Third World countries (p. 60)—the chicken and egg problem in which there is no causal direction?

♣ **Credible commitments:**

- exchange of hostages
- ostracism of merchants who reneged on agreements
- reputations (especially in long-distance trade)
- kinship ties, various forms of loyalty, minority groups in societies bound together by common beliefs in a hostile world, ideological commitments to integrity and honesty(p. 55)

Chap. 8: Institutions and transaction and transformation costs

It takes resources to define and protect **property rights** and to enforce agreements. (cf. 28) Institutions (together with technology employed) determine those **transaction costs**, and they thus play a key role in the cost of production(=transformation).

(the threads of the argument so far pulled together)

A hierarchy of rules together will define the formal structure of rights in a specific exchange. Moreover, a contract will be written with enforcement characteristics of exchange in mind. Because of the costliness of measurement, most contracts will be incomplete; hence informal constraints will play a major role in the actual agreement. These will include reputation, broadly accepted standards of conduct, and conventions that emerge from repetitive interactions. (p. 61)

In this chapter, the **relationship between rights and constraints (=TC) in an exchange** is illustrated **at three levels**:

- 1) a single straightforward exchange,

transaction costs of transfer of a house: the resources necessary to measure the legal and physical attributes of house, the costs of policing and enforcing the agreement, and an **uncertainty discount** reflecting the degree of imperfection in the measurement and enforcement of the terms of the exchange.

(1) through market (market costs): legal fees, realtor fees, the insurance, title insurance, and credit rating searches

(2) other hard-to-measure costs: information gathering costs, searching costs (in obtaining information about crime rates, police protection, and security systems), and so forth to the buyer; and costs involved in obtaining information about the possibility of default on the part of seller

Here a hierarchy of rules is involved—institutions matrix: constitution; state laws (zoning laws for example); economic rules (pertaining to realtors, title insurance, credit bureaus, and savings and loans associations); and informal constraints (conventions of neighborhood conduct, ethical norms defining degree of honesty in information exchange between the parties involved)

Because the **market is imperfect**, institutions everywhere are a **mixed bag** composed of those that lower costs and that raise them.

The **security of rights** is especially important, and represents a **critical distinction** between the relatively efficient markets of high-income countries and the economies in the past as well as those in the Third World countries. .

- 2) the more complex relationship involved in the production process,
 → determine the organization of production and industry

The efficient production and factor **markets do not exist unless perfect measurement and enforcement are implicitly assumed. And, partly as a result of this**, the actual institutional framework (related to factor mobility, acquisition of skills, uninterrupted production, rapid and low-cost transmission of information, and invention and innovation of new tech.) is in fact a **mixed bag** of institutions that promote such productivity-raising activities and institutions that provide barriers to entry, encouraging monopolistic restrictions, and impede the low-cost flow of information.

The organization of production in a Third World economy is characterized by the consequences of poorly defined and/or ineffective **property rights**, with the result not only that transactions costs are high, but technologies that employ little fixed capital are used, and long-term agreements do not entail.

Much of the recent transaction costs literature implies (wrongly) that institutions only determine transaction costs, while techniques only determine transformation costs; but it is clear that the **relationship** among techniques, institutions, transformation costs, and transaction costs is **more complex**. Three cases:

- (1) deliberate deskilling of the labor force during the early 20th century (as Marxist writers contend) indicates that a new production technology (using less-skilled workers less apt to strike) was introduced to reduce transaction costs.
- (2) Unitizing an oil field: an institutional change that raised transaction costs (Libecap and Wiggins, 1985) that were more than compensated by lower transformation costs.
- (3) The deliberate policy of a semiconductor manufacturer who licenses the designs of new chips to competitors, so that customers can be assured that the chip manufacturer will not be able to hold up customers who adopt the new design (Andrea Shepard, 1987). Although this policy lowers transaction costs, it does so at the sacrifice of productive efficiency.

- 3) the economy as a whole

the cost of capital is determined by an elaborate structure of financial intermediaries, whose interconnections are constrained by a complex structure of governmental constraints and regulatory agencies, which in turn act according to formal constraints defined by political institutions—the **grist for the new political economy** in its attempt to spell out and provide an analytical framework for the institutional structures of Congress and other branches of government.

“In a Third World country...With insecure property rights [why? ambiguity of limits to government’s role, misconception about public interest...] , poorly enforced laws, barriers to entry, and monopolistic restrictions, the profit-maximizing firms will tend to have short horizons and little fixed capital, and will tend to be small scale. The most profitable businesses may be in trade, redistributive activities, or black market. **Large firms with substantial fixed capital will exist only under the umbrella of government protection** with subsidies, tariff protection, and payoffs to the polity—a mixture hardly conducive to productive efficiency. (p. 67)

Conclusion with some of implications (pp. 67-9)

- 1) The institutional constraints that define the opportunity set of individuals are **a complex of formal and informal constraints**. They make up an interconnected web that in various combinations shapes choice sets in various contexts. It is easy, given this understanding, to see why **institutions are stable** and why they typically produce many different margins at which choices are made. **Stability derives from the fact that there are a large number of specific constraints that affect a particular choice**, such as those described in the sale of house...Although the institutional constraints may not be ideal or efficient for one set of individuals involved in a particular exchange and therefore those parties would like to restructure the institutions, the same set of institutions for other sets of choices may still reflect as efficient a bargain as is possible. Moreover it is the bargaining strength of the individuals and organizations that counts. Hence, only when it is in the interest of those with sufficient bargaining strength to alter the formal rules will there be major changes in the formal institutional framework. [However, **only marginal incremental change is possible**. —the subject of Part II of the book.]
- 2) **The higher the measurement and enforcement costs, the more will the exchanging parties invoke informal constraints** to shape the exchange...Vertical integration offers a partial solution to these costs, always with a caveat that the measurement costs are not necessarily lower in this form...Therefore self-enforcing contracts will dominate forms of exchange...(when third party enforcement is not possible.)

Example: Organizational structure of chaebols in Korea

- 3) Transaction costs are the most observable dimension of the institutional framework that underlies the constraints in exchange. They consist of **those costs that go through the market**, and therefore are measurable, and of **hard-to-measure [even recognize] costs** that include time acquiring information, queuing, bribery, and so forth, as well as the losses due to imperfect monitoring and enforcement. These hard-to-measure costs make it difficult to assess precisely the total transaction costs resulting from a particular institution. Nevertheless, to the degree that we are able to do so, we progress in measuring the effectiveness of institutions.

- 4) The **most important moral** to be drawn from this chapter is that institutional framework plays a major role in the performance of an economy...However, I have been at pains to point out that some institutional constraints raise transaction costs. Therefore, the market overall is a **mixed bag** of institutions; some increase efficiency and some decrease efficiency. **Nevertheless, this institutional framework is the critical key to the relative success of economies, both cross-sectionally as well as through time.**

Part II: Institutional Change

Chap. 9: Organizations, learning, and change

Organizations and their entrepreneurs engage in purposive activity and in that role are the agents of, and shape the direction of, institutional change.

If information and enforcement were costless, it would be hard to envision a significant role for organizations(p. 73).

Two-way relationship between knowledge and ideology:

The way knowledge develops shapes our perceptions of the world around us and in turn those perceptions shape the search for knowledge.(p. 76)

The incentives that are built into the institutional framework play the decisive role in shaping the kinds of skills and knowledge that pay off. (p.78)

- 1) The institutional framework will shape the **direction of the acquisition of knowledge and skills** in which firms or other economic organizations invest;
- 2) That direction will be the decisive factor for the productivity increases and the long-run development of that society.(p. 78)

Maximizing behavior of economic organizations shapes institutional change by:

- 1) the resultant derived demand for investment in knowledge of all kinds;
- 2) the ongoing interaction between organized economic activity, the stock of knowledge, and the institutional framework;
- 3) and incremental alteration of the informal constraints as a by-product of maximizing activities of organizations.(p. 78)

Two alternatives for maximizing behavior by the firm or economic organizations:

- 1) Making choice within the existing set of constraints (learning by doing and investing in the kinds of skills and knowledge that will pay off) vs.
- 2) of altering the constraints (by devoting resources to changing the institutional constraints)

The choice (of direction) depends upon its subjective perceptions of the payoffs.

- 1) Organizations with sufficient bargaining strength will use the polity(change political rules) to achieve objectives, as suggested in Chap. 6, when the payoffs from alternative 2 exceeds that from **alternative 1**.
- 2) But the incremental change in the overall institutional framework is more comprehensive than what happens under alternative 1.
- 3) Organization will also encourage the society to invest in the kinds of skills and knowledge that indirectly contribute to their profitability, which will shape the

long-run growth of skills and knowledge, which in turn are the underlying determinants of economic growth.

U.S. economic history is illustrative:

The market for knowledge together with the subjective perceptions of the players (politicians and voters) coincided to produce a private and public investment in knowledge that approached the social rate of return.

The concept of **Adaptive efficiency**

- It is concerned with the **kinds of rules that shape the way an economy evolves through time.**
- It is also concerned with the willingness of a society to acquire knowledge and learning, to induce innovation, to undertake risk and creative activity of all sorts, as well as to resolve problems and bottlenecks of the society through time.(p. 80)
- It provides the incentives to **encourage the development of decentralized decision-making processes** that will allow societies to maximize the efforts required to explore alternative ways of solving problems.(p. 81)
- Different institutional rules will produce different incentives for tacit knowledge...Rules that encourage the development and utilization of tacit knowledge and therefore creative entrepreneurial talent will be important for efficient organization.
- Competition, decentralized decision making, and well-specified contracts of property rights as well as bankruptcy laws are crucial to effective organization. It is essential to have rules that eliminate not only failed economic organization but failed political organization as well.(p. 81)
- Allocative efficiency and adaptive efficiency may not be consistent. (As with institutional framework in general), adaptively efficient institutional frameworks have existed and do exist, just as adaptively inefficient ones have existed and do exist.(p. 82)

Chap. 10: Stability and institutional change

The **sources of change** are changing relative prices or preferences.

(→ change in **incentives** of individuals in human interaction):

1) **changes in relative prices**: [이기적 제도변화?]

--changes in the ratio of factor prices, change in cost of information, changes in technology

-- most of them are endogenous

(The process by which the entrepreneur acquires skills and knowledge is going to change relative prices by changing perceived costs of measurement and enforcement and by altering perceived costs and benefits of new bargains and contracts. Changes in bargaining power lead to efforts to restructure contracts, political and economic.)

2) **changes in preferences** or tastes [이타적?]

- relatively little known yet
- but it is clear that changing relative prices play some role in changes in tastes, behavioral pattern of people and their rationalization of what constitutes standards of behavior
- for example: changes in family structure,
- in particular in the case of antislavery movement, the electoral process (a structure of institutions) makes it possible for people to express their ideas and ideologies effectively at very little cost to themselves(p. 85)

In summary, institutions, by reducing the price we pay for our convictions, make ideas, dogmas, fads, and ideologies important source of institutional change. (p. 86)—but the interplay among these variables are not fully known.

♣ **Institutional equilibrium**: a situation where given the bargaining strength of the players and the set of contractual bargains that made up total economic exchange, none of the players would find it advantageous to devote resources into restructuring the agreements. Note that such a situation does not imply that everyone is happy with the existing rules and contracts, but only that the relative costs and benefits of altering the game among contracting parties does not make it worthwhile to do so. The existing institutional constraints defined and created the equilibrium. (p. 86)

The **skeletal outline of the pattern of institutional change** (p. 86)

--Agenda power, the free-ride problem, or the tenacity of norms of behavior may complicate this change process outlined above.

1) in the case of formal rules

changes in relative prices → one or both parties to an exchange perceive(s) the need to alter the agreement → renegotiation → restructuring a higher set of rules may be necessary → the party that stands to improve his bargaining position may very well attempt to devote resources to restructuring the rules at a higher level

Here the role of chief actor—the (political and economic) entrepreneurs—becomes important.

- (1) They may devote their talents or tacit knowledge to ferreting out profitable margins, estimating the likelihood of success, and risking the organization's resources to capture potential gains.
- (2) Sometimes it will pay to **create intermediary organizations** (trade associations, lobbying groups, political action committees) between economic organizations and political bodies to realize the potential gains of political change.
- (3) The larger the percentage of society's resources influenced by government decisions (directly or via regulation), the more resources will be devoted to such offensive and defensive (to prevent being adversely affected) organizations.

2) in the case of informal rules (norm of behavior)

changes in relative prices or change in tastes → gradual erosion or simply ignored by common consent and unenforced (withered away) (or replaced)

We are not yet able to explain precisely the forces that shape cultural evolution. But it is obvious that the cultural characteristics of a society change over time and that **accidents, learning, and natural selection all play a part.**

Cultural evolution theory is in its infancy. But it indicates: the persistence of cultural traits in the face of changes in relative prices, formal rules, or political status makes informal constraints change at a different rate than formal rules.

At a micro level, however, we know that

A major role of informal constraints is to modify, supplement, or extend formal rules.

change in formal rules or their enforcement will result in a disequilibrium situation → transaction costs altered by the resulting change in institutional constraints in either category → efforts to evolve new conventions or norms that will effectively solve the new problems that will have arisen (Ellickson) → a **new informal equilibrium** will evolve gradually after a change in the formal rules.

“However, sometimes formal rules are developed deliberately to overrule and supersede existing informal constraints that no longer meet the needs of newly evolved bargaining structures. Usually, the norms (informal constraints) that have evolved to supplement formal rules persist in periods of stability, but get overturned by new formal rules in periods of change.”(p. 88)

Example: The 1974 Bill of Rights of subcommittee in the House of Representatives in the U.S.

It produced a sharp change in formal rules that overrode previous informal committee structures. The change reflected a decline in party power over legislation and a sharp increase in the number of new liberal Democrats with a different agenda.

3) in the case of changes in enforcement

Example: history of U.S. land law

Lax enforcement of land law by the federal government led to a vast array of individuals, groups, and organizations attempting to capture the benefits from exploiting land. Finally a general preemption act was passed in 1830 and made permanent in 1841.

The single most important point about institutional change: The process of change is overwhelmingly an **incremental** one. (p. 83)

- The changes are an aggregation of literally thousands of specific small, continuous marginal alterations/adjustments in agreements spanning over a long period of time.

Example: the demise of feudalism and manorialism (p. 89)

Discontinuous change (=radical change in formal rules, as a result of wars, revolutions, conquests, and natural disasters), is not wholly impossible, but extremely rare. Why? (pp. 89-91—modified by me)

- 1) Broad based support for violent action requires ideological commitment to overcome the free-rider problem(North, 1981). The stronger the ideological conviction of the participants, the greater the price they will be willing to pay and hence the more likely the revolution will be successful.
- 2) However, it is **difficult to sustain**. Giving up wealth and income for other values is one thing in the face of a common and hated oppressor, but the value of the trade-off changes as the oppressor disappears. As a result, coalitions essential for the success of revolutions tend to have a short afterlife. The glue of ideological alienation and a common opponent is replaced by the dissolving solvents of ideological differences and conflicting payoff demands. One faction may simply eliminate the others, but more common is a lengthy period of uneasy and quarrelsome compromise. Conflict within the coalition over the restructuring the rules, and hence the distribution of rewards, leads to further conflict. That's why the most striking feature of such discontinuous change is that it is **seldom as discontinuous** as it appears on the surface. Moreover, the final outcome of successful revolutions become very uncertain
- 3) Perhaps most important of all, the formal rules change, but the informal constraints do not. In consequence, there develops an **ongoing tension between informal**

constraints and the new formal rules, as many are inconsistent with each other...The result over time tends to be a restructuring of the overall constraints—in both directions—to produce a new equilibrium that is **far less revolutionary**, reflecting the great survival tenacity of informal constraints which are deep-seated and culturally inherited.

Chap. 11: The path of institutional change: the process of **Path dependence**

Two fundamental questions of societal, political, and economic change (p. 92):

- 1) What determines the divergent patterns of evolution of societies, polities, and economies over time?
- 2) How do we account for the survival of economies with persistently poor performance over long periods of time?

Four self-reinforcing mechanisms of technological change (Arthur)—extendable to institutional change:

- 1) large setup or fixed costs (thus falling unit costs)
- 2) learning effects (in terms of product improvement or cost reduction)
- 3) coordination effects, which confer advantages to cooperation with other economic agents taking similar action
- 4) adaptive expectations, where increased prevalence on the market enhances beliefs of further prevalence (p. 94).

And their consequences: four properties

- 1) multiple equilibria
- 2) possible inefficiencies
- 3) lock-in
- 4) path dependence—the consequences of small events and chance circumstances can determine solutions that, once they prevail, lead one to a particular path.
- 5) 3) and 4) much more complicated in the case of institutions (relative to technological change) due to the interplay between polity and economy, many actors with different bargaining strengths and the cultural inheritance in each country.

Answer to the 2nd question:

There are **two forces** shaping the path of institutional change (p. 95):

- 1) increasing returns (**essential ingredient** both to technological and institutional change)
 - in a world in which there are no increasing returns to institutions and markets are competitive, institutions do not matter; But **with increasing returns, institutions matter**. Indeed, all four of Arthur's mechanisms apply. (Example: the evolution of the common law, the Rise of the Western World)
 - As long as the consequent markets are competitive or even roughly approximate the zero-transaction-cost model, the long-run path is an efficient one

- the best evidence:

“The evolution of North America and of Latin America differ radically right from the beginning, reflecting the imposition of the institutional patterns from the mother country (Britain and Spain) upon the colonies and the radically divergent ideological constructs that shape the perceptions of the actors.”(p. 102 and 113-17)

2) imperfect markets characterized by significant transaction costs
[transaction object 자체의 uncertainty; 대학입시에서 면접; bidding system]

If the markets are incomplete, the information feedback is fragmentary at best, and transaction costs are significant, then the subjective models of actors modified both by very imperfect feedback and by ideology will shape the path. Then not only can both divergent paths and persistently poor performance prevail, the historically derived perceptions of the actors shape the choices that they make.(pp. 95-6)

Path dependence

It is a way to **narrow conceptually the choice set and link decision making through time**. It is not a story of inevitability in which the past neatly predicts the future.(p.98)

Relationship between path dependent character of the incremental change in institutions and the persistence of patterns of long-run growth or decline:

Once a development path is set on a particular course, the network externalities, the learning process of organizations, and the historically derived subjective modeling of the issues reinforce the course.(p. 99)

- 1) in the case of **economic growth**: an adaptively efficient path allows for a maximum of choices under uncertainty, for the efficient feedback mechanism to identify choices that are relatively inefficient and to eliminate them (Example: Northwest Ordinance)
- 2) In contrast, the persistence of **unproductive paths**: The increasing returns characteristic of an initial set of institutions that provide disincentives to productive activity will create organizations and interest groups with a stake in the existing constraints. **They will shape the polity in their interests.** (Consequences and examples, p. 99)...And as a result, the economy will evolve policies that reinforce existing incentives and organizations.

In this context North makes **an very interesting, noteworthy argument** that contentions that place blame on external factors for poor performance of economies(e.g. dependency theory in Latin American countries) not only rationalizes the existing structure of those economies, but also contains policy implications that would reinforce the existing institutional framework.(p. 100) [–thus tend to be abused.]

Path dependence again:

It would be a mistake to think that successful paths get reversed by small events or errors and vice versa... Individual, specific changes in formal and informal constraints certainly may change history, but **for the most part do not reverse** its direction. Path dependence means that **history matters**. We cannot understand today's choices (and define them in the modeling of economic performance) without tracing the incremental evolution of institutions." (p. 100)

Answer to the 1st question:

In each society the change will result in adaptations at the margin, and the margins affected will be those where the immediate issues require solution and the solution will be determined by the **relative bargaining power of the participants**—that is, the organizations that have evolved in the specific overall institutional context(p. 101). Moreover, with different past histories and incomplete feedback on the consequences, the actors will have different subjective models and therefore make different policy choices. Hence, both the real incentive structures and the perceived consequences of policies will differ as well. Thus, a common set of fundamental changes in relative prices or the common imposition of a set of rules (examples: US Constitution transplanted into LA countries or property rights laws into Third world countries) will lead to widely divergent outcomes in societies with different institutional arrangements [even in the face of continuously lowering information cost and globalization].

Conclusion:

"...the increasing returns characteristics of the institutional matrix and the complementary subjective models of the players suggest that although the specific short-run paths are unforeseeable, the overall direction in the long run is both more predictable and more difficult to reverse."(p. 104)

Discontinuous institutional change by conquest or revolution only reinforce North's argument...because the tenacity of institutional constraints in the face of radical alterations in the formal rules of the game is the best evidence of the increasing returns characteristics of an institutional framework(p. 101).

Part III: Economic Performance

Chap. 12: Institutions, economic theory, and economic performance

I wish to assert a much more fundamental role for institutions in societies: Institutions are the **underlying determinant** of the long-run performance of economies.(p. 107)

Aims of this chapter:

- 1) specify what changes must be made in neoclassical theory to incorporate institutional analysis into that theory

Information processing by the actors as a result of the costliness of transacting underlies the formation of institutions. **At issue** are both the **meaning of rationality** and the **characteristics of transacting** that prevent actors from achieving the joint maximization result of the zero transacting cost model.

Neoclassical theory's **instrumental rationality postulate**:

(1) the actors possess information necessary to evaluate correctly the alternatives and (2) in consequence make choices that will achieve the desired ends.

But the actors are incompletely informed, devise subjective models as guides to choices, and can only very imperfectly correct their models with information feedback.

Hence, **procedural rationality postulate**.

It not only can account for the incomplete and imperfect markets in much of the present and past world, but leads the researcher to the key issues of just what it is that makes markets imperfect. This leads us to the costs of transacting.

Incentive incompatibility in economic and political organization is the key: object of much of the recent literature of industrial organization and political economy

The informational and institutional conditions necessary to make incentives compatible:

- 1) The affected parties must have the information and correct model to know that the bill affects them and to know the amount of gains or losses they would incur.
- 2) The results can be communicated to their agents(the legislator) who will faithfully vote accordingly.
- 3) Votes will be ascertained by the aggregate net gains or losses
- 4) This exchange can be accomplished at a low enough cost of transacting to make it worthwhile.

A modern democratic society with universal suffrage approximates such condition.

But many disincentives are built into the system:

- 1) rational voter ignorance
- 2) legislators act independently of constituent interests (agency theory)

3) incentive to compensate losers lacking

Because politics make and enforce economic rules, it is not surprising that property rights are seldom efficient. But even when efficient property rights are devised, they will still typically have features that will be very costly to monitor or enforce, reflecting built-in disincentives or at the very least aspects of the exchange that provide temptation to renege, shirk, steal, and cheat. In many cases informal constraints evolve to mitigate these disincentive consequences. And the modern Western world provides abundant evidence of markets that work and even approximate the neoclassical ideal. But they are exceptional and difficult to come by, and the institutional requirements are stringent. (p. 110)

Summary of the consequences of institutions for contemporary economic analysis:

- 1) Economic (and political) models are institution specific and in many cases highly sensitive to altered institutional constraints.
- 2) To understand how institutions influence outcome is important. We need to explore the implications of the costly and imperfect processing of information for the consequent behavior of the actors. Our preoccupation with rational choice and efficient market hypotheses has blinded us to the implications of incomplete information and the complexity of environments and subjective perceptions of the external world that individuals hold.
- 3) Ideas and ideologies matter, and institutions play a major role in determining just how much they matter. Ideas and ideologies shape the subjective mental constructs that individuals use to interpret the world around them and make choices.
- 4) Much more integration of politics and economics than has been accomplished so far is needed. We must develop **a true political economy discipline** that acknowledges the importance of institutional constraints...Not only do politics specify and enforce property rights that shape the basic incentive structure of an economy, in the modern world the share of GNP going through government and the ubiquitous and ever-changing **regulations** imposed by it are the most important keys to economic performance...This can only be done by building a model of the political-economic process that incorporates the specific institutions involved and the consequent structure of political and economic exchange.

2) Implications for the **static** neoclassical analysis of economic performance:
We need to construct an entire theoretical framework, because no such model exists.

- 3) Implications of institutional analysis for the construction of a **dynamic** theory of long-run economic change

Path dependence is the key to an analytical understanding of dynamic, long-run economic change. (p. 112)

- illustrated by the comparison of British-North American path and Spanish-Latin American path (pp. 113-17)

Chap. 13: Stability and change in economic history

Institutions provide the basic structure by which human beings throughout history have **created order** and attempted to reduce the uncertainty in exchange. Together with technology, they **determine** transaction and transformation costs and hence the **profitability and feasibility of engaging in economic activity. They connect the past with the present and the future** so that history is a largely incremental story of institutional evolution in which the historical performance of economies can only be understood as a part of a sequential story. And they are the **key to understanding the relationship between the polity and the economy** and the consequences of that interrelationship for economic growth (or stagnation and decline)...The argument advanced in this study is that the current forms of political, economic, and military organization and their maximizing directions are derived from the opportunity set provided by the institutional structure that in turn evolved incrementally.(p. 118)

Question: Why are some forms of exchange stable (thus leading to stagnation) while others lead to more complex and productive forms of exchange?

North provides a different story about the characteristics of the stages theory of economic history (German historical school or Rostow's model)

His question: What kinds of institutions are necessary to enable the costs of transacting and transformation to be at a level that will permit this increasing specialization and division of labor to occur?

First, stable patterns of very limited cooperation manifested in tribal/village trade, suq, and caravan trade that have persisted through history described.

Here the skills and knowledge requisite to success on the part of the organizations or individuals involved did not entail or induce productive modifications of the basic institutional framework. In each case the sources of institutional change were external.

To summarize:

the central features of suq:

- 1) high measurement costs
- 2) continuous effort at clintization
- 3) intensive bargaining at every margin

In these tribal societies innovation would be seen as a threat to survival.

Why these inefficient forms of bargaining would continue in the suq?

Missing in the suq are fundamental underpinnings of legal institutions and judicial enforcement that would make such voluntary organizations (which would evolve to

ensure against the hazards and uncertainties of such information asymmetries) viable and profitable. In their absence, there is no incentive to alter the system.

Think of North and Weingast's "Constitutions and commitment"

Second, the history of long-distance trade in early modern Europe, the story of sequentially more complex organization that eventually led to the rise of the Western world, is contrasted.

Here innovations that lowered transaction costs consisted of organizational innovations, instruments, and specific techniques and enforcement characteristics. These innovations (most of them were borrowed from medieval Italian city-states or Islam or Byzantium and elaborated in subsequent development) occurred at three (apparently overlapping) cost margins:

1) those that increased the **mobility of capital**

- abolition of usury laws,
- evolution of bill of exchange,
- development of financial centers (first fairs, then banks, and finally financial houses) and discounting methods,
- improved enforceability of contracts,
- devising ways to control agents in long-distance trade, e.g. more elaborate accounting procedures for monitoring the behavior of agents,

2) those that lowered **information costs**,

- printing of prices of various commodities, exchange rates

3) those that spread **risk**.

- development of insurance, portfolio diversification, joint stock company that transformed uncertainty into risk

(We can think of insurance and portfolio diversification in the modern world as **methods for converting uncertainty into** (actuarial and ascertainable) **risks** and thereby reducing, through the provision of a hedge against variability, the costs of transacting.)

These specific innovations and particular institutional instruments evolved as a result of the interplay of two fundamental economic forces (Surely the causation ran both ways):

1) the **economies of scale** associated with the growing volume of trade

2) the development of **improved enforcement mechanisms** that made possible the enforcement of contracts at lower costs; particularly important

- “The **gradual blending** of the **voluntaristic structure of enforcement** of contracts (developed by merchant themselves as merchant laws) via internal merchant organizations with **enforcement by the state** is an important part of the story of increasing the enforceability of contracts.”(p. 128)
- The two types of law did not accommodate each other very well to begin with.
- Many rules of merchant law developed because common law interfered with trade; e.g. the problem of protecting bona fide purchaser....A major player in this evolution was the **state**, and there was continuous interplay between the fiscal needs of the state and its credibility in its relationships with merchants and the citizenry in general.(p. 129)
- In particular, **the evolution of capital markets was critically influenced by the policies of the state**, because, to the extent that the state was bound by commitments that it would not confiscate assets or in any way use its coercive power to increase uncertainty in exchange, it made possible the evolution of financial institutions and the creation of more efficient capital markets.
- The shackling of arbitrary behavior of rulers and the development of impersonal rules that successfully bound both the state and voluntary organizations were a key part of this institutional transformation.
- These diverse innovations and institutions were put together in the Netherlands, and Amsterdam specifically, to create the predecessor of the efficient modern set of markets that make possible the growth of exchange and commerce.

In the case of Western Europe, the evolution is **a consistent story of incremental change** induced by the private gains to be realized by productivity raising organizational and institutional change...and increasing stock of knowledge and its applications...the interaction of economic and political structure.... It was the **Netherlands and England** that were the carriers of institutional change. The characteristics of path dependence, set within the context of contrasting initial conditions, produced the divergent stories of England and Spain.(p. 130)

Chap. 14: Incorporating institutional analysis into economic history (/studies of policy and public administration)

Incorporating institutions into history allows us to tell a better story than we otherwise could.(p. 131)

“It helps to explain the diverse patterns of growth, stagnation, and decay of societies over time, and to explore the way in which the frictions that are the consequences of human interaction produce widely divergent results.”(p. 132)

Integrating institutional analysis into economics and economic history is redirecting emphasis, but not abandoning the theoretical tools already developed. Redirecting the emphasis entails (1) modifying the notion and implications of rationality, (2) incorporating ideas and ideologies into our analysis, (3) explicitly studying the costs of transacting for the functioning of political and economic markets, and (4) understanding the consequences of path dependence for the historical evolution of economies.(p. 135) How does such an approach alter our perception and writing of economic history? Let me illustrate from U.S. economic history.

“Institutional framework can shift the analysis **from ad hoc descriptions to an integrated story** and will, in consequence, achieve a much deeper understanding of the critical periods of economic history”(p. 136)

North’s speculation about the central issue of economic history: Institutions determine the performance of economies, but what creates efficient institutions? How does one reverse the increasing returns characteristics of a particular institutional matrix?

Two related features of the institutional matrix matter(p. 138).

1) the informal constraints

- pervasive influence on the institutional structure
- reinforced by ideologies
- subjective perceptions of the actors are not just culturally derived, but are continually being modified by experience
- Therefore, fundamental changes in relative prices will gradually alter norms and ideologies, and the lower the costs of information, the more rapid the alterations.

2) the transaction costs inherent in the political process.

- the political actor throughout history has been far less constrained by constituent interests.
- They may encourage the formation of groups that may institute more radical economic change.
- The key is the incentives facing the politician that make some of the constituents—those willing to undertake change—more important than others. The political actor, then, is in the position of being able to initiate more radical change.

- Example: North and Weingast, 1989, in which the political struggle led to the increased security of property rights, and to development of capital markets, the formation of the Bank of England, and to the subsequent rapid economic development, political hegemony, and ultimately the dominance of the world.

It is tempting to claim too much. But

It appears plausible that the underlying informal constraints were hospitable to the change in the formal rules. [The stability of the consequent political-economic system evidences this.] **When there is a radical change in the formal rules that make them inconsistent with the existing informal constraints, there is an unresolved tension between them that will lead to long-run political instability... Informal constraints matter.** We need to know more about culturally derived norms of behavior and how they interact with formal rules to get better answers to issues such as whether a polity can have efficient institutions/whether the state is really a leviathan. We are just beginning the serious study of institutions. The promise is there. We may never have definitive answers to all our questions. But we can do better.(p. 140)

