

1. Institutions and the Performance of Economies Over Time

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1. INTRODUCTION

The discipline of economics is made up of a static body of theory that explores the efficiency of resource allocation at an instant of time and under the restrictive assumptions of frictionless markets. Recent research has explored the nature of the frictions by incorporating institutions, transaction costs, and political economy into economic analysis thereby providing the theory with a bridge to the real world of real economies. But the first constraint of static analysis severely hinders our ability to analyze and improve the performance of economies in a world of continuous change. And, in fact, the employment of static theory as a source of policy recommendation in a setting of dynamic change is a prescription for the policies producing unanticipated and undesirable results. In this essay I intend to provide an approach to the study of the process of economic change. There is still much that we do not understand about the process but this essay provides an analytical framework that does, I believe, highlight the problems that must be confronted in order to understand and improve economic performance. I first describe the intentional nature of human interaction in a world of pervasive uncertainty (2) before going on to describe the process of economic change (3). I conclude with drawing some implications from this approach to the process of change which highlight the lacunae in our understanding of this process (4).

2. INTERACTIONS IN A WORLD OF UNCERTAINTY

¹In contrast to standard theory that draws its inspiration from physics, modeling the process of change must derive its inspiration from evolutionary biology but in contrast to Darwinian theory in which the selection mechanisms are not informed by beliefs about the eventual consequences, human evolution is guided by the perceptions of the players in which choices—decisions—are made in the light of these perceptions with the intent of producing outcomes downstream that will reduce the uncertainty of the organizations—political, economic, and social—in

¹This section is drawn from my essay “Five Propositions about Institutional Change”, in Knight, J. and Sened, I., *Exploring Social Institutions*, Michigan: The University Press, 1995.

pursuit of their goals. Institutional change, therefore, is a deliberate process shaped by the perceptions of the actors about the consequences of their actions. The immediate vehicle by which the actors attempt to shape their environment is by altering the institutional framework in order to improve their (and their organizations') competitive position. Let me state five propositions that describe this process:

1. The continuous interaction between institutions and organizations in the economic setting of scarcity and hence competition is the key to institutional change.
2. Competition forces organizations continually to invest in new skills and knowledge to survive. The kind of skills and knowledge individuals and their organizations acquire will shape evolving perceptions about opportunities and hence choices that will incrementally alter institutions.
3. The institutional framework provides the incentive structure that dictates the kinds of skills and knowledge perceived to have the maximum payoff.
4. Perceptions are derived from the mental constructs of the players.
5. The economies of scope, complementarities, and network externalities of an institutional matrix make institutional change overwhelmingly incremental and path dependent.

Let Me Expand on These Propositions

1. Institutions are the rules of the game—both formal rules, informal norms and their enforcement characteristics. Together they define the way the game is played. Organizations are the players. They are made up of groups of individuals held together by some common objectives. Economic organizations are firms, trade unions, cooperatives, etc.; political organizations are political parties, legislatures, regulatory bodies; educational organizations are universities, schools, vocational training centers. The immediate objective of organizations may be profit maximizing (for firms) or improving reelection prospects (for political parties); but the ultimate objective is survival because all organizations live in a world of scarcity and hence competition.
2. New or altered opportunities may be perceived to be a result of exogenous changes in the external environment which alter relative prices to organizations, or a consequence of endogenous competition among the organizations of the polity and the economy. In either case the ubiquity of competition in the overall economic setting of scarcity induces entrepreneurs and the members of their organizations to invest in skills and knowledge. Whether through learning by doing on the job or the acquisition of formal knowledge, improving the efficiency of the organization relative to that of rivals is the key to survival.

While idle curiosity surely is an innate source of acquiring knowledge among human beings, the rate of accumulating knowledge is clearly tied to the pay-offs. Secure monopolies, be they organizations in the polity or in the economy, simply do not have to improve to survive. But firms, political parties, or even institutions of higher learning faced with rival organizations must