# Introduction

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Douglass C. North has earned himself a place of honor in the pantheon of the most influential social scientists of his era, as was recognized in 1993 when he and economic historian Robert Fogel were awarded the Nobel Memorial Prize in Economics for their work in economic history.

North was born in 1920 in Cambridge, Massachusetts. He received his undergraduate and graduate degrees from the University of California at Berkeley. He then took an appointment at the University of Washington until he moved to Washington University in St. Louis in 1983.

In 1959–1960, North cofounded *cliometrics*, an association of economic historians that systematically applied statistical methods and economic theory to the study of history. However, by the late 1960s, his ideas about institutions and their central role in the study of economics began to evolve, dominating his work. Later, during the 1970s, he also cofounded the New Institutional Economics, a group of social scientists that expanded the reach of standard economic analysis by taking into account transactions costs and the importance of institutions and organizations as critical determinants of social phenomena in terms of processes, actions, and outcomes. The group's work has had a strong effect on all of the social sciences, but its most remarkable influence is felt in political science and economics.

The purpose of this volume is to showcase the essence and the impact of North's work through several exemplars that best illustrate the breadth and depth of his influence. The volume thus speaks less of his work – which is remarkably widespread and well known – and more about his legacy. By his legacy, as the title of this collection indicates, we refer mostly to his influential work in the field of *New Institutional Social Sciences*, and more specifically on scholarship pertaining to the understanding of property rights, the institutions that support the system of property rights, and economic growth.

Indeed, North was a pioneer in pointing out that institutions, understood as the set of formal and informal rules and constraints that structure life in societies, are a key determinant of the process of economic growth and development. In fact, "throughout history, institutions have been devised by human beings to create order and reduce uncertainty in exchange . . . and history in consequence is largely a story of institutional evolution in which the historical performance of economies can only be understood as a part of a sequential story" (North 1991, 97).

Moreover, the institutional setup of a society in a particular moment in time can shape the way in which this society is going to evolve: "Institutions provide the incentive structure of an economy; as that structure evolves, it shapes the direction of economic change towards growth, stagnation, or decline" (North 1991, 97).

The first half of the twentieth century saw a vast expansion of the social sciences, with formal and behavioral social sciences leading the charge. Formal social sciences made quick strides in developing the foundations of social sciences from formal, logical, and mathematical principles, translating the intuitive contributions of Adam Smith and his followers into precise mathematical structures that could be tested on logical and empirical grounds. Behavioral social sciences rode a prolific wave of technological innovations in computers and other tools of measurements to record and systematically organize a wide range of observable human behaviors, whether in the marketplace or in the social and political arena in which humans interact.

By the 1960s, Professor North had matured as a scholar, and both the formal and behavioral schools of thought in the social sciences had made tremendous progress, proving the feasibility of and the promise in pursuing rigorous social sciences.

One important question, however, kept haunting the success of the social sciences at the time: How to explain the clearly observable variance in success of economics performance across regions and countries? North provided the discipline with a resounding answer: Institutions make the difference. How they make the difference is the central theme of his work, the legacy with which he leaves us, and the main subject matter of this edited volume.

Before the introduction of institutions as the critical variable in explaining the success or failure of societies and economies, the state-of-the-art explanation for this variance revolved around the concept of transaction costs. The neoclassical, general-equilibrium model of free markets established that with zero transaction costs, free and competitive markets should result in efficient allocations of scarce resources at any time in any place. What, then,

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explains the fact that some market allocations are seemingly very inefficient while others seem closer to being optimal? The most common answers in the 1960s, 1970s, and even beyond, referenced the concept of transaction costs. Because transaction costs are never zero, a key to the variance in the performance of different economic systems is in the extent to which they experience higher or lower transaction costs. But where would this difference in the magnitude and significance of transaction costs come from?

As the formal understanding of individual behavior developed further, the so-called collective action problem emerged as a troubling sister to the problem of transaction costs. The collective action problem was first highlighted in Garrett Hardin's 1968 article "The Tragedy of the Commons." In her contribution to this volume, Elinor Ostrom articulates her lifelong dedication to the study of this problem, which is closely related to the management challenge of common pool resources (CPR) (Ostrom 1990). The problem emerges from the violation of one of the key assumptions in the generic model of competitive markets: that individual property rights are well-defined and enforced. When property rights are not well-defined, when they are ill-enforced, or when a collective of agents rather than individual agents holds ownership rights, basic individual incentives that in competitive markets would lead, according to commonly accepted scholarship, to efficiency results instead fail, and the efficiency results vanish with them.

Research at the time resorted to two "easy solutions" to the problems of transaction costs and collective action. One trend in the literature, called constitutional economics, highlighted the role of the state in resolving these problems (Buchanan and Tullock 1962). The other trend, developed in the 1960s and 1970s, highlighted the idea of a spontaneous emergence of property rights structures (Sugden 1986).

By the late 1970s both arguments had suffered major setbacks from advances in the social sciences. The calculus of consent (Buchanan and Tullock 1962) was proven to be a whole lot more complicated and much less predictable due to a third major problem that established for itself a solid reputation in the 1960s and came to be called the problem of collective choice (Arrow 1951). Collective decision making was proven to lack the elegant transitivity condition that most of us are assumed to satisfy in our individual choices (McKelvey 1979). Contrary to the premise underlying "constitutional economics," collective decision making could not be expected to result in straightforward, elegant, or efficient policy making, regardless of the constraints imposed on the process. Politics, and collective decision making more generally, are, simply put, generically messy. While the initial discovery of the problem dates to the late-eighteenth-century writings of Marie Jean Antoine Nicolas de Caritat, Marquis de Condorcet (e.g., Young 1990), Arrow (1951) brought the issue back to the forefront of the scholarship on the topic. However, Arrow's impossibility theorem was widely overlooked. In the late 1970s and early 1980s, a group of political scientists close to Professor North at the time began to highlight the relevance of Arrow's theorem and study it carefully. A series of seminal results, often labeled collectively "the chaos theorems" (McKelvey 1979; McKelvey and Schofield 1986, 1987), presented a serious challenge to the study of economics and politics as they seemed to suggest that the outcomes of majority-rule, collective decision making may be indeterminate. William H. Riker, a leading political scientist of the era and a close friend of Professor North, went as far as to conclude that

> Politics is *the* dismal science because we have learned from it that there are no equilibria to predict. In the absence of equilibria we cannot know much about the future at all, whether it is likely to be palatable or unpalatable, and in that sense our future is subject to the tricks and accidents of the way questions are posed and the way alternatives are offered and eliminated. (Riker 1981, 447)

Kenneth A. Shepsle's contribution to this volume is a generic follow-up to the debate that raged at the time and is still central to contemporary social sciences, between those who gave up on any stability in "collective" choice environments and those who suggested that institutional structures may introduce some generic stability and predictability in the spheres of public political and economic decision making. Shepsle, who Professor North would soon join as an intellectual leader at the Center in Political Economy at Washington University in St. Louis, is credited with what would become a key foundation of the new institutional social sciences: "Standing between the individual qua bundle of tastes and available social choices are institutions . . . frameworks of rules, procedures and arrangements – that prescribe and constrain . . . the way in which business is conducted" (Shepsle 1986, 51–55).

At the heart of neoclassical literature on competitive markets, a different role was highlighted for economic institutions. Economists acknowledge the role of property rights as fundamental to the functioning of free markets. For decades, leading scholars in this school tried to explain this external determinant of social order from within the framework of the friction-free competitive market (e.g., Demsetz 1967). When these efforts failed (e.g., Demsetz 1982), a considerable effort was made to explain the "spontaneous" emergence of property rights using variations of repeated games logic (Sugden 1986) by which, in equilibrium, unconstrained agents with no external government enforcement would settle on some self-enforcing governance of property rights. Research of the late 1990s disputed this argument. First, it was shown that self-enforcement is unlikely in most realistic environments. Even small groups of agents with moderate levels of future discount factors cannot hope to sustain self-enforcement property rights structures (Calvert 1995). Second, governments were shown to be rather reliable enforcers of property rights under a wide range of conditions. This established a clear role for governments as protectors of the property rights of their constituents to allow free markets to function and economies to prosper (Sened 1997).

In his seminal work, *Essays on the Political Economy of Rural Africa*, Robert Bates summarizes the state of existing empirical evidence on the origin of property rights: "[T]oo much emphasis has been placed upon decentralized systems. On the one hand, their occurrences appears to be relatively infrequent; on the other, even in so far as decentralized societies do exist, they can arguably be regarded as transitory – as societies that once were centralized or which are in the early stages towards more centralized forms" (1983, 20). In his comprehensive study of the issue, Eggertsson (1990) concludes that "the institutional equilibrium of stateless society has, in most cases eventually given away, and the state, in its various forms, has emerged" (305). In his contribution to our volume, Robert Bates goes further to argue that one limitation of the new institutional social sciences is that they fail to pay enough attention to the actors who play the central role in those political institutions. If political institutions are critical to the understanding of social phenomena, we need a better understanding not only of those institutions and how they work, but also of the central players – that is, the human leaders who make them work.

Amid this growing interest in the role of institutions in social lives, North structured a legacy that was soon to move into the sphere of academic social sciences and far beyond. In this volume, both John Joseph Wallis as well as Claude Menard and Mary Shirley submit two well-documented histories of the ascendance of North's legacy and its history. In this introduction we limit ourselves to a series of short comments on its essence.

Following the concern with the uncertainty and instability that political structures introduced into society, Professor North's first intuition was that "the major role of institutions in society is to reduce uncertainty by establishing a stable (but not necessarily efficient) structure to human interactions" (1990a, 52).

What are institutions exactly? North (1990a) offers the following definition: "Institutions are the rules of the game in a society or, more formally, are the humanly devised constraints that shape human interaction." Thus, he emphasizes that institutions, in consequence, "structure incentives in human exchange, whether political, social, or economic" (54).

Once the importance of institutions was recognized, North set out to understand the reasons why inefficient institutions persist and, more broadly, the process and dynamics of institutional change. Institutional persistence and change has been the main theme of his work since the 1981 publication of *Structure and Change in Economic History*. This theme led North to investigate both path dependence and transaction costs, achieving a theory of the state in which, under the presence of transaction costs, political systems do not inevitably evolve into efficient institutions.

North's work also makes an important distinction between institutions and organizations. Institutions are hard to define because the rules that apply include written laws, formal social conventions, informal norms of behavior, and shared beliefs about the world. In contrast, organizations are concrete. They are made up of specific groups of individuals pursuing a mix of common and individual goals through partially coordinated behavior. This way he opened a large venue to the possibility of a dynamic relationship between the interests and incentives facing the organizations and the structure of the rules of the game that govern their actions and interactions. Ultimately, North paved the way for an integrated theory of the state that incorporates coercion as a tool of government.

North's view represented a significant novelty in the field of economic development as well. Economic growth theories traditionally ignored the institutional dimension of development by focusing on capital accumulation and technological change in a world where property rights were perfectly enforced. However, Ronald Coase's (1960) seminal work showed that creating, specifying, and enforcing property rights is costly and, thus, property rights will never be perfect.

The new institutional approach to development economies pioneered by North recognizes this and assumes that, in a world with positive transaction costs, enforcement of property rights has a cost that affects the allocation of resources and thus has an effect on growth. Hence, institutions that assure those rights become a relevant piece in the economic architecture that the process of growth and development is built on. As Douglass North and Paul Thomas (1973, 76) stated: "The factors we have listed (innovation, economies of scale, education, capital accumulation, etc.) are not causes of growth; they are growth." Factor accumulation and innovation are only proximate causes of growth. In North and Thomas's view, the fundamental explanation of comparative growth is differences in institutions.

Following his seminal work on the origin of institutions and their critical role in shaping economic systems, North led his scholarly journey to the frontier study of how both beliefs and ideological persuasions persist, and thus make all institutional change incremental at best. This idea plays a central role in *Institutions, Institutional Change and Economic Performance* (1990a) and is the central focus of *Understanding the Process of Economic Change* (2005).

In his most recent work, *Violence and Social Orders* (2009, with Wallis and Weingast), North poses a conceptual framework to understand recorded human history. The salient feature of this work is the attempt to assemble an equilibrium theory of the state and its role in shaping different social orders, through which we can understand the history of societies, from primitive ones to modern developed societies where open orders prevail.

Science in general progresses when curious people pose smart questions and then answer them. This is precisely what Douglass North has been doing throughout his entire academic career – at least fifty years of making progress in understanding human social history. The result has been an enormous impact on social sciences, which we hope is reflected in the broad collection of topics covered in this volume by a distinguished group of scholars working in the domain of the questions North's work has stimulated.

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In Chapter 1 of this volume, Claude Mènard and Mary M. Shirley thoroughly review the rise of New Institutional Economics, giving special attention to the evolution of North's ideas and how they shaped the emerging field.

In Chapter 2, John Joseph Wallis recounts the evolution of North's ideas, but he does so through the lenses of the persistence and change of institutions in society. His essay explores North's intuitive reaction to the literature on the persistence of institutions and his insistence that the problem we should be investigating is institutional change.

Robert Bates in Chapter 3 goes a step further in advancing the field of New Institutional Social Sciences, arguing that this school of thought has failed to pay enough attention to those who play the central role in all political institutions. He explains that the environment from which politicians come has a significant effect on how they deal with the institutions at hand or lack thereof. Comparing the "path-dependent" respective developments of Kenya and Uganda, he shows how the unique pattern of relationships between politicians and their respective constituency has led to very significant divergence of the final outcomes in each case.

Kenneth A. Shepsle's contribution to this volume (Chapter 4) represents a central debate in contemporary social sciences, between those who do not see any stability in collective choice environments and those who suggest that institutional structures may introduce some generic stability and predictability in the spheres of public political and economic decision making. Examples drawn from the U.S. Congress are used to exhibit the ways in which rules arise, change endogenously, and are sometimes even violated.

In Chapter 5, Nobel Laureate Elinor Ostrom revisits and further articulates her lifelong dedication to the study of the problem of the management of common pool resources (CPRs). The problem of CPR management emerges from the violation of a key assumption in the generic model of competitive markets: that individual property rights are well-defined and enforced. Property rights in CPRs are ill-defined, ill-enforced, or defined and enforced collectively in a way that individual incentives do not lead, at least given commonly accepted scholarship, to the efficiency results expected in perfectly competitive markets.

In Chapter 6, Sebastian Galiani and Ernesto Schargrodsky present a study of the causal effects of property rights. Douglass North's research has shown the importance of the institutional dimension in the process of economic development. Among the institutions that foster growth, the enforcement of property rights appears most prominently. Land rights are particularly important in the process of economic development. Relying on a unique natural experiment of land titling at the outskirts of Buenos Aires, Argentina, Galiani and Schargrodsky review the effects of titling the poor on their physical and human capital investments, household decisions, access to credit, earnings, and beliefs.

Gillian K. Hadfield and Barry R. Weingast in Chapter 7 highlight North's influence on the emerging field of research of law and society. Scholars agree that a legal system providing for impersonal exchange is important for long-term economic growth. In their paper they explore the complex questions of what law is and what its components are. They ask why law has the attributes characteristically associated with the rule of law, why law involves public reasoning, and how this system is sustained as an equilibrium.

In Chapter 8, Joel Mokyr addresses the issue of culture, institutions, and economic growth. Following on the work of North in *Understanding the Process of Economic Change*, Mokyr examines the role of innovative grand ideas and the "intellectual entrepreneurs" that help spread them in the evolution of culture, suggesting ways in which we can understand cultural change and how it affects the economy. He then applies this framework to provide an understanding of a special case of considerable interest to students of economic change, namely the British economy on the eve of the Industrial Revolution.

Steven C. A. Pincus and James A. Robinson in Chapter 9 revisit a key debate in economic history. The Glorious Revolution of 1688–1689 is one of the most famous instances of institutional change. It fascinates scholars because of the role it may have played in creating an environment conducive to making England the first industrial nation. This claim was advanced forcefully by North and Weingast (1989). And yet, existing literature in history and economic history dismisses their arguments. Pincus and Robinson argue that North and Weingast were correct in arguing that the Glorious Revolution represented a critical change in institutions. In addition, and contrary to the claims of many historians, most of the things they claimed happened, such as parliamentary sovereignty, did happen. But Pincus and Robinson argue that they happened for reasons different from those North and Weingast put forward. This chapter shows that rather than being an instance of a de jure "re-writing the rules," as North and Weingast argued, the Glorious Revolution was actually an interlinked series of de facto institutional changes that came from a change in the balance of power and authority and was part of a broader reorientation in the political equilibrium of England. Moreover, it was significant for the economy not because it solved a problem of credible commitment, but because the institutional changes meant that after 1688, party politicians rather than the king set the economic agenda, and also because the ministries were dominated by Whigs with a specific program of economic modernization.

In Chapter 10, Scott Gehlbach and Edmund J. Malesky address the issue of institutional change in Eastern Europe and the former Soviet Union. Their essay traces the evolution of the literature on this topic, showing how the study of transition has responded and contributed to our understanding of the emergence and evolution of key political and economic institutions.

Pamela Jakiela (Chapter 11) and Pedro Dal Bó (Chapter 12) close the volume with two examples of the imprints of North's legacy on the field of experimental social sciences. Jakiela investigates informal institutions, with moral preferences at the heart of her research in experimental economics. Dal Bo applies the tools of experimental economics to the study of formal institutions. His essay reviews part of the extensive experimental literature on the workings of democratic institutions, starting with the description of the existing literature studying the determinants of efficient institutional change. That is, when will people choose institutions that provide incentives for them to take socially optimal actions? Results from original experiments he conducted with his research collaborators show that whether subjects vote for efficient institutions may depend on their understanding of the environment. The essay summarizes the recent literature, showing that democracy can affect behavior itself, in addition to its effect on the choice of policies and regulations.