

Douglass C. North: Understanding the Process of Economic Change (Princeton University Press, 2005)

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The New Institutional Economics has been neglected research program of the economic theory for a very long time. This is largely due to most of the mainstream neoclassical economists' dominant view that institutions simply "don't matter". More recently this view has started to change. With his two previous books (*Institutions and Institutional Change* and *Institutional Change and Economic Performance*), Douglass C. North, a Nobel Prize Winner in Economic Sciences in 1993 has in many ways contributed to changing this dominant direction and ushered in genuine small revolution in understanding institutions. North is now widely acknowledged as one of the economists most responsible for a successful story of the New Institutional Economics research program over the past two decades. "Institutions matter" North claims, and in his latest book *Understanding the Process of Economic Change* (Princeton University Press, 2005) goes one step further to offer a radically new theory of economic change.

This new theory is largely based upon his own insight into the dominant role the human *intentionality* plays in shaping the institutional foundations of society and particularly in its capacity for changing circumstances. As North says: "[t]he key to understanding the process of change is intentionality of the players enacting institutional change and their comprehension of the issues" /p. 3/.

The very source of the human intentionality is, as North argues, the ubiquitous effort of humans to reduce the uncertainties of their environment. Uncertainty (the term is used in Frank Knight's sense) and ubiquitous human efforts to deal with it and confront it is the first building block of the theoretical frame applied in this work.

In the next step North integrates the cognitive aspect into his analysis and tries to give answers to some of the following questions: how people understand reality? How do beliefs get formed? Whose belief matters and how does individual belief aggregate with belief systems? How do they change? What is the relationship between beliefs and institutions? North argues that people construct mental models of the outside world – beliefs that are both positive

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models of how the system works and normative models of how it should work. But what counts are the beliefs of the dominant economic and political entrepreneurs capable of imposing policies. Their beliefs result over time in accretion of the fundamental structure of institutions. At the same time the structure itself imposes severe constraints on players who seek to improve or change their competitive economical or political positions. Thus, the change is incremental and path dependent. The final result of this continuing change is the alteration of institutional matrix and revisions of players' perception of reality which, in effect, spurs new efforts by entrepreneurs to improve their positions.

In nuce, the process of change can be shown as follows: perceived reality – beliefs – institutions – policies – altered perceived reality.

The first part of the book (named “Issues Involved in Understanding Economic Change”) is mainly about elaborating the outlined theoretical frame in great depths. Thus, Chapter II deals with the uncertainty in non-ergodic world. Following Herbert Simon’s ideas on bounded rationality, North argues that uncertainty cannot be eliminated because the nature of human mind is such that our knowledge is necessarily partial and incomplete. He also stresses the importance of the fact that the world studied by social sciences is essentially “non-ergodic” – that is, the underlying structure of the human domain shifts as human attempt to alter it.

Chapter III (“Belief System, Culture, and Cognitive Science”) deals with the structure of individual beliefs, its logic of change and its aggregation with belief system embedded in culture. In order to provide a better understanding of how individual beliefs are formed North delves deep into cognitive sciences by further elaborating recent discussions on how the brain really works. One of his major contributions in this book is to align his institutionalist priors with theories of connected or embedded cognition. Relying on Hayek’s ideas as expressed in *The Sensory Order: An Inquiry into the Foundations of Theoretical Psychology*, North argues that humans think and act within the context of a system of categories and assumptions that provides a necessarily incomplete model of the world. Further elaborating this intriguing idea, North claims that our institutional environment supplements and shapes our individual cognition by reducing the uncertainties that would otherwise overwhelm our cognitive capacity. According to North there is no understanding a society’s structure of interaction independently of the “mental models” or systems of belief that help constitute that structure.

Finally Chapters IV (“The Scaffolds Human Erect”) and V (“Taking Stock”) tend to explain the links between beliefs and institutions, the nature of institutional change and how performance is affected by institutions. Although North, on the trail of his previous works, defines institutions as the formal and informal constraints of human interaction and enforcement characteristics of both, in this book he significantly advances his conception of the nature of

institutions by integrating ideas from the cognitive psychology and philosophy of mind.

After the analytical frame has been established, North continues with applying it in the second part (titled “The Road Ahead”) to the wide array of questions concerning different aspects of economic history from a dawn of human evolution to the demise of the Soviet Union. Chapter VII (“The Evolving Human Environment”) particularly focuses on the past two millennia of change in the human landscape. North argues that there are two sorts of institutions – those ones constructed to deal with uncertainties of physical environment and those constructed to deal with the human environment. North’s central message is that there is no economic development until the former is being altered with the latter.

In the next chapter author tries to identify the main sources of order and disorder. If the existing institutional matrix provides better predictability in human interaction, as argument goes, there will be greater order which implies reduction in uncertainties and *vice versa*. North stresses the importance of the “adaptively efficient institutional structure” /p. 111/ pointing to differences between the British Empire’s successful long-term growth and the Spanish Empire’s failure.

After illuminating some historical cases of getting it right and getting it wrong in Chapter IX, North in Chapter X (“The Rise of the Western World”) tells us a dynamic story of a successful change through time pointing to the critical impact of a “competitive decentralized environment” /p. 137/, as differentiated from centralized empires, such as those of China and the Ottomans. It is worth pointing out that the main line of argumentation in this chapter is based on one of his prior classic articles under the same title.

The eleventh Chapter deals with more contemporary issues, namely, with the rise and fall of the Soviet Union indicating what happens in the absence of the “adaptive efficiency” and a flexible institutional structure.

The ongoing problems of underdevelopment and transition countries is at the core of Chapter XII (“Improving Economic Performance”). According to North the evolving structure of economic and political markets is the key to improve economic performances. But, North warns that “there is no set formula for achieving economic development” /p.165/.

In the last chapter (“Where are we Going?”), North explores how much we can know about the future. On the basis of his own insight into a very limited human foresight, the autor suggests more sober appraisal of humans future in the face of ubiquitous uncertainty in non-ergodic world.

The book is a brilliant achievement. This path-breaking work boldly opens new frontiers in economic research. One of the striking features is that the author bravely distances himself from the economism dominating over the most part of economic historians’ analyses. North heavily draws from different disciplines such as: cognitive sciences, anthropology, political science, sociology, history

and economics in order to provide a deeper understanding of the nature of institutions. But it doesn't mean that North abandons the neoclassical economics. As he once said: "to dismiss the neoclassical economics is to dismiss the economics as a science." Operating within the New Institutional Economics research program he tries to modify the neoclassical theory, to extend it, particularly its rationality postulate in order to permit it to come to grips with an entire range of issues heretofore beyond its ken. Moreover, in this book North sets forth a radical reconceptualization of the task and methods of the social sciences in general and economics in particular.

Anyone who is interested in the research field of the New Institutional Economics and in an alternative view of economic history should inevitably read this book.

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