1. **Summary of the major arguments**

North begins his book by stating that “institutions are the rules of the game in a society or, more formally, are the humanly devised constraints that shape human interaction.” That being said North then proposes to examine institutions, changes in them, and their impact on economic performance over time. He has divided the book into three parts.

Part I is the examination of the nature of institutions and their manifestations for economic performance. From there, Part II outlines the theory of institutional change and how it explains how past behaviors influence present and future behaviors. It also explores the impact of incremental changes within institutions and its effect on the nature of path dependence. Part III is the primary objective of the North’s work. It is to understand the differential performances of various economies through time.

The author is careful to make the distinction between institutions and organizations. Both are components of the structural framework that supports human interaction but they are not the same. As stated previously, institutions can be considered the rules of the game and organizations can be considered the players. The purpose of the rules is to define the way that the game is played.

Organizations are groups of individuals who work toward a common goal or objective and have common interests. Political parties, churches, schools, unions, or government agencies are some examples of organizations. The book considers organizations primarily as the agent for institutional change with emphasis on the interaction between the rules (institutions) and the players (organizations).

North contends that any theory on institutions must be based on human behaviors since all institutions are created and changed by humans. Understanding that the major role of institutions in a society is to reduce uncertainty by establishing a stable structure to human interaction this study attempts to answer the following questions: (7)

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

C. How can we explain the radically different performance of economies over long periods of time?

The answers, according to North, lie in the differences between the rules and the players and the interactions between them that shape and change institutions. Interaction is all about choices. Actors make choices based on costs and benefits with many of the benefits based on subjective perceptions. Actors frequently make choices based on imperfect information and the resultant institutional changes often have unintended consequences that are not always the optimal choice for improving the economic welfare of the organization.

North uses U.S. economic history as an example of institutional changes that have occurred over time and have, for the most part, persistently reinforced the incentives for organizations to engage in productive activity. Understanding, of course, that there have also been some negative changes that have occurred as well. On the other hand, North highlights many Third World nations economic history as being the obverse of the U.S. model where institutional changes encourage organizations to engage in distributive activity, to create monopolies and stifle competition and to restrict opportunities.

The point of the comparison is not the welfare of the organizations but the fact that as organizations develop and change within an institutional framework they will become more efficient in both cases, however, Third World examples will make their societies even more unproductive and the basic institutional structure even less favorable for revenue production.(9)

What has not been well researched is the understanding of the nature of coordination and cooperation among humans as it relates to economic development. One of the unanswered questions is under what conditions can cooperation across organizations exist without the imposition of institutional coercion to create cooperative solutions?

North address the use of the game theoretics in researching this question and disagrees with any game results that predict players will choose wealth maximization whenever possible. The problem according to North is that the game never considers transactional costs and how these costs are altered by the institutional structure. Therefore, North states the researcher must use the Coase Theorem to bring
more fidelity to the solution as it states that competition eliminates incomplete information and tends to bring transactional costs to nearly zero. (15)

Rational choice theory is another approach to view human decision-making and economic performance. In this case North does not support the theory because he believes humans make choices based on subjective perceptions of incomplete or imperfect information and therefore there is no pattern convergence and therefore no possibility of credible behavior predictions. North does allow the rational choice theory does work under certain controlled conditions like the study of finance where actors operate under a strongly structured institutional framework that allows for continuous observation of behaviors.

Economies conduct exchanges (choices) through organizations and modern economic growth is based on impersonal exchange. The key to impersonal exchange is the existence of third-party enforcement to reduce the risk of opportunism, cheating, and defection that occurs in complex societies. This is the coercive party needed to insure coordination and cooperation across the interactive environment.

However, enforcement requires formal rules and North elucidates on the small percentage of human interaction that is governed by formal rules. In Chapter V he delves into the informal rules derived from culture that regulate societal behavior. Some of these informal rules are self-regulating and some are not, the critical aspect of the argument is the apparent paucity of research on the impact of informal rules on economic performance. What is certain is that cultural traits have survived globally over time and cannot be discounted when processing information with the intention of making choices.

Chapter VI details the importance of formal rules and how they, in many cases, are complementary to informal rules. In some cases they actually supercede the informal rules in order to increase efficiencies of the institution and they will actually define behavioral constraints. Their function, generally, is to facilitate political or economic exchange in the face of uncertainty. (47) Formal rules are particularly important for exchanges with numerous actors or variables where the risk of defection is highest.

North further states that the combination of formal and informal rules that define the institution and provide the basis for continual incremental changes occurring within every institution. (68) These changes will alter the framework such that it will present a different set of choices than it began with.
In Part II North again examines the interaction between organizations and institutions. This time he focuses on economic performance over time and how "the systematic investment in skills and knowledge and their application to an economy suggests a dynamic evolution of that economy that entails a specific set of institutional characteristics."(80) He refers to this as adaptive efficiency and suggests that the institutional framework directs the process of human learning and the development of tacit knowledge that leads to the decision-making process.

The focus of Chapter 11 is the gradual institutional change that occurs through marginal adjustments. This type of change, according to North, is deliberate and is the dominant way by which societies and economies have evolved. However, conquest and revolution have caused radical change within economies over time yet have not generally destroyed the institutional framework within the society.

Part II is all about economic theory and economic performance. North writes how ideas and ideologies do make a difference and that institutions play a role in determining how much they matter. These concepts shape the mental roadmaps that people use to interpret the world and to make choices. This structuring of the environment in certain ways cause institutions to affect the price we pay for our actions. They provide the freedom to incorporate ideas and ideologies into the choices they make.

Incremental change comes from organizational gains after acquiring skills that enhance their objectives. It follows then that path dependence comes from mechanisms that support increasing gains for the members and tend to reinforce the direction of the organization on a certain path.

The conclusion of the book looks back at the questions posed in the first chapter and recognizes the fact that the questions have not been answered. He believes the analytical framework that was laid out in the book offers the promise of answering still unresolved questions. In the final analysis, incentives are the underlying determinants of economic performance.(135) They are implicit in every theory employed in his book. But to understand economic performance over time one has to realize that incentives change with time and therefore the rules change with them.

2. Evidence and methods

North’s book is a serious attempt at defining a new way to consider the structure of institutions and their impact on the organizations that abide by them. He has chosen to use a number of iterated case studies to illuminate his concepts and he also consolidates several theories to express his views. He takes a
behavioralist approach when he concentrates on early U.S. economic history with an emphasis on the
Northwest Ordinance, its charter and its economic development. He also makes several comparative
studies between various parts of the European state system, their local economies, and their institutional
framework against similar data from Third World or Asian nations. The case studies are well chosen and
do make the appropriate linkages to the theories he is applying.

3. **Interesting and/or irritating points**

   The most irritating point of the book was in the final chapter when North allowed he had not
answered the three questions he posed in Chapter I. I thought he should have made predictions based on
his skill and knowledge as a master of economic theory. I was disappointed he did not attempt to answer
the question of why grossly inefficient economies persist over long periods of time. He wrote around the
question but I didn’t get a sense that he really felt comfortable with the question or an answer. The book
was well written and readable. Much of what was written was, for me, common sense and readily
apparent. That being said, he did a great job of weaving a number of theories together into a cogent offering
that was easily followed. All in all, a decent read.

4. **Significance and implication of the readings**

   North has asked a number of pertinent questions that should be addressed by social scientists in the future.
He has shown himself to be a knowledgeable and capable researcher who cannot be ignored. I believe his
work on institutions and institutional change is spot-on. I also believe that the strength of his argument will
force neoclassical economic theorists to take a hard look at their theory and recognize the existence of
institutions and the need to incorporate these institutions into future research.