

Jerry Hough and Robin Grier

The Paradoxical Relationship of Douglass North,
Friedrich Hayek, and Karl Marx

Douglass North won a Nobel Prize in Economics in 1993 for his attack on the neoclassical model and his insistence that it is too static and has too narrow a definition of human psychology. The timing of his award likely was associated with the success of his warnings about the neoclassical economists who were advising the Russian government and the international aid agencies on the proper economic reform in the countries making the transition from Communists.

As Alan Greenspan said in 1997, "some had supposed" [he meant "most neoclassical reformers working on transitional economies] that "the dismantling of the central planning function in an economy does not ... automatically establish a free market entrepreneurial system."¹ His criticism of the neoclassical economists was correct.

Those transitional economists did, in fact, often express their argument in a very revealing analogy: the attempt to make a gradual transition from a Communist to a capitalist system, they said, was akin to trying to leap over a chasm in two jumps. The analogy assumed a well-functioning capitalism existed on the other side of chasm. By 1990, even before the overthrow of the Communist regime, North was

¹ Alan Greenspan, "The Embrace of Free Markets" (Washington, D.C.: The Woodrow Wilson International Center for Scholars, 1997), p. 2.

arguing that the change "has got to be incremental." The next year he criticized "the glib rhetoric of all the neo-classical economist types that have jumped into the reform the East Europeans game."²

When North accepted the 1993 Nobel Prize, he attributed the mistakes of these neoclassical theorists to "two basic erroneous assumptions." One is "that institutions do not matter," and the other is "that time does not matter."³ By "time," North meant that "it takes a long time" to build the stable rules and norms that are "the necessary prerequisite for political and economic development." In 2008 he spoke concretely of 400 years.⁴

² Letter from Douglass North to Vinod Thomas, April 26, 1990, Douglass North Papers, Box 2, April 1990 Correspondence folder, and letter from Douglass North to M. D. Morris, February 24, 1991, Box 2, February 1991 folder. The Douglass North papers are located in the Special Collection Library, Duke University.

³ Douglass C. North, "Epilogue: Economic Performance Through Time," in Lee J. Alston, Thrainn Eggertsson, and Douglass C. North, eds., Empirical Studies in Institutional Change (Cambridge: Cambridge University Press, 1996), p. 343. This article is North's entire Nobel acceptance speech.

⁴ For the "long time," see Margaret Levi, "A Model, a Method, and a Map: Rational Choice in Comparative and Historical Analysis," in Mark Irving Lichbach and Alan S. Zuckerman, Comparative Politics: Rationality, Culture, and Structure (Cambridge: Cambridge University Press, 1997), p. 36. For 400 years, see John Joseph Wallis, "Answering Mary Shirley's Question, or What Can the World Bank Learn from American History?" in Stephen Haber, Douglass C. North, and Barry R. Weingast, eds., Political Institutions and Financial Development (Stanford, Calif.: Stanford University Press, 2008), p. 92.

By "institutions, North meant the necessary stable rules and norms
One of his recent definitions of "institution" is comprehensive:"⁵

Institutions are the "rules of the game" ... the patterns of interaction that govern and constrain the relationships of individuals. Institutions include formal rules, written laws, formal social conventions, informal norms of behavior, and shared beliefs about the world, as well as the means of enforcement. The most common way of thinking about institutions is that they are constraints on the behavior of individuals as individuals ... However, institutions also structure the way individuals form beliefs and opinions about how other people will behave.

This definition is relatively clear. North usually, however, divides "institutions" into formal and informal components, but his "formal institutions" do not mean or include government. This has confused many readers, including many "New Institutionalists" who follow him. North defines "formal institutions" as "formal rules, written laws, [and constitutions]." He does not call the state or its specific structures "institutions," but instead "organizations."

North's definition of formal institution has led to enormous confusion. The "old institutionalists" did and do define "institution" as formal structures, including governmental structures. Thus, when Joseph Stiglitz in a 2011 interview criticized the "mainstream view that institutions don't matter," he was talking about the state. His

⁵ Douglass C. North, John Joseph Wallis, and Barry Weingast, Violence and Social Orders, : A Conceptual Framework for Interpreting Recorded History (New York: Cambridge University Press, 2009), p. 15.

definition of "institution" was conventional and hence was totally different from North's.⁶

The difference in the "New Institutional" and "Old Institutional" definition of institution reflects a fundamental difference between the two groups--and between Stiglitz and North personally. Stiglitz thinks that the state must play a major role in regulating the economy. North has been closely associated with the Liberty Fund. He has Friedrich Hayek's negative view of the state, and, like Hayek, North uses norms and beliefs to explain the constraints on the behavior that are necessary for "spontaneous" order.

North is absolutely right to insist that human beings never act on the basis of a simple cost-benefit calculation of "pure" self-interest. People's definition of self-interest is at least partly determined by societal norms and belief systems. Even their self-definition of their narrow interests is heavily influenced by norms. And if people followed their self-interest narrowly as The Wealth of Nations occasionally seems to advise, the result would be economic disaster.⁷

⁶ Leslie P. Norton, "The Dangers of Lessons Unheeded: Interview with Joseph Stiglitz, Barrons, March 21, 2011, p. 40.

⁷ In one of the most famous lines of the The Wealth of Nations, Smith says that the self-interested person will "be led by an invisible hand to promote an end which was no part of his intentions ... By pursuing his own self-interest he frequently promotes that of society more effectually than when he really intends to promote it." Smith seems to be saying that persons who want to promote the common good should pursue self-interest rather than follow a policy that they think promotes the common good.

Nevertheless, North's precise views remain quite ill-defined on the key developmental question of the nature of the institutional change required for an effective market and how to achieve it. He himself emphasizes that laws and constitutions are not effective--or, frequently, even meaningful--unless they are re-enforced by informal institutions of various types. As North emphasizes, the American Constitution has often been quite ineffective when introduced in other countries, especially, he emphasizes, Latin America.

England has no written constitution but is quite "constitutional." It must be the "unwritten constitution" that is really important in the United States since the formal constitution does not work as we in other countries. Yet, North never tries to define the informal institutions that are needed for an effective constitution or market, and he never discusses how and why they develop over a 400-year period even though he has Hayek's view of evolution of norms.⁸ He never talks about the intermediate stages.

One reason is that North never interacts with the literature in an effort to elucidate his views and distinguish them from others. Thus, North never cites Hayek even though the evolution of his thought

⁸ For Hayek on evolution, see F. A. Hayek, "Epilogue: The Three Sources of Human Values," in Frederick A. Hayek, The Political Order of a Free People (Chicago: University of Chicago Press, 1979), pp. 153-176. The "epilogue" is the Hobhouse Lecture, given at the London School of Economics on May 17, 1978. The volume is reprinted as volume 3 of F. A. Hayek, Law, Legislation and Liberty (London: Routledge & Kegan Paul, Ltd., 1982), same pages. The "epilogue" is the Hobhouse Lecture, given at the London School of Economics on May 17, 1978.

closely parallels Hayek's. He never discusses the difference between the norms of an effective market and those which preceded it--not even the simple distinction that Max Weber made between the personalistic values of tribal and village society and the impersonal values and professionalism of modern rational-technical society. Indeed, North never cites Weber except his book, The Protestant Ethic and the Spirit of Capitalism. North does not cite or discuss Joseph Schumpeter's insistence on the importance of "a social stratum ... that takes to politics as a matter of course"--a stratum with "traditions that embody experience, with a professional code and with a common fund of views."⁹

A second reason that Douglass North is less clear, especially on issues of interest to development economists, is that his own work is as static as that of the neoclassical economists he criticizes. As political scientist David Laitin wrote North in 1988, his "models emphasize continuities" rather than change.¹⁰ North declined Laitin's invitation to write a conference paper discussing change, and he never really has addressed the subject. Yet, while change is excruciatingly slow, it does take place. The question is how this occurs and how desirable change can be promoted.

⁹ Joseph A. Schumpeter, Capitalism, Socialism, and Democracy, (New York: Harper and Brothers, 1942), pp. 290-296.

¹⁰ Letter from David Laitin to Douglass North, April 13, 1988, Douglass North Papers, Duke University, Box 2, May 1988 Correspondence folder.

This paper is intended to clarify North's changing position on a number of key issues with respect to the state and market. Then it will briefly indicate the ways that economists can build upon North's insights and make them more operational. That is the purpose of the completed book manuscript on which this paper is largely partly based. We agree very much with Michael Woolcott of the World Bank that neoclassical economists are right to insist on the dangers of monopoly and restriction of entry to a well-functioning economy and on the advantages of free trade and comparative advantage in the economy, but that, like most academics, they prefer monopoly and restriction of entry in the branch and sub-branch of the economy in which they are employed. They never recognize the value of comparative advantage and a free trade of ideas with those not on their "turf."¹¹

We agree with Woolcott that economists should learn from their own insights, and we suggest that the work of the sociologist Max Weber, the old institutional economist Joseph Schumpeter, and especially North's great rival, the neoclassical economist Mancur Olson, are good places to begin. We explore issues much more fully in our forthcoming book that covers 1000 years from 800 to 1800 in four important cases, Why Time Matters: A Collective Action Analysis of The Formation of Government and Market in England, Spain, and their Colonies.

¹¹ Michael Woolcott talk, "The Past as a Foreign Country: Reconciling Contending Approaches to History and Development Policy," Economic History Workshop, Duke University, February 16, 2012.

Douglass North and the Rationality Assumption
of the Neoclassical Model

Douglass North has had a long and multi-faced intellectual evolution over what has now been 70 years. He began on the eve of World War II as a Marxist and, as an admiring former student noted, he was not afraid to identify himself as a Marxist at the University of Washington in the early 1950s during the McCarthy era. Yet, he never was a Marxist of the type associated with the Communist Party. North always was a deep pacifist and remained one even after Hitler attacked the Soviet Union in June 1941. No one remotely associated with Communist thinking would have taken that position at that time.

After World War II, North went to graduate school to the University of California at Berkeley and remained a Marxist during that period. When he began teaching at the University of Washington in 1950, he began talking with neoclassical economists, and, as he told an interviewer in 1993, he very quickly became "a Chicago School neoclassical theorist"—"gung ho on neoclassical economics ... holier than the Pope."¹² A student at this time refers to North's "long-term

¹² Transcript of interview with North, October 2, 1993, attached to letter of John Lyons to Douglass North, October 2, 1993, North papers, Box 3, Correspondence October 1993 (Part 2). The interview was published in John S. Lyons, Louis P. Cain, and Samuel H. Willington, Jr., eds., Reflections on the Cliometrics Revolution: Conversations with Economic Historians (London: Routledge, 2008), p. 199.

love affair with price theory." Indeed, in his 1993 interview, North said that he still was a neoclassical economist in his thinking.¹³

When North published his first theoretical book, The Rise of the Western World in 1973, he and his co-author, Robert Paul Thomas, used neoclassical analysis in traditional form to explain historical development. The book explained economic growth largely by changes in prices produced by factors such as changes in population and technology, and this seemed to imply an automatic process. North treated the political process largely as informal contractarian negotiations between society and the ruler. Government outcomes became largely a response to the demands of efficiency.

During the 1970s, however, North began to reflect on the fact that similar conditions and prices do not always produce identical economic performance and rates of growth. He began to wrestle explicitly with the real assumptions of the classical and neoclassical models. These models, in the words of Paul Aligica and Peter Boettke, basically assume that "the pattern of order and [its] positive consequences [emerge] out of the independent actions of individuals pursuing their

¹³ Jonathan R. T. Hughes, "Douglass North as Teacher," in Roger L. Ramsom, Richard Sutch, and Gary M. Walton, eds., Explorations in the New Economic History: Essays in Honor of Douglass C. North (New York: Academic Press, 1982), pp. 4-5. For the interview, see the preceding footnote.

own interest and trying to maximize their own welfare within a given system of rules."¹⁴

We have underlined the words at the end of the last paragraph. The neoclassical models do, in fact, have the predicted desirable result only if the economic actors follow the rules of the game and engage in free competition, observe contracts, respect each others' property rights, and so forth. Otherwise, the pursuit of self-interest will not lead to socially beneficial results except in long-term relationships that are based on the need for a reliable reputation.

Dennis Mueller presents an unusually sophisticated discussion of the rationality assumption of the neoclassical model when he recognizes frankly that the rational actor of the neoclassical model should not, in actuality, follow the rules of the game. Mueller begins with a conventional point: "probably the most important accomplishment of economics" was to demonstrate "that individuals with purely selfish motives can mutually benefit from exchange." But then he makes the awkward point: theft is more profitable than exchange:¹⁵

¹⁴ Paul Dragos Aligica and Peter J. Boettke, Challenging Institutional Analysis and Development: The Bloomington School (London: Routledge, 2009), p. 30.

¹⁵ Dennis C. Mueller, Public Choice II (Cambridge: Cambridge University Press, 1989), pp. 9-10. The identical language is retained in the third edition, Dennis C. Mueller, Public Choice III (Cambridge: Cambridge University Press, 2003), pp. 9-10. This book is a classic encyclopedic volume on public choice theory.

If A raises cattle and B corn, both may improve their welfare by exchanging cattle for corn... [However], the choices facing A and B are not merely to trade or not, as implicitly suggested. A can choose to steal B's corn, rather than give up his cattle for it; B may do likewise ... In an anarchic environment, the independent choices of both individuals can be expected to lead both to adopt the dominant stealing strategy.

Clearly not everyone will follow the rules of the game, and Adam Smith and all subsequent classical and neoclassical economists have understood this point. They have almost universally solved the dilemma by assuming that government and its potential use of force is needed to enforce the rules of the game and to protect property rights.

Indeed, from the late 1970s onward, as we shall see, North too has often spoken about impartial third-party enforcement of contracts by the state as the key to the protection of property rights. In 1979 he explained the different response of countries to similar prices to "the degree to which the State adopts alternative institutions [laws and rules] that decide whether efficient or inefficient ones will be adopted."¹⁶ He focused on a well-functioning court system, but he knew that the courts must rest on enforcement mechanisms.

The central problem with this traditional solution to the problem of rule-enforcement is that governments are staffed by human beings who should not be that different in their motivation from those in the economic sphere. As James Buchanan emphasizes, government should not act in a disinterested manner in making laws and enforcing them. Why

¹⁶ "To Alexander Field," October 16, 1979, North papers, Box 50, Correspondence Fall 1979.

should those in the economic sphere (homo economicus) strive to enrich themselves but not those in the political sphere (homo politicus)?¹⁷

That is, the neoclassical model implies that corruption is rational behavior. Instead of enforcing the rules of the game impartially, the political actors should make favorable decisions in exchange for various kinds of payments and future rewards.

The only obvious difference between homo economicus and homo politicus is that the government controls the military, the police, and the court system and that there is no outside government to prevent them from violating property rights. In a sense, the government and military officials are in Mueller's "anarchic environment" and should "adopt the dominant stealing strategy." A written constitution should not be able to constrain them. Indeed, those in control of military force--both civilian leaders and military commanders--should overthrow the rules of the game altogether.

Most who embrace the neoclassical economic model "solve" these problems by assuming a "loose" definition of rationality that includes ethics and/or that makes violation of the rules of the game a deep taboo, especially for those working in government. North is correct that this is not really legitimate. We must recognize that the

¹⁷ James Buchanan, Economics From the Outside In: `Better than Plowing and Beyond (College Station: Texas A & M Press, 2007).

model's definition of rationality is an inadequate depiction of human nature and adopt a more realistic definition.

By 1979, North was writing colleagues that he was focused on "the dilemma the free rider problem [the consequences of the pursuit of narrow self-interest] poses for the neoclassical economic theory." He made this point in his 1981 book, Structure and Change in Economic History. As North later acknowledged, he only "abandoned [his earlier] efficiency view of institutions" in this book. The clause in his October 1979 letter "subject to the degree to which the ruler, either a lord or a king, is willing to adopt such rules" was a transitional one. Yet, North mentioned in this letter in October 1979 that he had "come to realize the limitations of neoclassical models in history" and that he had written a rough draft of a piece on ideology, the predecessor to his emphasis on institutions.¹⁸

As North wrestled in the second half of the 1970s with the problem of explaining the diversity of response by different countries to similar price stimuli, he drew the conclusion that the homo economicus assumptions of rationality in the neoclassical model were not the sole or, perhaps even the most important, determinant of behavior. In his speech accepting the Nobel Prize in 1993, he declared that "it is necessary to dismantle the rationality assumption underlying economic

¹⁸ "To Alexander Field," October 16, 1979. Douglass North letter to Moses Abramovitz, September 26, 1979, North papers, Duke University, Box 50.

theory."¹⁹ By 2005, he was making the point in the sharpest language: "The uncritical acceptance of the rationality assumption is devastating for most of the major issues confronting social scientists and is a major stumbling block in the path of future progress."²⁰

North implicitly placed special emphasis on the state and its role in protecting property rights. In general, however, he accepted Buchanan's point that government officials are likely to take actions that serve their self-interest. As we will discuss in the next section, he generally has had a quite negative evaluation of the role of the state unless it is restrained by society, generally through representative bodies.

North made his basic point in a number of ways since the late 1970s, but he consistently has argued that people always function within "a human construct of rules, norms, conventions, and ways of doing things that define the framework of human interaction." He insisted that this "construct" affects their behavior--their very definition of self-interest--and that the neoclassical model does not recognize this.²¹

When North began modifying his theory in the 1970s, he first labeled the "something else" which must be added to the neoclassical

¹⁹ North, "Epilogue: Economic Performance Through Time," p. 346.

²⁰ Douglass C. North, Understanding the Process of Economic Change (Princeton: Princeton University Press, 2005), p. 5.

²¹ North, Understanding the Process of Economic Change, p. 11.

model as "ideology." As he wrote a friend in 1979, "the strength of ideology is precisely the premium that people are willing to incur to not free ride."²²

Over time, North abandoned the word "ideology" in favor of "belief system" as an equivalent. As he explained in 1999:²³

The reason I cavil at the term "ideology" is that it carries too much of a burden. In the work I now do in cognitive science I use the term "belief systems"; it is more normal, and it does not get me into as much trouble. "Ideology" connotes the Marxist notion of false or incorrect beliefs. I do not mean either; I mean that everybody has belief systems. Belief systems enable us to interpret that part of reality that we are trying to understand and build into models for ourselves a positive and always a normative perspective on that world.

"Belief system" is also particularly broad and hard to analyze.

North tried to develop a more operational framework by speaking about economically-relevant rules of the game ("institutions") as incentives to which people would respond.

All scholars would agree with North on the general point that people operate within "a human construct of rules, norms, conventions, and ways of doing things that define the framework of human

²² Douglass North letter to Moses Abramovitz, September 26, 1979, and Douglass North letter to Jack Hirshleifer, February 8, 1983, North papers, Duke University, Box 50.

²³ Douglass C. North, "Response to Geddes and Keohane," in James E. Alt, Margaret Levi, and Elinor Ostrom, eds., Competition and Cooperation: Conversations with Nobelists about Economics and Political Science (New York: Russell Sage Foundation, 1999), p. 250.

interaction." The problem is that this has been true since people first became quasi-humans several million years ago. Hence a general statement about people operating within constructs and belief systems means nothing unless it leads to concrete distinctions among these constructs and belief systems. It is no more than a tautology to state that people are constrained by constitutions, laws, and norms to the extent that they are actually constrained by them. North is very close to saying this.

A close associate of North's, Margaret Levi, is right in suggesting that North is "treating ideology as a residual category for those situations in which self-interest is clearly not explanatory."²⁴ Yet, he makes no attempt to define this residual, let alone explain it in concrete situations. The same criticism applies to "institutions." In particular, he never even tries to describe the "institutions" that are a precondition of an efficient market.

North surely would have endorsed the following sentence from Alan Greenspan's 1997 discussion of the problems of Russia. "There is a vast amount of capitalist culture and infrastructure underpinning market economics that has evolved over generations: laws, conventions, behavior, and a wide variety of business professions and practices that that has no important functions in a central planned economy."²⁵

²⁴ Margaret Levi, Of Rule and Revenue (Berkeley: University of California Press, 1988), p. 51.

But what is this capitalist culture? At a minimum, one would have thought North would have referred to Max Weber's rational-legal norms (e.g., professionalism and impartial and impersonal relations in the economy), but he does not mention this work at all. Rather, he talks only about ethical constraints as if the main problem were not the changing of the definition of ethics in traditional society that focus on the priority of personalistic, family, and non-impartial relations.

From the perspective of our book, the failure of North to define desirable ideology or institutions precisely is not that harmful. All great thinkers are imprecise, confused, and inconsistent to one extent or another. If North's analysis had a dynamic element that provided a general but very incomplete indication of the direction and cause of change, it would be extremely useful. Max Weber's analysis of the difference in the values of traditional and modern society is, after all, quite general and oversimplified, but scholars have found it illuminating for over a century. Unfortunately, Douglass North's analysis is both general and static.

The static nature of North's work has provoked severe criticism, and North himself has been acutely aware of this difficulty. He has fully understood, as he wrote in 1983, thirty years ago that "I'm not going to convince the Gary Beckers of the world without some empirical

²⁵ Alan Greenspan, "The Embrace of Free Markets" (Washington, D.C.: The Woodrow Wilson International Center for Scholars, 1997), p. 2.

measurement.”²⁶ He drew the logical conclusion. As he told a long-time friend in 1991, “I am deep into cognitive psychology these days since my next book--years off--is going to be a theory of ideology and to do that properly I am going to have to spend a long time in the immense and very fascinating literature in cognitive science. North did, in fact, look at this psychological literature and did use it to some extent, but he never completed a book on ideology or informal institutions. The problem is that “the immense and very fascinating literature” itself still does not yet provide convincing answers, and North has never made the effort to analyze concrete values or change.

In short, North focused on trying to explain why society and economies changed slowly. But he, in fact, did not even do that, but merely stated the basic fact that the past and history has an impact. But if there is no dynamism in the model, we cannot explain how and why change does occur, and why it was slower in Spain than in England. As we said in the opening pages, we think that the work of Max Weber and Mancur Olson is extremely useful in helping us in performing this task.

Douglass North and the Nature of the State

²⁶ See, for example, D. C. Coleman, Times Literary Supplement (TLS), January 5, 1982, and Robert B. Ekelund, Jr. and Robert D. Tollison, Politicized Economies: Monarchy, Monopoly, and Mercantilism (College Station: Texas A & M University Press, 1997), pp. 224 and 18. Letter to Jack Hirshleifer, February 8 1983, North papers, Box 50.

Neoclassical theorists such as James Buchanan and Mancur Olson may be right or wrong, but their basic assumptions and analyses are usually relatively precise and, thus, relatively easy to discuss. Douglass North, by contrast, has used vague and imprecise concepts, and his analysis and language changed substantially from the early 1970s to the mid-1990s. Perhaps as a result, there are puzzling aspects of North's position about the state that seem not to fit neatly together and leave unclear what he actually is saying.

In his first theoretical book, which was published in 1971, North and his co-author Robert Paul Thomas portrayed the political system largely in contractarian terms as a response to the demands of efficiency. He described the government outcomes as the product of informal negotiations between the societal actors and the ruler.

North and Thomas even applied their analysis to the Middle Ages. They asserted that "the contractual arrangement of the classic manor can now be seen as an efficient arrangement for its day."²⁷ They thought that "the customs of the manor became the unwritten 'constitution', or the fundamental institutional arrangement of an essentially anarchic world." The manor and local baron, they said, served "the functions of providing justice and protection."

²⁷ Douglass C. North and Robert Paul Thomas, The Rise of the Western World: A New Economic History (Cambridge: University Press, 1973), p. 11 and 32.

The nation-state, North and Thomas said, took over from the manor these functions of justice and protection. The rise of the nation-state, they asserted, was "probably the inevitable result of the development of a money economy and the expansion of trade."²⁸ In their view, the relationship of the king and constituents remained as basically contractual as had that of the baron and serfs:²⁹

Even in our day, the government is primarily an institutional arrangement that sells protection and justice to its constituents ... In return for this service, the state receives payment in the form of taxes. Since economies of scale in the provision of protection and justice makes this transaction potentially worthwhile to the constituents, a basis exists for a mutually advantageous trade between the governed and the government. So long as economies of scale continue, the state's widened protection and enforcement of property rights increases the income of all constituents and this saving is divided in some manner between the constituents and the state.

By the late-1970s, as we have seen, North began to confront the fact that countries in similar economic situations had very different levels of economic performance. He concluded that "the degree to which the State adopts alternative institutions [laws and rules] that decide whether efficient or inefficient ones will be adopted" was of crucial importance.³⁰ This is a powerful independent role for the state.

²⁸ North and Thomas, The Rise of the Western World, p. 80.

²⁹ North and Thomas, The Rise of the Western World, p. 97.

³⁰ "To Alexander Field," October 16, 1979, North papers, Box 50, Correspondence Fall 1979.

At this time, North began to emphasize strongly that an effective government was crucial in establishing an efficient market. He stated this not only in his writings, but in many of his letters. He sharply criticized those with a rent-seeking, contractarian, or self-enforcing contracts approach to distinguish himself from them.

Two 1987 letters to a libertarian economist, Donald McCloskey, were typical: "Certainly in my view, though probably not in yours, the development of a judiciary and a system of law or third party enforcement of contracts has played an overwhelmingly important role in the development of western economies." Six months earlier he had told McCloskey that "I don't think it is possible to have high income and complex interdependent societies without government approximating third-party enforcement of contracting:³¹

Now, I agree, Don, that there is an immense literature on self-enforcing contracts, reputation, trust, and so on ... Still, given all of that, it does seem to me that what gives you the semblance of their being self-enforcing is that underlying it is a body of rules and law that constrain the way parties write contracts. Now, don't misunderstand me, that does not mean that it is the rule of law by itself that is doing it, rather it is an interplay between the rules of the game, the way they are enforced, the kinds of contracts people write in the context of those rules, and their enforcement characteristics.

³¹ Letter to Donald McCloskey, July 27, 1987, and letter to Donald McCloskey (January 16, 1987), North Papers, Box 1, Correspondence January and July 1987. Also see North's letters to T. N. Srinivasan (September 4, 1985), Terry Anderson (April 18, 1986), David Feeny (November 18, 1987), and Daniel Bromley (December 14, 1987). North papers, Box 1. Younger scholars may know McCloskey only as Deirdre McCloskey.

Yet, a scholar who goes through North's voluminous correspondence in the archives and who reads his published work in conjunction with his correspondence at the time develops a very uneasy feeling. Much evidence fits poorly with the usual argument about the importance of the role of the state. Perhaps the most jarring and unexpected piece of information is that over two decades from at least the late 1970s until the end of the mid-1990s, North was a frequent participant in the workshops of the libertarian Liberty Fund.³² Those participants are seldom proponents of government involvement in the economy.

A second piece of information that fits with North's Liberty Fund involvement is the similarity of the evolution of North's views and those of Friedrich Hayek. North never cited Hayek's work and only began expressing his admiration for him at the end of the century. Yet, the parallels between the evolution of thought of the two men are striking, although in North's case with a considerable lag.

Hayek began as an economist almost obsessed with price theory and the role of prices in producing efficiency in a spontaneously functioning economy. As Steve Fleetwood writes, Hayek had always implied the existence of constraints based on "conceptions, ideas, beliefs, attitudes, and so forth," but only around 1960 did he begin to

³² The first reference in the archives is in 1979. The latest reference is to a 1999 session reported in Bruce Caldwell, Hayek's Challenge; An Intellectual Biography of F. A. Hayek (Chicago: University of Chicago Press), p. 352n.

emphasize the existence of an integrated “underlying structure of rules” that underpins the price mechanism and the market process.³³

Hayek himself expressed the point most clearly in 1973:³⁴

Man is as much a rule-following animal as a purpose-seeking one. His thinking and acting are governed by rules which have by a process of selection been evolved in the society in which he lives, and which are thus the product of the experience of generations.

The reader who returns to North’s definition of institutions cited at the beginning of this paper will note the similarities. One suspects that this book of Hayek, Rules and Order, had an impact on North.

During the 1940s, as we noted, North considered himself a Marxist, and Marx is usually considered on the other side of the ideological spectrum from Hayek. Yet, the reason for North’s early attraction to Marx is not clear. He certainly was not in the Soviet Marxist stream of Communism, and we find it hard to believe that he really ever was attracted to the state socialism with which future generations associated Marx. We suspect that if we are understand North, we must recall Marx’s utopian view of the future Communist society.

³³ The words are Fleetwood’s. Steve Fleetwood, Hayek’s Political Economy: The Social-Economics of Order (London: Routledge, 1995), pp. 5, 29, 73-75, 83-86, and 98-100. The key book in 1960 was Friedrich A. Hayek, Constitution of Liberty (Chicago: University of Chicago Press, 1960).

³⁴ Friedrich Hayek, Rules and Order: A New Statement of the Liberal Principles of Justice and Political Economy (London: Routledge and Kegan Paul, 1973), p. 9 and 11.

The most famous shorthand description of Marx's utopia was that private property would be abolished, the state would wither away, but that order and some kind of planning would exist. Each individual would give to society according to his ability and receive according to his needs. Many understandably saw this so unrealistic that they dismissed it as no more than revolutionary propaganda without content.

Nevertheless, Marx was not simply a revolutionary. He was an extremely sophisticated classical economist who was heavily influenced by Adam Smith and David Ricardo and who spent an enormous amount of time in the British Museum working on Das Kapital. It was not an accident that many Soviet economists who were well trained in Marxism became extreme libertarian economists when they moved to the West.³⁵

If Marx ever mused about his image of the future, it is difficult to believe that he never thought about how the Communists utopian society would solve the problem of efficiency. If he did, he may not have been as far from Smith and Ricardo as is assumed. They too had a highly negative view of the state. D. C. Coleman has remarked on Adam Smith's "remarkable hostility" towards merchants and manufacturers and their "mean rapacity" and "monopolizing spirit."³⁶ The classical

³⁵ The most prominent example of such an economist in the United States is Andrei Shleifer. See Andrei Shleifer and Robert Vishny, The Grabbing Hand: Government Pathologies and Their Cures (Cambridge, Mass.: Harvard University Press, 1998), p. 10.

³⁶ D. C. Coleman in his "Adam Smith, Businessmen, and the Mercantile System in England," in his Myth, History, and the Industrial Revolution

economists were absorbed with what we would call crony capitalism and rent-seeking.

One can imagine that Marx understood he was presenting an idealized version of his utopia for popular consumption, but that, first and foremost, he was talking about attacking the manufacturers, merchants, and the mercantilist state they dominated. It is possible that Marx's roots in classical economics led him to take for granted a price-driven market under Communism and saw "each according to his needs" more as a Swedish extended safety net. He may have thought that the invisible hand would function well if greedy owners were removed.

If so, Marx's withering away of the state was quite close to the "spontaneous order" of James Buchanan. Buchanan describes the market as a mechanism that "coordinates the separate activities of self-seeking persons, without the necessity of detailed political direction." He writes of the market as having "a political function, which is to minimize the need for politicized control over and decisions concerning resource use." He calls this the "coordinating principle" of economics.³⁷

By all the evidence, Mikhail Gorbachev and his aides took Marx's definition of a good society seriously--in fact, far too seriously. North too may have been attracted to Marx's negative attitude about the

(London: The Hambledon Press, 1992), pp. 153-63. The quotations are from pp. 153-154.

³⁷ James Buchanan, Economics From the Outside In: `Better than Plowing and Beyond (College Station: Texas A & M Press, 2007), pp. 71-72 and 97. The emphasis is in the original.

state and his image of spontaneous order under Communism. In the mid 20th century, a Polish Marxist economist of the mid 20th century, Oskar Lange, argued for a type of market socialism in which the state used the price mechanism as its main instrument of planning.

In 1990, North hinted that Lange was the link who brought together his fascination with Marx and prices. North wrote that "the debate between Hayek, von Mises, and Lange ... is important because it really did focus on the way in which price system is important and the information that prices carry that were only very, very imperfectly carried when planning mechanism were used in their place."³⁸

Clearly, North decided that private property is crucial for spontaneous order, but he is extremely ambiguous about the wealthy. On the one hand, as we will see, he sometimes describes representative institutions based on the wealthy as the key to establishing constraints. This could make him similar to Andrei Shleifer, who retains his Marxist notion that the owners of the means of production are the base of the capitalist state but who sees this as a good thing. Yet, North never says anything positive about bureaucracy either in government or in the corporation (a major difference from Max Weber) and he is highly critical of the contractarianism of Oliver Williamson which focuses on the bureaucracy in a corporation. It is a mystery.

³⁸ Letter to T. N. Srinivasan, October 31, 1990, North papers, Box 2, Correspondence October 1990.

But if North originally was attracted to Marx because of his state-utopia and retained this during his contractarian period in the 1960s and most of the 1970s, what happened during the evolution of his theory during these years? How did he arrive at the sharp insistence on the crucial importance of the state that we quoted from his correspondence to Donald McCloskey?

The answer to this question is far from clear, and perhaps North made his analysis deliberately obscure on key points. In one of North's letters to McCloskey that we cited, North wrote that their disagreement on "the extent to which government has played any positive role at all" is "probably not so much when (if you'll excuse the use of the word) we get our `rhetoric' organized." North warned McCloskey against the possibility that "you will end up with a right-wing tract. North thought "that might be a mistake" not only because government does play some positive role, "but also because it would be a strategic mistake since I think you would alienate most of your audience before they looked further."³⁹ It is within the realm of the possible that North was giving McCloskey advice drawn from his own experience.

Certainly North retained a very mixed picture of the benefits of the state. In one of his letters to McCloskey, North wrote that "it probably is true that governments by and large have been bad for growth

³⁹ North letter to Donald McCloskey, July 27, 1987, North Papers, Box 1, Correspondence July 1987.

... Throughout history it has not been in the interests of those who ran governments to promote efficient property rights."⁴⁰

In 1993, an exchange of letters between North and Mancur Olson indicates clearly that North retained this view. In 1993, Olson sent North a manuscript that was to become his article "Dictatorship, Democracy, and Development." Despite the title, the article became famous for presenting Olson's theory of the formation of the state. The state, Olson said, arose when a roving bandit (militia leader) defeated all other such group leaders in an area to become a "stationary bandit" (a ruler of an area) and monopolize theft through taxation.

Olson's theory was theoretically interesting--and to us convincing--in providing an excellent solution to the collective action problems of the social contract theory of the state that attracted North. But, more important from our perspective here is Olson's argument that the stationary bandit and his successors were driven by a desire to maximize their tax income and that this drove them to expand the tax base by maximizing production. Thus, in Olson's view, the state rested on the self-interest of those who controlled military force, and this was the driving force in the development of civilization from the time of the formation of the first settled communities some 15,000 years ago.⁴¹

⁴⁰ Letter to Donald McCloskey, January 16, 1987.

Some writers use the metaphor of the "predatory state," but this is misleading, even for autocracies ... The metaphor of predation obscures the great superiority of stationary banditry over anarchy and the advances of civilization that have resulted from it. No metaphor or model of even the autocratic state can therefore be correct unless it simultaneously takes account of the stationary bandit's incentive to provide public goods at the same time that he extracts the largest possible net surplus for himself.

This argument is at the heart of Olson's argument about the development of constraints on rulers. Olson contended that a ruler interested in maximizing long-term tax revenues must maximize economic production as the best way of achieving this goal. If rulers realize that restraints on themselves are needed to increase predictability and efficiency, then rulers have a long-term interest in self-restraint. This implicitly was also Adam Smith's argument in The Wealth of Nations that George III should grant independence to the colonies in America: he would receive more taxes from the manufacturers who could produce more and earn more taxable profits if trade in the Atlantic were free. We suspect that this was the source of Olson's model.

In his 1993 exchange of letters with Olson, North directed the heart of his fire against this argument. The "key issue" between us, North wrote, is "where you are asking why a roving bandit when he settles down ... only takes part of the take." North argued that Olson should accept more seriously an argument by Margaret Levi that rulers

⁴¹ Mancur Olson, "Dictatorship, Democracy, and Development," *The American Political Science Review*, vol. 87, no. 3, pp. 568-569.

are predatory. Olson retorted that he had already rejected her thesis at a conference session with her "some time ago." "It was at that session that I first argued that a rational autocrat, no matter how selfish and brutal, would never be a predator [since] he had an encompassing interest in the productivity of the domain from which he took his exactions."⁴²

In the book in which she was to articulate her views, Levi had said that "rulers are predatory in the sense that they are revenue maximizers."⁴³ Mancur Olson seemingly would agree completely. Yet, there had to be a reason why Olson had been so brusque in describing his conference session with Levi. He had heard everything said in the session, and Levi had made her difference with him quite clear. In fact, when she used the word "predatory," she was thinking of an exploitative situation in which the ruler was not driven by his own self-interest to promote the economic well-being of those he ruled. She thought the ruler tried to maximize tax revenue in the short run.

North, as we have seen, was not that different in his view of the state. Moreover, he directly associated himself with Levi in his exchange of letters with Olson, and she dedicated Of Rule and Revenue to North. In the acknowledgements she jocularly blamed him for some of

⁴² Douglass North to Mancur Olson, February 17, 1993; Mancur Olson to Douglass North, February 24, 1993, North Papers, Box 3, Correspondence February 1993.

⁴³ Margaret Levi, Of Rule and Revenue (Berkeley: University of California Press, 1988), p. 202.

her errors. But what then is the solution when we try to reconcile North's negative view of the state with his insistence to McCloskey and others that the state is crucial. By far the most plausible hypothesis is that North was being quite literal--and quite limited in his point--when he wrote to Donald McCloskey that "the development of a judiciary and a system of law or third party enforcement of contracts has played an overwhelmingly important role in the development of western economies."

Over the years, North directly or indirectly often implied that the protection of property was the central desirable role for government--perhaps the only such role outside of spheres taken for granted by all libertarians. Thus, in 1985 when he was asked for advice by a US official working in the Third World, North answered, "The prime problem in these [Third World] countries is developing a form of stability and responsiveness that enables government to act as a third party to enforce contracts."⁴⁴

In 1989, North made a particularly interesting comment on a 57-page paper by Joseph Stiglitz that discussed what he considered a series of useful functions for government. In his comment, North had a section entitled "What Government Should Do." It would have been appropriate for him to discuss a number of functions of government,

⁴⁴ Letter to Frederic Mabbatt, July 1, 1985. North Papers, Box 1, Correspondence July-August 1985.

but, instead, he referred only to its role in establishing ill-defined rules and then serving as a third-party referee in contract disputes.⁴⁵

North obviously would list other functions for the state such as defense and infrastructure construction, and he may consider himself a man of the left because he supports a more generous social safety net than Hayek did, let alone Buchanan. He must be on the left on current social issues. Nevertheless, the need for law and order and the protection of property rights in the courts is a point that all libertarian economists have always taken for granted.

We are, however, left with the question with which we began: if North did not think the ruler was restrained by a desire to increase taxable profit, how did he believe that the restraints on the ruler necessary for an efficient market were established? The reader of this paper will have noted that North at various times talked about social contracts, "ideology" (renamed "belief systems"), norms and values, culture, and formal institutions including constitutions.

But if, as North said in his argument with McCloskey, these informal institutions are not enough to support a spontaneous order by themselves, how do they control a ruler whom North sees as predatory in an exploitative sense? Why does he think that such a ruler will serve as a neutral third party enforcer of contracts rather than a threat to

⁴⁵ Douglass North, "Comments 2," Joseph E. Stiglitz, The Economic Role of the State, ed. by Arnold Heertje (London: Blackwell, 1989), pp. 109-110.

property rights? North did, after all, write that "throughout most of history the State has not provided as framework conducive to economic growth ... A State that is self-consciously concerned with the performance of the economy is a relatively modern phenomenon."⁴⁶

But what changed in relatively modern times? If the answer is norms and belief systems, what is their character and how did they become effective? As we have seen, North does not answer these questions. If he rejects Olson's argument that the self-interest of the ruler could lead to self-constraint, if he is so vague that even Levi can conclude that he is "treating ideology as a residual category for those situations in which self-interest is clearly not explanatory," then where are we left?

The answer to which North increasingly turned in the late 1980s was that which he presented in his most famous article, that which he co-authored with Barry Weingast in 1989 on the importance of the Glorious Revolution of 1688 for the Industrial Revolution.⁴⁷ North and Weingast pointed to the great financial advances made in England in the 1700s, advances that they thought crucial in the economic development of the century. They then attributed these advances, and especially,

⁴⁶ North, "Comments 2," p. 108.

⁴⁷ Douglass C. North and Barry R. Weingast, "Constitutions and Commitment: The Evolution of Institutions Governing Public Choice in Seventeenth Century England," The Journal of Economic History, vol. 49, no 4 (December 1989), pp. 808-832. The quotation is from p. 829.

the decline in bond interest rates to the increased confidence of lenders in repayment because of the consent of the governed.

A critic wrote to North and suggested that he should acknowledge his debt to John Locke and cite him. North responded that he hardly knew when to cite Locke. "I certainly owe Locke a great deal, but at times I don't know when I'm talking Locke and when I'm talking North since I'm sure that I have absorbed him through my pores for a long time."⁴⁸

The essence of the North-Weingast article was, indeed, Lockian. They asserted that "the principal lesson of our article is that the fundamental institutions of representative government ... are intimately related to the struggle for control over governmental power." In explaining why bond rates declined after 1688, they stated that the parliamentary authorization of loans reassured the lenders who were willing to accept lower rates. "The wealth holders gained a say in each of these decisions through their representatives in Parliament. This meant that only if such changes were in their own interests would they be made."

The North-Weingast article is deeply flawed. Unfortunately, as the authors frankly admit, they present no explanation or modeling either of the changes from 1603 to 1688 that led to the transformation

⁴⁸ North to Donald A. Nichols, May 23, 1991. Nichols letter was dated May 16th. North Papers, Box 2, Correspondence May 1991.

in 1688 or of the revolution itself.⁴⁹ They simply state as a fact that that Parliament somehow imposed self-enforcing constraints on the monarch. A large literature has challenged the factual argument. Interest rates did not decline until the 1720s when, as Adam Smith emphasized, the Hanover kings were able to establish very firm control over Parliament.

Moreover, North and Weingast simply repeat the old Whig interpretation of English history and fail to examine the modern historical literature. It treats the Restoration of 1660 as a naval coup and the Glorious Revolution as a joint navy-army coup headed by the navy. The financial change that occurred in the first decades was not a decline in rates, but a massive increase in the amount of loans to finance foreign wars. It is hard to imagine why the rural-dominated Parliament would want this development and easy to see why the military would. It was the power of the military, we argue in our book that was created a very credible "or else" commitment to lenders that made the loans possible. And, in fact, the funds were being used to build what John Brewer called "the sinews of power," a "military-fiscal state," and a powerful bureaucracy that could collect more taxes.⁵⁰

This paper is not the place for an historical argument. That is done in our book on 1000 years of English and Spanish history. The

⁴⁹ North and Weingast, "Constitutions and Commitment," p. 801, fn 1.

⁵⁰ John Brewer, The Sinews of Power: War, Money, and the English State, 1688-1783 (New York: Knopf, 1989).

important point for our purposes is that North largely came to rely on representative institutions to explain how predatory rulers were brought under control. These institutions rest on common values. North and Weingast wrote in 1989 that "a constitution must arise from the bargaining context between the state and constituents," and it "must be self-enforcing in the sense that the major parties to the bargain must have an incentive to abide by the bargain."⁵¹

In 1997, Weingast elaborated the argument and stated that a coup d'etat or usurpation of power could be prevented if people have "a shared belief system about the legitimate ends of government and the extent of citizen rights [and] a credible commitment that citizens [will] react in concert when officials violate their rights."⁵² North continued to use similar language in later work that often was co-authored with Weingast.⁵³

⁵¹ North and Weingast, "Constitutions and Commitment, pp. 808, 806, and 829.

⁵² Barry R. Weingast, "The Political Foundations of Democracy and the Rule of Law," The American Political Science Review, vol. 91, no. 2 (June 1997), pp. 245-263.

⁵³ See, for example, Douglass C. North, Understanding the Process of Economic Change (Princeton: Princeton University Press, 2005), and Douglass C. North, John Joseph Wallis, and Barry R. Weingast, Violence and Social Orders: A Conceptual Framework for Interpreting Recorded Human History (New York: Cambridge University Press, 2009).

Of course, North's neoclassical views were not inconsistent with increasing emphasis in the late 1970s on the need for the development of the judiciary and third party enforcement of contracts. Adam Smith certainly would have agreed with this point. North is saying that the constraints are developed only through a long-term process.

North in a Broader Framework

This paper is essentially descriptive and analytical. It logically could lead in one of two directions. One would be a speculative analysis in the realm of intellectual history on the functions that are served by vagueness and obscurity that must be deliberate when it continues for decades in the face of repeated criticism and demands for analysis of change. When this vagueness is widely accepted and becomes the basis for, as Michael Woolcott emphasizes, for innumerable scholars embracing broad and meaningless concepts such as "property rights," "rule of law," and "institutions" without exploring them, there becomes a crying need for a functional analysis. This is particularly so, when Woolcott rightly says that this is the path to receiving \$40,000 fees to be the keynote speaker at conferences.

The older--much older--and less cautious--much less cautious--of the two authors has a tentative answer to this question, but the book is completely sober. It ends in 1800 and focuses on pre-modern

society. It fully accepts the insight of North and Oliver Williamson that the creation of an effective government and market takes in the words of Oliver Williamson centuries or millennia. The research design is logically based on examination of a 1000-year period and suggest that "colonial heritage" of the United States and Mexico must also go back this far. Indeed, we argue that the 1260s happened to be crucial both for the United States and Mexico—specifically, that Alfonso X captured Cadiz in 1262 and had nominal control over a 600-mile strip from Bilbao to the South Atlantic and that Henry III defeated the lords to capture London in 1265 and create the base for a London city state from 1265 to 1485.

As the reader of this paper can judge, we think that North is quite correct in emphasizing the importance of values, but we think that values change as Weber emphasized. We think that Rousseau and Aristotle before him that "might" normally precedes "right" (that is, value change.) We think Weber is right that bureaucracy is a key basis of the development of constraints and was a powerful factor in the 1700s of England. It was the lack of bureaucracy in Spain and Latin America until the second half of the 1700s that was crucial.

In short, we think that North was wrong simply to dismiss neoclassical assumptions of rationality. That was what deprived him of a tool to analyze change because those assumptions underlie the collective action theory of Mancur Olson that we think crucial in understanding historical development. Olson, unfortunately, limited

himself to analyzing the small stationary bandit and then to the collective action problems of modern society. Our book focuses on the intervening period where we think his insights to be extremely illuminating.