

Economic change

Understanding the Process of Economic Change. By Douglass C. North. Princeton, NJ, Princeton University Press, 2005, 170 pp., \$35/hardback.

Douglass C. North, a Professor of Economics at Washington University in St. Louis, is a Nobel Prize winner in Economics and prolific author. His most well-known work, *Institutions, Institutional Change, and Economic Performance*, was written in 1990. His current work is a very substantial extension of that book, again focusing on institutional change. North, in his own words, “has placed institutions at the center of understanding economies because they are the incentive structure of economies.” In fact, North’s ideas have inspired the development of a new subfield of economics known as New Institutional Economics.

According to North, institutions are the rules of the game and organizations are the players. Institutions consist of formal rules, informal rules, and their enforcement characteristics. To reduce uncertainty in their lives, human beings make innovations in their institutions. People construct elaborate beliefs about how their political-economic systems “should” work (how they would like them to work) in contrast to how they “actually” work (how they perceive them working).

The most powerful political and economic entrepreneurs, who hold society’s dominant beliefs, over time construct “an elaborate structure of institutions that determine economic and political performance.” These institutions make it difficult for entrepreneurs to innovate by limiting their set of choices. Change, therefore, although occurring continually, is typically incremental; the rate of change

depends on the level of competition between the existing organizations and their entrepreneurs. Economic change gives rise to an alteration in the institutional matrix, and hence also to perceptions of the “reality” of the political-economic system.

Perhaps North’s most important contribution in this book is the concept that the process of economic change can be best understood when one is aware of the intentions of the organizations (the “players”) enacting institutional changes and when one comprehends the issues. Countries fail economically either because the players’ intentions have been based on self-interest, rather than societal well-being, or because of their poor comprehension of the issues.

North illustrates this with an extensive analysis of the economic history of the Soviet Union, the ultimate demise of which was a result of both of these reasons. The Soviet Union, led by Vladimir Lenin, in its early years was guided by the principles of Marx and Engels, particularly in regards to property. However, Marx and Engels did not provide any details about how to construct a Socialist society. The Communist Party leaders had a “primitive understanding ... of the fundamental structure of an operating economy and [an] even more primitive understanding of the necessary incentive structure to accomplish their objectives.” To make matters worse, Russia’s new masters could not tolerate any dissent; in September 1922, there was a mass expulsion of the country’s finest economists, philosophers, scientists and thinkers. Several early crises caused a temporary retreat from their guiding Marxist principles with the New Economic Policy, but by 1928, now under Stalin, the government had returned to ideological orthodoxy. A gigantic state appara-

tus and complex institutional matrix developed and had some successes, notably in heavy industry, and other failures, especially agriculture. Agriculture remained a problem throughout the history of the Soviet Union, and eventually economic growth in toto came almost to a standstill in the Brezhnev era.

Being unwilling to change the existing set of institutions, the Communist leaders attempted minor reforms, but could not stem the tide of decline; the bureaucracy was too entrenched and powerful. Corruption, which had always been a problem in the Soviet state, became ubiquitous, and organized crime grew and became more violent. Under Gorbachev, perestroika (reorganization) became the watchword, and economic and political institutions were finally liberalized. The legalization of some private economic activity benefited the nation little, however, as directors of state enterprises took advantage of increased opportunities to hide production and skim profits for personal consumption. Furthermore, changing the political institutions led to the rapid disintegration of the existing control system and the fall of the Soviet state.

This reviewer has one major criticism of the organization of this book. There are numerous examples of terms that are crucial to the understanding of the book, but may very well be unfamiliar to the reader, being used before being defined. For example, “path dependence,” defined as “the constraints on the choice set in the present that are derived from historical experiences of the past” is used first on page 2 but not defined until page 52. A second important term, “adaptive efficiency,” defined as “the flexibility of institutional structures to try various alternatives to deal with novel problems that con-

tinue to emerge over time” is used several times prior to being defined on page 154. Even the definition of institutions does not come until page 48, despite being referred to on almost every previous page.

Additionally, North makes statements in the book such as “Religious fundamentalism, ethnic hatreds, racist stereotypes, superstitions ...” that clearly portray religious fundamentalists as both ignorant and evil. He also makes numerous references to evolution, including a new theory about the evolution of the brain called neural Darwinism. Both positions could be considered offensive to

readers who don’t happen to share his views.

This book seems to be intended primarily for economists, although people knowledgeable in political science or cognitive science might also find parts of it to be of value. There is no question that Douglass North, in this book and his numerous other books and articles on economic change, has had a powerful influence on the study of economics. Many readers obviously like this book, as reviews with high praise for it can be found on its cover or at Amazon.com. My concern is that it is written at a level beyond the understanding

of even a college graduate (B.A.) in Economics. If the reader has a strong background and interest in this field and wants to keep informed on a subject of growing importance, this is a book well worth reading. For those not so well read, North’s explanation of the process of economic change may prove intimidating and therefore unsatisfactory.

—Ronald Johnson
Office of Prices and Living
Conditions
Bureau of Labor Statistics