

XV Congresso Brasileiro de História  
Econômica & 16a Conferência  
Internacional de História de Empresas  
Osasco, 02 a 04 de outubro de 2023



ASSOCIAÇÃO  
BRASILEIRA DE  
PESQUISADORES  
EM HISTÓRIA  
ECONÔMICA

HISTÓRIA DO PENSAMENTO ECONÔMICO, HISTORIOGRAFIA E METODOLOGIA

## **Pursuing a Grand Theory: Douglass C. North and the Early Making of a New Institutional Social Science (1950-1981)**

*Perseguindo uma Grande Teoria: Douglass C. North e a Criação Inicial de uma Nova Ciência Social Institucional (1950-1981)*

Keanu Telles; Universidade de Brasília (UnB); keanutelles@gmail.com

**ABSTRACT:** We explore Douglass C. North's early intellectual development in pursuing a Grand Theory for why some countries are rich and others poor. The continuous and profound attempt to answer the Smithian Grand Question shaped North's journey from being a young serious Marxist to becoming one of the founders of New Institutional Economics. In the process, he was converted in the early 1950s into a rigid neoclassical economist, being one of the leaders in promoting New Economic History. The seeming success of the cliometric revolution exposed the frailties of the movement itself, namely, the limitations of neoclassical economic theory to explain economic growth and social change. Incorporating transaction costs, the institutional framework in which property rights and contracts are measured, defined, and enforced assumes a prominent role in explaining economic performance. In this period, North adopted a naive theory of institutions and property rights still grounded in neoclassical assumptions. Institutional and organizational analysis is modeled as a social maximizing equilibrium outcome. North abandoned this naive view in his 1981 book and gradually became more critical of the objective rationality postulate.

**Key-words:** Douglass C. North, grand theory, New Economic History, transaction cost, New Institutional Economics.

**RESUMO:** Nós exploramos as fases iniciais do desenvolvimento intelectual de Douglass C. North em sua busca por uma Grande Teoria para o porquê alguns países são ricos e outros pobres. Tal busca moldou a carreira de North de um jovem e sério Marxista para se tornar um dos fundadores da Nova Economia Institucional. No processo, North se converteu no início dos anos 1950 em um rígido economista neoclássico, sendo um dos líderes na promoção da Nova História Econômica. O aparente sucesso da revolução cliométrica expôs as fragilidades do movimento em si, nominalmente, as limitações da teoria econômica neoclássica em explicar crescimento econômico e mudança social. Incorporando custos de transação, a estrutura institucional no qual direitos de propriedade e contratos são mensurados, definidos e aplicados assume um papel proeminente em explicar a performance econômica. Nesse período, North adotou uma teoria inocente das instituições e direitos de propriedade ainda baseada em postulados neoclássicos. A análise institucional e organizacional é modelada como resultado de um equilíbrio de maximização



XV Congresso Brasileiro de História  
Econômica & 16a Conferência  
Internacional de História de Empresas  
Osasco, 02 a 04 de outubro de 2023



ASSOCIAÇÃO  
BRASILEIRA DE  
PESQUISADORES  
EM HISTÓRIA  
ECONÔMICA

social. North abandona essa visão ingênua no seu livro de 1981 e gradualmente se torna cada vez mais crítico do postulado de racionalidade objetiva.

Palavras-chave: Douglass C. North, grande teoria, Nova História Econômica, custo de transação, Nova Economia Institucional.

JEL. B31, N00, O43.

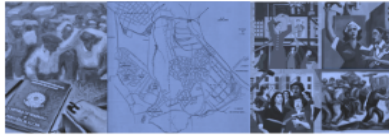
História do Pensamento Econômico, Historiografia e Metodologia.

## I. INTRODUCTION

Unquestionably, Douglass C. North (1920-2015) was one of the most influential economists of the twentieth century. For more than six decades, North's extensive research program was dedicated to understanding the old fundamental question stated 250 years ago by Adam Smith in *An Inquiry into the Nature and Causes of the Wealth of Nations* (1776). "I knew," North (1997a, p. 251) recalls, "where I was going from the day I decided to become an economist. [...] The search for the Holy Grail of the ultimate source of economic performance has taken me on a long and certainly unanticipated journey from Marxism to cognitive science, but it has been this persistent objective that has directed and shaped my scholarly career." North's intellectual evolution is characterized by pursuing a Grand Theory as a response to the Smithian Grand Question. Why are some nations rich and others poor?

In his introductory essay to *The Return of Grand Theory in the Human Sciences*, the intellectual historian Quentin Skinner (1990, p. 3) defines a Grand Theory as "the construction of abstract and normative theories of human nature and conduct." Skinner (p. 2) based his definition on the American sociologist C. Wright Mills. In *The Sociological Imagination*, Mills (1959, p. 6) argued for the integration of the domains of the individual and society through "the vivid awareness of the relationship between personal experience and the wider society," an approach that gives the title of his book. Mills (1959, pp. 22-3) contrasted this approach to three theoretical traditions that lack sociological imagination and harm the progress of social sciences.

The first is the exercise of interpreting recorded human history in order to construct some form of philosophy of history, "a trans-historical strait-jacket" in the lines of G. W. Friedrich Hegel, Auguste Comte, and Karl Marx. The second, even more dangerous, is to seek an abstract and ahistorical general theory of human action, what he called Grand Theory. That is, "a systematic theory of 'the nature of man and society'"



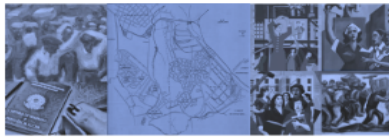
(p. 23). The theory of choice under scarcity constraints of neoclassical economics comes to mind as an example. The third tradition which hampers the sociological imagination is the danger of falling into pure historicism, the gathering, collection, and accumulation of “a series of unrelated and often insignificant facts” (p. 23).

North’s Grand Theory pursuit to understand the nature and process of economic growth and social change is not reduced or confined in Mills’ definition above, as we intend to demonstrate. Indeed, it is North’s theoretical originality to combine grand theorizing with historical and social context (Mills’ sociological imagination) to explain different institutional architectures, their dynamics, and their performance throughout history. The Grand Theory quest is not confined to economics or any singular discipline, rather it is a multidisciplinary effort to create what North would designate as a New Institutional Social Science. Thus, it is a task much broader in scale and scope than the generally delineated in New Institutional Economics - an approach for which North is generally known. As North put it in an interview with Brian Snowdon (2016, p. 124),

“If you want to change the world you need to understand the process and dynamics of economic change. Neoclassical economics was not developed to deal with these grand issues. But to understand the dynamics of change requires a multidisciplinary approach involving knowledge from all the social sciences as well as an understanding of how societies learn. We need grand theorising to understand the rise and fall of nations.”

In this paper, we explore Douglass North’s early intellectual development in pursuing a Grand Theory for why some countries are rich and others poor. His response lies in the causes of political and economic institutions, institutional change, and its impact on economic growth. North (1990a, p. 3) defined institutions as “the humanly devised constraints that shape human interaction” in coordination, cooperation, and competition. Institutions are divided into formal rules (e.g., constitutions and laws), informal constraints (e.g., cultural norms and social conventions), and the effectiveness of their enforcement (which are carried by third parties, second parties retaliation, or self-imposed codes).

The continuous and profound attempt to answer the Smithian Grand Question shaped North’s journey from being a young serious Marxist to becoming one of the founders of New Institutional Economics. In the process, North was converted in the early 1950s into a rigid neoclassical economist, being one of the leaders in promoting the cliometric revolution (the systematic application of economic theory and quantitative methods to the field of economic history) in the late 1950s and early 1960s. However, in the late 1960s and



early 1970s, North surprisingly became a serious critical voice of the cliometric movement and the neoclassical theoretical apparatus embodied in its approach.

We dispute the traditional interpretation that North's cliometric phase was not significant in his theoretical trajectory, in particular toward his emphasis on institutions (e.g., see Ménard and Shirley, 2014; Krul, 2018, p. 34). The seeming success of the cliometric revolution exposed the frailties of the movement itself, namely, the limitations of neoclassical economic theory to explain economic growth and social change. The cliometric pudding proof was to eat it - and North did. The critical failure of cliometrics as an approach to economic history is that neoclassical theory simply does not offer us an explanation of evolving economic structures and performance through time, the central task of economic history.<sup>1</sup>

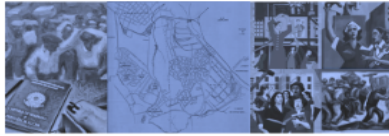
Pursuing a theory of the evolution of constraints that determines choices throughout time led North to incorporate transaction costs (in addition to neoclassical production costs), property rights, and contracts to explain divergences of economic growth. Institutions, in conjunction with technology, determine transaction costs and marginal transformation production costs, directly shaping economic performance. Moreover, institutions and technical progress are intimately connected and mutually dependent on different gradations.

In "The Nature of the Firm" (1937), Ronald Coase first introduced the notion of transaction costs, arguing that the existence of firms and their relative extension are determined by the costs of engaging in a market transaction, such as the costs of discovering the relevant prices, determining the quality and bargaining price, monitoring and enforcing the contract agreement, etc. Property rights refer to the set of permissible decisions to command an economic resource, the rights to perform certain actions with its legally or socially normatively defined benefits and costs. It is a bundle of rights in general attached to a physical commodity or service that are exchanged in the market, as Coase hinted in his "The Problem of Social Cost" (1960).

This property rights notion was further developed by Armen Alchian (1965) and Harold Demsetz (1967). In "Towards a Theory of Property Rights" (1967), Demsetz argued that property rights arose when it became the most efficient institutional arrangement, i.e., when its economic benefits surpassed its costs, documenting the case of the Montagnais tribe in Northeast Canada. North adopted this naive theory of property rights in his early work on institutional and organizational analysis. As property rights, contracts are intrinsically incomplete and costly to measure, define, and enforce. With transaction costs, the institutional framework in

---

<sup>1</sup> North (1978a, p. 77) defines explanation as an act of explicitly theorizing and searching for the potential of refutability. The structure is defined "as those characteristics of society that we believe to be the basic determinants of performance," which includes "the political and economic institutions, technology, demography, and ideology." Performance is understood as expressed in the main standard measures of economic output, per capita income, and income distribution.



which property rights and contracts are measured, defined, and enforced assumes a prominent role in explaining economic performance. Moreover, transaction costs opened a completely new territory regarding the choice of institutions, in particular, a theory of the state that defines property rights and enforces impersonal contractual arrangements and the role of ideology that frames the choice of the institutional architecture in a free-riding context.

## II. FROM A SERIOUS MARXIST AND PACIFICIST TO A VERY RIGID NEOCLASSICAL, CHICAGO-TYPE ECONOMIST

In 1938, Douglass North enrolled at the University of California at Berkeley. North was born in 1920 in Cambridge, Massachusetts, and he had been accepted into Harvard when he was about to go to college. However, his father was offered the head position of the Metropolitan Life Insurance Company office on the west coast and the family moved to San Francisco. Considering that North did not want to be that far from his family and his brother was at Stanford, he decided to go to Berkeley instead. In 1942, North graduated with a triple major in Philosophy, Political Science, and Economics, getting a C average in all the subjects.

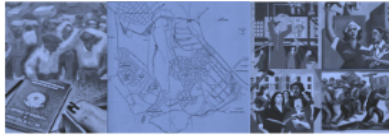
In his sophomore and junior years at Berkeley, with the social problems of the Great Depression vividly in mind, North (2009, pp. 159-160) became a radical. North discovered Karl Marx, becoming a convinced Marxist. The reason was that Marx just “had answers to everything.”

“I don’t know how anyone could avoid being a radical in those days, as surrounded by problems as we were. And so I drifted into being a Marxist. Not a Communist, a Marxist. That’s a big difference. [...] I was a serious student of Marx. I read his *Capital*. Not many people have read that book, but I did. I read lots of Marx. That was a big influence on my life, and it still is. I’m not a Marxist anymore, but still, he had an enormous impact.”

In North’s (1986) perspective, the great significance of Marx to the study of society is grounded in his grand vision of historical social evolution. In particular, the complex dynamic co-evolution of what Marx called the productive forces (mainly shaped by technology and technical progress) and the relations of production (the institutional social structure conditioned by the political and property rights system). In short, as North (2009, p. 159) would synthesize many years later, Marx’s big influence was realizing all the fundamental right questions, even though Marx and his followers had not very good answers.

With the surprise military attack on Pearl Harbor by Imperial Japan, on December 7, 1941, the United States precipitated its entry into World War II. North hoped to go to law school but his plans changed entirely as he





graduated from Berkeley in May 1942. North (2009, p. 159) was a resolute pacifist with a strong belief that he did not want to kill anybody in the war. In consequence, he joined the U. S. Merchant Marine as a cadet. “People could shoot at me but I wouldn’t shoot back,” he wrote. In two days of being in the sea, North was called to become a navigator. He was the only one in the crew that went to college so he seemed more suitable to learn the subject of navigation.

In the war years, North (1997a, p. 253) had much free time during his repeated trips from San Francisco to Australia. The same was true when he was sent to the Pacific front lines in New Guinea and the Solomon Islands. Therefore, he was given “the opportunity of three years of continuous reading, and it was in the course of reading that I became convinced that I should be an economist.” In 1944, North was designated as an Instructor in Celo-Navigation at the Maritime Service Officers’ School in Alameda, California. The Berkeley economist Paul S. Taylor as well persuaded North to become an economist - while Taylor’s second wife, the documentary photographer Dorothea Lange, tried at the same time to persuade North to become a photographer.

In January 1946, North returned from his military service at the Merchant Marine and applied to graduate school. Given his poor record as an undergraduate student, the only place which agreed to take him for at least one semester was Berkeley. In February 1946, North enrolled in Berkeley for his Ph.D. studies. When he returned to Berkeley, North (1997a, p. 254) had a clear intention that he wanted to improve the world. To achieve this goal, first he needed to understand how the economy could be successful; then, in a second step, to improve its performance. This ambition led him to study economic history. “My objective as a graduate student,” he recalls, “was to find out what made economies work the way they did or fail to work. Economic history appeared to be the best field for this objective.”

As a graduate teaching fellow at Berkeley between 1946 and 1949, North finished his graduate work in the fall of 1950. Interestingly, North decided to research the history of the business that his father wanted that he had followed. He chose to write his Ph.D. dissertation on the history of life insurance companies. As North (2009, p. 162) put it, his “Ph.D. dissertation was a muckraking attack on life insurance companies, something that my father wasn’t enthusiastic about, to put it mildly.” North (2009, p. 163) was supposed to write his dissertation under the supervision of the American economic historian Sanford Mosk, but Mosk rejected North as his student saying: “North, you’re never going to be any good.” As a result, Melvin Moses Knight (one of two distinguished economists that also were Frank H. Knight’s brothers) turned out to be North’s dissertation adviser and mentor.



XV Congresso Brasileiro de História  
Econômica & 16a Conferência  
Internacional de História de Empresas  
Osasco, 02 a 04 de outubro de 2023



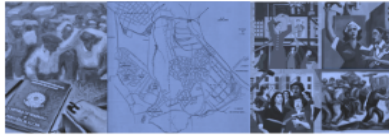
ASSOCIAÇÃO  
BRASILEIRA DE  
PESQUISADORES  
EM HISTÓRIA  
ECONÔMICA

M. M. Knight was an utterly interdisciplinary character, as North would strive to be in his life project of constructing a truly interdisciplinary social science. Knight emphasized the evolutionary dynamics of the scarcity economic problem imposed on society subject to geographical and resource endowment constraints. In “Water and the Course of Empire in French North Africa” (1928), for example, Knight analyzed “the millennial relation between physical changes in man’s environment and the structure of economic organization from prehistory through the Roman and Arab periods to modern times” (Pontecorvo and Stewart, 1979, p. 242).

In retrospect, North was greatly influenced by Knight’s eclectic, holistic, and ecological views on the economic approach to history. As Pontecorvo and Stewart (1979, p. 243) write in their tribute, Knight is a theorist of economic change and thinks “big and long.” He was primarily “preoccupied with the ultimate limits to growth within each economy.” In this sense, he differentiates himself from the neoclassical static general equilibrium analysis and the early American institutionalist movement in integrating institutions in the context of the economic problem that any society faces.

North (1997a, p. 254) describes Knight as certainly an “agnostic” about theory. Despite Knight’s extensive historical and theoretical knowledge and his exciting personality, North felt a lack of a more rigorous theoretical framework to structure the fundamental process of economic evolution that he and his mentor set out to understand. Indeed, deeply influenced by his French connections, Knight may be classified as closer to the French historian Fernand Braudel and his *École des Annales* but with an evolutionary perspective. Nevertheless, Knight’s geographical, ecological emphasis and implicit regional growth theory will be appropriated and worked out by North within a neoclassical analytical model in his early publications on location theory, regional economic growth, and the role of exports. Moreover, some of Knight’s intuitions are surprisingly similar to what North would evolve in his more mature intellectual developments.

In 1950, North was awarded a Social Science Research Council Fellowship to go to the east coast and work on his research. He went back to live in New York, where most life insurance companies were located, including the one of his father. While in New York, North sat in Robert Merton’s sociology seminars at Columbia University and made contact with Talcott Parsons, a sociologist at Harvard. Parsons was a close associate of Joseph Schumpeter. Through Parsons, North (1997a, p. 254) “became deeply involved in the Entrepreneurial school of Arthur Cole at Harvard. The result was that Joseph Schumpeter had a strong influence upon me.”



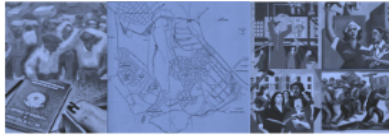
North refers to the Research Center in Entrepreneurial History, founded in 1948 and directed by Arthur H. Cole at Harvard. Schumpeter was an early member and the referential foundational figure of the center. In 1949, the center published the first issue of *Explorations in Entrepreneurial History* (later renamed *Explorations in Economic History*), with the driving theme being the connections between entrepreneurial and business history and economic growth. North was greatly influenced by Schumpeter's view of economic history as embodied in the broad concept of economic analysis.

“What distinguishes the ‘scientific’ economist from all the other people who think, talk, and write about economic topics,” Schumpeter wrote in his monumental *History of Economic Analysis* (1954, p. 12, “is a command of techniques that we class under three heads: history, statistics, and ‘theory.’ The three together make up what we shall call Economic Analysis.” This was also put forward by Cole's belief in economic history as centered on the entrepreneurial figure. In 1950, North published his first article on “Some Recent Views of the Modern Large Corporation” (1950) in *Explorations*.

In the fall of 1950, although still working on his thesis, North got his first academic appointment as an acting assistant professor at the University of Washington in Seattle. In the same year, Canadian-born Donald F. Gordon also joined the department. In Washington, North and Gordon played chess every day from 12 to 2 p.m. North beat Gordon at chess all the time, but Gordon taught North economics. As North (2009, p. 164) recalls, Gordon really “taught me economics. I knew so little economics that, when I graduated, I had just memorized all the right answers for the exams and reproduced them. I didn't know any economics, not even simple price theory.” As he re-learned economic theory, North realized that Marxism was unable “to answer a lot of mundane questions, such as prices.” This was the last step to his rejection and final abandonment of Marxism. As a result, in his words, North “became a very rigid neoclassical, Chicago type economist.” However, in contrast with the explanatory power of price theory in some areas, North noted that the fundamental questions that Marx posed “were still out there and couldn't be answered by standard economic theory.”

North's first published works are influenced by his contact with Cole's Center at Harvard. In 1952, North completed his Ph.D. dissertation. He focused on expanding and developing his dissertation analysis of major life insurance companies and their close-dependent relationship with investment banking. In the same year, he contributed a chapter on “Capital Accumulation in Life Insurance Between the Civil War and the Investigation of 1905” in William Miller's edited book, *Men in Business: Essays in the History of Entrepreneurship* (1952). This was followed by an article on “Entrepreneurial Policy and the Internal





Organization in Large Life Insurance Companies at the Time of the Armstrong Investigation” (1953) published in *Explorations* and “Life Insurance and Investment Banking at the Time of the Armstrong Investigation” (1954) in the *Journal of Economic History*.

In the last essay, North (1954, p. 209) explores the role that investment bankers’ had in the organization of financial institutions “and their significance for the development of these institutions and their reorientation toward the securities market.” North (1954, pp. 225-6) concludes that the insurance companies occupied a dependent and junior partner role in their association with investment bankers, benefiting from reciprocated services but still not capturing a significant part of the related trade gains. “Their status was that of a junior partner rather than merely a subsidiary. But it was clearly a one-sided arrangement in which the great bulk of the advantages accrued to the investment banker rather than to the insurance company. The officers of the insurance company on the other hand were most handsomely treated by the investment bankers.” Thus, the nature of the association between the major life insurance companies and the banking houses was an important element in the reigning supremacy of the latter.

In 1955, North published his first major article on “Location Theory and Regional Economic Growth” (1955) in the *Journal of Political Economy*. North contends that location theory and the sequences of stages delineated by standard regional economic growth did not provide an empirically validated framework to analyze American economic history. The typical regional economic growth theory, e.g., as exposed by Edgar M. Hoover (1937) and August Lösch (1938), describes a sequence of stages of a region’s development from a self-sufficient subsistence region to an economy specialized in tertiary exporting industries. Indeed, location theory mainly formulated this sequence based on the stylized historical experience of European economic growth that started with subsistence local economies linked with the manorial system.

Such experience is significantly different from the American development, North (1955, p. 245) argues, since from its beginnings subsistence was only a frontier condition. “America was exploited in large part as a capitalist venture. Settlement in new regions and their subsequent growth were shaped by the search for and exploitation of goods in demand on world markets.” Both “location theorists and the early stages in the theory of regional economic growth appear to be taken uncritically from European experience rather than derived from” the American economic history (p. 247). Echoing his mentor Knight, North (p. 257) sustains that “the concept of a region should be redefined to point out that the unifying cohesion to a region, over and beyond geographic similarities, is its development around a common export base.” On this ground, North



proposed a new analytical framework for regional economic growth from which he constructed his staple (defined as the chief commodity produced by a region) neoclassical theory of economic growth.

According to North (1955, p. 257), “[t]he success of the export base has been the determining factor in the rate of growth of regions. Therefore, in order to understand this growth, we must examine the locational factors that have enabled the staples to develop.” The export base also determines the development of residentiary secondary and tertiary activities, as domestic income grows and investment is made in subsidiary industries. He defines four types of manufacturing that can be developed as a result of increased residential income: (i) materials-oriented industries, (ii) service industries to the export industry, (iii) residential industries oriented to local consumption, and (iv) footloose industries (i.e., where transportation costs are not a significant component in location).

Except for the footloose industries, North (1955, p. 253) maintains that all other manufacturing industries “develop naturally because of locational advantages in a society responsive to profit-maximizing stimuli. There is nothing difficult about the development of such industries. The difficulties arise when promoters seek to develop industries which simply are unsuited for the area and which can therefore only be maintained under hothouse conditions.” Moreover, the export base also directs local political pressures that provide for concerted collective action toward reducing transportation costs, improving technological progress in connection with the export base, and mobilizing state and federal supply of public goods and social overhead benefits. These elements will establish the possibilities for economic growth and, in consequence, the widening of the export base as the region develops until the point at which the export base ceases to be identified as a region.

One main implication of this theory is that the standard view that industrialization is a difficult but necessary and indispensable condition for sustained economic development is not maintained. *Au contraire*, North (1955, p. 254) concludes that, first, “there is no reason why all regions must industrialize in order to continue to grow.” Second, a “great deal of secondary (and tertiary) industry will develop automatically either because of locational advantages” or as a result of the induced investment of the growing income derived from the export base. Third, the concept of industrialization *per se* is ambiguous and needs further clarification. In North’s (p. 257) view, in short, industrialization “may be neither necessary nor desirable.”

### III. THE GRAND THEORIST OF CLIOMETRICS



The birth of New Economic History, or cliometrics (a term coined by the Purdue mathematical economist Stanley Reiter based on Clio, the Greek muse of history), is dated in September 1957. On this occasion, the 24th Conference on Research in Income and Wealth occurred in a joint meeting organized by the Economic History Association (EHA) and the National Bureau of Economic Research (NBER) in Williamstown, Massachusetts. New Economic History, a term created by North (Hughes, 1982), is the application of economic theory and quantitative methods to the field of economic history, with particular reference to testing alternative hypotheses in interpreting historical data. It emphasizes the construction and specification of historical models derived from economic theory such that its implications can be refutable by empirical testing.<sup>2</sup>

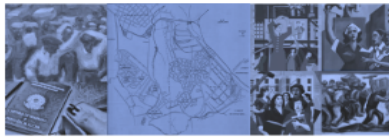
In 1957-8, North was a research associate at the NBER and spent one day a week with Simon Kuznets in Baltimore while working on new estimates of the U.S. balance of payments. Kuznets carried Wesley C. Mitchell's torch in the NBER empirical research tradition, especially regarding the U.S. national income accounts. In 1936, Kuznets was the head behind the creation of the annual Conference on Research in Income and Wealth, establishing an international organization counterpart in 1947. Previous work by economists and statisticians produced in the Bureau was key to the cliometric turn in economic history.<sup>3</sup> The EHA/NBER joint conference assembled a proceedings book volume edited by William Parker. In *Trends in the American Economy in the Nineteenth Century* (1960), new quantitative economic data for the nineteenth-century United States were provided, such as commodity output, regional income, wage series, prices index, factor shares, and North's (1960) revised estimates of the balance of payments from 1790 to 1860.

The 1957 conference was the beginning of cliometrics. However, this research program coalesced when Lance Davis and Jonathan Hughes, two of North's most famous students, organized the first annual meeting on cliometrics at Purdue University in February 1960. In this meeting, for instance, Robert Fogel (1964) presented his initial estimations of his classic work on the interregional social savings of the railroads based on the most important and innovative method of the cliometrics, the counterfactual methodology. Furthermore, from 1960 to 1966, North and Parker assumed the editorship of the *Journal of Economic*

---

<sup>2</sup> Deirdre McCloskey called this approach *Econometric History* (1987), that is, a history based on economic theory with statistics and quantitative measuring methods (thus the econometric part). The term is already present in the title of Fogel's (1964) classic book derived from his Ph.D. dissertation at Johns Hopkins University.

<sup>3</sup> As North (1974, p. 188) writes, "[m]any of the earliest contributions to the new economic history were efforts to provide additional quantitative measures of economic growth - indeed, the whole development of national-income accounting pioneered by Simon Kuznets and his followers was a basic impetus to this approach."



*History*, the EHA's scholarly journal. Both promoted the cliometric methodology in the editorship policy and accepted articles.<sup>4</sup>

Claudia Goldin (1995, p. 195) classifies North as the “grand theorist” of New Economic History, “arbitrating between economic history and organization theory.” Indeed, North (1955, pp. 243-4) writes presaging words regarding his emerging ideas on applying economic analysis to history.

“The reluctance of the economic historian to make more extensive use of the tools of the theorist reflects in good part the fact that most of the world's economic history falls outside our first condition [i.e., falls outside of market institutions] and that therefore economic theory is of little use in analyzing a large part of its development. On the other hand, the joint efforts of economic theorists and historians applied to the development of the United States and of some other areas hold out the promise of yielding valuable insights.”

Indeed, this is the research project that North undertook in the 1950s, culminating in his first book on *The Economic Growth of the United States 1790-1860* (1961). The analysis was expanded and developed in his second book on *Growth and Welfare in the American Past: A New Economic History* (1966), spanning from 1600 to the present day. This last book had several revised editions incorporating North's later theoretical developments. In this section, we reconstruct North's path to interpreting American economic history.

In 1956, North (1956a, p. 165) reacted to Charles Tiebout's (1956) critique of his model regarding the role of the export base in determining regional income and employment. In “A Note on Professor Rostow's ‘Take-off’ into Self-sustained Economic Growth” (1958), North critically addressed the validity of the Rostovian stages model of economic growth with a particular reference to the United States case (for the full-worked model, see Rostow, 1960). Rostow (1956, p. 47) defined the take-off as the rise in the rate of investment from 5 to 10 percent or more of national income, the development and accelerated growth of manufacturing industries, and the change in production techniques in such a form that perpetuates the new scale of investment and income. In sum, “the take-off is defined as an industrial revolution, tied directly to radical changes in methods of production.” Rostow (p. 31) categorized the American take-off as occurring in the 1843-60 period, stimulated by capital imports. In the 1840s, the first period can be distinguished as

---

<sup>4</sup> Robert Whaples (1991) measured that the articles which employed the cliometric approach were multiplied by more than seven in the *Journal of Economic History* regular issues from the 1956-60 period to the 1971-75 period. They went from 10 percent of the total articles in regular issues to 72 percent. The Harvard Center's *Explorations in Entrepreneurial History* also became dominated by the cliometric young Turks under the editorship of John Meyer. In “The Economics of Slavery in the Antebellum South” (1958), one of the most influential papers within the movement, Meyer and Anfred Conrad demonstrated that slavery had a positive economic rate of return. One year earlier, Conrad and Meyer (1957) also published a milestone paper on methodology that would be crucial to the cliometric approach.



subscribed to railroads and manufacturing industries in the east; in the 1850s, the second can be confined to railroad expansion into the middle west.

However, North (1958, p. 70) notes that “expansion in the east in the 1840s was accomplished without any significant capital imports.” Moreover, “(1) the boom in the midwest was well underway at the end of the 1840s before any significant amount of capital was imported and (2) the total capital imports for the entire period 1847-60 were very modest.” In contrast, it was the expanded foreign demand for wheat starting in 1846 which “led to a revival in westward expansion and stimulus to extension of railroads.” He reached this conclusion using existing estimates of the United States’ balance of payments - it did not change after North (1960) revised the numbers for the 1789-1860 period.

North does not argue that capital imports were not relevant to American growth in the period. Indeed, North (1956b) maintained that these capital flows did increase investment into railroads and helped to finance the balance of payments in some periods. However, in North’s (1958, pp. 71-2) view, “this is very different from saying that they set-off industrialization” or that they triggered the Rostovian take-off. Furthermore, Rostow overestimated the role played by the railroads in the 1850s in developing new and expanding exporting sectors (presumably, wheat and flour). Instead, until the Civil War, cotton in the south drove American export expansion.<sup>5</sup>

In North’s opinion, Rostow’s stages model places a set of pre-conditions on industrialization and wrongly equates industrialization with take-off. In acquisitive societies, Rostow (1956, p. 28) argues that the “take-off fails to occur mainly because the comparative advantage of exploiting productive land and other natural resources delays the time when self-reinforcing industrial growth can profitably take place.” North contrasts Rostow’s hypothesis with American economic history, in particular with New England’s take-off experience that began in 1820. New England’s textile industry development was possible primarily because of the expanding demand outside the region, greatly influenced by the expansion in income from cotton in the south and wheat, corn, and livestock in the west.

In other words, American economic history (and other examples, such as Canada) supports a very different picture than what Rostow’s model suggests. North develops these themes and the industry-agriculture dichotomy in regional economic growth in his paper on “Agriculture in Regional Economic Growth” (1959). In this article, North acknowledges that his 1955 original argument was incomplete. More precisely, the

---

<sup>5</sup> Additionally, Fogel (1964) demonstrates that the total (i.e., interregional plus intraregional) social savings of railroads were less than 2 percent of GNP in 1890. Fogel also argued that the economic impact of railroads in other sectors was not as large as Rostow hypothesized.





staple export base expansion is a necessary but not sufficient condition for regional economic growth. As taught by Adam Smith, economic growth is first and foremost caused by productive specialization and social cooperation under the division of labor.

Production for sale in external markets was the way paved by new regions in their economic development and the division of labor is limited by the extent of the market (see Stigler, 1951). Nevertheless, a region can remain tied to a single export staple, not diversifying its productive base and not sustaining manufacturing industries, urbanization, and economic growth. This can be explained, for North (1959, p. 945), by three reasons: (i) “the natural endowments of the region (at any given level of technology),” (ii) “the character of the export industry,” and (iii) “changes in technology and transfer costs.” At first, the natural endowments determine the potential private rate of return for different economic activities.

If the production possibilities are in such a nature that one commodity has a much higher return rate than any other economic good or service, then productive investment and economic expansion will tend to concentrate on this export commodity. The growth spurring in the region will not necessarily be accompanied by productive structural changes. The disposition of income from the export industry, the region’s propensity to import, and the magnitude of the regional multiplier-accelerator effect are a function of the most efficient organizational arrangement to explore the local comparative advantage and the commodity in which the export base evolves.

In the case of a plantation export industry, which exhibits increasing returns to scale in certain margins and is relatively labor intensive, North (1959, p. 946) sustains that regional economic growth will result in a concentrated and unequal income distribution. The bulk of the population will spend their income on basic foodstuff and subsistence demands, by contrast the ruling class composed of “plantation owners will tend to spend most of their income upon luxury consumption goods which will be imported.”

This unequal demand pattern obstructs the inducing investment derived from the export base income growth, positively reinforcing the system dynamics around one export staple commodity. Investment and technological progress will be directed to explore the plantation more efficiently. Plantation-type commodities require only a limited number of places for product collecting and exporting. The political coalition in power composed of property owners will be reluctant to invest in human capital, technology, and research and development. Thus, regional growth tends to be stuck in its primary exporting economic structure, not discovering, developing, and improving its comparative position in other sectors through active investment in education and knowledge.



On the other hand, a region can present broad production possibilities such that the potential rate of return of different goods and services is not so distant from the initial export commodity that constitutes the regional comparative advantage. In this context, the development of the staple export base takes place *pari passu* with the creation of new domestic segments and the broadening of the exporting sector. A staple export base that is most efficiently produced on a family-sized farm and in which labor is relatively scarce, especially compared to land, results in a more equal income distribution and the encouragement of new economic activities. The region will tend to improve its comparative position through public investments in education and research, broadening the resultant economic base.

The inherent features of transportation costs can considerably influence the region's economic structure and export base. Technical change and its impacts on transportation costs can alter or deepen the region's comparative advantage by increasing or decreasing the potential private rate of return of other goods and services. North notes that an early transportation development that helps to evolve the initial comparative advantage in a determinate staple base will tend to reinforce the dependence on it, creating positive feedback and increasing the potential return of the *status quo* export base. Moreover, in new regions, transportation is to a great extent only one way. The outward shipment of a bulky, standardized commodity has no counterpart in inward shipment. Thus, inward freights tend to be very low, so import goods competition prevents the creation and development of domestic goods. This reinforces the high import propensity picture described in the plantation economy.

North (1959, p. 948) illustrates the two economies delineated above by contrasting the development of the South and West until the American Civil War. From the War of 1812 to the Civil War, the South was a major force of growth with the cotton export base and other subsidiary plantation commodities (such as rice, sugar, and tobacco). Indeed, cotton was the most important component of U.S. exports in the period. In the West, an expanding export base developed in wheat, corn, and its derivatives (pork bacon, flour, and whisky).

First, the Southern economy was heavily concentrated on its dominant, single staple exporting base due to its immense comparative advantage. In contrast, the potential return in the West was much more equivalent in different economic activities. Second, given the natural endowments and technology which determined the potential return rates, the most efficient organization in the South was the large-scale plantation reinforced by slavery. In the West, the most efficient social organization to produce wheat and corn at the time was the family-size farm. These different institutions built for economic exploration resulted in different patterns of income distribution and consumer demand in the South (extremely concentrated) and the West (more equal).



Therefore, the South remained largely apart from the market economy and urban developments, while the West could grow in a myriad of domestic industries devoted to residential demand that eventually matured to become leading exporting industries. Since the cotton trade had such a tremendous return rate, the Southern economy did not produce investment in education, human capital, and knowledge (even within the white population). The co-evolution of factor endowments and initial conditions, institutions, and different paths of development explain the different economic dynamics of Latin and North America, as developed by the influential work of Stanley Engerman and Kenneth Sokoloff (1997, 2000) and Acemoglu, Johnson, and Robinson (2001). The Brazilian economist Celso Furtado also stresses this point in his 1959 classic work on *Formação Econômica do Brasil*, translated in 1963 as *The Economic Growth of Brazil*.

Third, North (ibid.) adds, “[n]either transportation development or extensive subsidiary industry were required” for the economic efficiency of the exporting cotton trade. “The Factor with his ties with northern credit and shipping served as both the exporter of the planter’s cotton, and importer of his foodstuff (from the West) and manufactures (from the Northeast and Europe). Large-scale investment in the South was devoted solely to the opening up of new cotton lands and the acquisition of slaves.”

In contrast, the substantial investments in railroads and other commutation means in the West were paramount in its formation. The ruling exporting commodities in the West had significant locational gains in the processing and manufacturing of its derivatives. In consequence, North (ibid.) writes, “a variety of such manufacturing grew up and promoted urban development in the West.” Fourth, the idiosyncratic characteristics of the ocean freight trade prospected by the one-way cargoes of cotton inhibited the diversification of local industries (a theme developed in North, 1958b). In the West, the great distances and transportation cost naturally protected manufacturing production for local consumption.

According to North (1959, p. 951), the quest for economic growth should not be reduced in the simple formula associated with industrialization, as in the Rostovian model or in the form of the view propagated by Galbraith (1951) that equates agriculture with stagnation. Indeed, this view is also present in some readings of Arthur Lewis’ (1954) dual-sector model, in which the capitalist modern sector is defined or understood as the industrial sector and the non-capitalist traditional subsistence sector is equated with agricultural activities. The relevant point is not “agriculture versus industrialization but rather revolves around a region’s ability to become integrated into the larger markets of the world through exports, and of the resultant structure of the regional economy which will influence its ability to achieve sustained growth and a diversified pattern of economic activity.”



#### IV. THE RISE AND FALL OF NEW ECONOMIC HISTORY

In the early 1960s, North was the torchbearer of New Economic History. In the event of the publication of the new and revised *Historical Statistics of the United States* by the U.S. Census, North (1963) pays tribute to the new quantitative work on the U.S. economy particularly produced in the 1957 EHA/NBER conference. North (1963, p. 128) argues that “[a] revolution is taking place in economic history in the United States.” The revolution has been carried through by “a new generation of economic historians who are both skeptical of traditional interpretations of U.S. economic history and convinced that a new economic history must be firmly grounded in sound statistical data.”

In this revolutionary process, North (1963, p. 129) sustains that many accepted truths of American economic history held sacred by historians had been destroyed in mere cursory theoretical examinations and empirical statistical analysis. The widespread “truth” of the unprofitability of slavery in the antebellum South, for example, is simply inconsistent with elementary neoclassical price theory (see also the empirical refutation by Conrad and Meyer, 1958). Other myths refuted by early cliometric research are “the indispensable role of the railroads in nineteenth-century American development” (Fogel, 1964) and “the importance of the Civil War in accelerating U.S. industrialization” (Cochran, 1961; North, 1961a).<sup>6</sup>

Nevertheless, it is a much more difficult task to reach positive conclusions and New Economic History only scratched the surface of the Smithian Grand Question. One of the few positive conclusions is the role of cotton and interregional trade in American growth as developed by North’s (1955, 1961a) staple export model. As North (1963, p. 129) put it, “[t]he tools of the economist provide initial hypotheses to explore a wide range of questions posed by the economic historian, but for those concerned with the great question of the economic rise and fall of nations the fare is still thin.” The nature and causes of economic growth and civilizational flourishing throughout history are *the* main tasks of economic history.

Two years later, in “The State of Economic History” (1965, p. 90), North adopts a deep critical tone toward his peers and the profession. In his view, (i) “the quality of research in economic history is generally very poor” and “the economics profession must take a large share of the blame.” In addition, New Economic

---

<sup>6</sup> In *Capitalism and the Historians* (1954), anticipating in some aspects the myth-busting tone of cliometrics, Friedrich A. Hayek complained about the widespread myth by historians that the rise of “capitalism” or industrialization in England was associated with the worsening of workers’ living standards.



History cannot be excluded from being part of this poor-quality *status quo*. Lacking theoretical sophistication and imagination, (ii) “the new economic history falls short of the mark in remedying this problem.”

In North’s (1965, p. 90) opinion, the results of the New Economic History “have been generally disappointing. Too much of it has been dull and unimaginative, and there seems to be a widespread conviction that econometric techniques, the computer, and running a few regressions can substitute for theory and imagination. Some of the new economic history written by economists is of distressingly poor quality. Some of it is so imprecise and fuzzy as to make it difficult, if not impossible, to make any model at all.” North (p. 91) concludes that “it is my conviction that we need to sweep out the door a good deal of the old economic history, to improve the quality of the new economic history,” and to strive to economic history to achieve the same rigorous standard expected in other areas of economics.

In his 1974 presidential address to the Economic History Association, “Beyond the New Economic History” (1974, p. 1), North invites his peers to go beyond the traditional limits imposed by neoclassical theory in historical research. The most significant innovation of New Economic History, the systematic use of economic theory and quantitative methods in history, is also its fundamental constraint. Although the standard neoclassical theory “has provided the incisive new insights into man’s economic past,” it “also serves to limit the range of inquiry.” In this sense, North complains that his “former revolutionary compatriots show distressing signs of complacency with the new orthodoxy.”

North (1974, p. 2) points to five considerable limitations of New Economic History as a *modus operandi* to historical research. First, “[t]he research has been more destructive than constructive.” New Economic History had a good track record of historical myth-busting but it did not replace the “old truths” with a systematic explanation of economic change. Second, the research was mostly “on specific issues or institutions, but little light has been shed on the long-run transformation of economic systems - that is, long-run economic growth.” Third, “[t]here is no role for government in the analysis except as it is brought in an *ad hoc* fashion.” Fourth, it does not account for the other three sources of decision-making outside the market process, namely, the household, organizations (such as firms), and government. Neither neoclassical theory accounts for the different combinations throughout time of these decision units. Fifth, “it is curiously unteachable at the undergraduate level.”

Most or all of these limitations are intrinsic to the neoclassical theoretical framework. As North (1974, p. 3) is ready to admit, neoclassical theory “was not designed to explain long-run economic change.” It is primarily a theory of choice within specified constraints, whereas economic history is about the changes in





those constraints. In a general equilibrium world, an economy is characterized by the equality of all the different subjective and objective marginal substitution rates which results in an optimum state of resource allocation. We are in the formal similarity world in which all societies must deal with the economic allocation problem imposed by scarcity. Welfare economics derived from this theory implies that economic growth should be inevitable and trivial, given certain assumptions on savings and population dynamics. Moreover, even the question that the neoclassical theory was designed to answer, i.e., the decentralized individual choice computation and the market static resource allocation, it provides limited answers confined to a world of perfect markets with zero transaction costs - i.e., zero costs of specifying, enforcing, and coordinating property rights and contracts among individuals.

According to North (1974, p. 4), one alternative is to “throw out neoclassical theory and start all over again.” The other and preferable solution is to broaden the neoclassical framework (maintaining the basic assumption of utility-maximizing behavior) to include all those missing analytical parts for a systematic theory of the institutional structure and economic change. North (p. 6) suggests that the development of household economics (with particular reference to a theory of fertility and the economics of family), a theory of property rights derived from transaction costs, and a theory of the state (which involves public choice theory and ideology) can be amalgamated into a common extended analytical structure. Transaction costs explain not only the different combinations within economic organizations, such as the decision to buy in the market or to make within the firm. Since the economic organization is a continuum from a purely market voluntary exchange and purely governmental coercion, transaction costs also can open “the door to an explanation of much of the institutional structure of an economic system” (see also North, 1977b).

In 1977, twenty years after the inaugural joint conference that marked the beginning of New Economic History, North (1977a) continued his critical reevaluation of the movement, comparing it with other schools of historical research - such as the old economic history, the Marxian approach, and the *École des Annales*. As North (1978a, p. 7) points out, the great merit of cliometrics is “its attempt to develop a more scientific history. The explicit use of theoretical models and the systematic use of statistical inference in testing procedures are the most distinctive contributions of this approach.” In other words, cliometrics “uses simple theory which can produce predictable and specific results rather than indeterminate consequences.” In this sense, “explanation entails the application of the principles of scientific explanation derived from the natural sciences” (North, 1977a, p. 190).



In contrast, old economic history immerses itself in the detailed, context-specific historical reconstruction of the past. It is mainly concerned with the institutional structure of a society, which provides the multidimensional matrix in which individual actions are constrained and social phenomena formed. Old economic history also employs theory, as every explanation inevitably does, but “the theory is implicit, frequently internally contradictory, or at odds with basic and widely accepted economic propositions” (ibid., p. 191). Old economic history is not capable of scientific testing.

In the same manner, North (1978a, p. 79) sustains that “the Marxist school cannot be faulted for ignoring the evolving structural aspects of economic systems. Property rights, the state, technology, and ideology have all been a part of Marxist economic history (although typically not demography).” But Marxian economic history, too, has a failure in specifying its models and testing its hypothesis. Marxists have made little additional theoretical and quantitative advances after Marx’s seminal contributions.

The Annales school cannot be properly classified as a school in the same way as the Marxists and cliometricians since it has not constructed a model.<sup>7</sup> In contrast with old economic history and Marxists, North (1977a, p. 1930) argues, neoclassical theory assumes as given all the institutional constraints involved in individual choices. But “[t]he essence of historical explanation is the interplay between the ongoing historically derived constraints and the choices open to the participants.” Thus, “for the economist qua economic historian, such an approach can only result in sterility.”

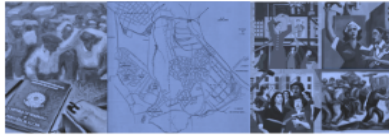
## V. THE FIRST STEPS IN MAKING A NEW INSTITUTIONAL ECONOMICS

In 1966, North went to live in Geneva, Switzerland, for a year as a Ford Faculty Fellow. In the 1966-7 academic year, he lectured at Oxford, the London School of Economics, Essex, Paris, Caen, and Geneva. During the fellowship, North wrote his first full-book on American economic history, *Growth and Welfare in the American Past: A New Economic History* (1966). However, in the same period, North decided to switch from American to European economic history. This change presented him with a great puzzle.<sup>8</sup>

---

<sup>7</sup> North (1978a, p. 80) writes that “Fernand Braudel’s masterpiece, *Le Monde Méditerranéen*, is not a model on which one can build a school. It is a work of art which, when subject to the critical scrutiny of the cliometrician, becomes a lot of brushstrokes on a canvas. Le Roy Ladurie’s *Les Paysans de Languedoc* is an enormous achievement, but because he misreads [David] Ricardo and confuses rent with profit, much of his economic analysis does not make sense.” Although Annales scholars have made significant quantitative and statistical contributions, they share their ignorance of price theory and contempt for testing hypotheses with the Marxist school.

<sup>8</sup> As North (2009, p. 165). recalls, “[y]ou can write all American economic history using simple price theory. The US has always been a market economy to some extent, one which became more and more a market economy. So just using a simple theory



In his early 1968 contribution to the *Festschrift* in honor of Walter Hoffman, North advocated “A New Economic History for Europe” (1968a, p. 140). He argues that the cliometric revolution that was “completely transforming the traditional discipline” in the United States was still missing in Europe “because there economic historians are trained as historians and not as economists.” In North’s (p. 147) view, “European economic history is in need of fundamental restructuring.” Only by combining “modern economic theory and the development of new theoretical insights, as well as by the imaginative employment” of these insights, we could start to understand the evolution of the Western World. “Such work can be done only by the new economic historian thoroughly trained in economic theory and statistics.”

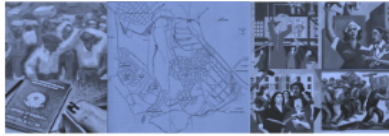
However, North (2009, p. 165) would soon find that neoclassical economic theory is essentially static. Thus, he “just couldn’t make sense out of history.” Employing this theory to understand European economic history made clear in a fundamental fashion the need to go beyond New Economic History and the theoretical framework implicit in it. In his research on the “Sources of Productivity Changes in Ocean Shipping, 1600-1850” (1968b), North found a promising step to the importance of institutions for productivity evolution. He discovered that the costs of ocean shipping decreased in the period analyzed, in particular the nineteenth century, mainly due to total factor productivity gains made by organizational and institutional innovations that reduced piracy and increased round-trips per year, the size of ships, and their load factor.

The interesting point is that technological progress did not play a decisive role in total productivity changes during the period, something that the standard neoclassical growth theory *à la* Solow-Swan would have predicted. Instead, technical progress interacts and co-evolves with the institutional environment determining transaction costs. Technologically superior vessels, such as the Dutch “flute” that was used in the Baltic, were already available long before their modified versions could be used in ocean shipping.

The reason for which these technologically superior ships were not used before was piracy, which forced ships to carry more crew members and armaments and fewer goods. From 1814 to 1860, North calculated that the total factor productivity in ocean shipping increased at almost 10 times the rate per year compared to the annual rate in the previous two centuries. The fact that the main component for the decline of transaction costs and increase of total factor productivity in ocean shipping was reduced piracy led North to develop the first sketch of a theory of institutional innovation using the neoclassical choice-theoretic approach at the margin.

---

of markets could tell the story of a lot of what had happened in the US alright. But Europe? How could you talk about feudalism and the manorial system with neoclassical theory? This is where I realized that we need to develop a better body of theory to confront the crucial issues.”



In *Institutional Change and American Economic Growth* (1971), co-authored with his student Lance Davis, North extended neoclassical theory to the choice of rules based on the wealth-maximizing hypothesis and used it to illustrate the institutional innovation process in American economic growth. Taking as given the institutional environment (the set of fundamental political, social, and legal ground rules) and some kind of exogenous disequilibrating force, the model attempt to predict whether some kind of institutional innovation will be established and in which economic decision unit level this new arrangement will be pushed forward by the relevant action group (purely individual, some form of voluntary cooperation, or the coercive power of government) and their timing.

The action group perceives that some potential external or redistributive income can be extracted by altering the institutional structure at the margin through a process of arrangemental innovation. Potential external income can be derived from economies of scale, externalities, risk and uncertainty, and market failures such as information costs. The primary action group innovates through a new arrangement, which can be the direct application of an institutional instrument (such as a document or device) or the creation of a secondary action group on which the potential income can be captured.

Davis and North (1970, 1971) formalized this process in a lagged supply model, where a change in demand caused by an exogenous disequilibrating force in one time period determines the lagged supply of an arrangement innovation to capture the potential rents created by the shock. Thus, the institutional innovation process is an equilibrium outcome to capture or internalize potential external or redistributive income. The initial equilibrium is defined in the lines of general equilibrium analysis, all potential external income is perfectly incorporated in prices, i.e., the structure of property rights is distributed in such a form that there exists an optimum allocation of scarce resources.

Given the initial equilibrium, potential income from institutional innovation emerges when exogenous shocks create an externality, a restructuring of risks, a shift in transaction costs, or an application of a new technology subject to increasing returns. The costs of operating the *status quo* institutions may also change due to some technological shock (in particular, in military technology) or due to a change in the relative factorial prices. Finally, legal and political shocks can occur in the basic economic environment (such as a drastic change in the distribution of property rights or a political revolution). The primary action group choice of arrangement innovation is defined as the maximization of the discounted stream of net future income of different arrangement alternatives.



Using this framework, Davis and North (1971) argued that a very important part of American economic growth occurred by action groups pursuing profit opportunities by changing and inventing new forms of institutional and organizational arrangements. They provide a myriad of examples (such as the evolution of capital markets, railroads, public goods such as canals, general incorporation laws, education, and regulation for the manufacturing sector) in which complementary institutional innovation was indispensable to productivity evolution in the United States. For instance, Davis and North (1970, p. 144) argued that “the innovation of the corporation with its unlimited life and limited liability lifts the restrictions on obtaining capital and therefore allows its innovators to reap the profits inherent in the economies of scale.”

Moreover, the model also explains the changing public-private economic mix in American economic history as the channel to capture external and redistribution profit opportunities. For example, the entrance of government in canal investment during the 1830s was a rational decision given the absence of developed capital markets. In the same manner, the rise of government in the twentieth century is a result of relative increase in the profit opportunities through income redistribution and divergences between private and social costs associated with urban development, externalities, and public goods.

One of the main weaknesses of the Davis-North model is the tautological trap of rationalizing every arrangement innovation as an equilibrium process of social welfare maximization, following Demsetz’s (1967) argument on the emergence of property rights. Therefore, institutions are seen as an efficient equilibrium result of maximizing rational agents. In a first approximation, it may be reasonable to expect that societies will tend to devise institutional forms that reduce transaction costs so that the property rights patterns are the most efficient to encourage the division of labor and productive exchange. But the political and ideological forces that shape informal and formal institutions are much more complex processes.

Davis was not an ideal collaborator for North to develop his novel ideas. As North (2009, p. 166) noted in an interview, “Lance was a terrible person to work with. He was impossible, obstreperous, ornery, and difficult.” So he started to work with the young economic historian Robert P. Thomas. In “An Economic Theory of the Growth of the Western World” (1970), North and Thomas applied the theory of institutional innovation outlined in Davis and North (1970, 1971) to explain European economic history and the Great Enrichment process that occurred in Western Europe since the nineteenth century. One year later, North and Thomas published “The Rise and Fall of the Manorial System: A Theoretical Model” (1971) using the transaction costs notion to describe the manorial system.





This previous research formed the core of one of North's most important books, co-authored with Thomas, *The Rise of the Western World: A New Economic History* (1973). North and Thomas argued that the immense wealth accumulation and astonishing rising standards of living experienced in Western Europe occurred due to institutional arrangements which compatibilized the expected private and social returns, generating the right incentives for efficient economic coordination, capital accumulation, and technological progress.

According to North and Thomas (1973), the different transaction modes in European economic history can be analyzed within the transaction costs framework. They argued that the manorial system in the Middle Ages was a rational economic organization considering the prevailing transaction costs, population, technology, and relative factorial prices. With the absence of product and factor markets, the serfdom institution can be understood as a contractual relationship (not without coercion) between the feudal lord and his dependents. The feudal lord exchanges protection against violence within the fortified manor house in return for obligatory labor-time services (such as the *corvée*) or in-kind products cultivated in the property. Changes in population dynamics and technology reverberate in different relative factorial prices, creating profit opportunities for institutional innovation.

In the tenth century, with a growing population, extensive land cultivation, and increasing trade and urban development, land became relatively scarce vis-a-vis labor. Thus, the amount of forced labor by serfs due to the landlords increased. In the mid-fourteenth century, with the bubonic plague pandemic, the relative scarcity between labor and land changed drastically. At least one-third of Europe's population was killed between 1347 and 1352. The black plague made labor a relatively scarce factor in relation to land. In this scenario, the amount of forced labor obligations by serfs greatly diminished. Lords were forced to change the contractual relationship with serfs, offering new organizational tenancy and leasing arrangements, so that in some areas of Western Europe serfs were liberated.

In the sixteenth century, landlords in the Netherlands started to encourage trade fairs in their regions, providing judicial courts to secure, define, and enforce property rights, promoting commercial exchange and productive specialization. In the next century, England incorporated some Dutch institutions but also developed its domestic institutional arrangements to promote the alignment of private and social returns. Thus, with the Glorious Revolution in 1688, the parliament shackled the Leviathan's absolute power and became the main executive body, establishing the basis for the rule of law and non-discretionary fiscal administration. Property rights were secured and independent courts (matured with the Act of Settlement of 1701) judged disputes based on common law. In addition, the Statute of the Monopolies of 1624 created a



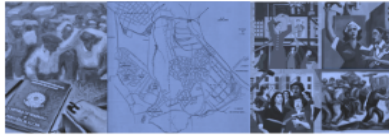
patent law system to secure temporary extraordinary private gains for technological innovation and the banking and credit system was developed (see also North and Weingast, 1988; Milgrom, North, and Weingast, 1990).

Nevertheless, institutional change carries two great problems that obstruct the capture of profit opportunities toward an optimal institutional structure or a Pareto-improving equilibrium. First, institutional innovation is a non-excludable and non-rivalrous public good such that there is a free-riding problem. Individual members can benefit from the innovation without paying their marginal share of implementation costs. Second, there are the costs of measuring, defining, and enforcing property rights and contracts. Transaction costs hamper the full private appropriation of social benefits and costs. Moreover, transaction costs (in conjunction with production costs) shape the most efficient organizational structure for the scarce economic resources of a society in a determined historical environment.

## VI. CONCLUDING REMARKS: TOWARD TO A NEW INSTITUTIONAL SOCIAL SCIENCE

Douglass North's intellectual journey is based on the search for a Grand Theory as a response to the Smithian Grand Question. What are the nature and causes of the wealth of nations? This objective was already clear in his mind as a young serious Marxist at Berkeley. It was the reason why North chose economic history as his main field of inquiry and specialization. His first major work dealing with location theory and regional economic growth is heavily influenced by his mentor M. M. Knight. North incorporated Knight's concerns with the fundamental scarcity problem and the dynamic social responses to it in the long run, together with the importance of initial endowments and the ecology of place, to construct a theoretical neoclassical model of regional economic growth grounded in staple export and market integration.

In the next few years, North refined his staple export-led growth model and his interpretation of American economic growth. North extended his model according to (i) the natural endowments of the region (at any given level of technology), (ii) the character of the export industry, and (iii) changes in technology and transfer costs. In the same period, North became the great theorist and promoter of the cliometric revolution in the United States. The success of New Economic History in historical myth-busting was not accompanied by reaching positive theoretical conclusions. Cliometrics was more destructive than constructive enterprise. And constructing an analytical framework to explain the rise and fall of nations, their structure and performance, is the main task of economic history.



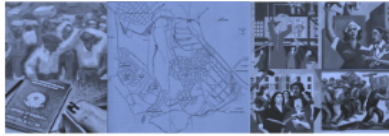
In his 1974 presidential address, North urged his cliometrician peers to go beyond New Economic History. In his view, while maintaining the utility-maximizing hypothesis, it was necessary to broaden the frame of reference of neoclassical theory. The Great Enrichment and the rise of Western civilization as the most developed economic region in the world cannot be explained by some form of the ergodic and static neoclassical production function. In *Institutional Change and American Economic Growth* (1971) and *The Rise of the Western World* (1973), North and his co-authors adopted what became known as a naive theory of institutions and property rights. They argued that the wealth of nations is essentially a path-dependent process of institutional building that minimizes the divergence of private and social returns. Implicit in this stage is the notion that institutions are efficient in some form (however defined).

However, if institutions are efficient, it is impossible to explain how some countries experienced long-run economic stagnation or decline. North realized that institutions and institutional change are determined by social and political choices. These are constrained by the individuals' subjective interpretations of the external objective world. He needed an analytical framework that could answer how institutions produced stagnant economies in the long run. In *Structure and Change in Economic History* (1981), North tried to formulate a theory that amalgamates the main factors which compose the structure of an economy and that determine economic change and performance. These are the social, political, and economic institutions, technology, demography, and ideology. North abandons his naive theory that institutions were efficient by incorporating ideology and a neoclassical theory of the state. The state is a collective-action entity that provides elementary public goods and services (such as protection, the formal rules which define and enforce property rights, and the political institutions which determine the social choice procedures) in exchange for revenue.

Influenced by the public choice literature, North sees the state as a wealth-maximizing ruler who attempts to maximize his own benefits (revenues) subject to the competitive constraint of losing his position as ruler and a transaction cost constraint (efficient rules can be more costly to enforce in terms of tax collection).<sup>9</sup> There is a divergence between the set of basic rules and institutions that maximize the ruler's private revenues and the one that maximizes the aggregate social output. North also argues that for any institutional set to be functional, there must be a moral value system, an ideology or what Denzau and North (1994) called shared mental models, which gives the *de jure* rules a *de facto* counterpart. Any institutional system carries a

---

<sup>9</sup> North (1990b) generalized this transaction cost argument for politics, arguing that political markets are inherently less efficient than economic markets due to the higher costs of measuring and enforcing agreements.



free-riding problem, so the costs of social conformity and the legitimacy of formal rules will depend on the informal norms and values. Alterations in ideology change the free-riding costs to influence political and social decisions.

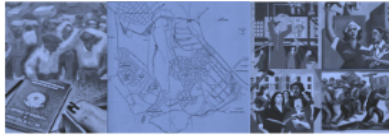
In the second part of the book, North applies his analytical framework to reinterpret economic history from the origins of agriculture ten thousand years ago to the twentieth century. Starting with the first economic revolution, he analyzes the Ancient World, the rise and decline of feudalism, the early formation of Europe, the industrial revolution, the second economic revolution, and the American growth experience. In particular, as illustrative of his political economy model, North (1981, pp. 156-7) contrasts the economic experience during the sixteenth until the eighteenth century in early modern Europe.

In stagnant France and declining Spain, the desperate need for revenue to finance a large bureaucracy dependent on the crown and war campaigns led to the undermining of property rights, market competition, and innovation. In its most famous example, Colbertism in France propelled the sale of market monopolies to guilds as a revenue method. In contrast, in the prosperous Netherlands and England, the political power of the merchant elites implied an institutional architecture that established secured property rights and market competition.

## VII. REFERENCES

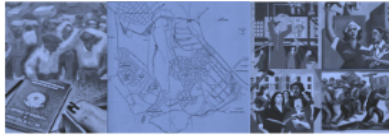
- Acemoglu, Daron, Johnson, Simon, and Robinson, James. (2001). The Colonial Origins of Comparative Development: An Empirical Investigation. *American Economic Review*, 91 (5), pp. 1369-1401.
- Alchian, Armen. (1965). Some Economics of Property Rights. *Il Politico*, 30 (4), pp. 816- 819.
- Coase, Ronald H. (1937). The Nature of the Firm. *Economica*, 4 (16), pp. 386-405.
- Coase, Ronald H. (1960). The Problem of Social Cost. *Journal of Law and Economics*, 3 (1), pp. 1- 44.
- Cochran, Thomas. (1961). Did the Civil War Retard Industrialization?. *Mississippi Valley Historical Review*, 48, pp. 197-210.
- Conrad, Alfred H. and Meyer, John R. (1957). Economic Theory, Statistical Inference and Economic History. *Journal of Economic History*, 17 (4), pp. 524-44.
- Conrad, Alfred H. and Meyer, John R. (1958). The Economics of Slavery in the Antebellum South. *Journal of Political Economy*, 66 (1), pp. 94–130.
- Davis, Lance and North, Douglass C. (1970). Institutional Change and American Economic Growth: A First Step Towards a Theory of Institutional Innovation. *Journal of Economic History* 30 (1), pp. 131–149.
- Davis, Lance and North, Douglass C. (1971). *Institutional Change and American Economic Growth*. Cambridge: Cambridge University Press.
- Demsetz, Harold. (1967). Toward a Theory of Property Rights. *American Economic Review*, 57 (2), pp. 347-359.
- Denzau, Arthur T. and North, Douglass C. (1994). Shared Mental Models: Ideologies and Institutions. *Kyklos*, 47(1), pp. 3–31.



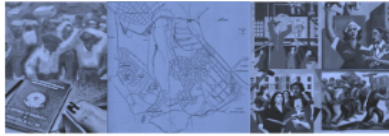


- Engerman, Stanley L. and Sokoloff, Kenneth L. (1997). Factor Endowments, Institutions, and Differential Paths of Growth Among New World Economies. In Stephen Haber, ed., *How Latin America Fell Behind*. Stanford: Stanford University Press, pp. 260-304.
- Engerman, Stanley L. and Sokoloff, Kenneth L. (2000). Institutions, Factor Endowments, and Paths of Development in the New World. *Journal of Economic Perspectives*, 14 (3), pp. 217-32.
- Fogel, Robert W. (1964). *Railroads and American Economic Growth: Essays in Econometric History*. Baltimore: Johns Hopkins University Press.
- Furtado, C. (1959). *The Economic Growth of Brazil – A Survey from Colonial to Modern Times*. University of California Press, Berkeley. 1963. Translation by R. Aguiar and E. Drysdale of *Formação Econômica do Brasil*. Rio de Janeiro: Fundo de Cultura.
- Galbraith, John K. (1951). Conditions for Economic Change in Underdeveloped Countries. *Journal of Farm Economics*, 33 (4), pp. 689-696.
- Goldin, Claudia. (1995). Cliometrics and the Nobel. *Journal of Economic Perspectives*, 9 (2), pp. 191-208.
- Hayek, Friedrich A. (1954). (Ed.) *Capitalism and Historians*. Chicago: University of Chicago Press.
- Hughes, Jonathan R. (1982). Douglass North as a Teacher. In Ransom, Roger L., Richard Sutch, and Gary M. Walton, eds., *Explorations in the New Economic History: Essays in Honor of Douglass C. North*. New York: Academic Press, pp. 3-11.
- Hoover, Edgar M. (1937). *Location Theory and the Shoe and Leather Industries*. Cambridge: Harvard University Press.
- Knight, Melvin M. (1928). Water and the Course of Empire in French North Africa. *Quarterly Journal of Economics*, 43 (1), pp. 44-93.
- Krul, Matthijs. (2018). *The New Institutional Economic History of Douglass C. North: A Critical Interpretation*. London: Palgrave.
- Lewis, Arthur W. (1954). Economic Development with Unlimited Supplies of Labour. *Manchester School*, 22 (2), pp. 139-91.
- Lösch, August. (1938). The Nature of Economic Regions. *Southern Economic Journal*, 5 (1), pp. 71-78.
- Ménard, Claude and Shirley, Mary M. (2014). The Contribution of Douglass North to the New Institutional Economics. In: Galiani, Sebastian and Sened, Itai (eds.). *Institutions, Property rights, and Economic Growth: The Legacy of Douglass North*. Cambridge: Cambridge University Press, pp. 11-29.
- McCloskey, Deirdre N. (1997). *Econometric History*. London: Macmillan.
- Milgrom, Paul R., North, Douglass C., and Weingast, Barry R. (1990). The Role of Institutions in the Revival of Trade: The Law Merchant, Private Judges, and the Champagne Fairs. *Economics and Politics*, 2 (1), pp. 1-23.
- Mills, C. Wright. (1959). *The Sociological Imagination*. Oxford: Oxford University Press.
- North, Douglass C. (1950). Some Recent Views of the Modern Large Corporation. *Explorations in Entrepreneurial History*, 2 (2), pp. 71-90.
- North, Douglass C. (1952). Capital Accumulation in Life Insurance between the Civil War and the Investigation of 1905. In Miller, William. ed. *Men in Business*. Cambridge: Harvard University Press, pp. 238-53.
- North, Douglass C. (1953). Entrepreneurial Policy and the Internal Organization in Large Life Insurance Companies at the Time of the Armstrong Investigation. *Explorations in Entrepreneurial History*, 5 (3), pp. 139-61.
- North, Douglass C. (1954). Life Insurance and Investment Banking at the Time of the Armstrong Investigation. *Journal of Economic History*, 14 (3), pp. 209-28.
- North, Douglass C. (1955). Location Theory and Regional Economic Growth. *Journal of Political Economy*, 63 (3), pp. 243-58.
- North, Douglass C. (1956a). Exports and Regional Growth: A Reply. *Journal of Political Economy*, 64 (2), pp. 165-8.
- North, Douglass C. (1956b). International Capital Flows and the Development of the American West. *Journal of Economic History*, 16 (4), pp. 496-505.
- North, Douglass C. (1958a). A Note on Professor Rostow's Take-off into Self-Sustained Growth. *Manchester School*, 26 (1), pp. 68-75.





- North, Douglass C. (1958b). Ocean Freight Rates and Economic Development 1730–1913. *Journal of Economic History*, 18 (4), pp. 537–555.
- North, Douglass C. (1959). Agriculture in Regional Economic Growth. *Journal of Farm Economics*, 41 (5), pp. 943-951.
- North, Douglass C. (1960). The United States Balance of Payments, 1790-1860. In *Trends in the American Economy in the Nineteenth Century: 24th Conference on Research in Income and Wealth*. Princeton: Princeton University Press, pp. 573-628.
- North, Douglass C. (1961). *The Economic Growth of the United States 1790-1860*. Englewood Cliffs: Prentice-Hall.
- North, Douglass C. (1963) Quantitative Research in American Economic History. *American Economic Review*, 53 (1), pp. 128-30.
- North, Douglass C. (1965). The State of Economic History. *American Economic Review*, 55 (1-2), pp. 86-91.
- North, Douglass C. (1966). *Growth and Welfare in the American Past: A New Economic History*. Englewood Cliffs: Prentice-Hall.
- North, Douglass C. (1968a). A New Economic History of Europe. *Journal of Institutional and Theoretical Economics*, 124 (1), pp. 139-47.
- North, Douglass C. (1968b). Sources of Productivity Change in Ocean Shipping, 1600–1850. *Journal of Political Economy*, 76 (5), pp. 953-970.
- North, Douglass C. (1971). Institutional Change and Economic Growth. *Journal of Economic History*, 31 (1), pp. 118-125.
- North, Douglass C. (1974). Beyond New Economic History. *Journal of Economic History*, 34 (1), pp. 1-7.
- North, Douglass C. (1977a). The New Economic History after Twenty Years. *American Behavioral Scientist*, 21 (2), pp. 187-200.
- North, Douglass C. (1977b). Markets and Other Allocation Systems in History: The Challenge of Karl Polanyi. *Journal of European Economic History*, 6 (3), pp. 703-16.
- North, Douglass C. (1978a). Evaluating Three Schools of Economic History. *Journal of Economic History*, 38 (1), pp. 77-80.
- North, Douglass C. (1978b) Structure and Performance: The Task of Economic History. *Journal of Economic Literature*, 16 (3), pp. 963-78.
- North, Douglass C. (1978c). *The Livelihood of Man*, by Karl Polanyi. *Business History Review* 52 (3), pp. 398–399.
- North, Douglass C. (1981). *Structure and Change in Economic History*. New York: W. W. Norton Company.
- North, Douglass C. (1986). Is it Worth Making Sense of Marx? *Inquiry*, 29 (1), pp. 57-63.
- North, Douglass C. (1990a). *Institutions, Institutional Change, and Economic Performance*. Cambridge: Cambridge University Press.
- North, Douglass C. (1990b). A Transaction Cost Theory of Politics. *Journal of Theoretical Politics*, 2 (4), pp. 355-367.
- North, Douglass C. (1991). Institutions. *Journal of Economic Perspectives*, 5 (1), pp. 97–112.
- North, Douglass C. (1994). Economic Performance Through Time. *American Economic Review*, 84 (3), pp. 359–68.
- North, Douglass C. (1997a). Douglass C. North. In Spencer, Roger W. and Macpherson, David A. *Lives of Laureates: Thirteen Nobel Economists*. Cambridge: MIT Press, pp. 251-68.
- North, Douglass C. (1997b). Cliometrics - 40 Years On. *American Economic Review*, 87 (2), pp. 412-4.
- North, Douglass C. (2009). Interview. In Horn, Karen. ed. *Roads to Wisdom: Conversations with Ten Nobel Laureates in Economics*. Cheltenham: Edward Elgar, pp. 153–172.
- North, Douglass C. and Thomas, Robert P. (1970). An Economic Theory of the Growth of the Western World. *Economic History Review*, 23 (1), pp. 1–17.
- North, Douglass C. and Thomas, Robert P. (1971). The Rise and Fall of the Manorial System: A Theoretical Model. *Journal of Economic History*, 31 (4), pp. 777–803.
- North, Douglass C. and Thomas, Robert P. (1973). *The Rise of the Western World: A New Economic History*. Cambridge: Cambridge University Press.



XV Congresso Brasileiro de História  
Econômica & 16a Conferência  
Internacional de História de Empresas  
Osasco, 02 a 04 de outubro de 2023



ASSOCIAÇÃO  
BRASILEIRA DE  
PESQUISADORES  
EM HISTÓRIA  
ECONÔMICA

- North, Douglass C. and Weingast, Barry R. (1989). Constitutions and Commitment: The Evolution of Institutions Governing Public Choice in Seventeenth-Century England. *Journal of Economic History*, 49 (4), pp. 803-32.
- Parker, William N. (Ed.). (1960). *Trends in the American Economy in the Nineteenth Century: 24th Conference on Research in Income and Wealth*. Princeton: Princeton University Press.
- Rostow, Walt W. (1956). The Take-Off into Self-Sustained Growth. *Economic Journal*, 66 (261), pp. 25-48.
- Rostow, Walt W. (1960). *The Stages of Economic Growth: A non-communist manifesto*. Cambridge: Cambridge University Press.
- Schumpeter, Joseph A. (1954). *History of Economic Analysis*. New York: Oxford University Press.
- Skinner, Quentin. (1990). (Ed.) *The Return of Grand Theory in the Human Sciences*. Cambridge: Cambridge University Press.
- Smith, Adam. ([1776] 1970). *An Inquiry into the Nature and Causes of the Wealth of Nations*. Harmondsworth: Penguin.
- Snowdon, Brian. (2016). Institutions, Economic Growth and Development: A Conversation with Nobel Laureate Douglass North. *World Economics*, 17 (4), pp. 107-152.
- Stigler, George J. (1951). The Division of Labor is Limited by the Extent of the Market. *Journal of Political Economy*, 59 (3), pp. 185-193.
- Tiebout, Charles. (1956). Exports and Regional Growth. *Journal of Political Economy*, 64 (2) pp. 160-4.
- Pontecorvo, Giulio and Stewart, Charles. (1979). Melvin Moses Knight. *Exploration in Economic History*, 16 (3), pp. 243-45.
- Whaples, Robert. (1991). A Quantitative History of the *Journal of Economic History* and the Cliometric Revolution. *Journal of Economic History*, 51 (2), pp. 289-301.