Douglass C. North

The Answer Is "Transactions Costs"

MICHAEL C. MUNGER

My first experience with Professor Douglass North was when as a Ph.D. candidate I saw his "job talk" at Washington University in St. Louis in 1982. Of course, it wasn't clear who was interviewing whom. I remember being unimpressed with the talk—no equations, some purely verbal story about the Neolithic Revolution and the problem of organizing human institutions. When I heard that North had accepted "our" offer to transpose "University" and "Washington" in his affiliation and move two thousand miles east to St. Louis, I was surprised at the celebration, bordering on rejoicing, I saw from the Wash U faculty.

My dissertation was focused on congressional institutions and the attempts by corporate and labor political action committees to shape, even direct, the regulations that were supposed to direct *them*. The perspective was straightforwardly Stiglerian, and I was well along on the project. Nonetheless, I asked Doug, soon after he arrived, if he would serve on the committee, and he graciously (as I now know, given his status and mine) said yes.

Barry Weingast was my primary adviser, and most of my work was done to satisfy him, but Doug had some useful comments and suggestions. Finally, at my thesis defense, Doug asked a question. It seemed like a complicated question, and I went to the board and wrote some equations. Finally (mercifully), Doug interrupted me. Waving his hand slowly, as if addressing a not-very-bright child, he said, "Michael, the answer is just two words . . . *transactions costs*!"

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It took me several years to realize and more than a decade fully to understand that for Doug it didn't really matter what the question was. The answer always starts with "transactions costs." The reason it took me so long to fully understand this perspective is that unexpectedly—if your focus is on traditional economics—Doug was right.

I did resist this view, I have to admit. In 1989, I published a paper with William Dougan entitled "The Rationality of Ideology" in the *Journal of Law and Economics.* The claim was that the Stiglerian/Chicago view of ideology was largely correct, making ideology a commitment device rather than an independent variable. Thus, having an ideological reputation was "rational" for political actors because it reduced transactions costs of the complex "exchange" with voters, who had little information and even less incentive to monitor the politicians' actions. (I should note that Robert Higgs independently published a paper with a very similar empirical hook that same year, though he was focusing on defending ideology from his own perspective [see Higgs 1989].)

By 1994, I had reversed my view completely, publishing with Melvin Hinich a book titled *Ideology and the Theory of Political Choice,* an attempt (I think we would now have to say "failed attempt") to synthesize the Downsian theory of ideology as a signal and the Higgs–North theory of ideology as an independent—and perhaps malign—force in politics and history. (I don't mean to equate the Higgs and North views of ideology; for the differences and similarities, see Morong n.d. Also, if it matters, I think that North was at least uncharitable in disconnecting his own views from Higgs's, which at the very least coevolved in close proximity of space and time.)

The problem is that ideology cannot be both a summary, an information shortcut, which would have to be correct on average, and a substitute for facts and reason. Ideologies are a way of summarizing means–end relations in ways that are relatively impervious to "feedback," in part because the results are hard to measure and in part because it is more pleasurable to hold beliefs that make you feel good about yourself than it is to hold beliefs that make you feel bad about the world, even if the "feel bad" results are more factually accurate.

Once one recognizes that institutional arrangements are in part the product of and in part supported ex post by ideologies, the "rational choice" view of mass politics becomes much harder to sustain. This recognition led Doug on a path that took him away from traditional economics, which has adopted—rightly, for the most part—its own "ideological" requirement that incentives, not tastes, must be the force that animates choices and changes in choices. His problem was that he had to devise a means of explaining why institutions almost never change . . . except when they do.

This means that institutions are hard and do not change easily. But they are hard like glass rather than like steel: if institutions break, they shatter and are not easily reconstructed. Consider what happens when a fairly large number of people arrive at more or less the same time for some service or arrive at a rate that exceeds the processing speed for that service. Access to the processing service is scarce. How is it rationed? It could be auctioned, but the transactions costs of running that ad hoc auction would be prohibitive. Access could be determined by pushing and shoving, or the group could follow the customary social norm (in most Western societies): queue up. No one needs to be told to queue up; doing so is understood. The line is likely to form in a way that is orderly and well functioning, without communication or threats from any outside force.

But the line can break. If a few people cut in line, there is murmuring and perhaps some anger, some pushing. The norm of queuing as a rationing device can survive some violations and is robust to "trembling hand" problems, provided the people standing in line provide the public good of norm enforcement (yelling at violators) and the violators care about public opinion (they are shamed into compliance). But if a substantial number of people, somewhere around 10 percent or so, start to cut in line and are indifferent to public shaming, the entire institution shatters, and the whole group surges forward, reverting to the less-efficient but locally stable norm of pushing and shoving to get to the front. It turns out that this approach to understanding institutions and enforcement is quite robust (see, for example, Greif, Milgrom, and Weingast 1994).

Doug moved for a time toward the study of psychology and behavioral economics because he became convinced (with the assistance of Barry Weingast on some papers and in work that Weingast did with other collaborators) that the "constitution" of the group or society itself is a coordinating device and that emotions play an important role in that coordination. So when someone cuts in line, the rational, marginal reaction "should" be indifference. One person in line ahead of me costs me about twenty seconds, the amount of time required to sell that person one more movie ticket or cup of coffee. But people don't react "rationally" in such a situation; they threaten violence because their emotions rob them of rational volition. The result is that people are better at enforcement and are therefore better at cooperating than one would expect from a society of *homo economicus* clones.

Doug's later work focused more and more on violence, and in some ways that work brought him closer, in both assumptions and conclusions, to the classical liberal view than his earlier work might have led one to predict. In *Violence and Social Orders* (2009), couthored with John Wallis and Barry Weingast and modestly subtitled *A Conceptual Framework for Interpreting Recorded Human History*, he drew a striking conclusion: states qua states can operate only by selling violence. The transition to open-access order is a potential Pareto improvement, but only if the stakeholders in the current, violence-based closed-access order can be guaranteed a stream of rents at least equal to what they now enjoy. But such a guarantee is usually difficult and may be impossible to offer. One reason is that those outside the ruling elite see the current rent distribution as illegitimate and are unwilling even to offer such "reparations" (an example would be compensating slave owners to give up slavery). Another is that self-interest will lead to an ex post recontracting in boodle if there is a de facto redistribution of power. So although there exists a Pareto-superior arrangement, no feasible contracting path can lead to it, and nations bump along at the bottom of the possible range of growth patterns for extended periods. This explanation is important but frustrating because it means the transition to "good" institutions requires a highly contingent set of historical circumstances, something that allows a credible commitment to pay off elites or a paroxysm of violence sufficiently brutal to take the power of the elites out of the picture. Institutions *matter,* as Doug would always say, but his own theory shows that institutions can't always be *selected*. The particular history, what many economists call "path dependence," matters more than it should. And attempts to study institutions without paying attention to the particularities of history are doomed to failure and misdirection for policy.

This leads me to close with two anecdotes that sum up much of what was novel and interesting and frustrating about Doug. After he shared the Nobel Prize with Robert Fogel in 1993, the Nobel ceremony in Sweden was full of pomp and importance. I was watching it on television in the middle of the night because C-SPAN had not run the presentation ceremony live. A question was asked of Fogel, who gave a long, involved answer and then said, "I've written a lot about that subject, and I could talk about it for a long time." Doug immediately chimed in, coming close to doing a Groucho Marx impression, "And if no one stops him, he will!" The interviewer, being Swedish, made only a small snorting noise and kept his composure, but I have treasured that televised memory ever since.

The other incident was apparently repeated several times in different settings. After one wins the Nobel Prize, at least if one is an economist, there is a blitz of opportunities to provide advice on development and policy to nations that are looking for that sort of thing. Given the timing of the prize in 1993, Doug was invited to Latin America and central Europe and asked over and over, "What do we need to achieve development?" North's answer was consistent: "That's simple. All you need is a different history."

I feel fortunate that my own history included learning from Douglass North.

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