

## **Institutions and Economic Growth:**

A Skeptical Journey Through North & Weingast (1989), with a Pit Stop in North (1990)

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### **Synopsis**

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This précis journeys into the institutionalist argument of Douglass North and Barry Weingast's seminal 1989 article, "Constitutions and Commitment."<sup>1</sup> It begins by taking a "pit stop" in North's transaction costs theory of institutions detailed in his 1990 book, *Institutions, Institutional Change and Economic Performance*,<sup>2</sup> for this is the theory leveraged by North and Weingast (1989) to analyze the impact of the post-Glorious Revolution constitutional settlement on subsequent English economic growth. It concludes by delivering a critique of North and Weingast (1989)'s interpretation of the Glorious Revolution and by posing some questions for class discussion.

### **The Theory of Institutions in North (1990) and North & Weingast (1989)**

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#### **North (1990)'s Transaction Costs Theory**

North defines institutions as "the rules of the game in a society or [...] the humanly devised constraints that shape human interaction" (1990: 3). Relying on the canonical work of Ronald Coase (1937; 1960),<sup>3</sup> North argues that when transaction costs are negligible, institutions are unnecessary and the neoclassical theory of free market exchange holds (ibid: 12). The problem is that in most cases "it is costly to transact," and thus production costs not only incorporate inputs of land, labor, and capital, but also the costs of defining, protecting, and enforcing property rights (ibid: 12; 18; 61). In other words, the assumptions underlying expect utility approaches in neoclassical theory – transitivity of preferences, perfect information, and agents possessing the computational abilities necessary for utility-maximizing behavior – are frequently violated (ibid: 18). Indeed, behavioral economists have found evidence of non-transitive preferences, framing effects, preference reversals, and imperfect information/uncertainty in market exchanges (ibid). Combined with the presence of multiple equilibria, unique and non-repetitive choices, and imperfect responses to shifting incentive structures, North argues that third party enforcement becomes critical to achieve reasonably efficient outcomes (ibid: 24; 35).

North concludes that "impersonal exchange with third-party enforcement" has "been the critical underpinning of successful modern economies involved in the complex contracting necessary for modern economic growth" (ibid: 35). Whereas primitive societies engaging in simple economic transactions could rely on informal institutions – norms, kinship ties, and tradition – backed by the threat of violence to achieve relative harmony, more complex societies also require formal institutions – particularly a constitution and an effective judiciary – to reduce transaction costs and protect property rights (ibid: 38-40; 35; 44; 59). Note that here North treats informal institutions as "sources of continuity in long-run societal change," and thus describes cultural norms as "a source of path dependence" (ibid: 37; 44). It is therefore unsurprising that North and Weingast (1989), who are interested in assessing whether rapid economic development in a relatively complex society (17<sup>th</sup> century Britain) can be the byproduct of changes in institutional design, tend to focus on formal institutions rather than informal ones.

#### **North and Weingast (1989)'s Articulation of the Transaction Costs Theory**

Leveraging the transaction cost theory of institutions described by North (1990), North and Weingast argue that institutions curtailing executive authority serve as credible commitment devices (1989: 803). The underlying logic is that institutions are a means for the bargaining parties to prevent *ex post* opportunism *ex ante* (ibid: 807; see also North 1990: 50). The observable implication of this theory is that if a sovereign is able or likely to alter property rights for his own benefit, the expected returns from investment and subsequent investment incentives will be low (North and Weingast 1989: 803). This aligns with North's argument that without a credible enforcement mechanism for contracts, transactions are subject to a "risk premium" that will often be prohibitive, thereby

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<sup>1</sup> North, Douglass, and Barry Weingast. 1989. "Constitutions and Commitment: The Evolution of Institutions Governing Public Choice in Seventeenth-Century England." *The Journal of Economic History* 49 (4): 803-832.

<sup>2</sup> North, Douglass. 1990. *Institutions, Institutional Change and Economic Performance*. New York, NY: Cambridge University Press.

<sup>3</sup> Coase, Ronald H. 1937. "The Nature of the Firm." *Economica* 4 (16): 386-405; Coase, Ronald H. 1960. "The Problem of Social Cost." *Journal of Law and Economics* 3: 1-69.

limiting economic exchange (1990: 33). While a history of good behavior by the sovereign may facilitate making credible commitments, evidence from the history of medieval states demonstrates that even seemingly reliable sovereigns reneged on past promises when an alternative, more plentiful source of funds emerged (North and Weingast 1989: 807; see also North 1990: 57). Further, monarchs facing the threat of war heavily discounted the future in order to extract the funds required for war-making, thereby substituting extractive practices for policies fostering long-run economic growth (North and Weingast 1989: 807). For these reasons, institutionalizing a self-enforcing constitutional arrangement becomes necessary, where “self-enforcing” means that the bargaining parties have an incentive to abide by the bargain after it is finalized (ibid: 806).

### **North & Weingast (1989)’s Case Study of the Glorious Revolution in England**

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North and Weingast analyze the evolution of the constitutional arrangements in England following the Glorious Revolution of 1688, underscoring the political and institutional factors underpinning economic growth and the emergence of market exchange (1989: 803). Whereas in the early 1600s the crown’s unpredictable fiscal needs engendered arbitrary expropriation of wealth, the post-Glorious Revolution constitutional settlement required Parliamentary assent to extract revenue and modify pre-existing agreements (ibid: 803-804). The independence of the common law courts was secured, and judges were better able to uphold contracts and to secure property rights. The economic consequences of this new constitutional structure were immediate and eye-opening: “[f]ollowing the Glorious Revolution [...] not only did the government become financially solvent, but it gained access to an unprecedented level of funds. In just nine years (from 1688 to 1697), government borrowing increased by more than an order in magnitude [...] reflecting] a substantial increase in the perceived commitment by the government to honor its agreements” (ibid: 805). North and Weingast dramatically conclude that “the institutional changes of the Glorious Revolution permitted the drive toward British hegemony and dominance of the world” (ibid: 830). Further, the authors posit that a necessary condition for the creation of “modern economies” is a constitutional framework that checks the government’s ability to upset commercial intercourse by contracting parties (ibid: 831).

#### **The Arbitrary Rule of the Stuarts, 1603-1688**

The Stuarts who wielded the British throne in the early 17<sup>th</sup> century epitomized arbitrary executive rule. The substantial fiscal needs facing them incentivized frequent expropriation of wealth and desperate attempts to generate revenue. Arbitrary executive acts were made possible by the institutional structure of government. Public laws and expenditures were not subjected to a public budgetary process, and Parliament played a negligible role in decisions over expenditure and investment (ibid: 809). The only potential source of Parliamentary influence was its ability to provide tax revenue for extraordinary (usually war-related) purposes, though in practice the Stuarts continued to extract revenue without the consent of Parliament. Even when the Stuarts did borrow from moneyed interests represented in Parliament, the loans were seldom repaid in a timely fashion and in compliance with the contractual terms governing them (ibid: 811). Even so, the crown regularly ran substantial yearly budget deficits and was thus forced to resort to desperate measures to make up the difference (ibid: 809-810). These measures included selling some 25 percent of royal lands; raising customs and placing new “impositions” on its constituents; restricting the distribution of patents so as to extract rents in exchange for monopoly rights; expanding the peerage and the number of seats in the House of Lords by selling titles of nobility; leveraging the power of purveyance to expropriate land for “public purposes” and offering minimal compensation to the landowners; and selling dispensations, or the royal authority for specific individuals to dispense with a particular law (ibid: 810-812). In short, the Stuarts’ rule was desperate, capricious, and arbitrary.

The Stuarts also managed to appropriate and fuse the legislative and judicial powers with their executive authority. The Parliament passed laws combating the monarch’s selling of patents/monopoly rights for revenue, and the courts attempted to enforce them, but the crown did not depend on Parliamentarians for revenue and had little incentive to comply (ibid: 813). Further, the throne’s “royal prerogative” bestowed upon the monarch a quasi-legislative authority by granting him/her the ability to issue edicts without Parliamentary consultation (ibid: 814). Finally, by controlling the judicial payrolls and generously exercising their ability to remove judges from office, the Stuarts were able to shape the jurisprudence of the common law courts in their favor (ibid).

Eventually, opposition to the Stuarts’ rule mounted and plunged England into civil war. Without recourse to a standing army, in 1642 Charles I fell to the Parliamentary opposition, which disbanded the monarchy and the House of Lords, executed Charles I, and dismantled the crown’s administrative apparatus for revenue extraction (ibid: 815;

829). Yet these acts came to be perceived as radical failures, so in 1660 the Stuart monarchy was reinstated (ibid: 815). The predictable consequence was to pin the crown against Parliament once more. When James II disenfranchised the predominantly Whig opposition from political participation, Englishmen united against Stuart rule, and in the Glorious Revolution of 1688 James II was deposed (ibid).

### **The Post-Glorious Revolution Settlement and Economic Boom**

The Glorious Revolution inaugurated the modern era of parliamentary sovereignty, which replaced the rule of “the King alone” with government by “King in Parliament” (ibid: 816). Yet the focus was not so much on eradicating the monarch’s authority, but on constraining it (ibid: 817). The King retained agenda-setting powers via his exclusive right to propose new expenditures, but the *modus operandi* became one where the King needed to negotiate with Parliament to raise funds (ibid: 818).

Parliament curtailed the crown’s independent revenue sources and gained the exclusive authority to raise new taxes; it secured the ability to audit and veto government expenditures; and now had the sole authority to remove judges from office (and only in cases of criminal misconduct) (ibid: 816). For its part, the Parliament committed to bolstering the government’s financial position by providing sufficient tax revenue (ibid: 817). Combined with the obvious credibility of the parliamentary threat to the crown in light of irresponsible executive behavior, this arrangement minimized the monarch’s incentive to engage in arbitrary extraction (ibid). Further, the diversity of viewpoints held by members of Parliament, combined with the ruling Whig coalition’s belief in limited political interference with the common law courts, ensured that it would not replace the monarch as the wielder of arbitrary rule (ibid: 818).

Exercising the fruits of newfound independence, the common law courts were able to limit the government’s ability to renege on its agreements and became staunch defenders of private property rights (ibid: 819). The courts also helped enshrine a new set of political and civil rights to prevent a relapse to the pre-Glorious revolution period, when the monarch regularly jailed dissidents without charge or trial and imposed excessive bail (ibid: 829). A Bank of England was incorporated with the responsibility of handling the government’s loan accounts, along with the requirement that it seek Parliamentary assent before lending money to the crown (ibid: 822). This new constitutional architecture, characterized by a separation of powers, checks and balances achieved by “endowing several actors with veto power,” and a commitment to property rights quickly became self-enforcing (ibid: 818).

The economic results were dramatic and timely, for from 1689 through 1697 England was at war with France (ibid). The government was able to tap moneyed interests in an unprecedented way: within nine years, government expenditures and debt quadrupled, providing England with the necessary resources to defeat the French (ibid). By 1720, government debt was fifty times greater than in 1688, even as the interest rate on its loans was halved during the same period (ibid: 823). Spurred by the financial innovations developed by the Bank of England, in the early 1700s banks proliferated (ibid: 828). The emerging capital markets mobilized savings, provided financial services, and financed business activities within an increasingly integrated national market (ibid). The contrast with France, which lacked a similar institutional arrangement capable of securing credible commitments, is striking: whereas in the late 1600s the fiscal health of the British and French governments was comparable, “by 1765 France was on the verge of bankruptcy while England was on the verge of the Industrial Revolution” (ibid: 831).

### **A Critique of North & Weingast (1989)**

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In the following critique, I do not challenge the logic of the transaction cost theory of institutions articulated by North (1990) and North and Weingast (1989). Rather, I challenge its application by North and Weingast (1989) to interpret the case of the English Glorious Revolution.

It is curious that an argument premised on the impact of “constitutions” establishing fragmented systems of governing authority should be based on the case of the United Kingdom, a state that lacks a written constitution and that is hailed as the cradle of “parliamentary sovereignty.” Indeed, I argue that a closer inspection of post Glorious-Revolution England suggests that it is not the presence of a constitutional architecture of checks and balances, but rather the triumph and interests of Parliamentarians that can be credited for the economic boom post-1688.

First, we must note that the post-Glorious Revolution settlement was not characterized by a balance of power between monarch, Parliament, and courts: the Parliament was clearly first amongst supposed equals. Indeed, besides the monarch's agenda-setting authority, North and Weingast (1989) do not provide us with any evidence that the crown wielded substantial powers post-1688. Second, North and Weingast (1989) conflate the courts' newfound independence from the crown for judicial independence proper. Yet a historical survey of common law jurisprudence in England reveals that the courts largely acquiesced to Parliamentary preferences. Sir William Blackstone, an exponent of parliamentary sovereignty and England's most influential 18<sup>th</sup> century jurist, argued the conventional wisdom in his *Commentaries on the Laws of England*: acts of Parliament were to be upheld unless they were "impossible to be performed;" in other words, unless the statutes in question were so internally contradictory that they could not be enacted without a judge remedying the inconsistency (quoted in Corwin 1914: 33; see also O'Neill 2005: 14).<sup>4</sup> This largely followed the canons of interpretation that existed in the pre-Glorious Revolution era as articulated by Sir Edward Coke, in turn the 17<sup>th</sup> century's most important jurist, who believed that "[b]eing a court, Parliament was necessarily bound by the law, even as it declared and elaborated it; but being the highest court, its interpretations of the law necessarily bound all other courts" (Corwin 1914: 29; see also Wolfe 1994: 18).<sup>5</sup> Coke's commentary highlights the degree to which the British Parliament has historically possessed quasi-judicial authority: indeed, until 2009, the Supreme Court of the United Kingdom was the House of Lords.

We should note here the fundamental importance of England's lack of a written constitution: without a single document representing the sovereign 'will of the people,' it was Parliament that came to embody the popular will. The canons of interpretation of the common law courts support this conclusion: unless the Parliament openly contradicted itself, the courts would honor its will. As for the monarch, given the precedent set by the successful Parliamentary revolutions of 1641 and 1688 and the subsequent dismantling of executive powers, could it reasonably be argued that the crown retained the power to significantly challenge Parliament? Probably not. In other words, far from being a codified constitutional system *à l'Americaine* premised on institutional constraints, the unwritten constitutional consensus of post-Glorious Revolution England was one where Parliament largely ruled supreme.

If the foregoing argument has validity, then what matters is not so much the *constraining structure of government* but the *composition and preferences of Parliament*. Put differently, and borrowing the language of North (1990: 4-5), I propose focusing not on *institutional constraints* but on *organizational preferences*. I argue that Parliamentarians did not replace the monarch as arbitrary rulers vis-à-vis issues of taxation, contracts, and private property because it was not in their own self-interest, not because a constitutional structure constrained their actions. North and Weingast themselves note that Parliament "represented wealth holders" and was composed of a "commercially minded ruling Whig coalition" that was "anxious to avoid encroachment upon the privacy of the business of those groups from which it drew its support" (1989: 804; 818). In other words, the Parliament represented the emerging capitalist class, so it is only natural that it would not obstruct the fledgling capital markets and that it would secure property rights. And while one may, as North and Weingast (1989: 818) do, reference the "natural diversity of views in a legislature" as a fallback explanation for the Parliament's non-arbitrary rule, not only does this argument do away with the causal role of constitutional structure, but its logic is ultimately unconvincing: are we to believe that a Parliament largely representing a relatively small constituency of capitalists is going to be internally divided on such questions as whether to protect of property rights and the freedom to contract? Surely such an unlikely claim necessitates particularly convincing evidence, yet North and Weingast (1989) provide none.

To use a soccer analogy, the case of the post-Glorious Revolution settlement suggests that efficient outcomes did not resort from new rules enforceable by independent referees preventing rough play by the malevolent team of royal courtesans, but rather by removing most of its players (including the goalie) from the field so that our amiable team of capitalists could begin to score with relative ease. In short, a persuasive interpretation of the English economic boom following the Glorious Revolution is *not* that the post-1688 constitutional settlement fragmented institutional authority and constrained arbitrary government action; rather, it is that a sovereign Parliament representing the emerging capitalist class acquired the freedom to secure its own economic interests.

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<sup>4</sup> Corwin, Edward S. 1914. *The Doctrine of Judicial Review*. Princeton, NJ: Princeton University Press; O'Neill, Jonathan. 2005. *Originalism in American Law and Politics*. Baltimore, MD: Johns Hopkins University Press;

<sup>5</sup> Wolfe, Christopher. 1994. *The Rise of Modern Judicial Review*. Lanham, MD: Rowman & Littlefield.

## Questions for Class Discussion

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- (1) Are you persuaded by North and Weingast (1989)'s interpretation of the Glorious Revolution? Would an alternative case study have been better suited to illustrate a transaction costs theory of institutions?
- (2) What exactly do we mean when we say that institutions are "self-enforcing"? What independent causal role do institutions play in such situations?
- (3) To what extent does a transaction costs theory of institutions seem to map onto your own day-to-day interactions with others?
- (4) To what extent is a transaction costs theory of institutions premised on the existence of two or more bargaining parties? Is it ever rational for a *single actor* to constrain its future self via institutional pre-commitment?
- (5) To what extent is North (1990)'s transaction costs theory of institutions an improvement over neoclassical treatments of market exchange? What do North (1990) and North and Weingast (1989) say that Ronald Coase did not already say in his 1960 article, "The Problem of Social Cost"?