

**A CONFERENCE ORGANIZED BY
THE CENTER FOR INTERNATIONAL PRIVATE ENTERPRISE
(CIPE) AND
THE RONALD COASE INSTITUTE**

**PROMOTING INSTITUTIONAL REFORMS IN
LATIN AMERICA**

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SAO PAULO, BRAZIL**

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DAY ONE**
[TRANSCRIPT PREPARED FROM TAPE RECORDINGS.]

[Dr. North is not on microphone.]

DR. NORTH: Thank you, John, and thank you for all of the very generous comments that [inaudible] comments that you made, and I'm glad you pointed out that I make a lot of mistakes.

[Laughter.]

DR. NORTH: I intend today to try to provide a useful attempt for research that I hope will facilitate improving the performance of the economy generally and [inaudible]. So I'm going to open by some background discussion of the nature of institution, why we need to have a theory of institutional analysis and why the present theories that we've had and that we've inherited from social scientists and [inaudible] economic don't do what we need to have done in order to be able to improve performance.

So let me start off, therefore, with some fundamentals. We know a lot about economic performance. We know--we have evidence about the performance of economies around the world. We have good statistical [audio break] on gross national product, and per capita income, and what they mean and what they don't mean, since they are very imperfect ways of measuring performance.

We also know what it takes to make economic growth. That's very straightforward. Economic development is a function of the productivity of an economy, nothing more and nothing less. If an economy is productive, it's going to be rich. If an economy is not productive, it's going to be poor. Therefore, what we need to know is how to get a country to be productive and therefore realize the potential that we know exists around the world.

Now, we not only know what makes for economic growth--productivity--but we also know the kind of institutions that produce, and generally they are very straightforward, and I'm sure you're all familiar with them. You have to have well defined and specified property rights that provide incentives for people to be productive, and that's the first thing.

Then, you've got to have both a political system that will put in place a legal system and a judiciary that will enforce contracts and agreements of [inaudible] cost, what makes--you've not only got to be productive, but you've got to see that you have the institutional framework to take advantage of that productivity, and that requires that you have third-party measurement of enforcement of contracts and agreements, and you have a way to do that and have it done on a level playing field in the sense that it's open to everyone and not just to a select few.

Now, you may say to yourself I hope you are [inaudible]. If we know all of that, how come we're not all rich? That's a good question. Because it's one thing to know the sources of economic growth. It's another thing to know the kind of institutions you've got to put in place to realize economic growth. There's still something more to know how to get there. So I'm going to spend some time talking about fundamentals. Before [inaudible] address specifically issues that [inaudible] relevant to economic development in Latin America and to some of the issues that are part and parcel of this conference.

Now, why do we need this theory? The answer is straightforward. The theory we've developed in economics was never

designed to tell you how to get economic growth. What we call neoclassical economic theory was designed to talk about how well-developed markets work and how they improve performance of already well-developed markets.

But we have a much more fundamental problem. We've got to know how to create efficient markets, not only economic markets, but first of all political markets because, as I hoped to show you, it is political markets that first put in place the economic rules of the game and enforcement. So if you don't have a policy that in turn is going to encourage putting into place sufficient property rights and a judicial system, you're not going to get them.

The economic theory we have has three [inaudible] for that.

First of all, it's [inaudible]. If you look at one economic theory [inaudible], it assumes markets work perfectly without any resources devoted to making them work, that you don't have any government, you don't have any institutions. You don't need them because everybody knows everything. So the first [inaudible], and a crucial one, is that it's [inaudible], and we've got to overcome that.

The second problem that we face is it's static. The theory we've inherited in economics is concerned with performance of an economy at a [inaudible] time, and therefore the policy implications you derive are policy implications that are once and for all changes that will produce the results you wanted. That doesn't help you a bit. We live in a dynamic world of continuous change, and this dynamic world is one in which you've got to have comprehension of time, of the way [inaudible],

and of history because it's the historical past that constrains the present and the future. So you need to overcome static.

Third of all, economics assumes it's an ergodic world. I always have to go around and usually pause and wait for people to run out and get the dictionary, but I'll save you the time. An ergodic world is a world in which there is a constant underlying structure to, in this case, the economy. So all you've got to do is find what that underlying structure is, and then you build up and you can solve any problem you have with it.

Now, that may be true with the physical sciences, which is where economics inherited that idea. Whether you have chemistry or physics or genetics, if you go back to fundamentals and find out the basic unit, whether it's elements or protons or neurons or genes, and then if you want to solve the problem, you build up on that to confront the problem and deal with it.

We don't have anything like that in social sciences. There is no such thing. In fact, all of the problems and the fundamentals are here in our head, so that the problems in the world of continuous change, not only is it that you've got to be concerned with the dynamics of the problem, but also, and this is much tougher, and this is one where we face really fundamental dilemmas, we're creating new and novel worlds that never existed before. And an assumption that the economics is ergodic is simply wrong. The kind of problems that humans face--and I am an economic historian, and I've written about 10,000 years of economic history--the problems that humans faced back in the neolithic revolution in 8,000 B.C. don't look at all like problems we

get later, still later, and by the time you get to the world we're in, it's a whole different world, completely different, and completely fundamentally got to be rethought.

Now, that doesn't mean that the theory we derived, particularly price theory, which is a very useful tool, that it's useful. It means that we've got to continually modify our theory and modify our understanding of the world so that we're dealing with problems in a contemporary world, many of which are purely novel and have no historical basis for them, which I'm going to come back to.

Now, how do we overcome these problems? Well, [inaudible]. We overcome them by institutions. I'm going to come back and talk about that--static. In static, we've got to incorporate time and how human beings learn over time. In ergodic, it means that we've got to be concerned with fundamental change over time.

Now, there's one other missing element, and it's a missing element that is terribly important. When we economists have borrowed theory to see if we couldn't bring it up to date to apply to solve problems, we naturally turn to evolutionary theory, since evolutionary theory was the closest thing to a dynamic [inaudible] theory, which we could draw from to try and understand our world. And that's been very useful. Indeed, evolutionary theory is now becoming, and rightly so, a useful set of tools to understand process of change in societies over time, but it has two fundamental limitations that are important for us:

One, it assumes that mutation occurs in societies like it does in the evolutionary physical sciences. In evolutionary theory, mutation occurs by sexual combination and mutation of the offspring,

and you get changes therefore that are different. We don't have anything like that in economics and social sciences.

But a much more serious limitation, and one we're going to spend a lot of time on, is that change in mutation in evolution is blind. It is not done with intentionality. It is done, it is purely [inaudible], and you get mutations, and then those that have survival characteristics persist, and the rest disappear.

Human beings don't work like that, and we don't work like that. The heart of understanding and the heart of what you all have to understand, if we're going to improve societal [inaudible], is you've got to understand the intentionality of the equation; that is, we do things with a view that downstream it'll produce results, whoever is making the institutional change, downstream it's going to produce results that will be favorable to the well-being of the people making the change. And therefore human intentionality is the very heart of the thing that we've got to understand.

Well, now, let me spend a little bit of time talking about each of these before I then turn to specifically addressing issues that I think are directly relevant to [inaudible] here and Latin America.

Let me talk a little bit about institutions. Institutions are incentive systems as [inaudible]. It's important to understand that because being incentive systems, they provide a guide to human behavior. So that what they do is they provide punishments and rewards for doing certain kinds of things, and if they provide rewards for being productive and creative, and punish unproductive, uncreative activity, then you get institutions put in place that are what you want.

Now, they're made up of--and this is where it gets complicated--they're made up of formal rules which are constitutions, laws, rules and regulations that are put in place by government, informal constraints, which are norms of behavior, conventions, codes of conduct, which are equally important and much more difficult for us to be able to model and analyze, and finally they're enforced. Now, by enforcement, you've got to have some way by which both the formal rules get enforced and the informal norms of behavior.

Now, let me illustrate my point by showing that I can apply the same set of concepts to very different problems, and I'm going to talk about football, professional sports. It can be your football, which we call soccer in America, or it can be our football, which is football.

[Laughter.]

DR. NORTH: Now, the way football is played, whether it's yours or mine, is played with formal rules that define what players can and can't do, norms of behaviors, such as you're not supposed to deliberately injure players on the opposing team, and enforcement mechanisms, which are umpires and referees, to see that the formal and informal rules are lived up to.

Now, you probably are much nicer than we are in the United States, but let me tell you that professional football in the United States, if you play dirty, you're going to do very well, as long as they don't catch you. Now, that means that the way the game is actually played is very different than the formal structure that we set up. To the degree that you can get away with injuring the key players on the opponent's team, the odds are you're going to win the game.

Moreover, it's very hard to be able to get effective enforcement. The referees don't see everything, and indeed the referees may even be biased or indeed be blind. The norms of behavior may not be strong enough to get people to live up to standards of honesty and integrity that you want. All of those things suggest an important dilemma about institutional analysis that you must keep in the forefront when you're going to do institutional [inaudible], and that is institutions are the best game in town, but they're very imperfect with respect to the way in which they produce the outcomes we want.

And you must, therefore, understand how the formal rules and informal norms and enforcement characteristics that work in particular markets, what makes them work the way they do and what makes them work differently from their intention, and that's the beginning of intelligence. That's the beginning of being able to understand what's happening, and therefore [inaudible].

The kind of research that I'm hoping to encourage you all to do is ones in which you've got to do empirical research on how institutions work in particular markets and why they work the way they do.

Now, static. Now, static, as I said, means that you're concerned with time, and one of the things that is the beginning of wisdom in institutional analysis is to recognize that the constraints that you have today with respect to how you can alter the way the game is played are very, very limited because you've inherited from the past laws, rules, norms and beliefs that you have, and they are what you have to live with. And because you've inherited them, they have built

into them the views of the players and many of the players who feel that their survival depends on the persistence of those rules. So past dependence, which is the cultural heritage you have from the past, which is the function of the beliefs, institutions that you have from the past, tend to be very conservative, and they tend to provide built-in protection for the existing structure.

Obviously, that's at the very heart of the problem we're concerned with. But then if you want to improve institutional performance, you've got to understand your culture, you've got to understand your history, your beliefs, your institutions, and then you can, knowing that, then you can see at what margins and where you can improve performance by modifying the way the game is being played.

So static requirement requires that you understand history, you understand where you've been in order to know where you're going, and you also understand that the heart of what you're concerned with is working; that is, you're trying to learn enough about how your system works so you can understand it, and therefore, understanding it, make some changes in it.

Now, human intentionality, my next criteria, means that you've got to ask yourself how people understand the world around them. Now, economics is, and I [inaudible] believe this, is a theory of choice. And indeed when we teach our students that, we say, well, it's a theory of choice, and what you've got to understand is how people make choices.

The trouble with standard economics is that it assumes that people know everything. The rationality assumption assumes not

only that people are perfectly informed, know all of the alternatives, and act on the basis of pure logical calculus, but more important, and much more difficult, is the belief system people have determines what the incentive structure is that they believe will work.

Now, in Western societies like the United States, we have a belief system which [inaudible] because we have a belief system that says what we want is to reward productivity growth and things like this and the utility functions of the players are [inaudible] provide rewards and punishments that relate to performance. You'll get the right outcome.

But if I go to--I'm not going there, but I might--Iraq--
[Laughter.]

DR. NORTH: I hope I'm not going there. One of the incentive structures that move Muslim fundamentalists, they're different than our incentive structures, and if you don't understand their beliefs and therefore the incentives built into their beliefs, then the kind of institutional change you're going to make is not going to work. So that a crucial part is understanding the belief system of any society that you're going to do and how that in turn affects the incentive structure that's going to work.

Now, there's one more piece to human intentionality, and I don't have time to deal with it. I'm just going to mention it. In economic theory, we assume people are perfectly rational and calculating, and as a result, we can, therefore, say they're logical, and they'll respond, therefore, to all of the kind of incentives that a rational, logical world would have.

How can you explain Muslim fundamentalism? How do you explain in America 9/11, where you have 19 human beings who put themselves into airplanes and blew themselves and 2,500 other people up? We better understand it because we've got to understand why belief systems like that exist, why they produce the kind of outcomes that you get with behavior like that. If we don't, we're not going to be able to solve the problems.

So we're concerned with why belief systems exist, not just religions, generally, but all kind of beliefs, supernatural beliefs, beliefs about all kinds of things, whether they're from the Koran or whether they're from witchcraft. Whatever they're from, we've got to understand them.

So now that we have this background, let's see if we can address some of the issues that I think we've got to deal with in order to be useful to you.

Where does Latin America stand in all of this? In Latin America, you have a long heritage, a heritage inherited from your institutional beginnings, whether from Portugal or Spain, and those institutional frameworks continue to be important features of what you've had [inaudible]. Latin American heritage is one of personal exchange.

Now, why personal exchange? Personal exchange has evolved over the millennium; that is, human beings, when they were hunters and gatherers, gradually evolved a genetic predisposition to cooperate with family, with plans, with small groups that you had an interaction with, but also to be very dubious and very leery about engaging in exchange with people you didn't know.

Now, that was a genetically valuable survival trait in a world of hunters and gatherers, but the heart of what makes economies rich is something that Adam Smith said is so properly portable, and that is specialization, division of labor and the size of the market are the keys to the wealth of nations. But the size of the market requires that you move from personal exchange to impersonal exchange. You've got to develop a structure that can enable you to have exchange with people you don't know, you may never see again, and that they're going to take place over long periods of time and that are going to involve honesty and cooperation in a big way.

For those of you who are familiar with game theory, the analogy is a very simple one. We say the game theory is one in which it pays to cooperate with the other player, when you have repeat dealings with them, when you have small numbers, and we know a lot about them. Also, game theory tells you, you will [inaudible] when you have no more dealings with somebody or they deal with them only once, when you have large numbers of players and when you don't know them.

Now, in personal exchange, it's that kind of a world, and the movement from personal exchange to impersonal exchange is the most fundamental dilemma that exists in economic development in the world. It took the Western World five or six centuries to gradually evolve institutions that made possible a world of impersonal exchange.

And what is that? Well, you've got to have capital markets, you've got to have long-distance trade, you've got to engage in worldwide exchange, you've got to deal with people you're never going to see again, and you've got to develop institutions that will allow you to

do that and make it so that it's worthwhile for the parties to engage in such trade.

Now, personal exchange is natural in the sense it is genetically inherited for the last three or four million years. Impersonal exchange requires not only that we fundamentally alter the way the game is played to get cooperation with people we don't know, but it requires you to know, one, you have a political system that not only will put in place rules that will encourage such development, but you have enforcement mechanisms, judicial systems and a legal system, that will allow you to enforce contracts across time and space so that you can take advantage of those things.

Now, Latin America, I've had some experience in Latin America. The problems of creating efficient markets that are built on impersonal exchange, both political and economic markets, is one which is at the very heart of the problems that you must confront.

Now, turning to the next issue, if that's so, how come the last 30 or 40 years the Washington Consensus has not managed to produce that? That's easy. The theory they used was wrong. The theory that was used to develop policies with respect to the rest of the world or the IMF or the World Bank [inaudible], assumed that a neoclassical model of the world, in which people had perfect information, in which the institutions already existed, and therefore you had all of the essential things. All you had to do was incrementally change things at the margins, and all would be level. A term that was used frequently, all you had to do was get the prices right. If you eliminated price controls, exchange controls, rent controls, everything would work.

Well, that's a lot of "apple butter," to use my favorite expression, and you can translate that any way you want.

[Laughter.]

DR. NORTH: What you've got to do is you've got to have a body of theory that's going to confront these problems, and that body of theory is institutional analysis, which is directly concerned with the kind of institutions and with the kind of belief systems that you've got to confront and understand before you get success.

Now, this means that [inaudible] undergo a fundamental transformation. First of all, you've got to understand how your economy works, and to do that you've got to understand and measure within the costs of human interaction. Now, that's transaction costs. Transaction costs are the costs of measuring and enforcing contracts, whether it's in capital markets or product markets or political systems, and that's the beginning of [inaudible]. Because until you measure, you don't understand what the institutional impediments are to your having low costs in transacting.

But if you start out by finding out what the costs of measurement are, whether it's in the capital market, whether it's in product markets, whether it's in agricultural loans, whatever, then you would be able to confront the issues you've got to deal with.

And so one of the things, and I'm delighted to see that this is a major topic of this conference, is to get at measurement transaction costs so that we can begin to understand exactly what it is that is causing us to have imperfect, and imprecise and inefficient institutions.

Now, that means you've also got to, when you've done the transaction cost measurements, then you're going to have an understanding of how your economy works, and that's the beginning of what you've got to do.

Now, let me give you an illustration from some of my experience in Latin America. I'll just take one illustration from the times I spent in Venezuela. I was invited by the then-President Calavera to come down to Venezuela in the beginning of the 1990s, and his request was a very simple one. He said, "Professor North," he said, and he didn't quite say it in these words, you understand, but he said, "We're broke, but the Venezuelan government owns all of the valuable, productive things in steel, and aluminum, and [inaudible] and so on, and so I want to sell them so I'll have some income. Then, we can do the changes that I need to do." But he couldn't find anyone even to buy them, and that's when he called. He doesn't like economists. He told me that.

[Laughter.]

DR. NORTH: "But," he said, "in spite of your being an economist, can you tell me why nobody wants to buy my assets that I've got?"

Well, it took me about 30 minutes to find out what the problem was. It's very straightforward, and that is the assets were not worth a hoot. That's another expression that doesn't translate properly into Spanish or Portuguese.

[Laughter.]

DR. NORTH: And they weren't worth a hoot because you had the assets were so encumbered by the various impediments that if you bought a steel mill or an aluminum plant or a power plant, you would be saddled not only with the costs of buying that asset, but also with a variety of impediments to your being able to use and draw from them that were just gigantic. I'll just give you one illustration.

At that time in Venezuela, you had severance pay issues in which for every I think it was two days that a worker had worked in a factory, if he quit, he got one day's pay. And therefore if you have a steel mill in which you have workers that have been working for 10 or 15 years, and they were either let go or they left, you'd be obligated for four or five years' worth of income.

Now, that was just one of many such things. So what I tried to persuade President Calavera is you've got to understand that the value of an asset is not only what you can get for it directly, but the encumbrances that go with it are crucial.

And so what you do, therefore, is you've got to, if you're going to be successful in improving performance, what you've got to do is understand the existing impediments. You, first of all, have got to understand the cultural heritage, and I want to emphasize this. You cannot make sense out of any economy by just starting and looking at it fresh.

If I go and give advice to any economy, I spend at least six months learning their history, their belief system, their values, their institutions. Then, when I want to try to make changes, I'll know what margins, incremental margins--because you can't make big changes.

You already have too many vested interests of people wanting to protect existing institutions. But if you begin to, if you understand it enough, you'll know at what margin you can make changes to make the system work better.

So the first issue you've got to do is you've got to be able to understand the existing structure of your economy and the transaction costs. The next question is you've got to understand your heritage, and your history, and your background, so that when you start, and knowing what makes for productivity growth, which we do know, then you want to then try to make at what margin you could change the way the game is played to make it work better.

Now, don't misunderstand me. Having had lots of practice, and being wrong a lot of the times that I [inaudible], why you learn after a while what you can and can't do, but all of that requires that you understand those things.

And what we have to do, what all of you have to do is you've got not only to understand how your economy works, and you've got to understand your history and your background so that you know the past dependent limitations on your being able to make change. Then, you're ready to start to improve the way the game is played, and so that's the major thing.

Let me make a few final comments, and then I'm going to open it up for questions and discussion.

Now, not everybody is an equal status in the society. And, indeed, here in Brazil, you have enormous income distribution problems and inequalities of wealth and income, and you have groups that are

disadvantaged. And here, at this point, you want to modify the market structure to see that you can improve the lot of people that don't have equal opportunity.

Now, in the case of Latin America, in general, and Brazil, in particular, and I don't know enough about Brazil to give you advice, but this is free advice, and it's worth every cent you're paying for it--

[Laughter.]

DR. NORTH: A big problem of that is a necessary condition, is to raise the knowledge and skill level in the countries that have been successful in development from backwardness to economic growth, and have done so at all levels--rich, middle class, and poor all increased performance. South Korea and Taiwan, for example, have done so by enormous investments in education and human skills so that, as you become more productive, all groups in the society share in it. So you're concerned with bringing other groups into the situation.

How do you deal with vested interests that want to block reform? That's obviously the central question, and the only way that you're going to deal with it intelligently is if you know enough about the existing institutions, and the organizations that support the existing institutions, that is, organizations that would be opposed to reform, you've got to understand them because then you'll be able to understand the degree to which you can change the way the game is being played, and that requires intimate knowledge of not only institutions, but the existing organizations and their interest groups, and how the political system works.

Now, all of that means that what you have in Latin America, and everywhere else in the world, is you've got to understand what you're doing. You've got to understand where you've been. You've got to understand the structure of the existing economy, and then you've got to know enough about the way institutions work so that you can modify both the formal rules and the informal norms of behavior and enforcement mechanisms just to make it work more effectively.

I wish you all good luck in doing just that.

Thank you.

[Applause.]

[END OF TAPED RECORDING.]