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Veröffentlichungsversion / Published Version

Zeitschriftenartikel / journal article

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### Empfohlene Zitierung / Suggested Citation:

Diebolt, C. (2011). Does Douglass North Offer an original research agenda to analyse the relationships between education and economic performance? *Historical Social Research*, 36(2), 338-342. <https://doi.org/10.12759/hsr.36.2011.2.338-342>

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<https://nbn-resolving.org/urn:nbn:de:0168-ssoar-342803>

# Does Douglass North Offer an Original Research Agenda to Analyse the Relationships Between Education and Economic Performance?

*Claude Diebolt\**

**Abstract:** »Liefert Douglass North eine originelle Forschungsagenda um die Verhältnisse zwischen Bildung und ökonomischer Leistungsfähigkeit zu analysieren?«. Douglass North offers an interesting alternative when he suggests that institutions and the resulting organisations play an essential role in explaining the economic performance of nations. Among these organisations, as an extension of North's work, we find educational systems and in particular university systems. According to the type of institutions, these organisations act either towards increased competition, innovation, the search for productivity and entrepreneurship, or on the contrary towards rent seeking activities, thus discouraging productive activities.

**Keywords:** North, education, economic performance, cliometrics.

If the proper choice of a model depends on the institutional context – and it should – then economic history performs the nice function of widening the range of observation available to the theorist. Economic theory can only gain from being taught something about the range of possibilities in human societies. Few things should be more interesting to a civilized economic theorist than the opportunity to observe the interplay between social institutions and economic behaviour over time and place (Solow, 1985, p. 329).

As opposed to those authors who belong to the tradition of endogenous growth – who consider that social institutions are irrelevant or at best secondary in analysing development processes – Douglass North seems to offer an interesting alternative when he suggest that the institutional framework and the resulting organisations play an essential role in explaining the economic performance of nations. Regularised interaction schemes are devised to take into account a complexity that standard economics cannot reveal. In more formal terms, institutions are all the rules of the games, or in other words “[...] *the humanly devised constraints that structure political, economic and social interaction.*” (North, 1991, p. 97).

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North stresses how important it is to take transaction costs into account in economic analysis. From his point of view, together with the transformation costs, they define the production costs in the economy.

In 1960, Coase showed that in case there are no transaction costs, the market-based allocation maximises the total product independent of property rights. But as soon as the transaction costs are not equal to zero, this is not the case any more. From that point of view, the transaction costs are expected to increase with the development of the economy, since the increased size of the market entails a growing number of transactions (Coase, 1960).

If game theory shows that it is rather easy to secure cooperation in order to benefit from the profits of exchanges in small groups, this becomes much more difficult in bigger groups (see for instance the one-shot prisoner dilemma). This could be considered as the origin of the emergence of a third party, namely the State, in order to make sure that the contracts are honoured.

Hence the State and institutions in general seem necessary to reduce the unavoidable (irreducible) uncertainty which presides over human interactions. They participate in the process of reducing transaction costs by providing a stable and predictable framework for contractual relations. That is their major advantage. Institutions, set up at the very beginning of social life, are necessarily efficient. It is the balance of power between individuals and the groups forming society which contribute to their definition. Once they are considered satisfying, they crystallise over time. Once they exist, they create a network of incentives among which organisations emerge, which in turn strengthen the resulting institutional structure (cf. David's concept of *path dependence*, 2007).

Among these organisations, as an extension of North's work, we find educational systems and in particular university systems. According to the type of institutional framework, these organisations act either towards increased competition, innovation, the search for productivity and entrepreneurship, or on the contrary towards rent seeking activities, thus discouraging productive activities.

The underlying idea is that efficient institutions are one of the keys of the economic success of a nation: they provide positive incentives for productive activity which means that these organisations all promote the economy. It is therefore essential, in a given economy, to study the nature and evolution of incentives which orientate the action of agents.

From a methodological viewpoint, North takes into account the historical (irreversible) time dimension and proposes a research programme which partially departs from strict methodological individualism. He considers first feedbacks from society to individuals, even if those individuals did set up the institutions in the first place. These institutions limit the choices available to individuals by distorting the nature of the incentives they face. Hence there would be a moderate individualism where individuals would set up institutions in order to reduce the uncertainty attached to their individual behaviours but

where these social set ups would at the same time have an impact on individual behaviours.

We suggest using this approach to account for various phenomena. On the one hand, to understand the origin of institutions of higher education considered as organisation structures looking for their own interests within given structures. On the other hand, to analyse the choices provided by institutions of higher education (structure of training supply) and the decisions made by individuals (student who choose their training areas), in connection with the set of incentives devised by institutions.

North considers that the type of knowledge, skills and learning to which members of an organisation commit themselves reflect the benefits – incentives – integrated in institutional constraints. This process presents increasing outputs. The nature of institutions which govern the functioning of a society influences in a decisive way the type of knowledge which will be looked for. This knowledge might or might not promote economic development. If the basic institutional structure makes the reallocation of wealth (and not production) economically more attractive (profitable), one should expect a very different development of knowledge and skills than in a frame of productivity enhancing activities which would seem more profitable (such as the chemical industry in the 20th century). These are quite extreme examples but as such they constitute ideal-types which account for a large part of economic history.

The general institutional structure is expressed in incentives to acquire one type of knowledge rather than another. This demand leads to the emergence of organisations which try and draw a profit by supplying this type of competence. The supply structure of teaching in turn reflects the incentives to be found within the institutional structure of society. It should therefore be taken into account that the supply of and demand for qualifications are not independent from the more general organisation of society. Moreover a balance between supply of and demand for qualifications does not guarantee an optimal situation as far as long term economic development of a society is concerned. Such a balance might hide two opposite situations.

In the first situation institutions are efficient and devise incentives to act in a way which will promote the development of the productive capacities of a community. In such a framework supply of and demand for qualifications will most likely also promote development. In addition politicians' and voters' perceptions of the value of such an investment will evolve. The final result will reinforce the initial perception of the complementarity between economic performance and investment in growth and the dissemination of knowledge.

In the second situation, institutions are not efficient. They create incentives to acquire knowledge leading to useless or harmful activities for long term economic development. From a historical point of view such would be the case in many third world countries, where many higher education students choose to study law and political science in order to get a job in the administration, which

is the source of low income, prestige and power. The levies on the profit of entrepreneurial activity both by these civil servants as well as by imposed family solidarity have a strong decreasing impact on the incentives connected with this type of activities. A stable situation is thus created in which economic agents, while acting rationally, contribute to maintaining their community in a state of under-development.

This idea is rather old in social thought. Tocqueville (1856) was the first to suggest such an approach. In his book *L'Ancien régime et la Révolution* (The Old Regime and the Revolution), he tried to explain why at the end of the 18th century capitalist agriculture and trade did not develop in France at the same speed as in England. The main reason was that in Ancien Régime France the very level of administrative centralisation meant that the State had more prestige than in England and that State positions were more numerous and more sought after. Hence when a land owner had the choice between staying on his property and striving to improve its output on the one hand and acquiring a royal office in town on the other, he usually chose latter.

According to North, whereas the distribution of knowledge in society can be explained by the theory of investment in human capital, the development of formal education and of the types of socially valued knowledge can be explained by the institutional characteristics of a society. Hence North has his doubts about the self-regulatory capacity of human capital markets. If institutions are inefficient, aggregating individually rational decisions will keep society on a sub-optimal trajectory. This explains how difficult it becomes to implement social change. North's argument could actually be used to argue in some cases in favour of a strong external intervention in order to radically modify the institutions on which the functioning of societies are based.

For North, there are two efficiency concepts. The first one, *allocative efficiency*, is well known by economists, leading to Pareto's efficiency conditions. The other, *adaptive efficiency*, concerns the type of rules which shape the way economy evolves over time and which generate a society's wish and ability to acquire knowledge, to induce innovation, to run risks and to get involved in creative activities.

In order for a society to evolve, it must insist on allowing trials, errors and experimentation in order to learn how to solve problems over time. Decentralised decision making must be encouraged in order to allow society to maximise the efforts required to solve problems which might be either stochastic or systematic, i.e. ideological.

In North's work, institutional rules are strongly influenced by a liberal commitment. Competition, decentralised decision-making and specific contracts and property rights are considered as indispensable elements of a good organisational efficiency. *Laissez-faire* is not necessarily the most adequate solution to guarantee the optimal reacting ability of institutions to society's needs.

For instance, what is the ability of institutions of higher education to react to changing demands of those who make use of their degrees: the State and private firms mainly?

This question is obviously most topical both in France and abroad.

As public means become increasingly limited, they must be used in the most productive way. The production of quasi-public goods, such as education in decentralised institutions suggests that incentives must be devised which guarantee that a product corresponding to the needs and wishes of users will be supplied at the lowest possible cost.

On a more aggregate level, one could also say that public funding of higher education can only be justified in so far as this investment benefits society as a whole, in particular through its contribution to economic performance. One could consider that higher education, which generates externalities, does actually contribute. However not all agree on this point. Some think that one should distinguish between disciplines and some consider that a specific threshold of technical and economic development should be reached before higher education can effectively contribute to growth.

There is another possible explanation which would lie in the role of institutions. Institutions which are not that favourable to the creation of wealth are not favourable either to economic performance (by offering for instance curricula aimed more at extracting rents than aimed at innovation and technology, i.e. humanities against scientific and engineering disciplines). As individual choices will be affected by the same incentives, a situation may arise where the training supply would meet a demand, where educational markets would be balanced and where individual choices would be rewarded by high salaries, but where the talents and the nation as a whole would be trapped in economic under-development!

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