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TOWARD A THEORY OF THE EFFECTS OF THE INTERACTION OF FORMAL AND INFORMAL INSTITUTIONS ON SOCIAL STABILITY AND ECONOMICDEVELOPMENT

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INTRODUCTION

The purpose of this paper is to develop a testable theory, the interaction thesis, capable of explaining why do we observe differences in economic stability and growth rates between various countries; or--the same thing--why less efficient countries do not duplicate economic policies of more successful ones. The new institutional economics provides the basis for the development of the interaction thesis. Analysis identifies the effects of the interaction of formal and informal rules on incentives and transaction costs as a major factor affecting economic stability and growth rates, and the method of choosing formal rules as a major circumstance upon which the consequences of the interaction of formal and informal rules depend.

While the new institutional economics is a fast-growing method for analysis of economic and social issues, it is also a young method still in the process of creating its own mainstream. Some scholars see the new institutional economics as an attempt to enlarge the scope of ability of neoclassical economics to explain a larger class of real world events. Others consider neoclassical economics merely as a point of departure for redirecting economic analysis toward the effects of alternative institutions on economic behavior; Libecap said that "the new institutional economics retains its general attachment to neoclassical economics with its emphasis on individual maximization and marginal analysis, but with attention to transaction costs, information problems, and bounded rationality."[1] This paper is in tune with those scholars who consider the new institutional economics to be a *sui generis* method of analysis, with strong ties to the subjectivism of the Austrian School and the public choice theory.

In the first section of the paper I briefly define the four concepts upon which the interaction thesis rests: formal and informal institutions, property rights, and transaction costs. Then I develop the interaction thesis and consider its effects on social stability and growth. Finally, I turn to the evidence for refutable implications of those effects in Eastern Europe.

WHAT SETS THE NEW INSTITUTIONAL ECONOMICS APART FROM OTHER METHODS OF ECONOMIC ANALYSIS?

We observe that the standard of living, economic stability, and growth rates are not the same in India and Japan, Germany and Portugal, the Czech republic and Ukraine. We notice that exogenous shocks have different consequences in different countries. Opening up of the Americas produced different economic outcomes in Spain and England. The end of colonial rule did more for the standard of living and economic development in southeast Asia than in Africa. The end of communist rule had different effects in the Czech republic and Slovakia, Slovenia and Croatia, Belorus and Estonia. Finally, we observe that the same legal rules have different consequences on economic performance. Douglass North wrote:

> The U.S. Constitution was adopted (with some modifications) by many Latin American countries in the nineteenth century, and many of the property rights laws of successful

[1] G. Libecap, "The New Institutional Economics and Economic Development," Working Paper 15/98, International Centre for Economic Research, Torino, Italy, 1998, p. 4.

> Western countries have been adopted by Third World countries. The results, however, are not similar to those in either the United States or other successful Western countries. Although the rules are the same, the enforcement mechanism, the way enforcement occurs, the norms of behavior, and the subjective models of the actors are not [the same].[1]

Economists have developed a number of competing methods for analysis of economic stability and growth rates. To explain my preference for the new institutional economics, I review here a few analytical methods that have been most frequently used since 1776.

Classical economics. Classical economists understood that social stability and economic growth depend on an increase in knowledge, on private property rights, and on open market competition. Unfortunately, classical economists, specifically David Ricardo, succumbed to the assumption that an increase in knowledge will not be sufficient to offset the law of diminishing returns in the production of goods. Thus, classical analysis failed to predict the sustained economic growth in this century in the West.

Marxism. Karl Marx rejected Ricardo's doomsday predictions. Marx's vision of the ability of scientific progress, which he claimed to be unlimited, to offset the law of diminishing returns turned out to have been right. On the other hand, Marx's economic analysis was quite primitive. Thus, it predicted nothing. Profits in capitalist countries show no tendency to fall, the reserve army of unemployed workers is yet to be born, the ownership of capital has been diffused, and the rate of entry by small firms has been rising. While Marx's predictions about the future of capitalism failed to materialize, his teaching was directly responsible for the socialist experiment, perhaps the costliest experiment in human history.

The Economics of Public Policy and Governmental Controls. In the late 1940s and early 1950s, the majority of intellectuals believed that high growth rates require large public expenditures and substantial governmental controls of the economy. To justify public expenditures and governmental controls, it was necessary to assume that the social welfare function exists, that government leaders know it, and that they can be trusted to implement it selflessly. Each of those assumptions required a second coming of Christ, which failed to happen. Nonetheless, public decision makers developed a variety of public policies, such as codetermination in Germany, planning for growth in the Third World, and activist monetary and fiscal policies in the United States. Predictably, the outcome of public expenditures and governmental controls in the 1960s and 1970s was more unemployment, more inflation, and less growth.[2]

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[1] D. North, *Institutions, Institutional Change and Economic Performance*, Cambridge: Cambridge University press, 1990, p. 101.

[2] Those failures of governmental controls were attributed to a variety of "objective" factors, such as an inadequate resource base, shortage of capital, exploitation by their former colonial rules, and poor economic planning. None of those reasons holds water. (a) As the colonial rule ended in the late 1940s and 1950s, the economies of most countries in Africa and southeastern Asia were much alike. Today, most East Asian countries are doing quite well, while many African countries seem to be in no better economic shape than they were at the time they became independent states. It is becoming increasingly embarrassing for African states to use the colonial exploitation argument, after some fifty years of independence, as an excuse for economic stagnation. (b) Evidence does not support the claim that an inadequate resource base explains a low rate of economic growth. Much depends on what is done with resources people happen to have. To

Neoclassical economics. Neoclassical economics has been the most influential method for analysis of economic issues since the 1930s. It has immensely enriched our understanding of the economic forces at work. However, the basic assumptions of neoclassical economics hamper its ability to explain a wide range of real world events. Those assumptions are maximizing behavior, stable preferences and market equilibrium. The first assumption ignores the transaction costs of identifying and pursuing maximizing behavior; the second assumption ignores that preferences do not exist independently from the knowledge-creating process of exchange through which they are generated; and the third assumption directs analysis away from the process of adaptation and toward the search for unique solutions in a world of many different property rights, positive transaction costs and incomplete knowledge. The ability of neoclassical economics to explain real world observations is then limited. Schotter wrote:

> ...The only institutions existing in [the neoclassical model] are markets of the competitive type in which all information on the economy must be transmitted through the prices formed in these markets. The economy is therefore assumed to have...none of the many social institutions that are created by societies to help coordinate their economic and social activities by offering information not available in competitive prices.[1]

And Coase said:

> The reason why economists went wrong was that their theoretical systems did not take into account a factor that is essential if one wishes to analyze the effect of a change in the law on the allocation of resources. The missing factor is the existence of transaction costs.[2]

New Institutional Economics. Instead of emphasizing "efficiency" criteria and "results," new institutional economics focuses on how alternative institutional arrangements facilitate innovation and "discovery." Increases in knowledge, innovations and other activities create new opportunities for gains. Those potential gains are realized through exchange, which, in a world of uncertainty and incomplete knowledge, is not costless. By reducing the flow of resources into new and more valuable uses, positive transaction costs then threaten to be a limiting factor on the extent of exchange. Analysis must hence answer the question: Which set of institutions provides incentives for transaction costs to be reduced by those who can do it at the lowest costs, so that the gains from exchange could be realized.?

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attribute economic problems in India, Bangladesh and China to overpopulation is refuted by a look at the economic performance of Japan, the Netherlands and Hong Kong. Not too long ago, the Texas plains were among the most uninviting parts of the world. Today, the same area is one of the most affluent regions on earth. Russia and Ukraine are certainly resource-rich and performance-poor in comparison with the Czech republic and Belgium. (c) Economic development is not held back by a shortage of capital. Private capital is a very mobile resource that is highly responsive to higher yield opportunities. It is also highly responsive to risk and uncertainty. Political instabilities, currency controls, restrictions on the right of ownership, noncredible legal institutions, discriminatory taxes, and corrupt governments are holding back the flow of private capital. There has been no shortage of capital in East Asia compared to Africa, or in Hungary and the Czech republic compared to Belorus and Bulgaria.

[1] A. Schotter, "Why Take a Game Theoretical Approach to Economics," *Economie Applique* 36, 1983, p. 675.

[2] R. Coase, *The Firm, the Market, and the Law*, Chicago: University of Chicago Press, 1988, p. 175.

The basic premises of the new institutional economics that set it apart from neoclassical economics are: (1) The incentives effects of the rules and the feedback of their consequences replace the maximization paradigm. (2) The competitive process is a knowledge-creating process. (3) The selection process among discrete institutional alternatives replaces the assumption of a rational agent who is able to identify the market equilibrium in each situation without any learning process.[1] H. Simon wrote:

> [New economic theories] are not focused upon, or even much concerned with, how variables are equated at the margin, or how equilibrium is altered by marginal shifts in conditions. Rather they are focused on qualitative and structural questions, typically, on the choice among a small number of discrete institutional alternatives.[2]

Basic Concepts of the New Institutional Economics

Social activity involves human interactions at two levels. The first is about the rules of the game or institutions, while the second is about the game itself. In this paper I define institutions as the legal, administrative and customary arrangements for repeated human interactions. This definition suggests that the prevailing institutional framework in a society consists of formal and informal institutions; their major function being to facilitate exchange via the predictability of human behavior in a world of uncertainty and incomplete knowledge. Implications for economic analysis are that (1) the rules matter, and (2) changes in the rules change the way the game is played.

Informal Institutions. *Informal rules are traditions, customs, moral values, religious beliefs, and all other norms of behavior that have passed the test of time.* Informal rules are often called the old ethos, the hand of the past, or the carriers of history. They embody the community's prevailing perceptions about the world, the accumulated wisdom of the past and the prevailing set of values. Thus, informal institutions are a part of a community's heritage that we call culture.[3] They are maintained via transmission from one generation to another. Major transmission methods are imitation, oral tradition and teaching.

The enforcement of informal rules takes place by means of sanctions such as expulsion from the community, ostracism by friends and neighbors, or loss of reputation. In the process of enforcing informal rules, tribal chiefs and religious leaders have been (and in some parts of the world still are) known to use more severe forms of punishment.

Formal Institutions. *Formal rules are constitutions, statutes, common law, and other governmental regulations*. They determine the political system (i.e., the governance structure, the individual's rights), the economic system (e.g., property rights, contracts), and the

[1] The rational expectation theory brings the new institutional economics and neoclassical economics close to each other but not together. The rational expectation theory considers the process of adaptation to an optimal solution as a steady trial-and-error process in which the participants are not acquiring new knowledge.

[2] H. Simon, "Rationality as a Process and as a Product of Thought," *American Economic Review*, 68, 1978, p. 6.

[3] D. North, *Institutions, Institutional Change and Economic Performance*, p.37. E. Gellner defined culture as "a distinct way of doing things which characterizes a given community." E. Gellner, *Plough, Book and Sword: The Structure of Human History* London: Collins Harvill, 1988, p. 14.

enforcement system (i.e., judiciary, police). Governmental authorities enforce formal rules by means of sanctions such as fines, imprisonment, and execution.

Property Rights. *Property rights are relations among individuals that arise from the existence of scarce goods and pertain to their use.* They are not about the relationship between individuals and objects. Institutions are like containers which hold property rights. They are the aggregation of property rights that people have in all scarce goods. The most common types of property rights today are private property rights, communal property, and state or public property.

The more property rights in a good the person has, the closer is his or her private cost to the social costs of using that good, and the more incentives that person has to seek the highest-valued use for the asset. That is, different property rights in goods, via their impact on the relationship between private and social costs of using those goods, create their own incentives, which in turn affect human behavior in specific and predictable ways.

Transaction costs. *Transaction costs are the costs of all resources required to transfer property rights from one economic agent to another*. They include the costs of making an exchange (i.e., discovering exchange opportunities, negotiating exchange, monitoring, and enforcement), and the costs of maintaining and protecting the institutional structure (i.e., judiciary, police, armed forces).

THE INTERACTION THESIS

Incentives and transaction costs

From the standpoint of individuals, institutions have their own benefits and costs. The benefit of a rule is the predictability of other people's behavior. The cost of that same rule is the constraints on our own behavior. Those costs and benefits, which differ from one rule to another, create their own incentives and transaction costs affecting human behavior. Informal rules emphasizing the work ethic and thrift create incentives to accumulate wealth. Laws prohibiting abortions create black markets for abortions. The right to capture the entire profit from one's investment enhances risk- taking innovations. Rent controls reduce incentives to maintain privately owned apartments. Privately owned forests need no protection from overexploitation.

The pre-1996 welfare system in the United States is a good example of how institutions affect economic outcomes by way of incentives and transaction costs. *The right to guaranteed income* was the system's most critical rule. It gave single-parent families (predominantly female headed) open-ended claims on the flow of cash and noncash benefits from welfare resources; that is, a welfare recipient had claims on the flow of benefits for as long she maintained eligibility. In 1994, those benefits included about $7,500 in cash and about $5,500 in housing allowances, medical care and other noncash benefits.

The right to guaranteed income created its own incentives. Welfare beneficiaries had incentives to pursue activities that would allow them to remain on welfare indefinitely, such as not looking for employment, disinvesting in human capital and seeking covert work. The rule provided incentives for "outsiders" to seek ways to qualify for welfare benefits. Finally, the absence of time limitations on the flow of welfare benefits created incentives for rent-seeking coalitions to be formed in order to "protect" and "manage" the beneficiaries' welfare rights.

The right to guaranteed income also created its own transaction costs. Those costs included the costs of bureaucracy required to formulate the program, to sell it to the general public, to administer it, and compliance and enforcement costs; the difference between the costs of resources required to provide noncash benefits and the value of those benefits to welfare recipients;[1] and the expenditure of resources that are not even included in the welfare budget, such as the costs of research grants to universities and institutes in support of welfare studies, and police and court costs of enforcing welfare programs.

Institutional Change and Economic Outcome

If the rules affect the way the game is played, changes in the rules must change the game. It is then important to know why and how institutions change. The demand for institutional change comes from those who decide that their benefits from pursuing activities that require institutional restructuring exceed the costs of overcoming the community's resistance. Institutional restructuring may be needed either because prevailing rules prohibit those activities or because new rules would reduce the transaction costs of pursuing them. The following example shows how the development of new opportunities for exchange brought about changes in both formal and informal rules in the United States.

The growth of output coupled with an enormous increase in the range of durable consumer goods changed the opportunity costs (i.e., relative price) of being a homemaker in the United States. But new opportunities for exchange were not in tune with the prevailing informal and formal rules. The prevailing rules expected men to specialize in earning incomes while women were expected to specialize in the efficient spending of that income and in raising children. Single women were socially marginalized. Wives went to work in order to pay some specific bills, between pregnancies, and after kids went to college.

An increase in the supply of females looking for work produced a predictable response in the market for labor. Given the high information costs of identifying career-oriented women, the market treated all women as a high-cost resource relative to men. Pressures on legislators from various feminist groups to equalize money incomes of men and women by fiat (e.g., equal pay for equal work) raised the transaction costs of monitoring and enforcing employment contracts without solving the real issue. The competitive market for labor was not discriminating by sex; it was responding, in a predictable way, to the prevailing rules. In order to capture potential gains from

[1] For example, a rent subsidy that cost taxpayers $4,000 would generally be worth less than $4,000 to the recipient of that subsidy because $4,000 in cash offers a greater range of choices. That is, if the recipient of welfare received $4,000 in cash and chose to spend all or some of that sum of money on other goods, his behavior would reflect that he valued $4,000 worth of housing less than another bundle of goods that $4,000 can buy.

joining the labor force, women had to press for institutional changes. The real issue was to remove the constraints of informal and formal rules, so that the competitive market for labor would have no reason to differentiate between men and women.

With some women earning differential returns at the cost of social ostracism and others following in their footsteps, the pressure for changes in the rules came from within the system. Eventually the rules began adjusting to the new requirements of the game. Today, we observe changes in informal rules which provide social acceptance for the Pill, single motherhood and live-in arrangements as well as changes in formal rules that permit abortions and simplified divorce proceedings. It would be wrong to characterize those changes in formal and informal rules as being brought about by a general decline of the moral standards in the United States. The cause-effect relationship is just the opposite. Changes in the socioeconomic conditions of life required adjustments in the prevailing formal and informal rules so that women could compete in the labor market as equal to men. A major cost of those adjustments in informal and formal rules has been a decline in moral standards.

Formal and Informal Rules: Conflict or Cooperation

It is time to raise an important question: Are formal and informal rules, which together define the rules of the game, in conflict or do they cooperate with each other? The question is not new.[1] What is new is the systematic treatment of the relationship between formal and informal institutions.[2] The following relationships between formal and informal rules are critical for the interaction thesis:

Formal institutions can suppress but they cannot chase out or change informal institutions. McAdams suggests that formal rules can change informal rules.[3] He refers to laws restricting smoking, bans on dueling, anti-discrimination laws in the United States. The problem with the proposition is that we observe many more cases in which formal rules have failed to change or chase out informal rules. Similar formal rules in the United States and South America have produced different outcomes because informal rules in South America have failed to change. Japanese culture has survived American (or Western) laws of commerce. Serbs (and countless other ethnic and religious groups) preserved their informal institutions through five centuries of Turkish formal rules. The rise of "ghettos" in American cities reflected a strong preference of ethnic, racial and religious groups, all living under the same formal rules, to maintain their respective cultures. To accomplish that objective, members of well-defined groups chose to stay close to those whose behavior they could understand and predict.

While it might be possible to identify instances in which formal rules chased out or changed informal rules, it is not clear what analytical purpose is served by looking for exceptions from general

[1] An article by Goetz Briefs was an early attempt to look into the history and development of the relationship between formal and informal rules. See G. Briefs, "The Ethos Problem in the Present Pluralistic Society," *Review of Social Economy*, 15, March 1957, pp. 47-75. I have touched upon the subject in S. Pejovich, "Community, Leadership, and Progress," *New Individualist Review*, 5, Winter 1968, pp. 13-16.
[2] R. Cooter, R. Ellickson, J. Landa, R. McAdams, and others have made major analytical and empirical contributions to the relationship between formal and informal institutions.
[3] R. McAdams, "The Origin, Development, and Regulation of Norms," *Michigan Law Review*, 96, November 1997, p. 349.

observations. An alternative explanation, capable of explaining a larger class of observations, is that informal rules on smoking, dueling and discrimination had already begun changing, so that new formal rules only institutionalized the ongoing process into the legal framework.

Formal rules are in direct conflict with informal rules. The difference between formal rules suppressing informal rules and being in conflict with them is one of degree. Recent developments in the market for afterlife in Russia are a good example of how the conflict between formal and informal rules may arise. The Russian Orthodox Church has had a monopoly in the market for religion since the time of Ivan the Terrible (1547-1584). The Romanovs (1613-1917) used the legal system to protect the Russian Church from competition by other churches. Communists did the same thing by raising the cost of entry into the market for religion. The result was that the Russian Church became (or came to consider itself) the guardian of Russian customs and traditions.

In recent years, many Protestant denominations have found the market for religion in Russia receptive to their packages of religious and ethical norms of behavior. In response to this demand for other religions, the Russian Church wants the state to pass a law prohibiting (or at least seriously restricting) other churches from marketing their services. Otherwise, the Church argues, Russian tradition is going to be Westernized or destroyed, which, in the eyes of the Russian Church are one and the same thing. Of course, the argument is merely the facade of words hiding the Church's true purpose, which is to use the law to preserve its monopoly position at the price of restricting voluntary changes in informal rules in Russia.

Formal rules are ignored. McAdams cites several research papers showing that individuals sometimes find the costs of making informal arrangements lower than the costs of depending on formal rules to resolve specific problems.[1] He discusses Lisa Bernstein's analysis showing that American merchants in general prefer to resolve their disputes without resort to the expensive legal system for enforcing contracts,[2] and Robert Ellickson's research on how ranchers in Shasta County in California "enforce informal...rules for disputes involving cattle trespass and boundary fences and thus resolve certain conflicts without the legal regime."[3] A visit to a village in Montenegro could easily second McAdams' analysis.

Formal rules and informal rules cooperate. Formal and informal rules can and often do co-exist in harmony. Such formal rules are sustainable at low monitoring and enforcement costs. Examples are formal rules protecting one's reputation, formal rules protecting one's life and property, and many others. Research on the development of property rights in the American West is a good example of the state institutionalizing into the legal system informal rules that have emerged spontaneously in response to the development of new opportunities for economic gains.[4]

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[1] *Ibid*., pp. 342-345

[2] See L. Bernstein, "Merchant Law in a Merchant Court," *University of Pennsylvania Law Review*, 144, 1996.

[3] R. McAdams, *op.cit*., p. 345.

[4] See T. Anderson and P. Hill, "Privatizing the Commons: An Improvement," *Southern Economic Journal*, 50, 1983, pp. 438-450; G. Libecap, "Economic Variables and the Development of the Law," in *Empirical Studies in Institutional Change* (L. Alston, T. Eggertsson, and D. North, eds.), Cambridge: Cambridge University Press, 1996.

The Interaction of Formal and Informal Institutions

Thus far, analysis has established that (1) institutions matter; (2) changes in institutions change the way the game is played; (3) the relationship between the rules and the game is reciprocal; (4) institutions develop their own incentives and transaction costs; (5) institutions and economic outcome are linked via the effects of the former on incentives and transaction costs; and (6) when there is a conflict between formal and informal rules, it takes more resources (i.e., higher transaction costs) for individuals to make contracts and for the state to monitor and enforce the legal system. When there is no conflict between formal and informal rules, transaction costs tend to be lower.

How formal and informal rules interrelate substantially determines transaction costs in society. I call this proposition the interaction thesis. It says the following: *If formal rules are in harmony with informal rules, the incentives both create will tend to reinforce each other. A harmonious interaction of formal and informal rules reduces the transaction costs of maintaining and protecting the rules of the game, and frees resources for the production of wealth. When formal rules conflict with informal rules, however, their respective incentives will tend to raise the transaction costs of maintaining and enforcing the prevailing institutional environment, and therefore to reduce the production of wealth in the community.*

Various observations support the interaction thesis. It explains why enormous resources were required to maintain and enforce the communist regimes in Eastern Europe. The interaction thesis explains the differences in economic development between Catholic and Protestant countries in Europe, between North America and South America, as well as the differences in the transaction costs of enforcing anti-abortions laws in religious and less religious communities. Prohibition laws in the United States clearly conflicted with the country's prevailing tradition of social drinking. The Al Capones served the important social function of giving people what they wanted, at a price. Eventually, the high transaction costs of maintaining and enforcing prohibition laws helped to convince the government to eliminate the conflict between formal and informal rules concerning the consumption of liquor. People who went to jail for selling liquor in one year were contributing to the country's GNP the following year.

The verification of the interaction thesis, however, requires more than causal observations; it requires analysis of the process for making both kinds of rules as well as their effects on transaction costs.

Rule Making: Informal Institutions. Informal rules are clearly not a policy variable. Informal rules change primarily through their erosion, which is a slow and time consuming process.[1] Suppose a new idea hits a community, either from outside or originating from within (by someone's design or accidentally). An important economic consequence of the idea would be to enlarge the set of opportunity choices for human interactions. However, if new exchange opportunities were not in tune with informal institutions, the community would consider the behavior of those exploiting

[1] Analysis of the process of change in informal rules could also give us insight into their origins, which we know little about. It is possible that in the pursuit of survival, individuals discovered the importance of human interactions. Thus, they formed small bands which, by trial and error, developed rules for cooperation among members that passed the test of time. Those rules were then institutionalized into taboos, traditions, routine, etc.

those opportunities as submarginal. But if operating below the margin of accepted behavior provided a differential return, the success of those individuals doing so would attract competition from others. And if the returns were substantial enough relative to enforcement costs to generate and sustain a large number of repeated interactions, the demand would arise from within the system for adjusting the rules. Eventually, the very success of new activities would force informal institutions to adjust to embrace the novelty. The behavior that used to be submarginal would then become marginal (or intra-marginal).

Rule Making: Formal Institutions. Formal rules, on the other hand, are a policy variable. They may either change spontaneously or they can be imposed from without.

Formal rules that emerge from within the system should be expected to be in tune with the prevailing informal institutions. Otherwise, contractual agreements leading to the emergence of those institutions would have failed. This means that the interaction between informal rules and formal rules that emerge spontaneously creates low transaction costs. An implication is that the community that provides an environment conducive for human interactions leading to spontaneous changes in formal rules should be a stable and growing community.

Many institutions in the United States, such as the rule of limited liability and property rights in the American West, have emerged spontaneously from within the system. For example, technological development around the time of the industrial revolution made mass production of goods possible, relatively inexpensive, and profitable. However, large amounts of capital were needed in order to exploit new technological opportunities. The then prevailing rule of unlimited liability made the application of new techniques difficult to finance. With each partner held personally liable for the entire debts of the firm, the rule of unlimited liability made absentee ownership costly and restricted equity financing. In response to their desire for additional gains, individuals tried different contractual agreements hoping to find a way to resolve the problem of pulling together large amounts of capital. Some types of contracts were more successful than others and were repeated until, by trial and error, one of them was institutionalized into the legal system. The rule of limited liability became the most effective method yet for voluntary pulling together of large amounts of capital for long-term investment ventures.[1]

Institutional changes that are imposed from without may or may not be in conflict with the prevailing informal rules. It is difficult to develop a method for evaluating the effects of formal rules imposed from without on transaction costs. A promising but a time-consuming approach is as follows:

Suppose the leaders of a country decide to make a major change in that country's formal rules, such as LBJ's Civil Rights Bill of 1964, prohibition laws, rules on abortion, codetermination laws in Germany, or privatization programs in Eastern Europe. A new rule signals the ruling elite's intentions to restructure the prevailing institutional arrangements. However, if that rule

[1] An excellent source on the corporation and the rule of limited liability is F. Easterbrook, and D. Fischel, *The Economic Structure of Corporate Law*, Cambridge: Harvard University Press, 1991, chapters 1-2. For a different analysis of the rule of limited liability see R. Ekelund, and R. Tollison *Mercantilism as a_Rent-Seeking Society*, College Station: Texas A&M University Press, 1981.

is not in tune with informal institutions, people will view it with apprehension, uneasiness and even outright hostility. Higher costs of integrating the rule into the prevailing framework of property relations should be expected to push public policy makers into passing clarifying rules and regulations (hereafter: secondary laws). The purpose of secondary laws would be to bring either basic formal rules more in tune with prevailing customs, traditions, and moral values or to clear the way for their enforcement.

The interaction thesis assumes that the number of secondary laws depends on the reaction of the prevailing informal institutions to the new formal rule. Secondary laws and regulations are costly. First, they consume current wealth. Second, they also reduce the production of wealth in the future by creating a perception of frequent legal changes. The number of secondary laws that have to be passed in support of an important formal rule can be taken as a proxy for its effects on transaction costs. Analysis of the original texts of secondary laws is, then, a step in verifying the interaction thesis.

Political Order and Changes in Formal Rules

The interaction thesis says that economic stability and growth rates depend on whether the prevailing institutions create incentives for the rule makers to enact formal rules that are in harmony with the prevailing informal institutions. Those incentives depend on the prevailing political order. All countries can be classified as belonging to one of four basic types of political order: *liberal democracy*, *liberal autocracy*, *illiberal democracy* and *illiberal autocracy*.[1] Institutions specific to those four political orders create their own incentives and transaction costs, which in turn affect economic stability and growth rates. Let us briefly define those four political arrangements.

Democracy and liberalism are two philosophical concepts underlying those four political arrangements. Democracy is about the right of individuals to organize into political parties, the holding of free and fair elections, and a process of selecting government. The winning party (or coalition of parties) gains power to run the country. Liberalism is about the rule of law and the protection of civil freedoms such as those involving speech, assembly, religion and property.[2] While democracy is about who has power, liberalism is about limitation of government's power. The liberal state is one in which the law protects individual rights against majority rule.

The liberal democracies of the United States, Canada, and Western European countries and those of Hungary and the Czech republic in central Europe differ from each other; sometimes those differences are substantial. Yet, the common denominator for all liberal democracies is that they are best characterized not by free elections but by the rule of law and an impartial judiciary; that is, by stable and credible individual rights. Since the content of individual rights in liberal democracies has to be consistent with the prevailing customs and traditions (otherwise they would not be sustainable), new formal rules in those countries are likely to be either in harmony with or at least not very deviant from informal institutions. The interaction of formal and informal rules in a liberal

[1] For detailed analysis, see F. Zakaria, "The Rise of Illiberal Democracy," *Foreign Affairs*, December 1997, pp. 22-43.
[2] The paper ignores American political jargon which associates the term liberal with large public spending and income transfers.

democracy would then be expected to create, via low transaction costs, economic stability and sustained but not necessarily high or continuos growth rates. A good example is the role of common law in the United States, where old precedents are dropped and new ones are added to the legal system in response to changes in the socio-economic conditions of life. Buchanan said:

> The object of never ending search by loosely coordinated judges acting independently is to find "the law", to locate and redefine the structure of individual right, not ab initio, but in existing social-institutional arrangements.[1]

According to Zakaria, democracies are taking over the world; 118 of the world's 193 countries are democratic. However, the important issue is what happens after the elections. We observe "a spectrum of illiberal democracy, ranging from modest offenders like Argentina to near-tyrannies like Kazakstan and Belorus, with countries like Romania and Bangladesh in between."[2] In those countries, civil liberties are eroded and governments rule by decree (as does Yeltsin in Russia). Illiberal democracy is best characterized by free elections and little respect for the rule of law.

Most countries in East Asia are autocratic. Hong Kong, Singapore, Taiwan, South Korea and Thailand are not democracies but they have given their citizens stable and credible civil liberties. Liberal autocracy is best characterized by the combination of little or no political freedom but stable and credible civil liberties. Perhaps the most classic example of liberal autocracy was the Austro-Hungarian monarchy. Peter Bauer's research on economic and social development in British Africa offers good examples of the effects of a change from liberal autocracy to illiberal democracy on economic stability and growth.[3]

Until the process of decolonization began in the late 1930s, British rule in Africa was based on the principles of limited government, open economy, and non-interference with the authority of tribal chiefs in their villages. In general, the British found it to be in their self-interest to maintain the flow of life consistent with the prevailing informal institutions in Africa. While some tribal chiefs might be more capricious than others, they were all constrained by customs and traditions and by fear of deposition by either tribal councils or the British. A critical consequence of decolonization was that British-educated Africans replaced tribal chiefs. Pursuing either their self-interest or their vision of what was good for their respective countries, or both, new leaders centralized political power, maintained democracy (or semi-democracy) and embarked on economic planning for growth. Being in direct opposition to the prevailing informal institutions in Africa, the behavior of new rulers raised the transaction costs of governance politically (coups, occasional suppression of political parties, falsified elections); socially (tribal wars, corruption, noncredible bureaucracies); and in the economic sphere (failure of economic planning for growth).

Illiberal autocracy means the absence (to various degrees) of both political and civil freedoms. Nowadays illiberal autocracy is being replaced with illiberal democracy all around the globe. Yet,

[1] J. Buchanan, *Freedom in Constitutional Contract*, College Station: Texas A&M Press, 1975, p.46.
[2] F. Zakaria, op.cit., p. 23.
[3] P. Bauer, Black Africa: Free or Oppresses," in *Freedom, Democracy and Economic Welfare* (M. Walker, ed.), Vancouver: Fraser Institute, 1988, 213-223.

we still observe dictatorships in many countries such as North Korea, China, Cuba, and some Gulf states.

THE INTERACTION THESIS AND THE TRANSITION IN EASTERN EUROPE

A useful simplification for analysis of the transition in Eastern Europe is to refer to liberal democracies and liberal autocracies as the rule of law states, and to illiberal democracies and plain dictatorships as the arbitrary states. The former means credible absence of arbitrary use of power on the part of the ruling group, while the latter implies arbitrary use of power by the ruling group. With the exceptions of Hungary, the Czech republic and perhaps Poland and Estonia, all former communist countries in Eastern Europe and the former Soviet Union are arbitrary states.

Implications of the Arbitrary State

As socialist rule ended, East Europeans needed stable rules for carrying out interactions among themselves and with the rest of the world.[1] An important question to which we now turn is whether new formal rules in East European countries, as they interacted with the old ethos, created incentives that raised or lowered transaction costs.

Informal rules in Eastern Europe are not homogenous, but they do have some common traits. The old ethos in Eastern Europe has been largely free of such Western ideas as classical liberalism and methodological individualism. Although those nations that belonged to the Austrian Empire have a more Western tradition than other East European countries, classical liberalism, which is only a part of that tradition, does not have deep roots in the region. The prevailing concept of the community has a strong bias toward collectivism and egalitarianism. Moreover, the communities in the region have developed customs and common values along ethnic lines. Frequently a person's ethnic origin predicts that person's religion--usually Islamic, Roman Catholic, or Eastern Orthodox--reinforcing the differences in customs and values among ethnic groups. Interactions within most ethnic groups are thus subject to rules of behavior that do not necessarily hold in dealings across ethnic lines.

The old ethos in Eastern Europe, then, clashes with capitalist culture, which emphasizes self-interest, self-responsibility and self- determination; puts a premium on the rules that reward performance; cultivates risk-tasking attitudes; values the maintenance of individual liberties; and makes the keeping of promises important in the accumulation of wealth. In 1989, East Europeans needed time to learn that capitalism is not merely an alternative mechanism for the allocation of resources, but a way of life in which individuals voluntarily interact with one another in the pursuit of their private ends and, in doing so, create a culture *sui generis*. Forcing East Europeans to accept the institutions of capitalism, before they had become comfortable with the system's culture inevitably created a conflict with the old ethos.

[1] This section of the paper borrows from S. Pejovich, “Law, Tradition, and the Transition in Eastern Europe,” *The Independent Review*, 2, September 1997, pp. 243-254.

As new leaders in Eastern Europe, with considerable support from the West, used the strong hand of the state to build capitalism, in effect they replaced the old conflict between formal institutions and the region's ethos with a new one. The new conflict created an opportunity for two groups, former nomenklaturists and older people, to seek personal gains via the machinery of the state. Pursuing their self-interest, those two groups have produced some unintended consequences affecting the character of social, economic, and political life in Eastern Europe in the mid-1990s. One such consequence is the rising strength of pro-collectivist parties in the region.

Former Nomenklaturists. As socialist rule ended in Eastern Europe, former leaders had incentives to seek ways to preserve their power and privileges. Their human capital equipped them for seeking advantages in a bureaucratic environment; therefore, the transition to the free-market, private-property system threatened their well-being. To preserve the value of their human capital, former nomenklaturists, while paying lip service to free-market reforms, had to maintain or re-create a state-centered system. They knew that encouraging the perception of an external threat to their respective ethnic groups would give them a good chance to stay in power. Most former nomenklaturists, then, quickly transformed themselves into nationalists. Indeed, most leaders in the multiethnic states of Eastern Europe in the early 1990s were communists. Examples include Milosevic in Serbia, Kucan in Slovenia, Meciar in Slovakia, and Kravchuk in the Ukraine. Doing so was easy for them because nationalism and socialism have one important common trait: the collectivist mode of looking at the world.[1]

Older Workers and Retirees. Under socialism, East Europeans had no opportunity to save and invest in privately owned assets. Instead, the state provided them with assets specific to a non-private property economy, including (1) a variety of welfare benefits such as job security, allowances for children, medical benefits, and subsidized housing; and (2) opportunities unique to the shortages that were a major characteristic of socialist economies in Eastern Europe and the former USSR. Retired people and older workers find the returns from those assets irreplaceable.

Older workers see the institutions of capitalism as a threat to their current and future benefits from the system-specific assets. For good reason, they fear that the reminder of their working life is too short to allow them to replace the lost benefits by means of private saving and investments. Retired people have experienced a decline in the value of their pensions and other benefits. In addition, in the economies characterized by chronic shortages of all consumer goods, retirees were an important asset to their families in two ways. First, they had time to wait in line for consumer goods. Second, they specialized in knowing what goods would be available, where, and when. Thus, retired people raised the real incomes of their extended families. As market-clearing prices replace controlled prices, retired people fear that they will become a liability to their families.

Therefore, older workers and retirees have incentives to perceive the institutions of capitalism as a real threat to the value of their assets. They didn't purchase the socialist welfare package by choice, but that is all they got. Accordingly, many East Europeans, whatever their ideological preference

[1] In general, nationalism embraces the conviction that the community's common good transcends the private ends of its members. This implies that individuals can attain their greatest potential only through their nationality. Nationalism is thus incompatible with individual liberty and competitive markets.

might be, are hostile to capitalism for reasons of self-interest; older workers and retired people tend to support pro-collectivist parties In contrast, young people, who have made little or no investment in the old system's specific assets, strongly support the transition to capitalism.

IN LIEU OF SUMMARY: Institutional Change and Social Stability in Eastern Europe

The imposition of new formal rules that were not in tune with the prevailing informal institutions in Eastern Europe has provided incentives for rent seeking-coalitions to be formed, and those coalitions have played a major role in subverting the transition from socialism to capitalism. Nomenklaturists and old people adroitly exploited the old ethos to their advantage and pushed most East European countries, including those that were part of the former USSR, in the direction of arbitrary states (either illiberal democracies or dictatorships). The current crisis in Russia is but one manifestation of the economic problems in the arbitrary states of Eastern Europe.

Some spontaneous institutional changes have been occurring in Eastern Europe. Of the thousands of small private firms that have sprung up, many have failed or will fail, but many will survive and grow. Those enterprises are performing a vital function that privatized state enterprises do not and could not perform. They serve as the breeding ground for entrepreneurs, a work ethic, a capitalist exchange culture, and positive attitudes toward capitalism in general. They educate ordinary people to appreciate a way of life that rewards performance, promotes individual liberties, and places high value on self-responsibility and self-determination.

The interaction thesis suggests that instead of building capitalism by *fiat*, East European governments should try to provide-admittedly by *fiat*-a legal environment that would allow people to choose among alternative institutional arrangements, that is, to "participate in a market for institutions." This would predetermine neither a specific transition path in Eastern Europe nor the rate of institutional change. As I have argue elsewhere[1], the market for institutions would give people a chance to learn about the institutions of capitalism, try them out, and select those that perform well.

1 S. Pejovich, “The Market for Institutions vs. Capitalism by Fiat: The Case of Eastern Europe,” *Kyklos*, 47, No. 4, 1994, pp. 519-529.

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