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The Effects of the Interaction of Formal and Informal Institutions on Social Stability and Economic Development*

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Introduction

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 the Ukraine. It is also apparent that exogenous shocks have different consequences in different countries. The opening up of the Americas produced varying economic outcomes in Spain and England. The end of colonial rule did more to increase the standard of living and stimulate economic development in Southeast Asia than in Africa. The end of Communist rule had a different effect in the Czech republic than in Slovakia. Finally, we should also note that the same legal rules have different consequences on economic performance. Thus, according to Douglas North,

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

The purpose of this paper is to develop a testable theory—the interaction thesis—capable of explaining why there are differences in economic stability and growth rates between various countries; or, stated negatively, why less efficient countries do not duplicate the economic policies of more successful ones. The interaction thesis identifies the interplay of formal and informal rules as a principal factor affecting economic stability and growth rates. Furthermore, the thesis also sheds light on how the method of choosing formal rules is a major circumstance upon which the interplay of formal and informal rules depends.

The new institutional economics provides the basis for the development of the interaction thesis. In order to explain this author's preference for the new institutional economics, several of the best-known competing alternatives are reviewed in appendix A. In the first section of the paper, a brief definition of the key concepts and ideas of the new institutional economics will be given. Then the interaction thesis will be developed, and its effect upon social stability and growth will be analyzed. Finally, the paper will turn to empirical evidence in order to test for refutable implications of those effects in Eastern Europe.

Basic Premises of the New Institutional Economics

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 view the new institutional economics as an attempt to enlarge the competence 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. Thus, according to Libecap, "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."[2] Many economists, including this author, consider the new institutional economics to be a *sui generis* method of analysis with strong ties to the subjectivism of the Austrian School and Public Choice theory.

Social activity involves human interactions on two levels. The first concerns the rules of the game or of institutions, while the second has to do with the game itself. This paper defines *institutions* as the legal, administrative, and customary arrangements for repeated human interactions. The prevailing institutional framework in a society consists of formal and informal institutions, the major function of which is to facilitate exchange through predictable human behavior in a world of uncertainty and incomplete knowledge. The two implications of that statement for economic analysis are: (1) The rules matter, and (2) changes in the rules change the way the game is played.

Rather than emphasizing the properties of various equilibria, the new institutional economics focuses on how alternative institutional arrangements facilitate economic stability and economic growth. Increases in knowledge, technological 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 without cost. By reducing the flow of resources into new and more valuable uses, positive transaction costs threaten to be a limiting factor on the rate of growth. Yet, further analysis must answer this 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 can be realized? To pursue that and similar issues, the basic premises of our argument are as follows: (1) The effects of incentives on the rules and the feedback of their consequences replace the maximization paradigm; (2) the competitive process creates knowledge; and (3) the selection process among discrete institutional alternatives replaces the assumption of a rational agent who is able to identify market equilibrium in each situation apart from any learning process. Rational expectation theory brings the new institutional economics and neoclassical economics into proximity but not to convergence. Furthermore, rational expectation theorists consider the process of adaptation to an optimal solution as a steady trial-and-error process in which the participants cease to acquire new knowledge. 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.[3]

The four principal concepts upon which the new institutional economics rests are informal institutions, formal institutions, property rights, and transaction costs.

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 a current set of values. Thus, informal institutions are the part of a community's heritage that we call *culture*.[4] They are maintained from one generation to another through various transmission mechanisms such as 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 and individual rights), the economic system (i.e., property rights and contracts), and the enforcement system (i.e., the judiciary and the police). Governmental authorities enforce formal rules by means of sanctions such as fines, imprisonment, and execution.

Property Rights

Property rights are relationships 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. The most common types of property rights today are private property rights, communal property rights, and state or public property rights. Institutions, in this framework, can be seen as containers that hold property rights.

The more property rights a person has in a good, the closer his or her private cost is to the social costs of using that good, and the more incentives that person has for seeking the highest-valued use for the asset. That is, different property rights in goods create their own incentives through the impact they have on the relationship between the private and social costs of using those goods, 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 cost of making an exchange (i.e., discovering exchange opportunities, negotiating exchange, monitoring exchanges, and enforcing agreements) and the cost of maintaining and protecting the institutional structure (i.e., the judiciary, police, and armed forces).

Institutions, Incentives, and Transaction Costs

From the viewpoint of individuals, institutions have their own benefits and costs. The benefit of a rule is the predictability of another person's behavior. The cost of that same rule is the constraint it places on our behavior. Those costs and benefits, which differ from one rule to another, create their own incentives and transaction costs that affect 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 single mothers) open-ended claims on the flow of cash and non-cash 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 non-cash benefits.

The right to guaranteed income created its own incentives affecting both moral standards and the work ethic. Welfare beneficiaries had incentives to pursue activities that would allow them to remain on welfare indefinitely, such as remaining a single parent, not looking for employment, disinvesting in human capital, and seeking covert work. The rule provided incentives for "outsiders" to become single parents. Finally, the prevailing welfare system created incentives for rent-seeking coalitions to be formed in order to protect and enhance welfare rights.

However, the set of incentives arising from the right to guaranteed income created its own transaction costs, including the costs of the bureaucratic overhead required to formulate the program, to sell it to the general public, to administer it, and to enforce compliance. Other examples of such costs include the difference between the costs of resources required to provide non-cash benefits and the value of those benefits to welfare recipients,[5] not to mention the expenditure of resources that are outside of the welfare budget—such as the costs of research grants to universities and institutes in support of welfare studies, and police and court costs for enforcing welfare programs.

Institutional Changes

The relationship between the rules and the game is a two-way street. The rules affect the way the game is played but are, in turn, affected by changes in the economic conditions of life. The following example is suggestive of the relationship between economic growth and institutional change.

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 their 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 standards of morality. In order to capture potential gains from 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 change in the rules came from within the system. Eventually the rules began adjusting to the new requirements of the game. Today, we observe change in informal rules, which provide social acceptance for the Pill, single motherhood, and live-in arrangements, not to mention change in formal rules that permit abortions and simplified divorce proceedings.

It is my thesis that those changes in formal and informal rules are not a consequence of lower moral standards in the United States but the result of economic growth that has created new opportunities for gains. Thus, changes in formal and informal rules were necessary in order to exploit those potential gains. One can think of the social and economic consequences of those changes as the cost of economic growth.

Formal and Informal Rules: Conflict or Cooperation?

We must now address the relationship between formal and informal rules, which is by no means a new question.[6] However, what is new is the systematic treatment of the relationship between formal and informal institutions.[7] The following observable relationships between formal and informal rules are critical for the verification of the interaction thesis.

First, formal institutions can suppress but cannot change informal institutions. McAdams suggests that formal rules can change informal rules.[8] He refers to laws restricting smoking, bans on dueling, and anti-discrimination laws in the United States. An alternative explanation 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. The problem with McAdams' proposition is that we observe many more cases in which formal rules have failed to change 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 and stay close to those whose behavior they could understand and predict.

Second, formal rules are in direct conflict with informal rules. The difference between formal rules suppressing informal rules and being in conflict with them is merely one of degrees. Recent developments in the "religions market" in Russia is 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 Orthodox Church from competition by other churches. Communists leaders abetted this protection by raising the cost of entry into the market for religion. The result was that the Russian Orthodox 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 religious and ethical norms of behavior. In response to this demand for other religions, the Russian Orthodox Church lobbied the state to pass laws prohibiting (or at least seriously restricting) other churches from marketing their services. If this does not occur, the Russian Orthodox Church insists that Russian religious life and culture will be Westernized or destroyed, which, in the eyes of that church, are one and the same thing. Of course, the argument is merely a façade 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.

Third, formal rules are either ignored or rendered neutral. McAdams cites several sources documenting that individuals sometimes find the costs of making informal arrangements lower than the costs of depending on formal rules to resolve specific problems.[9] He discusses Lisa Bernstein's analysis showing that American merchants generally prefer to resolve their disputes without resorting to the expensive legal system for enforcing contracts,[10] and mentions Robert Ellickson's research on how ranchers in Shasta County, California, "enforce informal … rules for disputes involving cattle trespass and boundary fences and thus resolve certain conflicts without the legal regime."[11] A visit to a village in Montenegro could easily confirm McAdams's analysis.

Finally, formal rules and informal rules cooperate. Formal and informal rules can and often do coexist in harmony. Such formal rules are sustainable at low monitoring and enforcement costs. Some examples of formal rules are those that protect one's reputation, one's life and property, and so forth. Research into the development of property rights in the American West is a good example of the state legally institutionalizing informal rules, which emerged spontaneously in response to the development of new opportunities for economic gains.[12]

The Interaction Thesis

So far, our analysis has suggested that (1) institutions develop their own incentives and transaction costs; (2) institutions and economic outcomes are linked through the effects of the former on incentives and transaction costs; and (3) informal and formal rules change because some specific individuals and/or organized groups perceive that their benefits exceed the costs of institutional restructuring. The interaction thesis, which is stated in the following paragraph, derives from those three propositions:

> If changes in formal rules are in harmony with the prevailing informal rules, the interaction of their incentives will tend to reduce transaction costs in the community (that is, the cost of making an exchange and the cost of maintaining and protecting the institutional structure) and clear up resources for the production of wealth. When new formal rules conflict with the prevailing informal rules, the interaction of their incentives will tend to raise transaction costs and reduce the production of wealth in the community.

Various observations support this thesis. For example, it explains why enormous resources were required to maintain and enforce the Communist regimes in Eastern Europe. Furthermore, it explains the differences in economic development between Catholic and Protestant countries in Europe, North America, and South America, as well as the differences in the transaction costs of enforcing anti-abortion laws in religious and less religious communities.

Prohibition laws in the United States clearly conflicted with the country's prevailing tradition of social drinking. People, such as Al Capone, served the important social function of giving people what they wanted but 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. Verification of the interaction thesis, however, requires more than casual observations. It requires analysis of (a) the process for making rules, (b) the rule makers' incentives, and (c) the effects of those incentives on transaction costs.

Rule-Making: Informal Institutions

It is fair to assert that in the pursuit of survival, individuals discovered the importance of human interactions. Some interactions were repeated over and over again—not because individuals understood them but because they worked. Eventually, those interactions that had passed the survival test were institutionalized into taboos, traditions, moral values, beliefs, and so forth. That is why informal rules are not a policy variable. They change primarily through their erosion, which is a slow and time-consuming process. Suppose a new idea hits a community. 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 the prevailing ethos, the community would consider the behavior of those exploiting the 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 to generate and sustain a large number of repeated interactions relative to enforcement costs, the very success of new activities would compel informal institutions to adjust in order to embrace the novelty. The behavior that used to be submarginal would eventually become marginal (or intra-marginal).

Some communities are dominated by informal rules. We call them "traditional" communities. Their major (and predictable) features are social stability and economic stagnation. Peter Bauer's research on economic and social development in British Africa shows that the transformation of traditional communities into the modern state could have a high price tag.

Bauer said that until the process of decolonization began in the late 1930s, British rule in Africa was based on the principles of limited government, an 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 have been more capricious than others, they were all constrained by customs and traditions. A critical consequence of decolonization was that British-educated Africans replaced tribal chiefs. In order to centralize political power and embark on economic planning for growth, the educated elite ignored traditional values in favor of formal rules. Being in direct opposition to the prevailing informal institutions in Africa, new formal rules ended up replacing the old ethos with political corruption, social instability, and economic failures.[13]

Rule-Making: Formal Institutions

Formal rules are enacted, changed, and enforced by legislators, judges, bureaucrats, and other rule-makers. That is, formal rules are a policy variable. New, formal rules may emerge in response to the requirements of the game, or rule-makers could pass new rules in order to change the game. The emerging convention is to refer to the former as *spontaneous changes* or *changes from within* the system, and to the latter as *changes from without*.

Formal rules emerge spontaneously in response to changes in the economic conditions of life (e.g., new markets, new knowledge, new sources of supplies, and so on). Changes in the economic conditions of life create new opportunities for human interactions. To exploit those opportunities, individuals seek new contractual arrangements. Contractual arrangements that pass the market test create the demand for institutional change that promises to lower the transaction costs of exploiting new opportunities. New formal rules that emerge from this process should then be in tune with the prevailing informal institutions. Otherwise, voluntary contractual agreements leading to the demand for adjustments in the rules would not have happened. An implication is that the community that provides an environment conducive to spontaneous changes in formal rules should be both stable and growing. Many formal rules in the United States, such as the rule of limited liability, the right of ownership in the American West, and stock exchanges, have emerged in response to the economic forces at work.[14] Formal rules that are imposed from without (in order to change the game) may or may not be in conflict with informal rules. A great deal depends on the incentive structures under which rule-makers operate and the effect of the prevailing political order upon those incentives.

We can classify all countries as belonging to one of four basic types of political order: liberal democracy, liberal autocracy, illiberal democracy, and illiberal autocracy.[15] Liberalism and democracy are two critical 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 the process of selecting a government. Liberalism is concerned with the rule of law, stable and credible property rights, and civic and economic freedoms. While democracy is concerned with who has power, liberalism focuses on the limitation of government's power. The liberal state is one in which the law protects individual rights against the collective (majority) will. Thus, the liberal state creates incentives for individuals to pursue self-interest, self-determination, and self-responsibility. Two good examples of liberal democracies are the United Kingdom and the United States, where individual rights are generalized from specific decisions (precedents) entered by common-law courts. According to Buchanan, "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."[16] That is, legal precedents tie changes in the rules to changes in the game.

Public Choice scholars have addressed the problem of evaluating the incentive structures of different political orders. However, the evidence for refutable implications of those effects on the behavior of public decision-makers is yet to be developed. A promising approach for evaluating the effects of formal rules imposed from without is described below.

Suppose the leaders of a country decide to make a major change in that country's formal rules, such as Lyndon Johnson's Civil Rights Bill of 1964, or 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 is out of harmony with informal institutions, people will view it with apprehension, uneasiness, and even outright hostility. The higher costs of integrating the rule into the prevailing framework of property relations should force public-policy makers to pass clarifying rules and regulations (hereafter: secondary laws), which attempt to harmonize basic formal rules with prevailing customs, traditions, and moral values, or instead to clear the way for their enforcement.

Secondary laws and regulations consume current wealth. They also reduce the production of wealth in the future by creating a perception of frequent legal changes. Thus, the number of secondary laws that have to be passed in order to clarify and enforce an important formal rule can be taken as a proxy for its effect on transaction costs; that is, the number of secondary laws depends on the reaction of the prevailing informal institutions to the new formal rule.

The Interaction Thesis and the Transition in Eastern Europe

A useful simplification for analyzing the transition in Eastern Europe is to refer to liberal democracies and liberal autocracies as *rule of law states*, and to illiberal democracies and simple dictatorships as *arbitrary states*. The former implies credible absence of arbitrary use of power on the part of the ruling group, while the latter means arbitrary use of power by the ruling group. With a few possible exceptions such as the Czech republic, Estonia, Hungary, and Poland, all former Communist countries in Eastern Europe and the former Soviet Union should be considered as arbitrary states.

The Arbitrary State and Its Implications

As Socialist rule ended, Eastern Europeans needed stable rules for carrying out interactions among themselves and with the rest of the world.[17] An important question to which we now turn is whether new formal rules in Eastern 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 more of a Western tradition than other Eastern European countries, classical liberalism, which is only one 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. This bias raises the transaction costs of identifying and accepting alternative institutional arrangements. Moreover, the communities in the region have developed customs and common values along ethnic lines. Frequently, a person's ethnic origin predicts that the person's religion—usually Islamic, Roman Catholic, or Eastern Orthodox—will reinforce basic differences in customs and values among ethnic groups. Interactions within most ethnic groups are thus subject to rules of behavior that do not necessarily apply in dealings across ethnic lines.

The old ethos in Eastern Europe, then, clashes with capitalist culture, which emphasizes self-interest, self-responsibility, 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 for accumulating wealth. In 1989, Eastern 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 so doing, create a culture *sui* *generis*. Forcing Eastern 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.

As new leaders in Eastern Europe, with considerable support from the West, used the strong hand of the state to build capitalism, they basically replaced the old conflict between Socialist 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 through the machinery of the state. However, by pursuing their self-interest, those two groups produced some unintended consequences that have affected the character of social, economic, and political life in Eastern Europe since 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 recreate 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 multi-ethnic 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. Switching to capitalism was easy for them because nationalism and socialism have one important common trait, namely, the collectivist mode of looking at the world.[18]

Older Workers and Retirees

Under socialism, Eastern Europeans had no opportunity to save or to 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 remainder of their working life is too short to allow them to replace the lost benefits by means of private savings and investments. Retired people have experienced a decline in the value of their pensions and other benefits. Moreover, in 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.

Older workers and retirees have incentives to perceive the institutions of capitalism as a real threat to the value of their assets. They did not purchase the Socialist welfare package by choice, but that is all they received. Accordingly, many Eastern Europeans, whatever their ideological preference, are hostile to capitalism for reasons of self-interest. By 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 a Conclusion

The imposition of new formal rules that were not in harmony 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 elderly people have adroitly exploited the old ethos to their advantage and pushed most Eastern 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.

Nevertheless, 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 a high value on self-responsibility and self-determination.

The interaction thesis suggests that instead of building capitalism by fiat, Eastern 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 argued elsewhere,[19] 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. Silke Stahl has aptly summarized this notion:

> The transition process in Middle and Central Europe has clearly not been entirely spontaneous, yet the diverse outcomes of the transition processes in various countries also show that it is not feasible to design an economic system on a drawing board; prior developments constrain future change.[20]

Appendix A: Alternative Methods for Economic Analysis

Classical Economics

Classical economists understood that social stability and economic growth depend on an increase in knowledge, private property rights, and 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 of the West throughout the twentieth century.

Marxism

Karl Marx rejected Ricardo's doomsday predictions. Marx's vision of the ability of scientific progress to offset the law of diminishing returns was correct. On the other hand, Marx's economic analysis was quite primitive. Thus, it explained little and 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, which was perhaps the costliest experiment in human history.

Keynesian Economics

In the late 1940s and early 1950s, the majority of intellectuals believed that high growth rates required 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. Predictably, the outcome of public expenditures and governmental controls in the 1960s and 1970s was higher unemployment, higher inflation, and less growth.

Planning for Development

Failures of public policy in less-developed countries were attributed to a variety of "objective" factors such as an inadequate resource base, shortage of capital, exploitation by their former colonial rulers, and poor economic planning. None of those reasons is fully adequate. As colonial rule ended in the late 1940s and 1950s, the economies of most countries in Africa and Southeast Asia were nearly equal. Today, however, most East Asian countries are doing well, while many African countries seem to be in no better economic shape than they were at the time they became independent states. Evidence does not support the claim that an inadequate resource base explains the low rate of economic growth. Much depends on what is done with the resources people happen to have. To 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. In comparison with the Czech republic and Belgium, Russia and the Ukraine are resource-rich but performance-poor. Economic development is also not held back by a shortage of capital. Political instabilities, currency controls, restrictions on the right of ownership, non-credible legal institutions, discriminatory taxes, and corrupt governments hold 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.

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 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 limited, according to Schotter:

> 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.[21]

Notes

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1. Douglas North, *Institutions, Institutional Change and Economic Performance* (Cambridge: Cambridge University Press, 1990), 101.

2. G. Libecap, *The New Institutional Economics and Economic Development: A Working Paper* (Torino, Italy: International Centre for Economic Research, 1998), 4.

3. H. Simon, "Rationality As a Process and As a Product of Thought," *American Economic Review* 68 (1978): 6.

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

5. For example, a rent subsidy that cost taxpayers $4000 would generally be worth less than $4,000 to the recipient of that subsidy because $4000 in cash offers a greater range of choices. That is, if the recipient of welfare received $4000 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 $4000 can buy.

6. 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 Goetz Briefs, "The Ethos Problem in the Present Pluralistic Society," *Review of Social Economy* 15 (1957): 47–75. I have touched upon the subject in Svetozar Pejovich, "Community, Leadership, and Progress," *New Individualist Review* 5 (1968): 13–16.

7. R. Cooters, R. Ellickson, J. Landa, R. McAdams, and others have made major analytical and empirical contributions to the relationship between formal and informal sanctions.

8. R. McAdams, "The Origin, Development, and Regulation of Norms," *Michigan Law Review* 96 (1997): 349.

9. Ibid., 342–45.

10. Lisa Bernstein, "Merchant Law in a Merchant Court," *University of Pennsylvania Law Review* 144 (1996): 144.

11. McAdams, "The Origin, Development, and Regulation of Norms," 345.

12. See T. Anderson and P. Hill, "Privatizing the Commons: An Improvement," *Southern Economic Journal* 50 (1983): 438–50; G. Libecap, "Economic Variables and the Development of the Law," in

Empirical Studies in Institutional Change, eds. L. Alston, T. Eggertsson, and D. North (Cambridge: Cambridge University Press, 1996).

13. P. Bauer, "Black Africa: Free or Oppressed?" in *Freedom, Democracy and Economic Welfare*, ed. M. Walker (Vancouver, BC: The Fraser Institute, 1988), 213–33.

14. 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, Mass.: Harvard University Press, 1991), chaps. 1–2.

15. For a detailed analysis, see F. Zakaria, "The Rise of Illiberal Democracy," *Foreign Affairs* 76 (December 1997): 22–43. Liberal democracies 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. The main features of liberal autocracies, such as Hong Kong (before the city was taken over by China), Singapore, and Tiawan are few political freedoms, the rule of law, and credible individual rights. Illiberal democracies, which are characterized by free elections and little respect for the rule of law, are taking over the world; 118 of the world's 193 countries are democratic. In those countries, civil liberties are eroded and governments rule by decree (as does Yeltsin in Russia). We observe "a spectrum of illiberal democracy, ranging from modest offenders like Argentina to near-tyrannies like Kazakhstan and Belarus, with countries like Romania and Bangladesh in between." Ibid., 23. The main features of illiberal democracies, such as North Korea, China, Cuba, and some Gulf States, are the absence (to various degrees) of both political freedoms and individual rights.

16. James Buchanan, *Freedom in Constitutional Contract* (College Station, Tex.: Texas A&M Press, 1975), 46.

17. This section of the paper borrows from Svetozar Pejovich, "Law, Tradition, and the Transition in Eastern Europe," *The Independent Review* 2 (1997): 243–54.

18. 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 national identity. Nationalism is thus incompatible with individual liberty and competitive markets.

19. Svetozar Pejovich, "The Market for Institutions Versus Capitalism by Fiat: The Case of Eastern Europe," *Kyklos* 47 (1994): 519–29.

20. Silke Stahl, "Transition on the Spot: Historicity, Social Structure, and Institutional Change," forthcoming, 8.

21. A. Schotter, "Why Take a Game Theoretical Approach to Economics?" *Economie Applique* 36 (1983): 675.