HOW DOES GOOD GOVERNANCE COME ABOUT? ON EVOLUTION OF INSTITUTIONS

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Abstract

Economic welfare rests on entrepreneurs, competition, and good governance. All three have a positive effect if embedded in a set of good institutions. Major question here is: how do we get good institutions? The paper concentrates on the example of governance. Good institutions and good governance are not solely the result of discrete policy decisions; as far as beliefs and informal rules are concerned, they are also the result of an evolutionary process of *longue durée*. The core of the paper is a discussion of evolutionary institutional change. Three theoretical approaches are discussed: the Marx-Schumpeter approach and its neoclassical offsprings, a further extension by the Stanford economists Aoki and Greif, and Hayek's 'spontaneous' evolution. Change at the institutional frontier and imitation or catching up to the institutional frontier seem to be different processes. Why countries fail to catch up constitutes a challenging puzzle, for incumbent institutions show a remarkable persistence. Findings are illustrated by developments in post-socialist transformation.

Keywords: Institutions; institutional change; evolution; governance transformation

1 Introduction

According to the Marx-Schumpeter theory of development, the dynamics of a capitalist economic system depends on entrepreneurship which develops in a market context and is stimulated by competition in the market. At the same time, more recent research has suggested that the functioning of the market, and the entrepreneurial activity accompanying it, depends on the actions of the state, in particular good governance. As a corollary, economic welfare rests on entrepreneurs, competition, and good governance.

An entrepreneur is either leaving the trodden paths of equilibrium and exploring new combinations,[1] or he is trying to benefit from arbitrage opportunities of existing disequilibria.[2] Whilst the former destroys the equilibrium, the latter restores it. The former type can be compared to an adventurer, the latter more to a speculator. It is largely the adventurer who is referred to when one speaks of an entrepreneur. Entrepreneurship is an individual property of which we know little. It would appear innate; it is simply *there*. It is exogenous to economic theory.

Whether the individual property of entrepreneurship will develop, and in which direction, depends on its environment, in particular on the institutional structure of the society in which the individual is living. This is because institutions determine the pay-off of individual activity, and entrepreneurs, like anyone else, are striving for the highest pay-off. Take, for instance, the Soviet economic system, which did not allow for private enterprise. Entrepreneurial capacity had to move into the shadow of economy or deploy its energy within the ranks of the party. Even more important for economic welfare is the choice between productive and redistributive activity. If the rewards of rent-seeking, piracy, or corruption are expected to be higher than the profits from productive enterprise, it will be rent-seeking, piracy, or corruption that attracts most of the entrepreneurial talent.

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[1] J. A. Schumpeter, *The Theory of Economic Development* (1911/1934).

[2] I. M. Kirzner, *Competition and Entrepreneurship* (1973).

It has become common to define institutions 'as the constraints that human beings impose on themselves'.[3] Such constraints can be formal in nature, such as rules of the game and laws, or they can be informal, such as customs, traditions, and codes of conduct. The effectiveness of constraints depends not only on the respective norm, but equally on the mechanism of its enforcement. Despite their evident relevance, informal constraints are poorly understood, especially their enforcement mechanisms.[4] The state, with its monopoly of legal use of force, is the primary organisation that can enforce formal constraints effectively. However, the state is inconsistent; it may produce either good or bad governance. It may provide for a productive environment channelling entrepreneurial activity into welfare enhancing enterprise. If not properly kept in check by a constitution, the media, or the citizenry, the state can also be used as an instrument for redistributive activities.

The major question here is: how do we ensure good institutions? Little insight is needed to notice the huge gap between highly productive developed societies and less developed countries with a low level of welfare. Although there have always been differences between richer and poorer countries, this huge gap only appeared around 250 years ago (i.e. it is the consequence of modern economic growth).[5] A sanguine interpretation of this fact may point to the rather brief history of modern economic growth, for reason of which it would appear to be natural that some regions developed the factors conducive to economic growth, whilst others lagged behind, adapting slow to the new conditions. In terms of Schumpeter's dynamics, some enterprising nations have found new combinations and thereby broken up the old equilibrium. A new equilibrium will be restored by imitation and adaptation. The recent surge of catching-up by China, India and Brazil may be seen as confirmation of this view. However, if good institutions are part of the new combinations, a major question remains: why did it take 250 years to turn the trend? What can a less developed society do in order to embark on the path of welfare growth? And, if we know what will promote welfare growth, why can it not be implemented immediately?

The obvious answer to this question would be that good institutions and good governance are not solely the result of discrete policy decisions; as far as beliefs and informal rules are concerned, they are the result of an evolutionary process of *longue durée*. This paper attempts to justify such an answer. Of course, we cannot address the whole range of beliefs and institutions, but will concentrate on good governance as an example of political activity based on a certain set of good institutions. We will then look at theories of institutional change that are more elaborate with respect to formal rules. There are two types of theories, decision-based and evolutionary, which are both still rather tentative. The *longue durée* of evolution and the tenacity of informal rules does not signify that policy is powerless, but rather, that one has to be patient.

2 Good Governance

For the sake of clarity, we have chosen governance as an example of a set of institutions with a distinct impact upon economic welfare. Although this term may be new, the concept has been known for a long time. Kaufmann, Kraay and Zoido-Lobatón define governance as 'the traditions and institutions by which authority in a country is exercised. This includes (1) the process by which governments are selected, monitored and replaced, (2) the capacity of the government to effectively formulate and implement sound policies, and (3) the respect of citizens and the state for the institutions that govern economic and social interactions among them'.[6] To test the relevance of governance, it has to be measured. It is a major achievement of a World Bank team working with Daniel Kaufmann to have produced a set of six aggregate governance indicators that

[3] D. C. North, *Institutions, Institutional Change and Economic Performance* (1990), at 5.

[4] E. Schlicht, 'On custom', 149 *Journal of Institutional and Theoretical Economics* 1 (1993).

[5] Hans-Jürgen Wagener, 'Why Europe? On Comparative Long-term Growth', 6 *The European Journal of Comparative Economics* 2, at 287-323 (2009).

[6] D. Kaufmann, A. Kraay, P. Zoido-Lobatón 'Governance Matters', *World Bank Policy Research Working Paper 2196*, (1999).

have been calculated for, to date, 213 countries of the world over the period 1996-2009.[7] The method is complicated and is not significant in the context of this paper.[8] Suffice it to say that the indicators combine statutory rules on the books (i.e. formal institutions) with their implementation on the ground which is heavily influenced by informal institutions or traditions as the authors have called them.

The six dimensions of governance are:

- voice and accountability
- political stability and absence of violence
- government effectiveness
- regulatory quality
- rule of law
- control of corruption.

The institutional quality is clarified when it is exemplified in the antithesis between good governance and bad governance. This combines formal and informal institutions, policies, and actual conduct:

Good governance	***Bad governance***
Voice and accountability	*Political instability and violence*
Participation	unconstitutional conduct
democratic rights	interference of the military
freedom of press	political terrorism
government effectiveness	*regulatory burden*
transparent administration	incompetent personnel
credibility	market unfriendly policies
ability to compromise	Ineffective judicial control
rule of law	*Graft*
enforceability of contracts	Corruption
predictability of courts	state capture
respect of the institutions	rent seeking

Briefly summarised, good government is democratically legitimised, effective, and credible, whereas bad government is unpredictable, costly, and corrupt. Such attributes are created not only by formal institutions and their implementation, but also, to a considerable extent, by informal institutions, attitudes, and culture. Good governance implies good order, good policies, and the readiness of state officials and citizenry alike to honour the rules, traditions, and values. 'Good' can mean two different things in this context. Good order and good policies are state of the art as far as social science is able to define them. They can also be described procedurally, implying universal in contrast to particular measures, with impartiality as principal norm.[9]

The direct effect of good governance is a certain congruence between political intentions and their implementation, in the same manner as good management in a company enhances the commitment and productivity of the employees. This in itself does not guarantee welfare, since political intentions can be badly conceived as a result of, for instance, lack of knowledge and information. However, we know of no state that constitutionally supports corruption, whilst we know of many states where corruption

[7] <http://info.worldbank.org/governance/wgi/index.asp>.

[8] But see D. Kaufmann and A. Kraay, 'Governance Indicators: Where Are We, Where Should We Be Going?', 23 *The World Bank Research Observer* 1, at 1-30 (2008). Pertinent criticism can be found in S. Voigt, *How (Not) to Measure Institutions*, Paper Prepared for World Bank Workshop on Governance Indicators, Washington, DC, June 2008, available at <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1336272>.

[9] Such is the definition of B. Rothstein, *The Quality of Government. Corruption, Social Trust and Inequality in International Perspective* Chicago (2011), at Chapter 1.

is nevertheless highly prevalent. The indirect effect is a feed-back either from welfare, or from the experience of loyalty and constancy of rules, upon preferences, values, and beliefs of the actors. This influences their strategies and policies by which they determine not only their actual behaviour, but also choices concerning constitutional order and economic policy proper.[10]

The aforementioned feed-back effect demonstrates the difficulty in ascertaining an unambiguous causal link between good governance, or institutions in general, and economic welfare.[11] Since good governance develops, as will be seen, over a rather long period of time, we can only establish a kind of co-evolution for both good governance and welfare. Its result, however, is strikingly clear. The World Bank team gives a ranking (from 0 to 100) for the six governance dimensions. In the following table we have aggregated them by a simple arithmetic average. As illustration we compare the results from the 13 highest-ranking countries (very small countries omitted) and 13 lowest-ranking countries and their GDP per capita (at purchasing power parity).[12]

Table 1: Average Ranking of Governance Quality and GDP per capita

Country	Average ranking GI	GDP per capita in 1990 intern. $	Country	Average ranking GI	GDP per capita in 1990 intern. $
	2009	*2008*		*2009*	*2008*
Austria	93.2	24 100	Afghanistan	3.0	900
Australia	92.5	25 300	Burma	2.2	3 100
Canada	94.5	25 300	Chad	6.3	700
Denmark	97.0	24 600	Haiti	15.7	700
Finland	98.0	24 300	Iran	14.5	6 900
Germany	90.2	20 800	Iraq	7.5	1 000
Netherlands	94.5	24 700	North Korea	7.7	1 100
New Zealand	96.3	18 600	Somalia	0.3	1 000
Norway	95.7	28 500	Sudan	5.7	1 500
Sweden	97.0	24 400	Uzbekistan	11.7	5 300
Switzerland	96.2	25 100	Venezuela	12.0	10 600
UK	86.2	23 700	Zaire	3.8	250
USA	83.5	31 200	Zimbabwe	3.8	800

Sources: http://info.worldbank.org/governance/wgi/pdf/wgidataset.xls; http://www.ggdc.net/maddison/Historical_Statistics/horizontal-file_02-2010.xls; and own calculations.

The table needs little explanation.[13] It has to be kept in mind that the statistics are mean values of estimates with certain standard deviations. At 250 international Dollars of 1990 per annum, the population of Zaire could hardly survive. This figure indicates an absolute welfare minimum. Bad governance can be compensated to a certain degree by a richness in natural resources, as the cases of Venezuela and Iran would suggest. The other countries on the right side of the table encompass stories of political turmoil,

[10] Again, we may refer to Rothstein who shows that generalised social trust presupposes the experience of impartial activity of the administration. This seems obvious, for if we expect the administration to be corrupt and corruption to be the general rule, we cannot trust other people to treat us fairly. See B. Rothstein, *Social Traps and the Problem of Trust* (2005), at 109.

[11] M. Paldam and E. Gundlach, 'Two Views on Institutions and Development: The Grand Transition v. the Primacy of Institutions', 61 *Kyklos* 1 (2008).

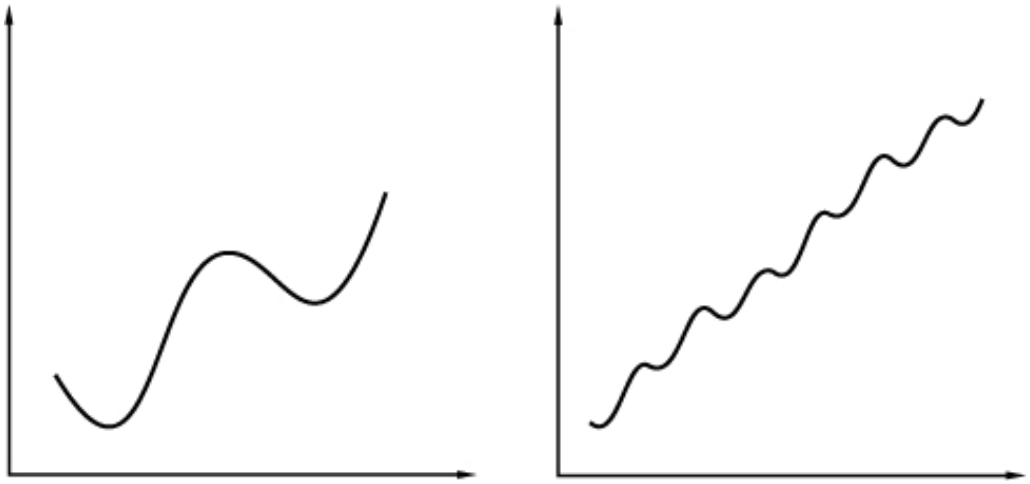
[12] For the method see A. Maddison, *The World Economy. A Millennial Perspective* (2001) and A. Maddison, *The World Economy: Historical Statistics* (2003).

[13] Although one should not dismiss too lightly the criticism that the governance indicators, being mostly based on subjective evaluations, will probably not be independent of the level of development. See Voigt, above n. 8.

dictatorship, and economic incompetence. In contrast, the high convergence of well-governed countries on the other side indicates that such nations operate at the welfare and governance frontier.

The table might evoke the idea of two equilibria: good governance and bad governance. However, this would be erroneous. If anything, we are confronted with a multi-equilibria situation. Between the two extremes shown in the table there is a more or less equally distributed continuum of the remaining 187 countries covered by the World Bank team. There are gradations of bad governance and the ranking of individual countries may vary over the (admittedly extremely short) period of observation, but with few exceptions, the relative position of the countries hardly changes. The following figure illustrates the two-equilibria and the multi-equilibria situation, with the troughs representing stable equilibria and the peaks representing unstable equilibria. The multi-equilibria situation can be considered more hopeful, since the distance and height of the rim between two adjacent cases are less difficult to overcome.

Figure 1: Multiple Equilibria of Governance and Welfare



An autocratic or cleptocratic governing elite may benefit from the situation even under very poor conditions, and try to perpetuate it by force. Generally, it can be assumed that both the governing elite and the population see the advantage offered by good governance. This assumption gives rise to the question: how was it possible that we do not have good governance and what is to be done to get it? This brings us to the problem of the emergence of institutions and institutional change.

3 Institutional Change and Evolution

Since Menger,[14] two paths have been identified through which social and economic institutions are developed:

- the pragmatic
- the organic.

Pragmatically constructed institutions are always the result of deliberate decisions or some kind of rational choice. Many institutions, in particular informal ones, are not derived from pragmatic construction but are unintended results of historical development. Menger was vague concerning the cause of pragmatic changes and how organic changes were brought about. He went to great lengths, however, to show that any analogy of natural phenomena and social phenomena, in particular organic ones,

[14] C. Menger, *Untersuchungen über die Methode der Socialwissenschaften und der Politischen Ökonomie insbesondere* (1883).

is understandable, but quite misleading.[15] Firstly, pragmatic institutions cannot be explained by an organic analogy; if anything, they would be explained by a mechanistic analogy. Secondly, analogy is only an unspecified feeling of similarity. And thirdly, the origin of institutions follows its own rules which are the rules of collective decision-making in the case of the pragmatic, and are 'the unreflected result of human activities that are aimed at basically individual intentions (i.e. the unintended outcome of the latter)'[16] in the case of the 'organic'. The origins of social phenomena and natural organisms are essentially different, with the distinction lying in the intentionality of the former.

Menger's examples of 'organic' institutions encompass the law in general, language, the state, money, and markets, all of which evolved in a distant past and are now well-entrenched. It is certainly true that money, for instance, is the product of historical development. Today's supply and regulation of money, however, is clearly a pragmatic process. The processes that govern the historical origin of social institutions need not be the processes that govern contemporary institutional change. What we need, therefore, is some more theory of both.

It is worth noting that Menger, although well acquainted with Darwin, carefully avoids the term 'evolutionary' and lists Herbert Spencer, the first social Darwinist, as among those who erroneously stress the naturalistic analogy. Indeed, since according to Darwin, purpose, planning, teleology and intentionality have no place in the evolution of species, economic evolution, as seen by mainstream economics, has nothing in common with Darwin. As Douglass North recently put it: 'In contrast to Darwinian evolutionary theory, the key to human evolutionary change is the intentionality of the players'.[17] This begs the question of what economic evolution or human evolutionary change really means.

Evolutionary economics, along with other forms of evolutionary social science, is a topical issue. Witt has shown that people can mean different things when using the term.[18] Evolution of nature, society, or the human mind consists of change resulting in the creation of new capacities and their dissemination.[19] From this it follows that pragmatic as well as organic institutional change can be termed evolutionary. What triggers the development process, who or what creates novelty, and by which processes or mechanisms new combinations are spread, may be specific to the field where evolution is observed. Menger and North, for instance, emphasise that the evolution of social institutions is always the result of deliberate human activity, which in natural evolution of the Darwinian type is clearly not the case. Intentionality of the players, however, only constitutes a distinctive feature if individuals possess a free will and act in a controlled way. This is an age-old philosophical question and presently a much-discussed topic amongst neuroscientists.

The development of the mind is governed by natural evolution. Yet it is hard to tell where, in this process, the dividing line between nature and civilisation should be drawn. Firstly, if the environment shapes the mind, natural and social phenomena will be of equal importance. Secondly, the infant industry of neuroeconomics has already shown us that alongside controlled processes, many activities are driven by automatic processes which do not follow from a preference – constraints calculus: 'As economists, we are used to thinking of preferences as the starting point for human behaviour and behaviour as the ending point. A neuroscience perspective, in contrast, views explicit behaviour as only one of many mechanisms that the brain uses to maintain homeostasis, and preferences as transient state variables that ensure survival and reproduction'.[20]

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[15] Id., at 142-146.

[16] Id., at 145. Therefore the denomination *organic* is somewhat unfortunate. Hayek, although following Menger quite closely, avoids it.

[17] D.C. North, *Understanding the Process of Economic Change* (2005), at Chapter 8.

[18] U. Witt ,'What is specific about evolutionary economics?', 18 *Journal of Evolutionary Economics* 5, at 547-75 (2008).

[19] Id., at 552.

[20] C. Camerer, G. Loewenstein and D. Prelec,'Neuroeconomics: How Neuroscience Can Inform Economics', 43 *Journal of Economic Literature* 1, at 27 (2005).

Although this does not deny the relevance of intentionality, it serves as a warning not to overemphasise it.

4 The Marx-Schumpeter Approach

In recent years, a number of attempts have been made to explain institutional change.[21] Economists, trained in rational choice models, concentrated upon the pragmatic case. Only after realising the importance of informal institutions, in particular of value and belief systems that evidently cannot be changed by deliberate decision-making, the 'organic' case attracted some attention. In an ideal neoclassical world, which equates to perfect and costless information and no transaction costs, institutions do not matter for the purposes of allocative efficiency. However, this state has nothing in common with economic reality, characterised by uncertainty and positive information and transaction costs. It was Ronald Coase who first took account of this state of affairs.[22] This was also the beginning of modern institutional economics.

Amongst the first economists to deal with institutional change was Karl Marx in his vision (it can hardly be called a theory) of historical materialism.[23] This is based on exogenous changes of knowledge and consequently production techniques. Such changes open up new profit opportunities which are, however, in conflict with existing property relations. These have to be changed to benefit from the new opportunities. With the change in property relations, the whole system of legal, political, and social relations, as well as, finally, the belief systems, will also change. Under capitalism, the motive force, innovation, will be endogenised by competition among the capitalists. The Marxian approach was tainted by Marx's teleological belief in progress adopted from Hegel. Progress in evolution means that there is a determinate target of the development process which, as we have seen, has been denied by Darwin for evolutionary biology.

With methodological individualism, derived from Menger (who called it atomism), Schumpeter makes clear that it must be individual decisions that propel development and his entrepreneur is the figure who opens the way for new combinations.[24] Considered one of the founding fathers of evolutionary economics,[25] Schumpeter avoided the term 'evolution' in the same manner, and for probably the same reasons, as Menger. Like Marx, he gives little attention to the creation of novelty, the process of invention. Schumpeter considers innovation, the activity of the entrepreneur, as most relevant in testing the viability of new combinations, since only innovation affects the economic equilibrium.

Thus, institutional change is part and parcel of the Marx-Schumpeter theory of economic development. This theory has found a number of reformulations and extensions quite closely connected to neoclassical microeconomics, a recent and influential one in North.[26] Change derives from the continuous interaction between institutions and organisations. It would appear to be in conflict with methodological individualism, but this is not actually the case, since organisations are represented by entrepreneurs who are the actual players. Like Marx and Schumpeter, North holds the opinion that 'changes in [the] stock of knowledge is the key to the evolution of economies'.[27] Competition stimulates the search for profitable new combinations through which institutions can be changed. According to North, the perception of feasible alternatives is governed by the belief system of the players, which acts as a filter to the information from experience.

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[21] For an overview see C. Kingston and G. Caballero, 'Comparing Theories of Institutional Change' 5 *Journal of Institutional Economics* 2 (2009). The earlier D. Kiwit and S. Voigt, 'Überlegungen zum institutionellen Wandel unter Berücksichtigung des Verhältnisses interner und externer Institutionen', 46 *Ordo. Jahrbuch für die Ordnung von Wirtschaft und Gesellschaft* (1995), is still worth reading.

[22] In his seminal article of 1937 'The Nature of the Firm', see R. H. Coase, *The Firm, the Market, and the Law* (1988).

[23] K. Marx, *Zur Kritik der politischen Ökonomie* (1859/1974).

[24] J.A. Schumpeter, *Das Wesen und der Hauptinhalt der theoretischen Nationalökonomie* (1908/1970).

[25] H. Hanusch (ed.), *Evolutionary Economics. Applications of Schumpeter's Ideas* (1988).

[26] North (2005), above n. 17, at 59.

[27] Id., at 63.

In revolutionary Marx, it was the dominant group of players, the ruling class, who determine the direction of institutional change. North appears to agree: 'the structure of an economic market reflects the beliefs of those in a position to make the rules of the game'.[28] However, his political and economic entrepreneurs, rather than forming a class, have widely diverse objectives and compete with one another. Change is the result of their bargaining process. The final outcome should not be so different from Marx's. This is because the group of entrepreneurs, as system managers, will see to it that the institutional body of society will not harm their interests. Only if competition yields unintended results will the outcome be less predictable. The mental construct of the belief system is exogenous in the short and medium term. In the very long term it is subject to endogenous change. The continuous search process makes normal change incremental. Discrete system transformations are the exception. Fixed mental constructs and institutional inertia make change path-dependent.

The Marx-Schumpeter theory, as well as some neoclassical further developments, such as those outlined by Demsetz,[29] are basically optimistic. Systems with successful players introduce not only more productive technologies but also efficient institutions. Thus, their welfare rises and less successful players will imitate or join them. If a change in the environment or in knowledge makes the incumbent institutional order obsolete (i.e. negative externalities arise), the search for a new order begins which ultimately will internalise the externalities. The paradigmatic case for this type of change is the introduction of private property. With North, optimism is somewhat attenuated, since not all profitable alternatives productively increase total welfare (they can also redistribute total welfare). Lin calls the former induced changes, since they follow from some changes in productive possibilities, and the latter imposed changes, since they result from a reshuffling of economic power.[30] Induced changes lead to a good equilibrium, imposed ones do not necessarily do so. Predatory power elites and fixed mental constructs may block progress.

Let us briefly summarise the paradigmatic case of the emergence of private property.[31] Neoclassical theory of institutional change has been succinctly formulated by Harold Demsetz: 'Property rights develop to internalize externalities where the gains of internalization become larger than the cost of internalization. Increased internalization, in the main, results from changes in economic values, changes which stem from the development of new technology and the opening of new markets'.[32]

Development of new technology and the opening of new markets are the achievements of Schumpeterian entrepreneurs (i.e. we are within the confines of the Marx-Schumpeter theory of institutional change). The driving force is the attempt of a community to maximise net wealth. This may require exclusive property rights. The costs of internalisation are exclusion costs and costs of internal governance. 'Internal governance costs are likely to fall when a population becomes more homogeneous and adopts a common ideology.[33] Here, informal norms and customs enter onto the stage. For what makes a population more homogeneous? Not so much common genes, but rather common tradition, language, and ideology. All three rest on common informal norms.

As long as Soviet-type economies were thriving, it was thought that exclusive property rights could be implemented by two more or less equivalent equilibria – private or communal property rights – the choice being determined by the presence of either more individualistic or more collectivist preferences. Communal property rights could be seen as less efficient by either not fully internalising the externalities when exclusive rights are shared or causing higher costs of internalisation. In reality, this was exactly what happened. The breakdown of the socialist economic system and

[28] Id., at 50.
[29] H. Demsetz,'Toward a Theory of Property Rights', 57 *American Economic Review* 2 (1967).
[30] J.Y. Lin, 'An Economic Theory of Institutional Change: Induced and Imposed Change', 9 *Cato Journal* 1 (1989).
[31] See, for instance, H.J. Wagener, *Zur Analyse von Wirtschaftssystemen. Eine Einführung* (1979), at 173-81 and T. Eggertsson, *Economic Behavior and Institutions* (1990), at 247-77.
[32] Demsetz, above n. 29, at 350.
[33] Eggertsson, above n. 31, at 258.

the transformation from plan to market (i.e. from communal to private property rights) exemplify the discrete institutional change by which a more efficient regime replaces a less efficient one. The change was triggered by liberalisation of the admissible property rights regimes or a shift in ideology and preferences which ultimately equate to a shift in power relations.

Preferences, or the belief system in general, can block efficient solutions. Such a situation can also be the result of powerful interests. Whilst the naïve neoclassical model is perfectly competitive (i.e. disregarding power), more sophisticated approaches, for instance, that of Libecap,[34] take account of the probable winners and losers of institutional change and their influence in the political arena. We do not need to rely on preferences in order to explain communal property rights. There may be specific structures of exclusion costs and internal governance costs for reason of which rational individuals prefer communal to private or unspecified property rights. As long as any arrangement is admissible, and there is competition between property rights regimes, the rich empirics of commons proves to be potentially efficient. In order for this to occur, very specific rules have to be institutionalised, since a common pool is known to have an efficiency problem or a prisoners' dilemma right from the start. How these rules are designed, agreed upon, controlled, and eventually changed is an intricate question that can better be answered by case studies than by general theory.[35]

5 The Stanford Extension

Institutions are helpful in creating equilibria of coordination processes since they economise on information and dovetail expectations. It is therefore little wonder that institutional economics has tried to tap game theoretic equilibrium analysis for further insights. This has been done by, amongst others, two Stanford scholars, Masahiko Aoki and Avner Greif, in what they call the institution-as-an-equilibrium approach.[36] In order to understand their explanation of institutional change I will briefly summarise this approach, which can be considered to be an extension of the Marx-Schumpeter theory. For although there is mention of tacit belief systems, institutions are said to be humanly devised, exogenous changes play an important role in triggering change, and so do institutional entrepreneurs who test new combinations and attempt to get such combinations accepted.

An institution is seen as a self-sustaining system of shared beliefs that individuals have about the rules of a repeated game. The (Nash-)equilibrium of a game has the nice property that the expectations of all players are fullfilled and therefore nobody has the desire to change the situation. It is self-sustaining. There may, of course, be players who can imagine more agreeable situations. But given the parameters of the game, among which are to be found the role of each player and his respective power, such situations are not feasible. In a market, for instance, some players would prefer to have a monopoly position instead of being competitors. But as long as there is competition, their best strategy is to be a price taker and to adapt the quantities offered. By this behaviour competition is reinforced.

Game theory demands that individual players have a high degree of knowledge about the strategic options and probable outcomes of all players. That is where institutions enter onto the stage. The beliefs of individuals, which institutions coordinate, constitute summary representation or compressed information about the equilibrium of a game: 'Agents' strategic choices made on the basis of shared beliefs jointly reproduce the equilibrium state, which in turn reconfirms its summary representation. Thus the institution becomes self-sustaining and information compressed in it becomes taken for granted by the agents. … In this way, although endogenously created, an institution becomes objectified'.[37]

[34] G.D. Libecap, *Contracting for Property Rights* (1989).
[35] E. Ostrom, *Governing the Commons. The Evolution of Institutions for Collective Action* (1990).
[36] M. Aoki, *Toward a Comparative Institutional Analysis* (2001); A. Greif, *Institutions and the Path to the Modern Economy. Lessons from Medieval Trade* (2006).
[37] Aoki, above n. 36, at 12.

The example of the price system provides a useful illustration. The rules of the market (free entrance and exit, freedom of trade, competition) allow to aggregate each individual's private information into the system of relative prices. Taking prices as given, individuals make their own decisions. If the price system is not in equilibrium, excess demand and supply will push it toward equilibrium. If all private information is taken account of, equilibrium is reached and individual decisions will be optimal. Each individual follows the rules and takes the market price as given, thus confirming the order. However, life is not as simple as that. As soon as strategic behaviour shows up in the context of imperfect competition, multiple equilibria are possible. In the long run, however, only robust and stable strategies will survive and will be used by all.[38] Thus, there must be convergence of beliefs regarding the rules of the game.

The summary representation of an equilibrium may be symbolic or tacit, which comes close to formal and informal institutions. Examples of symbolic representations are statutory laws, agreements, and structural arrangements or organisations that define and distribute differentiated roles. These elements become an institution only if agents collectively believe in and observe them. Such beliefs can be based upon hierarchical control processes which, again, have to be credible. Thus, any formal rule needs an informal validation to become an institution. As soon as the institution represents a Nash-equilibrium, validation is guaranteed, since it is in the best interest of each agent to act accordingly. Tacit representations of an equilibrium such as custom get little attention in the Stanford extension. How they emerge, how they change over time, and how they are abandoned remains unknown.[39]

Apart from a genetic transmission of basic rules like fairness, of which little is still known, rules have to be learned anew by each generation. This is what we call socialisation. It can happen by observation and experimentation, or by formal and informal tuition. Before you obtain a driving licence you have to pass an exam testing your knowledge of the traffic rules. To switch the rules is a costly affair: the new generation will learn it as something normal, but the older generations will have to first unlearn the old rules and then adopt the new rules. These costs give rise to intergenerational changes and path-dependence. For rules that cannot be decreed, a switch is even more difficult: how do you convince a society that a corruption equilibrium is bad and should be replaced by a more efficient non-corruption equilibrium? Since this only works if all act accordingly, the switch to the Pareto-superior situation is a collective action problem.

Both Aoki and Greif stress the endogenous nature of the institution-as-an-equilibrium. As soon as the equilibrium has been established this is evident. But how does it become established? A game cannot begin without any rules. That is where history enters the scene. At any time there are institutions as default settings: 'One can never have an institution-free world from which to start the analysis and completely eliminate appeals to exogenously given, humanly devised rule structures'.[40] If they are not well-adapted to the technological parameters of the game, they will have to be adapted endogeneously. This brings us to the issue of institutional change.

Purely endogeneous institutional change poses logical problems: why should people leave a given equilibrium which confirms their expectations and which is confirmed by their behaviour? 'Endogenous instititutional change appears, then, to be a contradiction in terms'.[41] We may take this at least as an explanation of the persistence of institutions which can be observed even when parameters of the game have changed. Greif describes marginal institutional changes (i.e. evolutionary incrementalism).[42] Persistence of old institutions or the asymmetry between traditional and alternative institutional settings play an important role: 'Organizations inherited from the past have various capacities that they acquired through their operation: routines, information, and other assets, such

[38] J. Tirole, *The Theory of Industrial Organization* (1988), at 261.

[39] But see G.A. Akerlof, 'A Theory of Social Custom, of which Unemployment May Be One Consequence', 94 *The Quarterly Journal of Economics* 4 (1980) and Schlicht (1993), above n. 4.

[40] Aoki, above n. 36, at 15.

[41] Greif, above n. 36, at 159.

[42] Id., at 188-211.

as legitimacy; intraorganizational personal relationships and communication codes; information-processing capacities; technological know-how; and human, social, and physical capital'.[43]

Altering just some of these institutional elements, which are mostly interlocked, must be an extremely difficult task. Even if there are institutional entrepreneurs, they cannot do the job alone, but have to win over a critical mass of players who believe that the game is played according to new rules. Such a change has a certain positive probability if it is marginal with respect to ingrained institutions, and if it enlarges the domain of the game.

Aoki, on the other hand, stresses the mismatch between beliefs and actual conditions.[44] Thus, his is more a theory of institutional transformation. Once the old institutions cannot be taken for granted any more, there arises a cognitive disequilibrium between what is believed and what is experienced and, therefore, an institutional crisis. The causes are exogenous: technological innovation, new markets, external shocks, institutional changes in neighbouring domains such as political changes. However, they can also be endogenous in terms of cumulative internal impacts, such as a change in the distribution of assets or power. All this makes the implementation and reproduction of old rules rather dubious. However, only a large gap between aspiration and achievement will trigger entrepreneurial mutation or 'synchronized searches among agents for a redefinition of their respective subjective game models'.[45] The Schumpeterian flavour of this process is palpable. People search, learn, and emulate in order to find more appropriate rules of the game. If they do not, or fail, which is a distinct possibility, the old institutions persist and the system becomes stagnant.

6 Hayek's Approach

Turning now from the pragmatic approaches to institutional change towards the 'organic' ones, one might recall that both can be called evolutionary in the sense that they create and disseminate novelty. Design-oriented scholars like Demsetz, North, and Ostrom also consider their approaches as evolutionary, since the final state of institutional development has not been intended *ex ante*. Yet each step on the way to it is an act of deliberate choice. What we get is a process of sequential decision making or incremental change. Path-dependence and incrementalism may prevent the implementation of the most efficient institutional regime. However, as North has emphasised, there is nothing spontaneous about this process.[46] This may be called the pragmatic-constructivist variant of evolutionary theory.

Hayek's is a truly organic-evolutionary approach. He passionately opposes constructivism,[47] which he sees as the fundamental error in socialist planning of any type. The reason is a lack of knowledge: 'We have never designed our economic system. We were not intelligent enough for that'.[48] However, he had, of course, to recognise that positive design is an important source of institutional change. In contrast to Menger, Hayek identifies not two, but three sources of institutions and, hence, potential institutional change.[49] There are, firstly, the genetically inherited instincts, the state of the mind. It may be seen as the result of natural evolution. However, the mind is also the result of the social environment which is predominantly derived from the second source of institutional order, spontaneous evolution. The rules that, for the most part, make up the social environment do not stem from deliberate choice, but are acquired by chance and spread by a group selection process, for reason of the fact that they enhance

[43] Id., at 193.
[44] Aoki, above n. 36, at 239-244.
[45] Id., at 241.
[46] North (2005), above n. 17, at 51.
[47] F.A. Hayek, *Die Irrtümer des Konstruktivismus* (1975).
[48] F.A. Hayek, *Law, Legislation and Liberty, Volume 3: The Political Order of a Free People* (1979), at 164.
[49] Id., at 159-160.

prosperity. These rules rest in the mind as traditions, customs, beliefs, and modes of thinking. Finally, there is also 'the thin layer of rules, deliberately adopted or modified to serve known purposes'.[50]

Hayek's concept of institution consists of rules and order. In this context, order has a certain normative connotation and a special meaning.[51] As a matter of fact, it would appear to have two meanings. Firstly, order is the set of rules that govern behaviour. This comes very close to Aoki's representation of an equilibrium. From our partial knowledge of the order, we can derive expectations about the rest that may prove correct, which is clearly the function of institutions. Secondly, order is the equilibrium state of a system which has been shaped by, amongst other things, a set of rules. Examples include the division of labour, the price system, the legal order and the monetary order. The division of labour is obviously not an institution; the three others are, in the above-mentioned sense, 'constraints that human beings impose on themselves'. Prices, laws, and money motivate and constrain economic decision-making. All four kinds of order can be installed by pragmatic construction as, for instance, Soviet-type economies have done. However, to think that this could be efficient is, in Hayek's view, 'a fatal conceit'.

This is easily understood as far as the price system is concerned. The planned prices of socialist economies never reflected the intricate interrelations of economic quantities and they always were behind the times. It is clear that prices must be the result of spontaneous evolution and still are the result of rational individual decisions. After all, behind each price tag there is a price setting authority which has to adapt to the competitive market situation in order to survive. Thus, competition is the selection process which distinguishes between the successful and the less successful economic units. It is correct, however, to assert that the price system is a spontaneous order and has no purpose as a maker (since there is no maker) and intentionality within the order is lacking.

In the case of the legal and monetary orders, it is somewhat more difficult to show them to be the result of spontaneous evolution. Quite understandably, Hayek has a predilection for the common law system and a system of free banking which both show less constructivist positivism and more competitive elements. The rules that ultimately make up these systems may be the outcome of pragmatic legislation. The legal order behind the system is a spontaneous one. Nobody has designed it. Hayek holds that people come across new institutions by chance.[52] The idea is taken from the Scottish enlightenment philosopher Adam Ferguson that 'nations stumble upon establishments, which are indeed the result of human action but not the execution of any human design'.[53] Adam Smith's invisible hand metaphor reflects the same idea. What are known as chance and spontaneity are, in fact, the unintended consequences of mostly rational action. However, this is necessarily so, since laws may as well be formalisations of engrained customs whose rational origins are questionable: 'Although man never existed without laws that he obeyed, he did, of course, exist for hundreds of thousands of years without laws he 'knew' in the sense that he was able to articulate them'.[54]

Hayek's approach was not only derived from Scottish enlightenment. He also drew inspiration from Armen Alchian's brief, but brilliant, article of 1950.[55] Alchian makes it clear that, whatever the driving forces of individual entrepreneurs may be, the system selects those who show positive (not maximal) profits *ex post*. They survive. He does not deny that purposive, foresighted behaviour exists, although, in reality, there is not sufficient foresight to indicate profitable action *ex ante*. 'The essential point is that individual motivation and foresight, whilst sufficient, are not necessary'.[56] Innovation may be due to intentional experimentation using new combinations, as well as to random factors of which the actors may not even be aware. Intentionality is unnecessary for

[50] Id., at 160.
[51] F.A. Hayek, *Law, Legislation and Liberty, Volume 1: Rules and Order* (1973).
[52] F.A. Hayek, 'Arten der Ordnung', in F.A. Hayek, *Freiburger Studien* (1969), at 42 (32-46).
[53] Quoted in Hayek (1973), above n. 51, at 150.
[54] Id., at 43.
[55] A. Alchian, 'Uncertainty, Evolution and Economic Theory', in A. Alchian, *Economic Forces at Work* (1977).
[56] Id., at 27.

economic progress, and lacking knowledge makes it suspect. The system adopts success by survival and is unconcerned as to the motives or random factors behind success. Survivors can, at best, try to adapt intentionally to the factors they consider responsible for such success. However, past success is no guarantee of future success, and the factors behind success cannot easily be formulated as simple rules. Imitation is a crude method of encapsulating such factors. In this respect, Alchian is even more radical than Hayek, for whom imitation is a viable strategy to higher welfare. The difference lies in the object of analysis. Alchian is analysing firm behaviour for which the environment is changing rapidly, while Hayek is analysing social behaviour for which a successful solution will have longer lasting effects. Alchian's approach is meant as a Darwinian analogy, the economic system being 'an evolutionary, adopting, competitive system employing a criterion of survival'.[57]

As with the biological theory of evolution, chance produces new combinations which are then selected by competition. Groups with successful institutions or well-structured organisations crowd out less successful ones, or the latter will imitate the solutions of the former. This, of course, is an act of pragmatic constructivism. It is the order that emerges spontaneously, not necessarily the rules. Somewhat grudgingly, Hayek acknowledges the fact that positive rule-making may be aiming at a concrete order and does not immediately fall under the verdict of constructivism: 'Although undoubtedly an order originally formed itself spontaneously because the individuals followed rules which had not been deliberately made but had arisen spontaneously, people gradually learned to improve those rules; and it is at least conceivable that the formation of the spontaneous order relies entirely on rules that were deliberately made'.[58] We recall the tacit representations of equilibria by Greif and Aoki.

Whilst the pragmatic-constructivist theories of institutional change must treat institutions and beliefs separately, Hayek's evolutionary approach allows for the integration of the two: 'The mind does not so much make rules as *consists of* rules of action … which have come to govern the actions of the individuals because actions in accordance with them have proved more successful than those of competing individuals or groups'.[59] The individual mind is the product of its social environment and, at the same time, exerts a marginal influence upon it. The mind and the social order, or culture as Hayek also calls it, co-evolve in a unified historical process and not successively with the mind determining culture.[60] In the end, people share beliefs and expectations, and produce an equilibrium 'order'. However, the outcome is not necessarily good governance. The character of the emerging order is, in general, indeterminate. A state in which corruption is the rule will produce an order of low productivity and bad governance. Since corruption pays, people stick to it. On the whole, Hayek's approach is as optimistic as the Marx-Schumpeter theory: less efficient institutions will be superseded by more efficient ones if they are available.

Although Hayek does not endorse it, Max Weber's protestant ethic can serve as a nice example of spontaneous evolution *à la* Hayek. It is well known that Weber conjectured reformation having changed the belief system of those who adhered to the Lutheran or Calvinist creed. Neither Luther nor Calvin intended to promote capitalism. But strengthened individual responsibility, innerworldliness, and ascetic sobriety (as were required by the new creed) were thought to have set in motion a process of development, which resulted in the *spirit of capitalism*. Recent research by Becker and Woessmann[61] has given a new twist to the Weber hypothesis. They are able to show that it was not so much a new ideology, but an unprecedented push in education that was the decisive force in the aforementioned circumstances. Protestants were supposed to read the Bible personally, which meant they had to learn how to read. That constituted the deliberate intention of princes and city magistrates alike to develop the education system. The unintended consequence was a discrete rise in human capital and new possibilities for

[57] Id., at 31.
[58] Hayek (1973), above n. 51, at 45.
[59] Id. at 18.
[60] Hayek (1979), above n. 48, at 156.
[61] S.O. Becker and L. Woessmann,'Was Weber Wrong? A Human Capital Theory of Protestant Economic History', 124 *Quarterly Journal of Economics* 2 (2009).

the acquisition and spread of knowledge. A new order emerged spontaneously. The driving forces of the Marx-Schumpeter theory are not invalidated. However, clearly no entrepreneur could have planned this effect in advance. According to Hayek, there are no entrepreneurs driving the process of institutional change. However, once it is known that education is a key to economic welfare, appropriate policy measures can be conceived. If this does not happen, one has to look for powerful forces that block such measures.

7 Where Are We Now?

The question of institutional change can be split into two distinct problems and two distinct societal groups: innovation or change at the institutional frontier (the countries on the left side of Table 1), and imitation of or catching up to the institutional frontier (the countries on the right side of Table 1). The theories mentioned above deal primarily with the former. Hayek, in particular, is exclusively interested in institutional innovation, but also scholars in the optimistic Marx-Schumpeter tradition perceive this as the challenging puzzle. North, among others, is aware of the fact that, more often than not, the second group of countries fails to catch up; this constitutes an even more challenging puzzle. As the table clearly shows, good governance pays. It is the institution-as-an-equilibrium approach of Aoki and Greif which offers some explanation as to why equilibria are tenacious, as well as why a great deal of effort is required in order to bring about change within them.

It is certainly no understatement to conclude that institutional change remains a poorly understood phenomenon. What we have are institutions as sets of rules, beliefs, and habits that motivate and constrain individual behaviour. Actual behaviour and its outcomes reconfirm such institutions. Rules, beliefs, and habits do not operate separately. Rules become institutions only when people believe in them. This can be secured by control and enforcing devices that thus become part of the rules. But, again, such devices must be credible which remains a question of belief. Credibility can be procured by coercion, as the term *enforcing* suggests. But greater stability of institutions results from *self-enforcing* arrangements. Both methods may coexist. Through a well-developed civil law, a contract can be enforced by litigation. However, this happens only in exceptional cases, since the process is costly. Usually, contracts are fulfilled. The rules of the game are institutionalised and firmly observed, even by those who do not understand the proper legal procedure.

Equilibrium is attacked from the outside by changes in the knowledge and the environment that create externalities. The negative effects of such externalities can be mitigated by internalisation (i.e. institutional change). It is also attacked from the inside by changes in accumulated assets and power and, perhaps, spontaneous changes of players' perceptions. Internal developments in the market may, for instance, lead to the emergence of a monopoly position that gradually changes the rules of the game. Alternatively, some players 'stumble' upon new insights into how to organise their activities, and their resulting success induces others to adopt the innovation.

For reason of the asymmetry between incumbent and alternative institutions, the incumbent show a remarkable persistence. This raises the difficult question as to the time needed for institutional change. It does take time, and it is often said that very long periods are involved. It is assumed that people will trust each other and their institutions only after long periods of cooperative communication and experience, and that the power of those who frame institutions is reproduced by those very institutions. Several studies look into the origins and effects of trust and social capital, the aggregate of social institutions. The seminal work by Putnam shows how similar formal institutions within one country (Italy) function differently and have different outcomes in different regions.[62] For instance, the judicial system, which has been uniform for 150 years, works

[62] R.D. Putnam, *Making Democracy Work. Civic Traditions in Modern Italy* (1993).

differently in Northern and Southern Italy.[63] An explanation is provided by the beliefs and other informal institutions of civil society which have emerged over centuries in the respective regions. Putnam's conjecture concerns the long-term effect of having been an independent city-state some time in the Middle Ages. It has been confirmed by Guiso, Sapienza, and Zingales who show that even in Central and Northern Italy formerly independent cities have a higher social capital than formerly dependent ones.[64] Interestingly, the period of active experience of civilian cooperation required in order to produce such a beneficial effect may be rather short (i.e. 2 to 3 generations).This softens one of Putnam's pessimistic conclusions, namely that in the short-term, there is little that can be done about that state of affairs, since culture, by its very nature, is considered to be a slow moving phenomenon.

The influence of elites upon the persistence of institutions is less long-term compared to culture. But as long as ruling elites stay in power, they will be able to frame important institutions, and the belief of others that they will stay in power makes these institutions work. So institutional change is closely linked to the life cycle or exchange of elites.[65] A striking exemplification was the post-socialist transformation. It demonstrated that elites and their ideology, as long as they are powerful, can perpetuate less efficient institutions for quite a long period. Coercion has played an important role in this context. Necessary modifications are constrained, and prevailing beliefs hold that nothing can be done about it. It is an equilibrium, albeit not a very stable one. For once the barriers to change are removed, once ideology has lost credibility and elites have lost power, the process of change can become instantaneous and vehement. Liberalisation during the course of post-socialist transformation constituted the removal of legal and ideological impediments for alternative institutional solutions, among which the reform elites were then able to make a choice. Of course, for the reform elites to gain legitimacy and for the new institutions to gain credibility will take more time than the system switch itself.

8 Post-socialist transformation and evolutionary change

Transformations, for which there are many more examples, are obviously not cases of evolutionary institutional change. However, the relative success of the operation depends on long-term factors. Post-socialist transition countries share the legacy of a *bloc culture*, giving priority to communal values over individualism, safety and inflexibility over innovation and tolerance, dependence upon the state over self-reliance, but at the same time, creating mistrust towards public institutions and causing retreat into the private sphere.[66] In order to get rid of this legacy, a new generation, socialised in a different environment, is needed. On the other hand, post-socialist transformation has been characterised by a marked divergence of the emerging political and economic systems that is illustrated by differences in governance quality (see Table 2).

Bruszt et al. show that pre-transition existence and activity of civil society (i.e. a network of politically active individuals independent from the state) determine the intensity and direction of change: 'Countries with a vibrant pre-transition civil society have embarked on a path towards sound political institutions, economic reforms and democratization. Countries that had little in a way of civil society and/or whose governments repressed it have, in turn, introduced more authoritarian regimes or, at best, dragged their feet on economic and political liberalisation'.[67]

As in Putnam's case, the crucial question concerns what makes civil society active in some countries and sluggish in others. The respective countries are not spread randomly

[63] G. Tabellini, 'Culture and Institutions: Economic Development in the Regions of Europe', 8 *Journal of the European Economic Association* 4 (2010).

[64] L. Guiso, P. Sapienza and L. Zingales, 'Long Term Persistence', *EUI Working Paper, ECO 2008/30* (2008).

[65] J. A. Robinson, *Elites and Institutional Persistence,* UNU-Wider Working Paper No. 2010/85 (2010).

[66] P. Sztompka, 'Looking Back: The Year 1989 as a Cultural and Civilizational Break', 29 *Communist and Post-Communist Studies* 2 (1996).

[67] L. Bruszt et al., 'Civil Society, Institutional Change and the Politics of Reform. The Great Transition', *UNU-Wider Working Paper No. 2010/38* (2010), at 21.

over the whole post-socialist area. The pre-transition existence of civil society is strongly correlated with pre-communist experience with democracy and market economy and, at the same time, with geographical proximity to better governed societies (i.e. the West). Again, both factors have rather long induction periods.

Table 2: Average Governance Quality in Post-socialist Countries

Country	*1996*	*2009*	*Change*	*Country*	*1996*	*2009*	*Change*
Albania	– 0.19	– 0.13	+ 0.06	Bulgaria	– 0.32	0.27	+ 0.59
Armenia	– 0.51	– 0.22	+ 0.29	Czech Rep.	0.86	0.94	+ 0.08
Azerbaijan	– 0.92	– 0.73	+ 0.19	Estonia	0.64	1.08	+ 0.44
Croatia	– 0.31	0.44	+ 0.75	Hungary	0.81	0.79	– 0.02
Georgia	– 0.83	– 0.13	+ 0.70	Latvia	0.14	0.67	+ 0.53
Macedonia	– 0.26	– 0.01	+ 0.25	Lithuania	0.37	0.70	+ 0.33
Moldava	– 0.12	– 0.45	– 0.23	Poland	0.78	0.78	0.00
Serbia	– 1.04	– 0.17	+ 0.87	Romania	– 0.12	0.22	+ 0.34
Russia	– 0.63	– 0.72	– 0.09	Slovakia	0.47	0.79	+ 0.32
Ukraine	– 0.55	– 0.55	0.00	Slovenia	1.06	1.01	– 0.05
Kazakhstan	– 0.80	– 0.41	+ 0.39				
Kyrgyzstan	– 0.30	– 0.89	– 0.59				
Tajikistan	– 1.87	– 1.44	+ 0.43	Germany	1.54	1.42	– 0.12
Turkmenistan	– 1.35	– 1.44	– 0.09	Netherlands	1.64	1.62	– 0.02
Uzbekistan	– 1.07	– 1.27	– 0.20	Sweden	1.61	1.75	+ 0.14

Source: http://info.worldbank.org/governance/wgi/pdf/wgidataset.xls; own calculations.

Governance quality is measured by the World Bank team in units following a normal distribution with a mean of zero and a standard deviation of one. This implies that almost all scores lie between –2.5 and +2.5. The confidence interval of the individual mean values denotes that minor differences between countries and minor changes over time are not significant. 1996 is the earliest year for which data are available. Nevertheless, the table is quite informative. Each country has its own story and history which we cannot elaborate upon here. EU-member states (the right side of the table) have, from the outset, a significantly better governance quality than the non-EU-member states (the left side of the table). Amongst the former, the lowest ranking countries (Bulgaria, Latvia, Lithuania, Romania and Slovakia) have improved markedly over the last 15 years or so, whilst historically established 'westernised' states, such as Poland, Hungary, and the Czech Republic, did not change their comparatively high scores in the short-run. Amongst the latter, those countries that are candidates or prospective candidates of EU or NATO (Croatia, Georgia, Macedonia, Serbia) have improved their governance quality as well.

It seems patently clear that EU and/or NATO membership, or even just the prospect of joining such organisations, has a significant impact upon the governance quality of post-socialist transition countries.[68] Membership is considered a transformation anchor. Both organisations require certain standards of democracy, rule of law, internal conflict management, respect of human and minority rights, control of corruption, and both organisations support candidate countries personally and materially in acquiring such standards, which are clearly shaped by Western social culture. Table 2, however, also reveals that the two sets of countries differ already with regard to their initial conditions. In order to become an EU candidate, a country has to be in a certain geographical

[68] A. Belke et al., *Prospective NATO or EU Membership and Institutional Change in Transition Countries,* DIW Diskussionspapier Nr. 915 (2009).

location bordering EU territory which, at the same time, implies historical contacts with Western political and social culture. It is therefore not an easy task to separate the impact of short-term factors such as (prospective) membership of Western organisations from long-term factors such as a common physical and historical ground upon institutional quality and change.

Such history and spatial proximity will influence the transmission of values, beliefs, traditions, and customs, and thus facilitate the transmission of rules and regulations which may be taken for granted. This has also been confirmed empirically.[69] The transmission of rules and regulations constitutes either an act of deliberate institutional change or of hegemonial imposition. Both can happen over very long distances. Colonial rule has spread European legal practices across the oceans. Such practices were not relinquished when these territories gained autonomy. Other societies have voluntarily adopted or imitated what they considered to be best practices. Thus, we find traces of German civil law in Japan and traces of the Napoleonic code in South America. Joining the EU constitutes a special case, requiring the adoption of the so-called *acquis communautaire*. However, such are results of an autonomous decision taken by the recipient society.

European based rules and regulations constitute no guarantee for good governance. If *l'esprit des lois*, the values, beliefs, traditions, and customs that bring the formal institutions to life are lacking, sound formal regulations are to no avail. Moreover, this *esprit des lois* cannot be transferred by clever reform elites. Societies with the best chance of encompassing this notion are those which have lived with it for a period of time, or are in close contact with well-governed and welfaring neighbours. Becker et al. have pointed to what they call the *Habsburg effect*.[70] Many East-European countries were, at least temporarily, under Habsburg rule, some of the modern states, like Poland and the Ukraine, for only part of their present territory. Compared to other empires in the area, Habsburg rule was distinguished as having a fairly rational administration. The Habsburg empire was dissolved around a century ago. However, people who live on former Habsburg territory today still demonstrate higher trust in courts and police, and are less inclined to pay bribes: 'The institutional heritage influences not only preferences and unilateral decisions but also bilateral bargaining situations in citizen-state interactions'.[71]

Experience of good government gives rise to generalised trust, which is necessary in overcoming the collective action problem associated with the change from a bad to a good equilibrium. This conundrum is addressed by Bo Rothstein, who extensively describes how Swedish industrial relations switched in the 1930s from an antagonistic to a cooperative organisation.[72] In line with Rothstein's hypothesis, the switch presupposed mutual trust, which existed because of longer term experience of impartial state officials. The *Habsburg effect* seems to corroborate this hypothesis. However, we now enter into an infinite regress because we would like to know why Swedish state officials were impartial in the first place. In his more recent book, Rothstein answers the question by pointing to the Swedish modernisation process in the middle of the 19th century.[73] In other words, a concrete institutional change can be explained only in an evolutionary way, through a long historical process that, however, was not unique. Similar political developments unfolded all over Europe. Modern economic growth and institutional modernisation started some 250 years ago. They can be understood only in conjunction with one another.

But what of those countries that did not fall under Habsburg rule and were not included in the European wave of modernisation; are they doomed to bad governance and poverty? This is by no means the case, since path-dependence, history, and geography, important as they may be, are not deterministic factors of development. China, which until the

[69] E.g. most recently by P. Grosjean, 'The Weight of History on European Cultural Integration: A Gravity Approach', 101 *American Economic Review* 3 (2011).

[70] S.O. Becker, K. Boeckh, C. Hainz and L.Woessmann, *The Empire is Dead, Long Live the Empire! Long-Run Persistence of Trust and Corruption in the Bureaucracy*, CESIFO Working Paper No. 3392 (2011).

[71] Id., at 25.

[72] Rothstein (2005), above n. 10.

[73] Rothstein (2011), above n. 9, at 115-116.

late 1970s fitted perfectly into the general template of a backward society, suddenly switched to a path of good (economic) governance and economic growth. What had changed, however, were not the values, beliefs, and traditions of the entrepreneurial strata, but *only* the formal constraints and policies under which they were operating (i.e. the beliefs of the ruling elite and, perhaps, the ruling elite itself). Other backward and badly governed states could also unleash fettered forces of development through liberalisation and the removal of inflexible or predatory elites. Only then can long-term cultural factors be ascertained in an unbiased manner.

9 Conclusions

Douglass North concludes his exploration into institutional change with the following statements:

> [We are getting it right (good governance) when] we perceive correctly changes in the human environment, incorporate those perceptions in our belief system, and alter the institutions accordingly.
>
> [We are getting it wrong (bad governance)] when the accumulated experiences and beliefs derived from the past do not provide a correct guide for future decision making. There are two reasons. … The first of these factors stems from our not correctly comprehending what is happening to us; the second, from an inability to make the necessary institutional adjustments.[74]

These are almost tautologies boiling down to the statement: good governance is the result of good institutions and bad governance of bad institutions. We either have a good or a bad perception of the environment, or we are able or not able to devise the institutions accordingly. Given the huge difference in governance quality and welfare that is documented in Table 1, and assuming that human beings are sufficiently rational individuals, it is hard to believe that people do not notice what the circumstances around them are. Thus, the second factor exercises greater influence: people are unable to make the necessary institutional adjustments.

This is unsatisfactory for any society at the lower end of the welfare scale. Furthermore, North's excuse that 'By now it should be clear that no dynamic theory of change is advanced in this study and I hope that it is equally clear that no such theory that could be useful is likely to evolve'[75] provides little consolation. North's nihilism seems to be due to the crucial role of beliefs in his treatment of institutional change. They are fixed for the span of time that is politically relevant. Cultural change is out of reach for politics. Whilst this is true, there is a huge gap, documented in Table 1, between governance quality and welfare which cannot be ascribed exclusively to corresponding differences in culture. Making the necessary institutional adjustments is all that a pragmatic theory of institutional change entails. However, the ambiguous co-evolution of institutions and development allows for doubts about institutional change as a panacea against poverty.[76] But, bad governance can also be the result of bad governors. Changing the power distribution in society does lie within the time horizon of political actors.

Figure 1 above should be kept in mind. The aim of any society must be to reach the next highest equilibrium on its way to achieving good governance. Although each lower equilibrium is locked-in by beliefs, inertia, and prisoners' dilemma situations, there still are a number of things which can be done. The higher equilibrium is perhaps practiced in an adjacent country. Culturally, such a country may not be so different to one's own country; people may know and understand the traditions and beliefs of their neighbours, and could be able to learn from them. Indeed, there is the asymmetry between established and new beliefs. But new beliefs linked to a higher equilibrium are

[74] North (2005), above n. 17, at 116-117.
[75] Id., at 125-126.
[76] Paldam and Gundlach, above n. 11.

clearly advantageous: 'If it is advantageous to corner the custom in borderline cases, this will be done and the custom will erode'.[77] An institutional system is an equilibrium. It reproduces itself because people act accordingly and the interests of the system managers are catered for. But it can be a Pareto-inferior equilibrium. There will be entrepreneurs who will try to test new institutions. Pareto-superiority enables them to carry the costs of change and to compensate eventual losers. As a rule, this will be a gradual process.

Institutions change continuously in reaction to environmental changes. We may not be aware of this fact because most changes are slow and the precise content of some institutions, especially the belief systems, belongs to the realm of tacit knowledge. The economic argument based on utility is always an optimistic argument. It predicts incremental change (i.e. evolutionary progress and convergence). The cultural argument based on values and beliefs is rather pessimistic. Being hesitant about speaking of progress, it stresses differences and shuns prediction. Changes are considered slow, and by their very nature, evolutionary. The political argument based on power sits in between these extremes. If power is not properly checked and contested, it can explain divergence. If power is overthrown, changes may become revolutionary.

[77] Schlicht, above n. 4, at 185.