

Institutional Competition and Evolution of Perception of Norms

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Abstract: The purpose of this paper is to analyze the institutional competition among jurisdictions as interplay of formal and informal institutions (as norms of perception of norms). It distinguishes between a short-term and a long-term perspective of study. In the short term institutional competition shifts the market power on the market for institutions from the public authority to the individuals and corporations. Therefore informal institutions governing the perception of norms determine the results of the competition. In the long term informal institutions evolve; intergovernmental political competition and sociocultural evolution support creation of more efficient institutions, but effects of institutional pseudomorphism can effectively block this process. The normative conclusion of this paper is that institutional competition is efficient only if there is no deficit of vertical trust between the society and the government and informal institutions support efficiency-based behavior. Thus the application of institutional competition in transition and developing economies is limited. The experience of the post-Soviet space (the CIS) is used in order to prove the hypothesis formulated in this paper.

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1. Introduction

Institutional competition has been one of the major fields for neoclassical, ordoliberal and Austrian economics (see for an overview and critical discussion Pitsoulis, 2004) and political science (e.g. Scharpf, 1998) for already more than two decades. In a multi-jurisdictional system with numerous governments and free movement of capital and labor across the borders, governments compete for mobile private actors providing different formal institutional settings. A popular point of view is, that institutional competition could increase the quality of institutions (i.e. establish institutions with lower transaction costs) with its two main functions: “discovery process” and “taming the Leviathan” mechanism (Streit, 1996). First, interjurisdictional competition is defined as “a manner in which the free movement of goods, services people and capital constrains of independent governments” (ACIR 1991: 10), and creates an additional instrument of control over the government in form of the “exit option”. Second, institutional competition can initiate a spontaneous learning process in the sense of the *Hayekian* arbitrage, which leads to the improvement of governmental policies and institutions (Vanberg, Kerber, 1994; Wohlgemuth, 1999).

The majority of the studies in the theory of institutional competition focus on *formal institutions*, i.e. institutions enforced and designed by public authority. It is clear, that exactly this type of institutions can be used in order to improve government’s competitiveness in the interjurisdictional competition. The purpose of this paper is to analyze the problem of interaction between formal and informal institutions under institutional competition. The latter could include *direct norms of behavior*, as well as *perception rules*, which govern the individual’s attitude towards formal institution. The conflict between formal and informal institutions as alternative sets of direct norms of behavior is one of the most often discussed problems in the modern transition and development economics; for example, the failure of transition in the post-Soviet countries is explained by inconsistency and interaction between the formal and informal norms (e.g. Voigt, Kiwit, 1995; Leipold, 1997; Raiser, 1997; Gruževja, 2005 etc.).

In this paper I focus primary on the other side of informal institutions: their function as perception rules for formal institutions. This aspect is especially important for the problems of institutional competition among jurisdictions. From the point of view of the theory of the institutional competition the relations between the governmental structures and the private actors can be described as a market for institutions, social orders and public policies” (Bornschieer,

Trezzini, 1996; Kerber, 1998). The government offers certain goods (including public goods, formal institutions enforced by the public authority, and even private goods like assets in the privatization process) to private actors, charging a fee for their consumption mostly in form of taxes. Unlike a closed economy, where a government's monopoly on this market exists, in an open multi-jurisdictional economy the market for institutions is a competitive one, i.e. institutional competition creates a mechanism, which allows individuals to influence governmental decisions in order to create formal institutions, which reflect their preferences. If institutions provided by the government do not correspond to the expectations of private actors (either because of rent seeking, or lack of knowledge), they leave the jurisdiction ("exist"), thus worsening the taxation basis, economic wealth and political power of the incumbent, who start searching for more appropriate formal institutions.

It is normally assumed, that the preferences of individuals are given and that private actors prefer institutions with lower transaction costs (i.e. "efficient" institutions). This point of view may be challenged by the (more realistic) assumption, that the preferences of individuals on the market for institutions (their perception of norms) are defined by informal institutional framework. It means, that *informal institutions are crucial for the demand for formal institutions*. As institutional competition replaces supply-side monopoly on market for institutions by competitive order, the demand-side factors become more important. The outcomes of institutional competition are dependant upon the interplay of these two types of institutions.

It is necessary to notice, that the normative judgments are very difficult, if perception of norms is introduced, because any assessments also depend upon valuation norms. From the point of view of *Weber's* freedom from valuation of norms (*Werturteilsfreiheit*) principle, social sciences may not make rank values or make any statements regarding their importance, e.g. if people prefer less efficient economy, it may not be (scientifically) characterized as "bad". For the purpose of simplicity, in this paper the outcomes of institutional competition are evaluated and normative conclusions are made only from the point of view of establishment of efficient institutions. Efficiency is defined as transaction costs reduction. It is clear, that sometimes institutions have an ambiguous effect on transaction costs or even reduce costs of transactions for within a given group increasing them for the transactions between these individuals and the rest of the world. However, there are still economies with lower or higher general level of transaction costs, which represent different levels of economic efficiency (associated with poverty, lower

growth etc.). Our aim as economists is to explain these differences. Other consequences of social norms (which may be even more important) are not considered. This limitation seems to be reasonable: the main expectations from the institutional competition are connected with improving the public sector efficiency; therefore exactly this aspect is to be discussed more closely. Furthermore, it is important to distinguish between the value of economic efficiency as applied by the researcher just to measure and to compare different economic institutions, and the values of population and of politicians underlying their real action. In the social world there is no clear gap between the observer and the observed object, as in the natural sciences, but the social scientists still have at least to try to achieve a higher degree of objectivity (Wallerstein, 1974).

The paper is organized as follows: the next section discusses the difference between formal and informal institutions in the process of institutional competition. The third section considers the interaction of competition among formal institutions and spontaneous evolution of informal institutions in both short and long term. The last section concludes and discusses several normative implications of the study. In order to prove the theoretical conclusions of this paper the experience of the post-Soviet economic space (defined as 12 CIS countries) is used. The region is characterized by strong economic ties with lack of coordinated economic policy, as well as a nexus of problems of interrelation between formal and informal institutions. That is why it seems to be an appropriate “laboratory” to prove the hypotheses of this paper.

2. The Distinction between the Formal and Informal Institutions

Unlike formal institutions, which are set deliberately by the government, informal institutions develop in turn of a spontaneous evolution. Their origin is of emotional, religious or ideological nature (Leipold, 2000); they may have no manifestation in written documents and are ensured by the self-control or (un)organized supervision by private actors (Kiwit, Voigt, 1995). The major aspect of informal institutions relevant from the point of view of this paper is that they include certain notion of objectives of governmental regulation, which are used to judge concrete norms incorporated in law and other parts of formal institutional framework. These evaluation criteria comprise three major aspects:

- a) General attitude towards the government, or institutional vertical trust, i.e. the readiness of individuals to believe that changes in formal institutions initiated by the public authority may have positive impact on their life;

- b) “Shallow” notion of socially acceptable results of functioning of economic mechanism and economic behavior, e.g. concept of justice, freedom, relation to wealth, profit seeking, entrepreneurship etc.
- c) “Deep” notion of socially accepted economic behavior. Unlike the “shallow” level, which is consciously accepted by individuals, this “deep” level includes norms, which define the socially accepted situations”, when individuals may break prescriptions of formal and shallow-level informal institutions. The differences between “shallow” and “deep” level could result from strong concentration of power in the ideological sphere as “defensive patterns of behavior” in *Sztompka’s* (1993) sense. An institutional conflict between the shallow and the deep levels is probably one of the most important factors that make human behavior in concrete situations unpredictable.

From the point of view of the French economics of convention of *Boltanski* and *Thévenot* (1991), these informal institutions as a kind of “meta-rules” determine, which “orders of worth” are to be used in order to evaluate the governmental policies (and provide different “justice criteria” for actions and institutions). The standard theory of institutional competition implies, that the only “order of worth” to be used for this purpose is “the market convention”, similar to that applied on common markets (that is why the very metaphor of “market for institutions” is introduced”). In a real world market order of worth is used in state-society relations as well as other conventions (like civil, industrial or environmental).

The informal institutions as defined and considered in this paper are closely related to the cognitive rules, or internal rules of human reasoning, learning and decision-making (and may have partly similar effects on institutional competition) (Budzinski, 2001). Both types of rules determine individual’s preferences of certain formal rules and criteria used for evaluation of formal rules. However, cognitive rules are intrapersonal and evolve as a consequence of individual experience and learning. Informal institutions as discussed in this paper are interpersonal and evolve with the development of the whole society. In spite of this fact, evolution of cognitive rules and informal institutions as institutions of perception of other norms are closely related. A better description for informal institutions of the kind analyzed in this paper is the “shared mental models” by *Denzau* and *North* (1994), because the latter underline the interpersonal character of perception.

Therefore the most important feature of the informal institutions from the point of view of this paper is that they (1) do not change by order of the government and (2) change only in a long term. In a short term perspective perception of formal institutions is given. Because the institutional competition shifts the market power to the demand side on the market for institutions (“exit power” (Beck, 2001)), this factor is crucial for the success of jurisdictions in the competition process. Or, in other words, informal institutions create restrictions on efficiency of institutional competition among jurisdictions.

In the long term informal institutions change and the restrictions described do not exist. The distinction is similar to that between the short-term perspective of product markets (when individual preferences are given) and long term, evolutionary view (when individual preferences evolve). However, outcomes of short-term institutional competition and the existence of a multi-jurisdictional environment by itself influence the direction of evolution of informal institutions and create an indirect causal relation between initial informal institutional framework and long-term results of competition of formal institutions. Figure 1 provides a schematic representation of interrelations between the short-term and the long-term perspective.

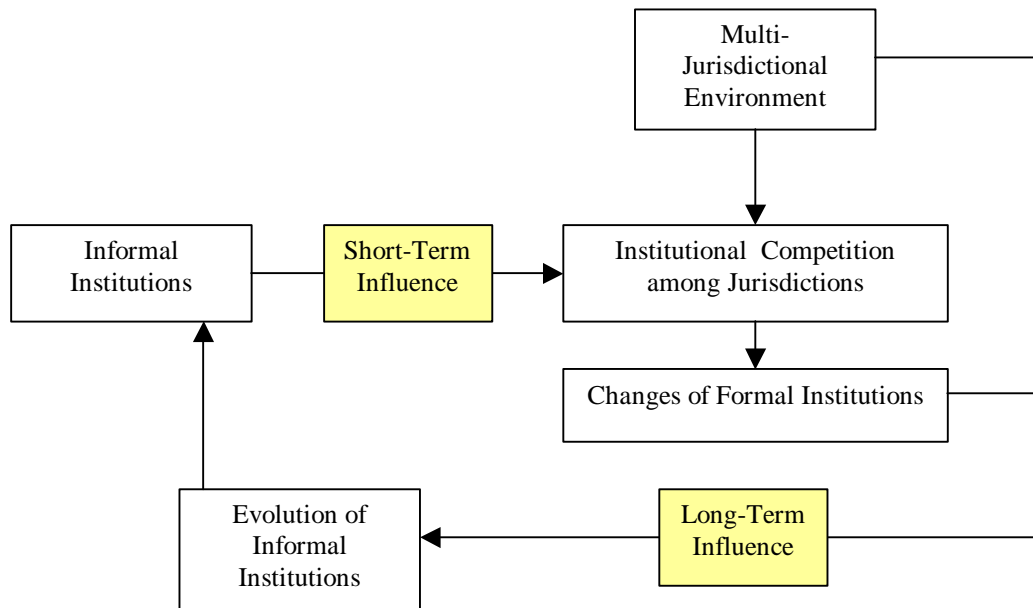


Figure 1: Short-Term and Long-Term Effects in the Interplay of Formal and Informal Institutions in the Institutional Competition

Of course, it is important to find out at least a possible idea for what a “long term” and a “short term” mean in the evolution of perception of norms. In some cases centuries are necessary to change the people attitude towards certain institutional frameworks. It may be possible that in

a globalized world with intensive flows of ideas the velocity of the evolution of informal norms increases, but this hypothesis requires empirical evidence, which is (especially in case of the deep-level institutions) controversial.

3. The Interplay of Formal and Informal Institutions Change under Institutional Competition

3.1. Short-Term Perspective

The major limitations of the institutional competition, which exist in the short-term perspective, result from the three elements of the informal institutional framework as defined above.

Deficit of vertical trust in the society could lead to rejection of any institutional innovations of the government. “It is better not to play games of chance with the government” is a well-known proverb in the most post-Soviet states (with “games of chance” including any initiatives of the public authority). The vertical mistrust (like trust) can be institutional, i.e. independent from concrete incumbents. If individuals have always suspected their government, any change of institutional environment is considered to be worse than the existing equilibrium. In this situation individuals support *existing*, and not *better institutions*. In case of institutional competition environment “exit” is a reaction on *any institutional changes*, and not on *worsening institutional environment*. The ability of the government to attract mobile factors of production by *changing* institutional environment is reduced; a better way to prevent “exit” is to maintain the existing institutional balance, even if it is not Pareto-optimal (Libman, 2005). Other point is, that in case of low vertical trust investments and labor migration are consciously organized via informal channels and support the less efficient institutions of the shadow economy. The governmental attempts to limit the expansion of shadow economy with softening the restrictive regulations do not improve the situation because people do not believe in reforms; coercive measures against the informal sector make the formal institutions even less appropriate for the private actors and only support the expansion of the shadow economy (i.e. formal outcomes of institutional competition support illicit economic activities).

“Shallow-level” notions of socially accepted economic behavior determine individual’s preferences on the market for institutions in a more direct way. In a real world the economic efficiency of institutions is not the only goal of individual decision-making (i.e. market

convention is not the only order of worth). Aims like social justice, sustainability of tradition or industrial efficiency could be more important for individuals. It is possible, that the informal institutions lead to the rejection of entrepreneurship, or supports destructive or unproductive kinds of entrepreneurial activity (Baumol, 1990). They also can predestinate the acceptance of a higher governmental share in the economy or a more active redistributive policy, than predicted by the theory of institutional competition. In this case individuals evaluate different packages of institutions provided by different government not from the point of view of their (transaction cost) efficiency, but considering their effects on other social values. *If individuals prefer institutions with lower efficiency, these institutions will survive.* For example, excessive governmental interventions with redistributive purposes could be supported by inflow of mobile production factors (e.g. labor). The learning via institutional arbitrage can only fix the existing institutional preferences of individuals.

The effects of the “deep-level notion” of socially accepted economic behavior are similar to the described above. However, unlike the “shallow-level” institutions, “deep-level” institutions create an additional problem: the preferences of individuals are partly unconscious and cannot be identified correctly by the government. The “deep-level” institutions could partly explain the apparently paradoxical situations, when dominance of inefficient formal institutions, which are openly unacceptable from the public point of view, is combined with the continuing “exit” of capital and labor or significant inflow of foreign investments (another reason may be power asymmetry and rent-seeking, see Mummert, Mummert, 2000; Libman, 2005a). The grade of divergence between deep-level and shallow-level institutions is therefore an important negative factor influencing the outcomes of institutional competition; if the gap between these two types of informal institutions is smaller, the possible negative influence is lower.

From this point of view, the efficiency of institutional competition is limited to a very narrow group of countries with developed vertical institutional trust and efficiency-oriented assessment of institutions on both deep and shallow level. Otherwise institutional competition cannot improve the quality of institutions. In the worst case it can effectively block government’s attempts to introduce better institutions and even create additional incentives for the public authority to provide institutional framework with higher transaction costs. Institutional competition becomes an alternative factor, which supports the inefficient equilibrium.

The effects of the deep-level and shallow-level institutions seem to be limited due to the very nature of the institutional competition, that is, mobility of factors. The latter implies, that exactly the individuals with a high degree of independence and mobility (a kind of entrepreneurial spirit) define the results of the competition. These individuals seem to be more efficiency oriented and risk friendly. However, historically high mobility and domination of the “market order of worth” have not always been intervened. For example, *Le Goff* (1984) states a surprisingly high degree of mobility of the medieval population, and *Volckart* (2002) even develops an interjurisdictional competition view on the medieval Germany (and the Middle Ages are definitively not the period of dominance of efficiency orientation in informal institutional framework).

The experience of the post-Soviet economic space provides certain evidence for the described short-term effects. The Commonwealth of Independent States (which includes all post-Soviet states except Baltic countries, which are now EU members) is an interesting case study from the point of view of institutional competition: it is a relatively high integrated area (especially due to the developed social integration factors, like the Russian as the lingua franca, common values, informal interpersonal communication networks, common mores and ways of doing business etc. (see Sterzhneva, 1999)) even if compared with the Europe, with a very low level of intergovernmental political coordination. The borders between states have remained transparent for capital and labor flows as an attempt to survive the appearing economic shocks of disintegration, which were of significant importance for the post-Soviet republics (Linn, 2004), as well as a manifestation of lacking capacity of new governments to create an efficient control over cross-border transactions. Despite these facts economic disintegration dominated the development of the post-Soviet space in the 90s. The share of intra-regional exports went down between 1995 and 2004 by more than 20 pp., if intra-regional imports – by about 10 pp. (CIS Interstate Statistical Committee, 2005). The formal integration structures created by the post-Soviet countries (either the CIS or the subregional groups established to substitute the inefficient Commonwealth, like the Eurasian Economic Community, Common Economic Space, Central Asian Cooperation Organization and Union State of Russia and Belarus) also proved to be less efficient than expected. Despite magniloquent declarations post-Soviet states could not even implement a wide free trade area (Kossikova, 2004); numerous international bodies do not have the necessary authority to create an impetus for economic integration.

The situation changed significantly in the first half of the 2000s. First, the volume of intra-regional trade increased significantly by a constant share of intra-regional trade (Kosikova, 2004a)¹. Second, and more important, the cross-border investment flows skyrocketed. The investment expansion of Russian transnational corporations was especially important. These cross-border flows are mostly statistically invisible (because of lack of control and use of “shadow” and offshore mechanisms); that is why statistical indicators do not provide an adequate representation of cross-border investment flows. For example, according to the official statistics Russian corporation account for less than 6% of total FDI in Ukraine. However, according to the expert opinion, Russian corporations control about 83% of the oil processing industry; 66,7% of the non-ferrous metallurgy (including 90% of the aluminum industry), 36% of the power utilities, 33% of the machine building industry and the banking sector, 20% of the ferrous metallurgy and the gas industry, 30% of the milk products market and 50% of the telecommunication sector (Lebedev, 2005). The UNCTAD (2004) estimates show, that Ukraine, Belarus, Kazakhstan and Uzbekistan were among the top 6 targets for Russian FDI projects abroad. Other post-Soviet countries also increased their investment activity in the region like Kazakhstan with its expanding banking sector. This trend has been typical for all corporations from the developing world, which started their international activity from their neighboring countries (UN, 1993). In the post-Soviet case the business structures use the mentioned resource of the social integration. Labor migration also remains significant for the majority of post-Soviet states (however, with similar problems of statistical information).

At the same time the post-Soviet countries have a very low level of vertical trust (Figure 2; see also Raiser, 1997; Raiser, 1999; Oleinik, 2005a), as well as a sophisticated interrelation of formal, deep and shallow-level informal institutions (Ledeneva, 2001) with a strong support of governmental redistribution, hostility towards entrepreneurship and private initiative (Voigt and Kiwit, 1995; Bruner, 1996; Latov, 2003) and association of individual action with disorder (Rosenbaum, 2001) at the level of the shallow institutions, as well as support of “shadow practices” and unproductive entrepreneurship at the deep level, which have dominated the whole economic system for decades (Kordonskii, 2000; Timofeev, 2000) and are still important for

¹ This trend does not seem to continue in the 2005 because of the introduction of the destination principle in the VAT taxation in the Eurasian Economic Community.

entrepreneurial activity, as well as for other aspects of life (Kliamkin and Timofeev, 2000; Ryvkina, 2001).

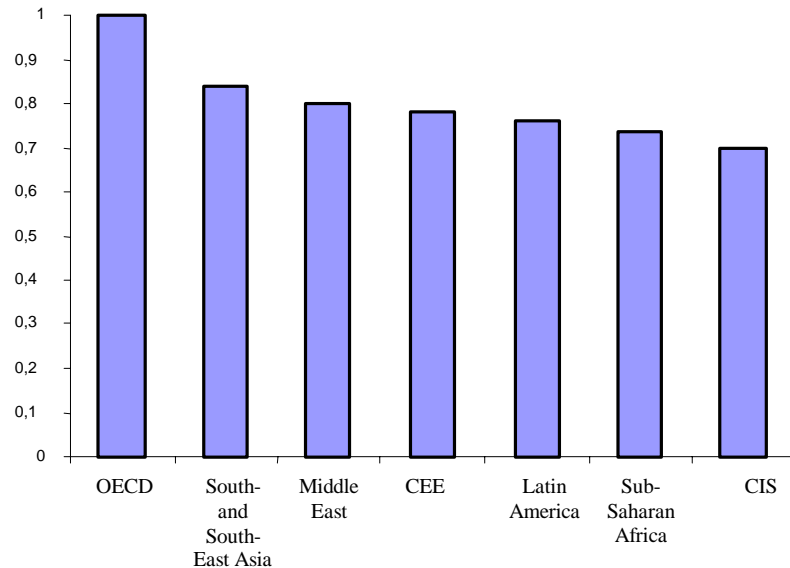


Figure 2: Index of vertical trust in different regions of the world as compared with the OECD Countries

Source: World Bank. 1997

The absolute majority of the post-Soviet states is characterized by persisting inefficient formal institutions. A survey of the World Bank demonstrates a relatively low quality of governance in the post-Soviet world, with very few exceptions, like Armenia (see figures 3 and 4). Other indicators like corruption perception indices of the *Transparency International* or economic freedom indices of *Heritage Foundation* or *Cato Institute* provide similar evidence (see e.g. Figure 5).

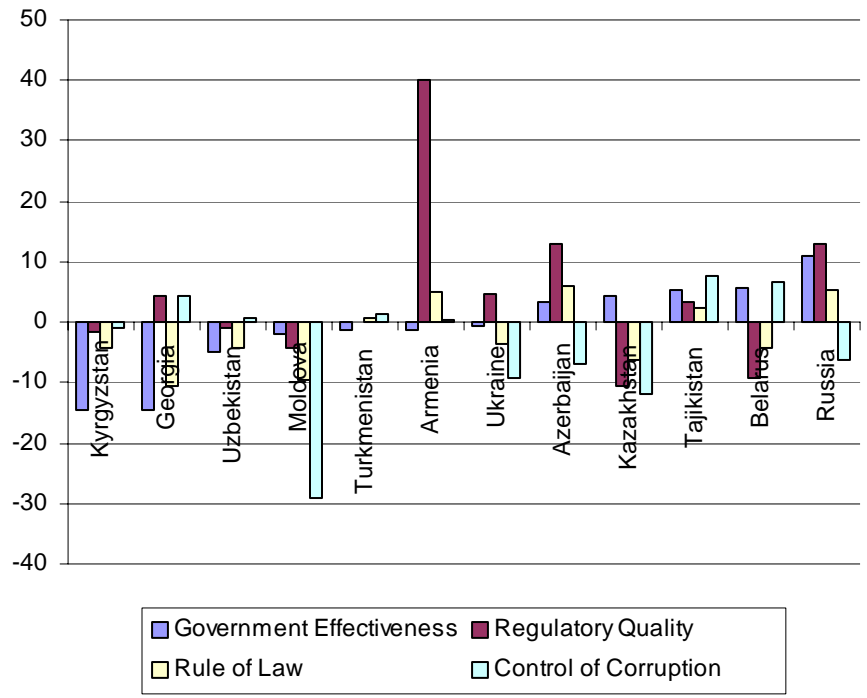


Figure 3: Changes in indicators of quality of institutions, 2002 to 1996, pp. (scale: 100 = maximum, high is good)
 Source: Kaufmann, Kraay, Mastruzzi, 2003

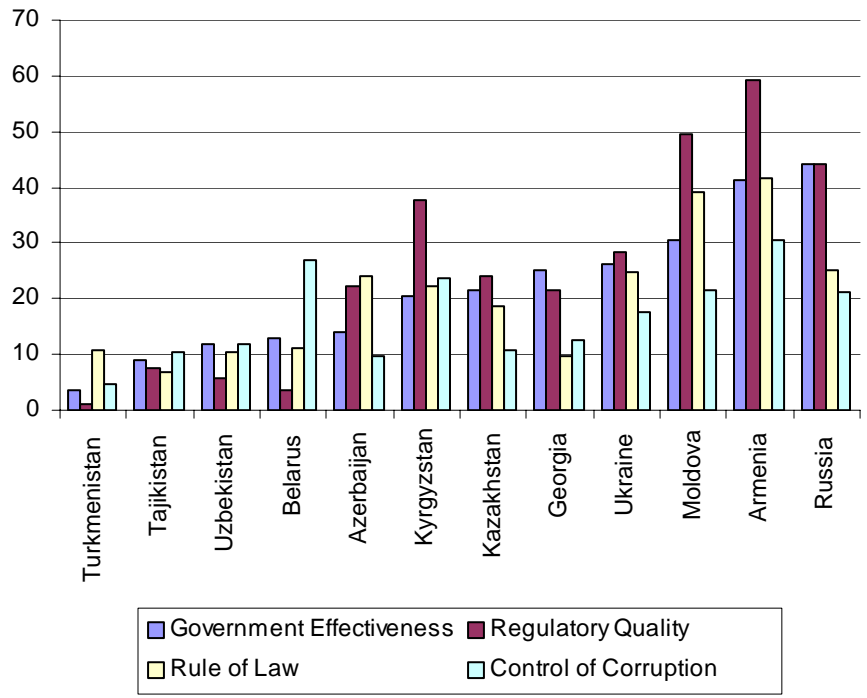


Figure 4: Quality of institutions in post-Soviet countries, 2002 (100 = maximum, high is good)
 Source: Kaufmann, Kraay, Mastruzzi, 2003

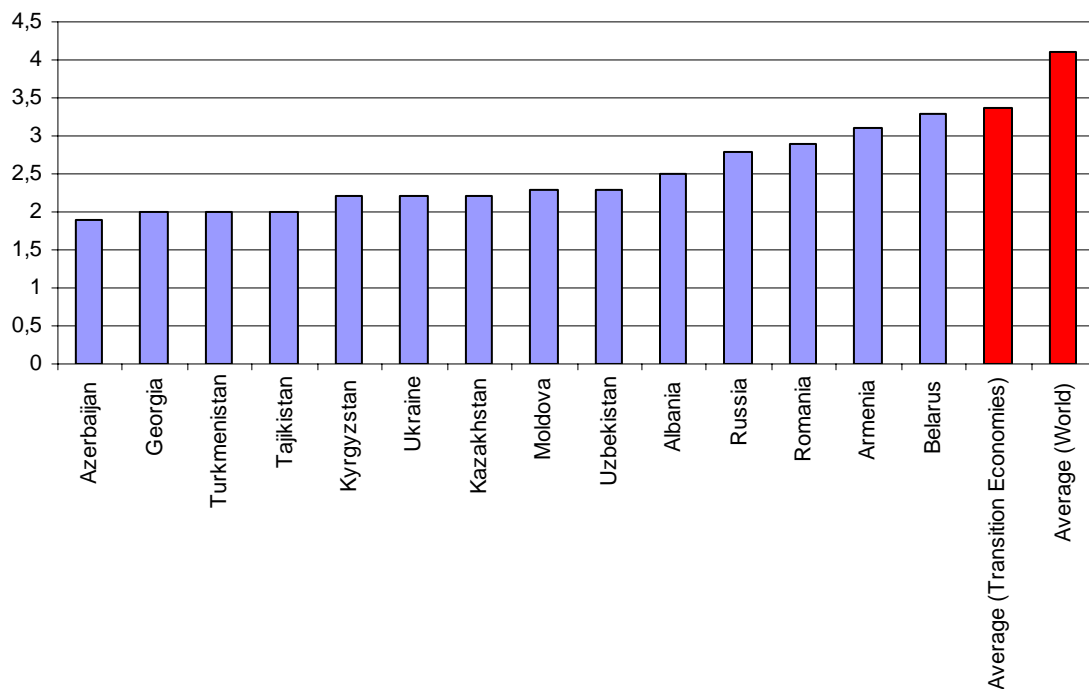


Figure 5: Perception of Corruption Index (low is bad)²

Source: Transparency International (2004)

In order to prove the hypothesis that the informal institutions of perception of norms determine the behavior of private actors in the multi-jurisdictional economy, it is necessary to consider the interrelations between the investment decisions and institutional change. As the statistical indicators of investment activity in the CIS are partly misleading, the case studies seem to be a more appropriate instrument of analysis. The recent experience shows that Russian investments in the post-Soviet space conserve inefficient economic and political orders. This behavior may partly be explained from the point of view of the rational rent seeking (Libman, 2005), but informal institutions may also be important. First, Russian corporations often use dubious investment and business mechanisms. Even the state-owned gas giant *Gazprom* organized its reselling activities with the Turkmenistan gas to be sold via Ukraine with subsidiaries *Eural TransGas* and (since 2004) *RosUkrEnergo*, which proved to be highly intransparent. As Russian business has significant experience in working with “shadow” schemes, it continues using this experience abroad. Second, investments are used to monopolize national markets. For example, a recently proposed *Eurasian Mining Company* of Russian, Ukrainian and Kazakhstan plants, has, according to several estimates, its most important

² Transition economies include CEE and CIS countries

objective in receiving control over the Russian *Magnitogorsk Metallurgical Plant (MMK)*. The first visible result of the establishment of this Company was the significant increase of supply prices for the MMK. Third, Russian corporations use their political influence to support semi-autocratic regimes. The most notorious cases are the investments of the *Deripaska's* group in the aluminum industry of Tajikistan and the planned activities of *LUKoil* in the oil sector of Turkmenistan. As semi-autocracies are one of the major sources of inefficient institutions in the post-Soviet countries, the Russian corporations thus support the existing inefficient institutional equilibrium (however, this feature (support of semi-autocracies) is typical not only for post-Soviet corporations, but also for many Western companies (e.g. Bayulgen, 2005)).

Other case (which requires more attention, but is even less visible) is the migration flows in the post-Soviet space, which have been substantial in the 90s. The labor migration in the post-Soviet space is to a great extent illicit and therefore embedded in inefficient institutions.

3.2. Long-Term Perspective

In the long term changes of formal institutions as result of the interjurisdictional competition can influence the evolution of the informal institutions. Two factors are relevant for this influence: the existence of the intergovernmental rivalry (in form of a kind of “invidious comparison” (Oleinik, 2005)) and strong ties between economies and societies in a multi-jurisdictional economy.

The rivalry between states has different forms in an interdependent international economy – from traditional military conflicts to strategic trade policy and competition for larger share of global markets or for political influence. However, the most important factor is that a more efficient economy is crucial for development of this international influence in all cases. An economy with better institutions (i.e. lower transaction costs) is *ceteris paribus* more efficient. In the short term factors like natural resources may give countries with a worse institutional frameworks additional competition advantages; but in the long term the role of institutions becomes more important. Therefore there is an impetus for institutional modernization even if there is no demand for better institutions (or demand for worse institutions) from below. The more intensive the international competition, the stronger is this impetus. As *Gerschenkron* (1992) states, government is the major factor of modernization in the backward countries, partly because the modernization pressure comes from the intergovernmental competition.

Interrrelation between societies and economies is also a factor, which makes more efficient institutions important. An open economy is a significant source of external shocks in different forms, because government's ability to control cross-border transactions is limited. Obviously societies with better institutions have a higher degree of adaptation (because costs of coordination and information transmission between interacting agents are lower) and can better sustain these shocks. As informal institutions determine institutional choice at the level of formal institutions, societies with more efficient-oriented informal institutions, higher institutional vertical trust and smaller gap between shallow and deep-level institutions have better chances to create institutional framework, which allows them to sustain volatility of an integrated economy. Therefore from this point of view of the *Hayekian* sociocultural evolution exactly these societies survive. Besides, invidious comparison is typical not only for governments, but also for individuals (that is the nature of what is called yardstick competition (Shleifer, 1986) in economics and institutional isomorphism (DiMaggio, Powell, 1991) in sociology). That is why cross-border flows of information can change people's attitude towards appropriate behavior schemes on deep and shallow level³.

The influence of invidious comparison and external shocks can weaken the short-term negative effects of informal institutions for the outcomes of institutional competition. Any government returns to the problem of institutional modernization from the point of view of international competitiveness and tries to enforce (even with coercion) better institutions; because of the mutual interdependence of formal and informal institutions this politics in turn changes institution's perception. The sociocultural evolution in presence of external shocks also leads to diffusion of more efficient institutions.

However, two factors run contrary to the possible long-term effects. First, due to diffusion of inefficient norms in a short term, there could be lack of efficient norms to imitate in the long term or the costs of imitation could exceed its advantages. A fundamental contradiction appears: without efficiency-oriented thinking, institutional competition leads to diffusion of inefficient institutions, without institutional competition and open economy efficiency-oriented norms' perception is hardly to appear. This problem does not seem to be crucial for the modern developing and transition economies because of the existence of the Western experience.

³ For example, studies of *Kliamkin* and *Timofeev* (2000) and *INDEM* (2005) show, that, despite partly increasing illicit activity and corruption in Russia, demand for corruption goes down.

However, at this stage cognitive problems occur. *Furman* (1995) shows similarities between the development of the post-Soviet economy and politics and the ideological visions of a capitalist society, which dominated in the USSR. The reforms have unconsciously implemented a cartoon with corrupt parliament members and illicit business activity – as in the Soviet textbooks. Actually there is evidence that post-Soviet leaders really perceive Western societies using the “Soviet glasses” (see *Furman*, 2004). This problem can be solved by long term learning process, but the temporal coincidence between this learning and the “long term” of evolution of informal institutions as defined above is ambiguous. Besides, implemented cartoons are also a source for learning – even a more important and visible, than foreign experience. As a result confidence in possibilities of import of institutions goes down.

This problem is strongly interrelated with the second negative factor. Unlike the competition of formal institutions, evolution of institutions’ perception is a long process with different social groups in a single state changing their perception models not simultaneously, but consecutively. That is why efficient institutions are formally imported from other institutional systems, but their ability to function is reduced by the general system of complementary institutions, or new institutions remain systematically misinterpreted when used by individuals (deliberately – as an instrument of rent-seeking – or offhand). That is why the efficiency of these institutions remains limited; they can even raise transaction costs because of complexity of the general system of institutions. This, in turn, leads to an increasing deficit of institutional trust in the society, which also disturbs the functioning of institutional competition in the future.

It is even possible, that important institutions apparently similar to the original ones perform a completely different function. This situation may be called “institutional pseudomorphism” (*Yevstigneev*, 1997). *Woodruff* (2000) discusses this problem, separating between the transactional and the judicial levels of market institutions in post-Soviet countries. His thesis is, that Russia’s effort to complete integration into the world economy leads to creation of market institutions (like money or property rights in corporations) on the transactional level (where these rights are traded and exchanged), but the judicial level (where these rights may be executed, e.g. in form of participation in a shareholders’ meeting) does not exist. According to *Pappe* (2000), a share in a Russian company means a claim, but not a guarantee of participation in the corporate decision-making. A similar “pseudomorphism” in political sphere represents the institution of elections: formally it exists, but a semi-authoritarian regime (like that dominating in

the majority of post-Soviet countries) does not allow any power change as result of free elections and tends to control it supporting incumbent candidates, changing the election rules and influencing the count process. *Olcott and Ottaway (1999)* define the post-Soviet political regimes (focusing on the Central Asia) as follows:

In choosing the term semi-authoritarian, we are not seeking to engage in a semantic discussion, but to highlight what we view as the defining characteristic of these regimes: *the existence and persistence of mechanisms that effectively prevent the transfer of power through elections from the hands of the incumbent leaders or party to a new political elite or political organization.* These mechanisms function despite the adoption of formal democratic institutions and despite a degree of political freedom granted to the citizens of the country.

Even the formal integration in the post-Soviet space could be interpreted from the point of view of the institutional isomorphism. A detailed consideration shows, that the post-Soviet integration (officially following the example of the EU) differs from the Western models. It means, that the formal structure of social institutions of integration adapted from the Western countries does not represent their real social function. European integration was supposed to construct a “common market” for the whole EU. The de-facto effects of the institutional competition include:

1. Protection of technological monopolies from competition inside and outside the CIS and protection of inefficient institutional systems in different countries (Yevstigneev, 1997). *Osmakov and Kopylov (2003)* call the post-Soviet integration projects “integration of common exclusions” (not of “common rules”), as their core is to guarantee exclusive monopolistic positions for every participant.

2. Protection of inefficient semi-authoritarian regimes, which seek the support of their neighbors to prevent democratization (Furman, 2004a). The experience of elections in Ukraine and Abkhazia (2004), as well as expectations for the coming elections in Kyrgyzstan show, that the structures of CIS usually support incumbents in their struggle with opposition. It is a typical situation for post-Soviet countries (which could be observed in Kazakhstan and in Ukraine in 2004), that observers from international organizations like OSCE give evidence concerning the incomplete conformity of elections with democratic standards, and observers from the CIS do not note any problems. It is probably possible to compare the CIS with the “Holy Alliance” of

European monarchies in the first half of the nineteenth century, which was established to prevent revolutions in Europe.

The institutions of “pseudomorphism” are “rules of the game” which contradict the “meaning of the game” and in that way destruct the game or change it so, that it becomes a new game with new rules (Sukharev, 2004). Individuals sharing the institutions of pseudomorphism, begin to believe, that the formal meaning of these institutions and their real social function are always identical, and that is why mistrust any institutions with the same appearance (as post-Soviet citizen often mistrusts any election, any entrepreneurship or any post-Soviet integration projects).

Institutional pseudomorphism, deficit of trust and misinterpretation of imported institutions can effectively block positive influence of invidious comparison and sociocultural evolution on informal institutions. Therefore inefficient outcomes of institutional competition can remain significant even in the long term. The initial state of informal institutions determines not only their short-term influence, but also paths of their long-term evolution. The lack of trust and systematic misinterpretation can ruin any attempts to get out the inefficient institutional equilibrium.

4. Conclusion and Normative Implications

The ability of institutional competition among jurisdictions to improve the quality of the formal institutions is limited because of the interplay of formal and informal institutions. In the short term perception of formal institution and of the government determines the institutional choice by private actors, which becomes more influential in the competition process. In the long term external shocks and invidious comparison may change the situation, but because of the effects of institutional pseudomorphism this positive effect can be limited.

This nexus of formal and informal factors at least partly explains the failure of economic reforms in several developing and transition economies, e.g. the post-Soviet space. Unlike other studies, which focus either on internal factors of several countries or on interrelation between the these countries and the global actors, this paper tries to uncover the less discussed problem of interrelations in the whole post-Soviet space as a region consisting of a number of independent states with strong economic ties but uncoordinated economic policies.

An advantage of this approach is that it goes beyond the standard thesis of “imperfect import of formal institutions” and “incongruence of formal and informal institutions”. The first approach focuses on rent-seeking behavior of bureaucrats and politicians, the second – on “resistance from below” to the new imported institutions. In the framework discussed in this paper these two points of view are combined: the egoistic behavior of incumbents is at least partly result of their participation in interjurisdictional competition, which in turn is determined by the informal institutions; the latter change in turn of the development of formal institutions and institutional competition in the long term.

Several studies (including the World Bank Development Report (World Bank, 2002)) propose the intensification of interjurisdictional competition as an important method of improving the quality of institutions in developing and transition economies. Moreover, institutional competition is an important element of the “market preserving federalism” of *Weingast* (1993), which is also often applied for federal states in transition and in developing countries. From the normative point of view, my paper argues, that institutional competition requires a system of informal norms regulating perception and valuation of formal institutions to be efficient. Otherwise institutional competition cannot improve the quality of formal institutions (measured from the point of view of transaction-cost efficiency) and even stabilizes inefficient equilibrium.

A central factor in the success of the institutional competition as instrument of ameliorating the quality of formal institutions is the development of vertical trust in the competing jurisdictions. Trust is crucial for short-term effects of institutional competition. It also prevents formation of long-term pseudomorphism effects. This feature is similar to the ordinary markets, where deficit of trust and information asymmetry lead to inferior outcomes (what may be called “pessimism agreement” (Oleinik, 2005a), when all actors assume the opportunistic behavior of opponents and lack of ability to prevent or control it). In the international economic relations due to (systematically) higher transaction costs the development of trust could be a more difficult task, than within national borders. Economic integration could act as an instrument of trust creating and signaling (see Fernandez, Portes, 1998), but in the post-Soviet case the pseudomorphism effects also dominate its institutions⁴.

⁴ An alternative, available only for limited number of countries in a very long term, theoretically could be the EU accession, but its prospects remain now unpredictable.

The second factor of critical significance for (especially) short-term and (partly) long-term effects of institutional competition is the acceptance of market order of worth for evaluation of government-business and government-society relations. It does not mean, that the market conventions should play an exclusive role in this sphere; however, if their influence is insignificant the chances to improve the quality of institutions via institutional competition are low; other instruments are to be used.

The third (long-term) factor, which could be important from the discussed point of view, is the intensity of “invidious comparison” (on both governmental and social levels) and of external shocks. If these factors are significant, the pressure of modernization necessity and sociocultural evolution is stronger. The increasing intergovernmental political rivalry in the post-Soviet space in the recent year could be therefore a positive factor influencing the results of institutional competition in this region.

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