

Post-socialist Transformation and Institutions

Competing Approaches and Challenges¹

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Abstract

Institutionalist analyses of post-socialist transformation have multiplied the meanings of *institutions*. We present neo-institutionalist and Hayekian approaches and underline their respective difficulties in analysing post-socialist transformation. We examine how an *original* institutionalist approach might overcome these weaknesses. The paper then evaluates the challenges for an approach inspired by original-institutionalism to post-socialist transformation. Specifically, these relate to (1) defining path dependence under rapid institutional change; (2) analysing routine change under hyper uncertainty; and (3) overcoming the duality spontaneous / constructed institutional evolution.

1. Introduction

In this paper we aim to 1) demonstrate the development of institutionalist post-socialist analysis has related to the multiplication of its meanings; and 2) outline the conceptual challenges faced by a framework inspired by *original* institutionalism when applied to post-socialist institutional evolution.

The notion of *institution* has been increasingly used in economic literature. We propose post-socialist transformation was one of the causes behind this theoretical shift in the late 1990s. Murrel (2003) shows the number of Econlit *papers in transition literature* focusing on institutions have grown and overlapped liberalisation and stabilisation subjects from 1995 onwards. We propose post-socialist *surprises* are a cause for this surge.

In Kuhn's analysis of scientific revolutions, *normal science* cumulates anomalies, which it cannot address. In economics, a-institutional approaches (particularly the *Washington consensus* approach²) cumulated *anomalies*. In post-socialist analysis, those *anomalies* or *surprises* were:

1. Early predictions proved to be highly optimistic³ (Chavance, 1994; Kolodko, 2001; Roland 2001a). Post-socialist *great depression* (Chavance, 1994: 176) was deeper and longer than anticipated. *Ex-post* mainstream economics' interpretation of post-socialist crisis revealed unconvincing (Chavance, 1994) and particularly powerless to explain why, in some countries,⁴ crises returned by the second half of the 1990s.
2. National economic performance divergence contrasted with the idea of homogeneity in *textbook planned economics*.
3. *Spontaneous privatisation*⁵ was also an unanticipated result of liberalisation.

4. Following Czech 1997 crisis, *mass privatisation*, which had been encouraged by the World Bank, proved to have led to property right expropriation and *tunnelling*.⁶ After being shown as a *good student*, Czech Republic deceived its tutors and Czech financial system proved to be less efficient than more regulated Polish financial markets (Glaeser *et al.*, 2001).

Why weren't these results anticipated? Several authors have related these problems to the a-institutional character of mainstream economics and its *tabula rasa* view of economic change (e.g. Chavance, 1994, 2002). By the late 1990s, awareness about institutions revealed in Washington-Consensus related publications.

«A lack of institutional development turned out to be the missing element in transition policies based on Washington Consensus (...). Hence, even with progress in liberalisation and radical privatisation, there was still no positive supply response» (Kolodko, 1999: 8-9).

«If anything, the experience of transition shows that policies of liberalisation, stabilisation, and privatisation that are not grounded in adequate institutions may not deliver successful outcomes» (Roland, 2001a: 30).

Elsewhere, short references to post-socialism were used to positively appraise original/sociological institutional economics (OIE).

«the recent experience of Eastern Europe and Russia would support the central tenet of sociological institutionalism (...) viz. the embeddedness of markets and economic behaviour in a complex nexus of social institutions and relation» (Zafirovski, 2000)

«the emerging and transitional political economies in general offer a unique laboratory for OIE (...). OIE suggests that perhaps the effects on Russian society should have been considered before, rather than after, the delivery of the shock therapeutic advice these amateur institutional economists offered» (Stanfield, 1999: 246).

The recent institutionalist surge in economic thought has not increased proportionately the interest in the *original* institutionalist tradition, but most often contributed to the development and increasing diversity of new institutionalism (NIE). We will develop later on how these differ in post-socialist analysis. This distinction relies on the traditional opposition developed by Nelson and Sampat (2001) (who

distinguish *neoclassical institutionalists* and *earlier institutionalist tradition*), Zafirovski (2000) (*new economic institutionalism* and *sociological institutionalism*), which Stanfield (1999) (*new institutional economics* and *original institutionalism*) and Hodgson (1998) and Hardy (2003) (*new* and *old* institutional economics, respectively NIE and OIE).

However, the simple opposition between the old and new institutionalist analysis neglects the particularities of analyses focusing on spontaneous evolution. Although Hodgson (2003; 2004) considers Menger to be NIE’s main influence, not all these authors focus on spontaneous evolution. As we shall see, a sort of NIE has developed close to *Washington consensus* institutions which relies on explicit and prescriptive rules. Moreover, this *newest* institutionalist analysis is very distinct from North’s work (whose contributions we will isolate). Although North (1993, 1997) acknowledges the importance of implicit, particularly informal, constraints, he treats them as exogenous and explicit institutions appear as determinants. Conversely, *original* institutionalism tends to oppose the distinction between implicit and explicit institutions and to focus on systems of institutions.

We propose to differentiate four institutionalist approaches, which distinguish, particularly, in their definition of institutions and their views on institutional evolution.

Table 1: A First Approach to Contrasting Institutional Analyses

| | | Institutional evolution | |
|------------------------------------|------------|---------------------------------|---|
| | | Mainly Perfecting | Can be non-perfecting |
| Treatment of informal institutions | Exogenous | NIE | North (1993; 1997) |
| | Endogenous | Spontaneous evolutionism | <i>Original</i> institutionalists North (1999) |

2. Four competing institutional approaches to post-socialist transition

a) Washington consensus, institutions and governance

Washington consensus cumulative theoretical revisions have encompassed, in the late 1990s, the introduction of *institutions* and *governance*. This perspective holds *Washington Consensus* failed because it did not make room for institutions.

«If institutional change is slow, the time horizons for structural adjustment programs need to reflect this. Adjustment that would sustainably improve development prospects simply cannot happen over three or five years — the typical duration of these programs.» (Rodrik and Subramanian, 2003: 34).

Following Douglass North, World Bank (2002) defines institutions as the rules of the economic game. These include both formal rules and informal norms. As institutions *«place restrictions on undesired kinds of individual behaviour»* (Roland, 2001a: 37), they will reduce uncertainty. Institutions are solutions to asymmetrical information problems as they secure property rights through legal and judicial systems, competition policy, financial systems and political institutions.

If we analyse this movement at the light of Kuhn's scientific revolutions, *Washington consensus* institutionalists are *normal science puzzle-solvers*. They reform mainstream economics theoretical framework, while protecting its core (maintaining Pareto-efficiency criteria, methodological individualism, universalistic modelling, static models and time reversibility). These developments support a certain theoretical *«shift of emphasis from markets and price theory to contracting and to the legal, social, and political environment of contracting»* (Roland, 2001a: 30).

One particular strand in this literature deals with *governance institutions*. Kaufman *et al.* (2003) *aggregate governance* includes six measures : (1) *voice and accountability*; (2) *political stability and absence of violence*; (3) *government effectiveness*; (4) *regulatory burden*; (5) *rule of law*; and (6) *freedom from graft*. This analysis is

influenced by both Oliver Williamson's and principal-agent literature's search for optimal governance structures under prominent opportunistic behaviour and asymmetrical information.

To Williamson (2000: 278-282) governance structures are not a part of the institutional environment, but are structured by it. However, some authors, completely assimilate *institutions* and *governance*. For example, Brunetti *et al.* (1997) propose «*institutions range from bankruptcy laws to regulations on insider trading to rules defining property and contract rights*» (*ibid*: 2). Rodrik and Subramanian (2003) also assimilate *institutions*, regulation and regulating bodies. Murrell (2005) account of institutional analyses of post-socialism also focuses on Williamson's governance structures analysis. To Murrell (2005: 37), Eastern European «*very quick formal institutional accumulation*» (*idem*) is remarkable.

Additionally, a set of econometric analyses has developed to evaluate the influence of institutions on economic variables, and particularly on economic growth. In post-socialist analysis, Campos (2000), EBRD indicators (e.g. EBRD 2003) and Brunetti *et al.* (1997) all evaluate transition based on property rights' protection related indexes, as well as some political stability and transparency measure.

This first type of *institutionalism* raises some questions.

First, there is a danger that *institutions*, as they substitute one-sided explanations of economic growth, may become *the* single cause for growth. Institutions affect, and are influenced by, other growth determinants (policies, inequalities, macroeconomic stability, human capital, etc.); this cumulative causation remains largely unaddressed.

Second, distinguishing *good* and *bad* institutions assumes growth promoting institutions are universal. Mainstream economics' universalistic penchant is so

significant, it cannot accommodate diversity. Although EBRD alerts specificities are important, its transition indexes⁷ continue to order countries in their *transition to a market economy* (Chavance, 2003). Similarly, although World Bank (2002) acknowledges from the start that «*there is no unique institutional structure guaranteed to lead to economic growth and poverty reduction*» (World Bank, 2002: 5), the report evaluates *institutional quality* based on universal measures such as ‘*complexity of procedures in debt collection*’ (p.12).

Third, institutional engineering pretensions often neglect bottom-up institutional emergence. To Campos (2000: 2), «*institutions are much more malleable than initially thought*». In fact the role and evolution of informal norms are ill-addressed. World Bank (2002) consecrates only 9 pages (less than 5%!) of the report on *building institutions for markets* to ‘norms and networks’. Informal institutions are largely treated as given constraints. In fact, Williamson (1990) suggests *embeddedness* influences but is not a part of the *institutional environment*.

Fourth, introducing institutions in mainstream economics models poses serious methodological questions, namely in dealing with history and rationality. For one thing, one cannot say *history matters* and use models that assume time reversibility (David, 2002: 16). Moreover, mainstream economics builds on a-institutional models of substantive rationality. Where bounded rationality is introduced, it is interpreted as imposing constraints on optimising behaviour with universal materialist goals. Informal institutions are often reduced to notions such as social capital or trust (vide, e.g. Raiser, 2003) and their emergence explained on the basis of rational decision (Peukert, 2001: 92) made on an Hobbesian state of nature.

Also, combining, as Roland (2001) proposes, Hayek and neoclassical microeconomics is problematic. Neoclassical economics completely neglects Austrian

subjectivism (Garretsen, 1994). Both traditions treat rationality, uncertainty and prices differently. To Austrian economics, prices imperfectly disseminate information. In fact, «[t]he Austrian (and notably Hayek's) well known criticism of a centrally guided economy also applies to the neoclassical analysis of a decentralised economy» (Garretsen, 1994: 96).⁸

b) Modified NIE : Douglass North on economic transition

North's framework has evolved importantly. Authors (e.g. Vandenberg, 2002) often emphasise 1990s turn, whereby he modified his rationality assumptions and opposed a vision of history as a tale of efficiency improvement.⁹ North has thus furthered from Williamson's a-historical analysis (Vanderberg, 2002) on which most *Washington consensus* institutionalism relies. North criticises overtly neoclassical theory, of which he keeps only «*the fundamental assumption of scarcity and hence competition and the analytical tools of microeconomic theory*» (North, 1994: 359).

North defines the institutional matrix as an admixture of formal rules, informal constraints and the enforcement of both. Institutions determine transaction costs, which explain economic performance. Economic performance is enhanced by *adaptatively efficient institutions* (North, 1997b: 3), which «*encourage trial and eliminate errors*» (*ibid*: 4). «*The creation and enforcement of efficient property rights depend on the polity ...[the] agent of change is the entrepreneur – political or economic*» (North, 1997b: 7). Entrepreneur's beliefs and choices are structured by the institutional matrix. Culture «*provides a language-based conceptual framework for encoding and interpreting the information that the senses are presenting to the brain*» (North, 1997b: 14). Learning and cultural transmission produce path dependence, while «[t]he sources

of institutional change are changing perceptions sometimes reflecting changes in relative prices and/or changes in preferences» (North, 1997b: 6).

North considers this model can explain *«difficulties involved in reconstruction when much of the scaffold crumbles, as happened in 1989 in Eastern Europe»* (North, 1997a: 16) because formal rule transfer is not a condition of good performance (North, 1994: 366). Differences between post-socialist countries can be tracked to informal norms diversity (North, 1997a: 17) ¹⁰ and to *«different ways to structure the game»* (North, 1999: 22) as Chinese reforms show.

Particularly, privatisation will not improve performance if informal constraints remain unchanged (North, 1999: 20).

«Changing merely formal rules will produce the desired results only when the informal norms are complementary to that rule change, and enforcement is either perfect or at least consistent with the expectations of those altering the rules» (North, 1997a: 16)

Nee (1998) also endorses enforcement costs depend on the complementarities between formal and informal institutions. Non-complementary formal rules hold high enforcement costs, since opposition norms may develop.¹¹

North clearly overcomes some difficulties experienced by *unmodified* NIE analyses. His analysis does not propose one single institutional framework and acknowledges the limits to institutional engineering. Yet, recent developments in North's framework collide with its neoclassical origins. For example beliefs are treated as constraints on choice (e.g. North, 1999: 11). Since *«[w]e do not possess the information to update our subjective theories to arrive at one true theory»* (1997b: 13), behaviour will be based on *«miscalculation leading to famine, starvation, deceit and warfare, death, economic stagnation and decline»* (North, 1999: 18). On the contrary, as we shall see, *original* institutionalism considers habits and routines enhance action.

While informal constraints are central in determining economic performance, social rules are under-elaborated (Hodgson, 2004: 426) and considered exogenous. Particularly, North does not explicitly analyse how individuals evaluate social sanctions and incentives (Hodgson, 2004: 430).

Informal norms are largely treated as static and inertial forces (Chavance, 2003). This neglects the importance of informal institutional evolution, for example, in post-socialist countries. Even what is considered as an heritage will, in fact, be different as it is adapted to a new and evolving institutional system.

Although North envisions *adaptive* (rather than allocative) efficiency (North, 1994: 367), his insistence on *efficiency* raises some questions. Efficiency is not a straightforward concept, as all situations involve a trade-off of rights and duties of different groups and individuals (Peukert, 2001: 110-111). Economic growth is not an end in itself. For example, when North (1999: 22) observes «*what China has done*» and praises the growth it has experienced, he disregards what China has not done to promote other components of human development.

c) Institutionalist analysis based on spontaneous evolution

Kornai and McKinnon favour an organic process of private sector development, based on the «*bottom-up development of the private sector*» (Kornai, 2001: 51). As Murrell (1992: 44-46) they all deplore the lack of interest received by new private firm development relative to attention paid to privatisation. This would have furthered post-socialist depression.

This perspective differentiates from previously reviewed analyses, which focused on the role of formal rules (namely property rights). And these approaches are particularly

influenced by Hayek's analysis of a market economy working through a set of implicit rules. To Hayek *«humans acquired the ability to bring about factually ordered arrangements serving their needs because they learned to order the sensory ordering from their surrounding according to several different principles»* (Hayek, 1988: 15). To Hayek property rights are abstract rules that elaborate on implicit rules which evolved spontaneously through the selection of groups adopting them.

While to NIE, institutions derive from an Hobbesian state of nature; to Hayek (1988: 12) *«[t]here was never a 'war of all against all'»*. Hayekian institutions *«are handed on by tradition, teaching and imitation»* (Hayek, 1988: 12). NIE does not envision, as Hayek does, that *«[t]he belief that one should follow a convention is the product of the same process of evolution as the convention itself»* (Sudgen, 1989).

Kornai (1993)'s notions of *systemic coherence* and *institutional affinity*. originate in Hayek's model of selection, where only those institutions that are adapted to the economic environment can survive. Specifically, both Hayek and Kornai establish an affinity between (private property) and (market) mechanism, and criticise combining market and state (e.g. *market socialism*).

McKinnon (1992) deduces that, on Hayekian grounds, reorganising the economy should be a lengthy process and thus criticises big bang-type massive surges of legislation. He suggests this explains the successes of China relative to Eastern Europe.

In Murrell (1992)'s evolutionist framework, a slow reform might have worse results, because it would have meant firms faced adverse environment for a longer period.¹² Murrell (2003) quotes Roland (2000: xx) who questions *«whether 'transitional institutions' represent stepping stones toward better institutions or whether they create vested interests that block further institutional transition»*

Contrary to Washington consensus reformists, who underline the need for formal rule provision, McKinnon (1992: 32) proposes «*the need for entirely new legislation – whether or not enacted by a duly elected legislature – is minimal*». Kornai (1990) remarked that by simply bringing an end to some restrictions, private sector developed rapidly.

These positions are resilient of Hayek, to whom the market is a spontaneous order «*which no brain has designed but which has grown from the free efforts of millions of individuals*» (Hayek, 1974). The idea that institutions serve human design is false and only pleasant to our vanity (Hayek, 1973: 9).¹³ Nonetheless Hayek (1988: 36; 69) appraises positively «*piecemeal improvement*» deriving from new investigations on property rights (he cites Coase). The line between legitimate and disruptive forms of intervention thus becomes ambiguous. While Kornai (1994; 2001), McKinnon (1992) and Roland (2001a, 2001b) criticised *mass privatisation*, which they judged contrary to market organic evolution, others (e.g. Frydman *et al.*, 1998: 29) have supported it because they find it less constructivist than buy-outs. In fact, Kley (1994: 32) considers spontaneous order and organisation should be regarded as *ideal types* (*ibid*: 32).

Moreover, Kornai (2000: 32) considers Hayek's insistence on spontaneous order is too extreme and incapable to «*reflect adequately the complexity of the transformation*». He concludes «*the spontaneous development of capitalism speeds up significantly if the state is an active assistant*» (*idem*). This paradoxical formulation results from the fact that, to Kornai (1994), the state will hold different responsibilities in a market and in a transitional economy.

Hayek's analysis tends to suggest that all that exists has a function, thus if we try to change it we will condemn humankind to starvation. Yet, since some people tend to «*condemn the wealth-generating institutions to which they themselves owe their*

existence» (Hayek, 1988: 119), he must admit some elements are dysfunctional. These people's reasons and Reason do come, as other's from *evolved morality*. How then can we distinguish functional from dysfunctional institutions? Furthermore, self-sustaining equilibria do not dismiss the need for third party intervention. Both spontaneous orders and Prisoner's dilemma are self-policing (Hodgson, 2004: 432-434).

d) Heterodox institutional analyses of post-socialist transformation

Traditionally heterodox economics is heterogeneous and thus analysis difficult to affiliate together. We define heterodox institutional analysis particularly because they refuse the idea of *transition to a market economy*, preferring to refer to socio-economic *transformation*. This meant post-socialism could not be seen as a shift between mirrored models of resource allocation.

Primo different authors acknowledged how real socialism was different from *textbook planned economies. state capitalism* (Chavance, 1995) and the *mobilised economy* (Sapir, 1990) were analysed as forms of capitalism with centralised allocation and state property. Moreover, national reforms gave rise to divergent adaptations of the *planning mechanisms*. Both Haney (2003) and Róna-Tas (1998) argue *marketization* in Hungary started in the mid-1980s.

Segundo novelty emergence means *transformation end point* is unknown and denies the existence of *one* road leading to *one* unique model of a market economy. Differences in exit paths as well as different policies will entail irreversible unexpected effects. Contrary to Kornai's insistence on affinity, *impurity* and *incoherence* are possible (Chavance and Magnin, 1996; Stark and Bruszt, 1998). Central European *recombinant property* appears as a common unexpected configuration emerging from diverse privatisation models (e.g. Stark and Bruszt, 1998).¹⁴ Conversely, Russian and

Chinese economies are different from any other existing market economies. Ericson (1999) suggested Russian economy is closer to feudalism than to capitalism. Moreover Russian economic actors cannot be understood by mainstream economics ideal types (Sapir, 1998).

Macro-level elite conversion and firm-level management conversion illustrate the existence of path dependence. Elite conversion (e.g. Hadey *et al.*, 1995; Rona-Tás, 1998; Szelenyi *et al.*, 1995) combines inertia in income distribution and to some upward and downward mobility. Through conversion, socialist social and cultural capital was converted into economic capital (Rona-Tás, 1998: 117-118). Intra-firm top management conversion processes also involved mobility (upward, downward and exit) as well as path dependence, since most upward hierarchical mobility is done by previous elite-in-waiting (second-rank managers) (e.g. for Czech Republic, Clark and Soulsby, 1996; for Russia, Linz, 1996).

Managerialism has been coined (e.g. Eyal *et al.*, 1997) to suggest post-socialist managers hold *de facto* property rights. This could also be a path dependent institution, since information asymmetry under central planning already gave managers an important autonomy. Yet, this power did not evolve linearly and is in part a result of privatisation. Mass, buy-out or insider privatisation all enhanced manager control.

Drawbacks:

Heterodox institutional analyses are not unified and only seldom cumulative. If openness and diversity is an advantage, they can also be a drawback, since non-cumulative efforts may be lost. The works applying to post-socialism are mostly independent.

it tends to underline incremental change and neglect novelty.

Incremental change is largely a result of routines and habits inertia under uncertainty. This, however, cannot hold under systemic transformation.

3. The potentialities and challenges of an OIE-inspired framework to post-socialist institutional evolution

a) An OIE-inspired framework

Original (or *old*) institutionalism (OIE) derives from American institutionalism and has particularly been influenced by pragmatism and German Historical School (see Peukert, 2001). Methodologically, it insists on the need for realism (Hardy, 2003) and privileges comparative method, qualitative data and interdisciplinary research (Stanfield, 1999). This does not mean it is descriptive or adept of *measurement without theory* (vide Hodgson, 1998). It builds theoretical conjectures on *stylised facts*.

There are different definitions of institutions and approaches. We shall rely here on the framework developed particularly by Hodgson (1993; 1998; 1999; 2003a; 2004). Hodgson (2003b: xiii; 2004: 14) defines institutions as «*durable systems of established and embedded social rules that structure interaction*». To Hodgson (1998; 2003a; 2004), the link between behaviour and institutions is mainly established by habits. Habits are «*a largely non-deliberative and self-actuating propensity to engage in a previously adopted pattern of behaviour*», which arises in repetitive situations (Hodgson, 1998: p. 178). Through *reconstitutive downward causation*, institutions structure habits of thought, which influence beliefs and these affect reasons and intentions, which will shape individual action (Hodgson, 2004: 162-175).

Yet, *reconstitutive downward causation* (Hodgson, 2003), from institutions to individuals, does not exclude upward causation (from individuals to institutions). Institutions mould individual activities on which they depend (Hodgson, 2003a: 163-

164). *Purpositive* action is embedded in a concrete relations system, which is produced and reproduced during interaction (Granovetter, 1985). OIE analyses institutions rather than individuals because «*each individual is born into, and moulded by, a world of pre-existing institutions: even if these institutions were made by others and can be changed*» (Hodgson, 1998: 184).

Original institutionalism does not exclude variety and heterogeneity. «*The institutionalizing function of institutions means that a degree of order and relative stability can be reinforced despite variety and diversity at the microeconomic level*» (Hodgson, 2003b: xvi).

Institutionalisation has an important cognitive dimension. Agents make decisions in self-reference environments since they «*create stable expectations of the behaviour of others*» (Hodgson, 2003a: 163). Institutions are repositories of social knowledge (Hodgson, 2004: 168; 181). Such definition establishes a (non deterministic) link between cognition and action.

Considering institutional evolution, we'll adopt Hodgson (1999) NEAR (novelty-embracing anti-reducionist) framework. This combines incremental change and novelty.

Evolution is partly incremental because «*regularities at the systemic level (...are) reinforced through positive feedbacks that act in part, upon the microeconomic elements*» (Hodgson, 1989: 171). Cumulative upward and downward causation entail path dependence, lock-in, stability and inertia. In economic evolution, habits act as *replicators* (Hodgson, 2003); they copy their structure with some fidelity in successive replications (Hodgson, 2004: 417).

Conversely lock-in does not imply deterministic evolution. «*Habits and routines may adapt slowly or 'mutate' as agents attempt purposeful improvements*» (Hodgson,

1998: 175). *Capricious novelty* is always possible (Hodgson, 1998: 173) and may, according to Veblen, result from *idle curiosity* (Hodgson, 2004: 189). It may also come from chance (as Jean Cocteau said, if you don't believe in chance, how can you explain the success of those you don't like?). Hodgson (1999) sustains in open systems, change is both endogenous and exogenous. Endogenous change may result from differential replication, owing to the interaction between some *interactor* and the environment (Hodgson, 2004: 417). While exogenous change can be a result of environmental changes.

Potential novelty emergence in a cumulative causation framework entails latent butterfly effects, irreducible uncertainty and imprevisibility. «*Novelty may be caused, but it will often appear as spontaneous and free*» (Hodgson, 2004: 62).

The next sections will consider the challenges of post-socialist institutional evolution analysis to an OIE-inspired framework. First, although original institutionalism is not deterministic, the use of *stylized facts* may underestimate both deviant behavior and *capricious novelty* emergence. Secondly, we'll examine the cognitive and behavioral consequences of path dependence under hyper-uncertainty. We analyze particularly how these will affect habit evolution. Finally, we deduce the consequences of our framework to the debate over the role of constructed and spontaneous institutional evolution. As we have seen earlier, (unmodified) NIE tends to underline institutional engineering, while Hayek considers constructivism will prevent complexity. These polarized positions have both been criticized. Yet, if we admit institutional evolution is simultaneously top-down and bottom-up, both North and Dulbecco (2003) underline problems of coherence and complementarity will arise.

b) Path-dependence and Economic Transformation

Institutionalist analyses tend to underline cumulative causality, increasing returns, path dependence and lock-in. North (1994) emphasised informal norms evolve slower than formal rules, which can be changed by decree. This principle has been applied to post-socialist transformation (e.g. North, 1997; Roland, 2001; Ibahim and Galt, 2002). Yet, path dependence only denotes irreversible branching processes, not stability nor determinism. A non-deterministic approach to post-socialism must acknowledge small changes and innovations can shape future institutions.

Yet, institutional economics lacks a model of revolution (Chavance, 2003). Douglass North proposes revolutions are less revolutionary than its mentors would like. This does not imply they are not revolutionary at all. As Skocpol (1979) puts it, revolutions are not made, they happen.

Conversely, post- and neo-Schumpeterian analyses focus on discontinuous change, under the form of paradigm revolutions. Dockès (1998: 92) defines paradigm as an *«economic and technological style, which characterises a given historical phase in a given space»*. This notion allows us to reconcile incremental innovations (inside a paradigm) and global innovations (jumps out of a paradigm). *Punctuated equilibria* underlines a period of rapid change is *«a process of selection between wide range of newly emerged types of routines... this process moves relatively rapidly to a new equilibrium situation»* (Andersen, 1994).

We consider the notion of paradigm does not exclude Darwinist selection, which can explain 1) the internal coherence of a paradigm and 2) why the new paradigm has been selected over its rivals. Both of these join the problem of selection, which has mobilised different authors.

Conversely, in Hodgson's generalised Darwinism routine stability results from habits' role as *replicators* (Hodgson, 2004). Yet, replication is differential, as a result of *interactors*. Consequently, institutional transformation will be a product of *interactors* and of the processes of selection that sort the more adapted routines. Thus our research should be directed towards the study of selection processes, *replicators* as well as *interactors*.

In Hayekian selection, groups adopting more adjusted rules prosper and those rules will generalise. Kornai deduces systemic coherence is promoted by institutional affinity. Yet, different theories of dualism (modern/traditional or official/non-official economies) have acknowledged incoherence can persist in existing economies. Even if different institutions do adapt and *polish each other*, coherence is a long-term tendency which can only develop in static systems. Dynamic economic systems will hold incoherence and impurity.

Institutional synergy may be a more useful concept. Synergy defines the «*systematic and organic working together of the antithetical forces of nature*» (Hodgson, 2004: 229) and will sustain emergence (Hodgson, 2004: 405-7). Relations between system components entail new system-level properties. Innovations and mutations institutionalise through emergence. Accordingly, institutional systems have systemic properties that cannot be derived from individual institutions. As such, institutional systems, rather than particular institutions, constitute the relevant subject; «*reality is appraised and analysed as a structure of irreducible levels*» (Hodgson, 2004: 407).

Incoherence is a source of heterogeneity. It opens the room for different forms of property, combining public and private owners. It is a source of innovation. Commons' *great men* like Schumpeterian entrepreneurs are within society but are deviant. Hodgson (1993) proposes an economy needs both Cartesian and Stochastic groups; while the first

are good at reproducing existing knowledge, the latter are essential to finding new solutions. More generally, from a Darwinist perspective, as economic agents constitute an heterogeneous population, what institutions and behaviours are selected depend on existing variety.

Yet extreme incoherence risks bringing about what Durkheim defined as *anomie*. A state where there are no fixed points to individual action and perception. The development of informal activities and organised crime reveals the opposition between legal fixed points and group-level norms. Incoherences have been particularly important in Russia and other CEI countries and more limited in Central Europe and Baltic states.

c) Uncertainty and routines

A better understanding of institutional evolution will have to address routine and habit dynamics. As we have seen, following Hodgson, habits reinforce and are re-enforced by institutions, thus inducing incremental (non-determinist) institutional evolution. Post-socialist countries experienced, simultaneously, extreme uncertainty and systemic transformation. How can we conceptualise decision-making under these conditions?

Keynes advanced that since individuals cannot perfectly forecast, they assume the future resembles the present.¹⁵ Since under these conditions substantive rationality is impossible, Herbert Simon proposed routines are the basis of an alternative (procedural) rationality model. To evolutionists, routines enable *intelligent action* (Loasby, 2000) and *rational choice* (Hodgson, 1998; 2004); these are « *more the source than the result of insight, reason and understanding* » (Hayek, 1988: 21).

Cognitive and behavioural stability, however, will emerge only « *[i]f the novel situation is similar enough to patterns that we have in our mind, that we have derived*

from past experience... To the degree that the situations are really novel, they pose fundamental dilemmas» (North, 1999: 14).

The topic of behavioural legacies has been a very important in post-socialist studies. In the early 1990s, firms tended to react to the post-socialist recession with previous strategies, like inter-firm debts (Chavance, 1994: 189). Was this a behavioural legacy, replicating in a different environment (demand crisis) what had been a good strategy previously (with supply shortages)? The composition of debt-creation strategies created a new and unexpected environment, dominated by cross-credit and cross-property. If inter-firm credit persisted it was because it allowed firms to survive (and their managers to get wealthier) in this new situation and not because of behavioural inertia.

It has been suggested post-socialist transformation bred *systemic uncertainty* (Chavance, 2003). Contrary to *normal* uncertainty (i.e. the incapacity to attribute objective probabilities to different situations), under *systemic uncertainty* economic actors cannot anticipate how institutions will evolve. Under this *hyper-uncertainty* existing rules will cease to produce expected results while creating important short term rents. *Expectations on change* and *change in expectations* will have an important role in shaping institutional evolution (Chavance, 2003).

Individualist traditions stress that routines apply to minor decisions, and that major decisions call for different procedures. Arthur (2000: 5) maintains that «*agents linger with the currently most believable hypothesis of belief model, but drop it when it no longer performs*». Yet, if they drop their mental model, how can economic actors decide and act?

Mary Douglas (1999) suggests most probably people will rely on institutions for major (not minor) matters. If we define institutions as rules on comprehension and if we assume routines are structured by institutions, routine change can be brought about by

cognitive dissonance (Sapir, 2003). To Commons, when individuals face «*situations that cannot be handled adequately with habitual patterns of behaviour (...they) engage in a process of problem solving and attempt to modify existing rules*» (Bazzoli, 2000: 71).

Institutional innovation will emerge from the action of *institutionalised* economic (and social) actor and from state institutional provision. This diverse sources of change bring us back to the problem of institutional incoherence and to the possibilities of institutional engineering.

d) Beyond Constructivism and Spontaneity: The Analysis of state Institutional Provision

Traditional approaches to state institutional provision can be polarised into constructivists and spontaneity supporters.

Constructivist approaches are based on the assertion that economic institutions can and should be imposed from above. Constructivists separate spontaneity from market and private sector development:

«If institutional arrangement is neglected and left to the spontaneous processes and unleashed forces of liberalised markets, then informal institutionalisation fills the systemic vacuum. The negligence of government in organizing market infrastructure with active policy is causing a situation in which informal organisations and institutional links among them are taking over. Extreme cases here are vast corruption and organised crime.» (Kolodko, 1999: 24).

As we have seen earlier, Kornai and McKinnon, following Hayek, supported spontaneity and a critic of constructivism, which he claims will impede complexity from developing. We have already criticised this approach and underlined ambiguities in the difference between constructed and spontaneous orders.

We propose these approaches are only partial, since state provision does not prevent complexity nor spontaneous evolution.

Top-down does not exclude bottom-up institutional evolution. Specific policies will always have unintended effects, some of which will be divergent. For example, generous social policy has been said to facilitate inactivity expansion in early 1990s Hungary.¹⁶ However, the effects of this policy are more complex. Had employment possibilities for older workers been less gloomy, inactivity expansion would be smaller.¹⁷ Conversely, female participation rate decrease might be attributed to stricter social disengagement, which increased prices in childcare services (Matos, 2002).

If we consider the economy as a multi-layer system of interacting institutions, state is an embedded institution. State agents' perceptions and beliefs are affected by habits, which are influenced by general system of institutions.

Hardy (2003) refers to the role of supranational organisations in framing *enabling myths*. These «amount to a fiction which plays down differences in institutional conditions to create a deceptive clarity that a specific ways of organising things is self-evident» (Hardy, 2003). Block (2000: 55) maintains «the project of creating a market system requires an act of collective imagination»; particularly, following Polanyi, he considers this involves thinking about labour, capital and land as if they were true commodities. Another example can be found in post-socialist countries, where, in the early 1990s, informal economy could not easily be distinguished from the *new private sector*. Governments, fostered by international agencies, feared fighting underground activities would worsen economic crisis (Matos, 2002).

State power is instrumental in inter-group disputes. Institutional evolution is structured by power; «some with power and status are manoeuvring to initiate changes that they believe will likely result in augmentation of their relative ranks» (Stanfield,

1999: 235). As institutions structure access to the decision making process, some groups have access to establishing future *dominant models of thought*. Michel Foucault studied how social definitions (and thus institutions) contain a form of cognitive violence.

In post-socialist countries, the definition of what kind of a market economy should be envisioned was doubled by local debates over punctual measures and legitimate interventions. Lissowska (2003) showed how interest and pressure group activities influenced Polish state intervention. The activities of these groups were stimulated by disputes over transformation policies.

On the other hand, the legal system will have feedback effects on society and informal norms. According to Zafirovski (2000) this question has been absent of both *neoclassical* and *sociological* institutionalism. For example, death penalty can be seen as central to one society and tremendous barbarian to another. Informal norms do not develop independently from formal rules.

Simultaneous bottom-up institutional emergence and top-down institutional provision create tensions and risks of non-complementarity. North or Nee sustain non-complementarities between formal and informal institutions increases enforcement costs and decreases efficiency. Chavance (2003) proposes divergent to incoherent configurations of formal and informal rules in post-socialist countries correlate with attenuated to weak enforcement.

Non-complementarity has often (e.g. North, 1997; Nee, 1998; World Bank, 2002; Dulbecco, 2003) been implicitly associated to formal rule provision irrespective of informal constraints. Nevertheless, we should acknowledge incoherence may emerge

from informal rules, particularly those that are enforced by competing groups. As such, the state will be called upon to correct informal constraint incoherence.

Additionally, incoherence may result from defective enforcement and public budget austerity. For instances, unrecorded wage and unrecorded employment expansion lowered fiscal resources, thus keeping payroll taxes high. Furthermore, important employment *informalisation* (Matos, 2002) entails costly statistical verification and rare denouncing, thus depressing budgetary resources.

4. Concluding remarks

This paper proposed the use of *institutions* in post-socialist analysis associates with the multiplication of its meanings. It additionally outlined what we consider are the major challenges to an institutionalist analysis of post-socialist evolution.

In the beginning of our paper, we have analysed how the surge in institutionalist concepts could be interpreted as a response to anomaly accumulation in normal science. According to Kuhn, when it is confronted with growing anomalies, dominant paradigm can try to sort them up as *puzzles*, or a crisis will open, after which an alternative paradigm establishes. In this particular case, neoclassical theory, associated with Washington consensus faced a theoretical crisis. Did it sort its puzzles out? The concept of institutions was often introduced as a solution-concept, yet its definition has been rather vague and *ad-hoc*. Will these procedures prevent a scientific revolution? Is there an alternative paradigm being outlined? This question is certainly a rather interesting one for future research.

We propose, however, that unpredictability may make OIE-inspired analyses unappealing to both politicians and to those economists who are too attached to

forecasting capacities. On the other hand, realism should be interesting to politicians, who often complain about (mainstream) economic models' lack of realism. And forecasting under hyper-uncertainty is largely self-defeating, as early 1990s forecasts for post-socialist countries proved.

Equally, as scientific knowledge is institutionally structured, subject uncertainty (which translates into unpredictability) is doubled by knowledge uncertainty (scientific indeterminacy). How can economic *science* sustain this? Most of these authors would probably confess with Hayek (1973) (as this is common between the two approaches) that they «*prefer true but imperfect knowledge, even if it leaves much indeterminate and unpredictable, to a pretense of knowledge that is likely to be false*» (Hayek, 1974).

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² Washington consensus model to economic development is based on the idea that development will stem from stabilisation, privatisation and liberalisation

³ IMF's early predictions expected a small crisis for 1991 and growth from 1992 onwards, yet globally output dropped by 10,7 and 3,6 percent in 1991 and 1992, respectively (Kolodko, 2001).

⁴ Bulgaria, Czech Republic, Latvia, Moldova, Romania and Russian Federation.

⁵ This process involved individual appropriation of state firms. In former Soviet Union countries, this associated with legal possibilities created by Soviet leasing and cooperatives in the late 1980s. In Hungary, it also entailed exchanging *debt for shares*. Everywhere, socialist firms' top managers profited from legal holes to appropriate firms' assets.

⁶ «*In a typical scheme, the managers of an IPF holding a large stake in a private company would agree with the managers of this company to create a new (possibly off-shore) entity, which they would jointly control. The IPF might then sell its shares in the company to this entity at below market price, thereby expropriating the shareholders of the IPF*» (Glaeser *et al.*, 2001: 26)

⁷ EBRD (2003) classifies transition progress on the basis of (i) the proportion of privatisation accomplished; (ii) progress in enterprise budget-constraint hardening; (iii) price, interest rate, trade and exchange rate liberalisation

⁸ This is particularly true for general equilibrium models, but also applies to standard microeconomic models.

⁹ «*We may write economic history as a great success story of an enormous increase in material well being, which has reflected the secular growth in the stock of knowledge. But it is also a vast panorama of decisions that have produced death, famine, starvation, defeat in wartime, economic decline and stagnation, and indeed the total disappearance of civilizations*» (North, 1997a: 15).

¹⁰ According to North (1997a: 17) «*The relative success of policy measures (such as the auctioning of state assets and the reestablishment of a legal system) in the Czech Republic as compared with Russia resulted from the heritage of informal norms that made for the relatively harmonious establishment of new rules*». Actually, Czech crisis in the same year as this publication, revealed Czech mass privatisation results were more problematic than assumed (e.g. tunnelling).

¹¹ «*Unlike formal norms, the monitoring of informal norms is intrinsic to the social relationship, and enforcement occurs informally as a by-product of social interaction*» (Nee, 1998: 88).

¹² In a slow reform, the environment is changing over a longer period and, as existing firms have been selected according to the needs of previously existing environment, adversity would last longer (Murrell (1992: 40-43).

¹³ «*That rules became increasingly better adjusted to generate order happened not because men better understood their function but because those groups prospered who happened to change them in a way that rendered them increasingly adaptative. This evolution is not linear, but resulted from continual trial and error*» (Hayek, 1988: 20).

¹⁴ *Recombinant property* is defined as network property. As networks include both states, state-owned and private organisations, this property is neither public nor private. Although some consider recombinant property to be a *transitory* feature of post-socialism, Stark and Vedres (2001) continue research on Hungarian network property.

¹⁵ «*the facts of the existing situation enter, in a sense disproportionately, into the formation of our long-term expectations; our usual practice being to take the existing situation and to project it into the future, modified only to the extent that we have more or less definite reasons for expecting a change*» (Keynes, 1978, VII, p. 148)

¹⁶ Note that nine per cent of the Hungarians are officially handicapped, whereas the average of OCDE countries is four per cent (OCDE, 1997).

¹⁷ Esping Andersen (1990: 148-153) makes a similar argument for early retirement provision systems in 1970s Western Europe.