



The wiiw Balkan Observatory

Working Papers | 022 | February  
2002

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Institutional Constraints on Southeastern European  
Development





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## *About*

Shortly after the end of the Kosovo war, the last of the Yugoslav dissolution wars, the Balkan Reconstruction Observatory was set up jointly by the Hellenic Observatory, the Centre for the Study of Global Governance, both institutes at the London School of Economics (LSE), and the Vienna Institute for International Economic Studies (wiiw). A brainstorming meeting on Reconstruction and Regional Co-operation in the Balkans was held in Vouliagmeni on 8-10 July 1999, covering the issues of security, democratisation, economic reconstruction and the role of civil society. It was attended by academics and policy makers from all the countries in the region, from a number of EU countries, from the European Commission, the USA and Russia. Based on ideas and discussions generated at this meeting, a policy paper on Balkan Reconstruction and European Integration was the product of a collaborative effort by the two LSE institutes and the wiiw. The paper was presented at a follow-up meeting on Reconstruction and Integration in Southeast Europe in Vienna on 12-13 November 1999, which focused on the economic aspects of the process of reconstruction in the Balkans. It is this policy paper that became the very first Working Paper of the wiiw Balkan Observatory Working Papers series. The Working Papers are published online at [www.balkan-observatory.net](http://www.balkan-observatory.net), the internet portal of the wiiw Balkan Observatory. It is a portal for research and communication in relation to economic developments in Southeast Europe maintained by the wiiw since 1999. Since 2000 it also serves as a forum for the Global Development Network Southeast Europe (GDN-SEE) project, which is based on an initiative by The World Bank with financial support from the Austrian Ministry of Finance and the Oesterreichische Nationalbank. The purpose of the GDN-SEE project is the creation of research networks throughout Southeast Europe in order to enhance the economic research capacity in Southeast Europe, to build new research capacities by mobilising young researchers, to promote knowledge transfer into the region, to facilitate networking between researchers within the region, and to assist in securing knowledge transfer from researchers to policy makers. The wiiw Balkan Observatory Working Papers series is one way to achieve these objectives.



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## Global Development Network Southeast Europe

*This study has been developed in the framework of research networks initiated and monitored by wiiw under the premises of the GDN–SEE partnership.*

The Global Development Network, initiated by The World Bank, is a global network of research and policy institutes working together to address the problems of national and regional development. It promotes the generation of local knowledge in developing and transition countries and aims at building research capacities in the different regions.

The Vienna Institute for International Economic Studies is a GDN Partner Institute and acts as a hub for Southeast Europe. The GDN–wiiw partnership aims to support the enhancement of economic research capacity in Southeast Europe, to promote knowledge transfer to SEE, to facilitate networking among researchers within SEE and to assist in securing knowledge transfer from researchers to policy makers.

The GDN–SEE programme is financed by the Global Development Network, the Austrian Ministry of Finance and the Jubiläumsfonds der Oesterreichischen Nationalbank.

For additional information see [www.balkan-observatory.net](http://www.balkan-observatory.net), [www.wiiw.ac.at](http://www.wiiw.ac.at) and [www.gdnet.org](http://www.gdnet.org)

Ljubomir Madzar  
Institutional Constraints on Southeast European Development  
– With Special Reference to Knowledge –

*Vinculo legum atque iuris continetur civitas.*

*Nullum est iam dictum quod non est dictum prius.*

*1. Introduction*

Despite its dazzling mathematical sophistication, the magnificent neoclassical scheme, designed to explain the rhythm and pattern of economic growth through the evolution of factor availabilities, turned out to have a limited intellectual out-turn, to suffer a number of serious conceptual deficiencies and to be insufficiently persuasive in empirical analyses. Equally important, it proved analytically barren and rather unproductive from a development, policy point of view. The low level of development and increasingly noticeable poverty in Southeastern Europe, and not so long ago in the developed West, used until quite recently to be explained by the scarcity of some strategically important resources, above all capital. Human capital has only rarely and, in fact, exceptionally been referred to. The low level of non-human wealth was treated as the key and practically ultimate cause of the modest amount of income. The insufficient quantities of precious non-human resources, with capital as the decisively most important production factor, could presumably be explained through the low rates of growth at which these resources had been expanded in the past. But what accounts for such inadequate rates of growth? It turned out that the widely differentiated wealth of nations and equally differentiated rates of its expansion, both in terms of total magnitudes and in *per capita* terms, could not be treated as causes of unequal development but had rather to be explained themselves.

This kind of reasoning directly leads into examining widely differing patterns of behavior of people with respect to resource use and expansion and the reasons because of which people manage to extract widely differing effects out of available quantities of the production factors. Thus, it is not the availability of resources themselves that accounts for differences in the levels development and the rates of growth but rather what, how and why people do with the income and wealth at their disposal. The basic component to be examined in the development nexus is not the quantity of various goods and factors of production, nor the quantitative relations among them, modeled in various ways, but the behavior of people and organizations which produce such a variegated factor availability in the first place. This is the way in which *institutions* rather than the quantities of wealth or amounts of certain resources come to occupy the center of the complex and ill-understood development scene. Two distinct approaches dealing with the role of institutions in development have evolved. Chronologically and conceptually the first one starts with basic development issues and then grows into an extended analysis of institutions as powerful determinants of growth (exemplified, among others by Stiglitz 1988). The second one sets out with analysis of institutions themselves and subsequently unfolds into an examination of their dynamic, developmental implications (exemplified by, say, North 1995/1990/). Each approach has its advantages and both merge into a broader, more complete elucidation of the next to unwieldy development story.

It has not been clearly recognized that the explanations of growth through factor availabilities are largely tautological. If the levels of income are explained by the available quantities of the production factors, or, more generally, by the existing wealth, and if additional and extraneous factors are not resorted to account for wide differences in what people do with their wealth and the effects extracted from it, then the generalized output is explained by wealth and the increment of wealth by output, so that the wealth is ultimately explained by itself. The various *vicious circles of poverty*, so popular in the early development literature (cf. Nurkse 1962, ch. 10, pp. 247-53; Nurkse 1963, pp. 263, 266; Meier 1963, pp.

60-4; Myint 1963, pp. 96, 107, 118), are a derived and somewhat remote manifestation of the circular reasoning which was, at least partly, woven into these analyses. Again, to break out of the intellectual *circulus vitiosus* one needs to bring in the factors which are outside of the interdependent conglomerate of the physical quantities and might be interpreted as the determining causes. Such factors can only be those affecting and, indeed, fundamentally determining economic behavior of individuals and organizations, which once more leads to institutions as the likely determinants of the economic growth and prosperity.

Recognizing the importance of institutions is a part of a much broader approach emphasizing a fundamental two-pronged feature of the development process. Development does certainly contain the process of a steady, and hopefully lasting and sustainable, increase of the quantities of goods and services as an unavoidable base of individual and social welfare. But, in parallel with it there has to develop the set of mechanisms regulating the material development itself as well as the immensely complex constellation of processes of the current functioning of the economy. The change of what Marx used to call material base of the society calls for the timely adjustment of the means and ways of controlling and steering the economy, the levers and devices of managing its current functioning and, particularly, its development. This is what in the contemporary literature becomes more and more frequently referred to as the issue of *governance* (UNDP 2000, pp. 4-5).

Governance may be defined as the capacity to control and manage, to promulgate and steer and to propagate and disseminate economic and, more broadly, social development while maintaining its sustainability and the political consensus needed to back the rich and versatile, steadily changing complex of directing, guiding and regulatory actions. Any society has to develop not only its productive capacity but also its ability to direct and manage itself. It is evident that the economic base of the society, in order to develop successfully, has to be managed and controlled, but equally evident is the need for a rapid development of the control system itself. To be effective, governance has to be continually developed. The test of the quality of governance and the indicator of its effectiveness is the degree to which it makes it possible to utilize the available resources and particularly to maintain a high rate of growth of their expansion. The proof of good governance is always in terms of what it gives through economic growth and how it enhances the welfare of the populace. Social development cannot unfold successfully unless the governance mechanisms are efficaciously developed as well. Insisting on just material development will sooner or later generate the bottlenecks in the vitally important regulating and control mechanisms and the material development itself will inevitably grind to a halt.

One important, in contemporary conditions vital, dimension of (good) governance is the degree of transparency and accountability with which public functions are being performed. The present conditions in the preponderant part of the world, and Southeastern Europe does certainly not appear to be an exception in that respect, call for a massive popular participation in the development venture, and this in turn calls for wide-ranging decentralization in all areas of decision making. Both require a continuous and efficient popular control over the centers of the governmental – and, more generally, public – decision making and policy implementation. Accountability is vital. The power centers to be controlled don't consist exclusively of governmental institutions with corresponding parliamentary, judicial and executive authorities, but comprise a much wider range of organizations including the political parties, the agencies involved in the electoral process, the mass media and the nongovernmental organizations. An aspect of governance, which has to be both carefully supervised and continually improved, concerns the manner in which public affairs are managed, particularly with respect to protection and respect for individual and collective (ethnic etc.) human rights. Another aspect deserving close and permanent attention is the tangle of relations towards the neighboring states and the international community in general.

The failure to develop the requisite governance machinery and the accompanying procedural infrastructure could be taken as one of the major determinants of the recently observed slow growth of economies in the Southeastern European countries and of the resulting and accompanying unsatisfactory social development and belated civilizational emancipation. In view of the fact that the existing institutional order represents both operating support and regulatory framework for any kind of governance, one completes the full circle and comes again to the institutional set-up as the strategic determinant of economic growth and social development. Institutions seem to represent a wide area in which major causes of developmental slowdown and civilizational lag are to be searched and eventually identified. At the same time this is an area in which most reforms will be taking place, an area in which the overall modernization will have to be initiated and to which a good deal of intellectual potential and political strength will have to be directed.

## *2. Institutional Framework as a Precondition for Effective Governance*

Institutions can be examined as a general phenomenon, abstracting from the idiosyncratic features of time and place. Or else, they can be analyzed as concrete, quite specific and unrepeatable social arrangements for regulating human behavior in the most diverse areas of life. In pondering over the peculiar long run development trends in Southeastern Europe one finds out quickly that both approaches give valuable insights into the developmental and civilizational destiny of this region. Very general considerations of institutional development find a ready application to the Southeastern European realities. On the other hand, taking into account the distinct tenets of institutions prevailing in this part of the continent throws an extraordinary light on the rhythm and directions of its development. It also provides a rich source of hypotheses about the causes and consequences of frequent, deep and painful changes that have almost uninterruptedly bedeviled this region. The research strategy incorporated in this study will endeavor to reflect both characteristics of the institutional analysis placed into the context of the Southeastern European realities. The first part of the study will center on the general ingredients and attributes of institutions, with a view to the specific traits of the region under consideration. The second half will switch to the more specific analysis and be devoted to identifying the institutional determinants of Southeastern European development idiosyncrasies. The first part will also provide a general analytical framework, while the second part will concentrate on the concrete applications of this framework. The purpose of the second part is, in particular, to spell out the implications of the singular, frequently unparalleled institutional setup and its equally unique development.

### *2.1 Technology and Institutions: the interdependence between the production and the control system*

The point most strongly emphasized in the introduction is the inadequacy of an approach to development analysis and policy which would be based exclusively on the available resources and the known and predictable set of technological relations connecting them. Viewed in the perspective of the development potential, any economic system consists of two basic subsystems – production system and the control (managing, steering, regulatory, governance...) system. In the sequel they are simply called production and control systems. The control system is a part of a more general institutional framework providing the operative support to governance in its widest sense. The control system is that part of the most broadly conceived governance mechanism which relates to the economy and provides the means for its current and developmental regulation. The overall efficiency of the system, no matter what criteria for its conceptual determination and operational measurement are adopted, clearly depends on the efficiency of both the production and the control systems. The conventional approach has been to center exclusively on the production system and to neglect altogether the control system. The basic determinants of individual and organizational behavior – and these are clearly the factors accounting for what people do with resources and how and why

they behave in a particular way with respect to income and wealth, thus determining the rhythm and pattern of their expansion – are undoubtedly located in the control sector. Therefore, the approach based exclusively on resources and technology could under no circumstances have been useful in diagnosing the roots of Southeastern European development. Even less could it have been useful in providing the basis for identifying the means and ways of initiating and successfully guiding the process of social modernization.

A convenient way of approaching the vital and yet largely neglected institutional determinants of economic development and social modernization is to summarize the critical observations directed to neoclassical economics, mainly from the quarters of institutional economics and the sisterly property rights and transaction costs schools. A major point in these critiques is that the standard, still prevailing, neoclassical paradigm assumes away what is the most determinative and truly crucial. It abstracts from, or rather takes for granted, the complex of institutional components which induce the type of behavior relating to income, wealth and economic resources in general, concentrating on mechanical, technological relationships among economic magnitudes. One is not in the position to understand the mechanisms perpetuating underdevelopment and preventing progressive change if one throws out of his analytical purview the most powerful, perhaps the only relevant set of causative factors. Any theory has to abstract from a multitude of elements of secondary importance, but what distinguishes good from bad theories is exactly the fact that bad theories ignore the decisively important elements or aspects of the phenomenon under consideration.

The truly important determinants of the long run development are certainly located in the control system. Development depends on what is being done with the resources and that is clearly the province of the control system. The control system provides managing, controlling and related mechanisms and instruments which account not only for the conventional static, i.e. allocative efficiency of the economy but also for its dynamic efficiency and growth potential. At least three relevant segments can be discerned within the control system. The first one is related to transacting across the markets, the second one to transacting within the firms and the third one to regulating and steering the economy as a whole, including the allocation of decision making authority among the economic subjects, the motivation and information structures (Neuberger and Duffy 1976, pp. 23-72) and, one might add, the character of the basic economic units themselves. This last dimension has to do with the design and setup of the fundamental decision-making units of the economy; they might be classical capitalist firms with varying legal models, or the state enterprises of the centrally planned socialist economies, self-managed enterprises, cooperatives... Clearly, the type of the basic decision-making unit is the institutional feature of an economy that greatly influences its efficiency and growth potential.

From the point of view germane to this analysis the firms arise for two cumulatively operating reasons: firstly, there is a conspicuous and important synergy of several inputs cooperating together – two men can lift the stone that one single cannot – there being no possibility of measuring their separate contributions, and, secondly, the transaction costs of separate contracting with the owners of individual inputs are prohibitively high. In fact, with the increase of the size of the firm the costs of management and control within the firm rise faster and faster, while the cost of contracting across the market become relatively lower. Clearly implied is a margin of optimal size of the firm and the optimal division between the market regulated and firm regulated set of transactions, vs. relationships. When it comes down to explaining the reasons of slow development and to finding the ways of its acceleration, there are at least three things associated to the control system to be looked into: (1) the institutional ordering of the firm sector, particularly the character of the contractual arrangements within the firms determining the type of the internal motivation structure, (2) institutional arrangements regulating the market transactions, and (3) the division of the entire

set of economic relationships and interactions into the subset regulated within the firms and the subset of those regulated through the market, i. e. through the inter-firm transactions. These are at the same time the areas of potential institutional deficiencies of the Southeastern European economies accounting for their underdevelopment and low rhythm of economic growth and social modernization. Namely, (1) the firms might be primitive, poorly organized, with contractual arrangements generating demobilizing motivation structure, (2) the institutional architecture regulating the workings of the market may be insufficiently developed, incomplete and dysfunctional, and (3) the division of the universe of economic relationships and business interactions between the market and the firm might be inappropriate.

## 2.2 *Objections to Mainstream Economics as a Source of Policy Initiatives*

The ideas of the causes of underdevelopment could also, and indeed abundantly, be drawn from the now standard critiques of the neoclassical paradigm from the quarters of the institutional economics and the related areas of study. There are a number of clearly articulated critiques all of which are on various occasions thoroughly elaborated by S. Pejovich (1987, 1989, 1995). Interestingly enough, the cited sources don't contain the same sets of critical objections, so that one can recognize the evolution of thought oriented to overcoming the established scientific stereotypes and centered on substantiating the shortcoming of the prevailing paradigm. The first objection deals with neoclassical abstracting from the behavioral effects of the intrafirm contractual arrangements and with an exclusive orientation on technological relationships. That, indeed, is a major shortcoming since the differences of such arrangements may lead to widely differing output on the basis of the same quantities of resources, so much so that some authors are inclined to incorporate the intrafirm relationships into the production function itself (Jovanovic 1998, p. 27). Thus, generally speaking, a comprehensive and realistic concept of efficiency should not remain irrevocably narrowed down to the conventionally conceived efficiency of the production system but should also take into account the effectiveness and the cost of the control system. The processes and the sets of processes that are very efficient in the conventional, stringently circumscribed sense – might prove quite inefficient in the wider sense. There is an obvious trade-off between the two components of efficiency: considerable costs of raw materials could be avoided by devoting more resources and attention to judicious control and management of the process, and, *vice versa*, some costs of management and control can be avoided by a less parsimonious use of raw materials and other inputs. By not taking into account the costs of the control system, the conventional thought has made it impossible to identify the true alternatives of resource saving and thus to delineate the strategic directions of institutional change which could foster economic and social development.

The second objection deals with resource valuation which in the neoclassical models is taken for granted while in the real world is only partially secured. The well known phenomenon of rent dissipation shows that, due to institutional reasons, some resources can be economically *completely* devalued and that potential social product, producible by such resources, could be irretrievably lost. A. Alchian and W. Allen (1983) have constructed their famous Fishlandia example (reproduced in Pejovich 1995, pp. 174-81 and Alchian 1999) in which the entire effect of a newly acquired boat is under some arrangements completely dissipated, coming down to as if no boat exists at all, while under other (private property) arrangements the boat finds its full economic valuation. This author has constructed a model, based on multi-factor Cobb-Douglas production function, in which some factors do not obtain their market valuation and, consequently, (1) their potential contribution to the product is lost, and (2) the total product is proportionally reduced in comparison to the result obtainable in a regime of complete valuation of the production factors. The proportionality factor depends on the efficiency term in the function, on the number of the non-valued factors and the

elasticities of output with respect to them. The absence of institutional devices making it possible to value certain resources, and deficient valuation in other cases, are certainly among determinants of poor economic performance of the Southeastern European countries.

A major, the *third*, deficiency of neoclassical approach, as seen through the ocular of neoinstitutional economics, consists in the fact that the choice set is taken for given, whereas a decisive factor of dynamic efficiency consists in the ability of the economy to expand it. An economy which learns quickly, accumulates fast economically relevant knowledge and speedily implements the abundant flow of innovations will probably grow much faster than an economy with stagnant technology and otherwise vastly superior (static) allocative efficiency (Pejovich 1987, pp. 462-3 and 1989, pp. 58-9). Seen as a disruption of the prevailing constellation of the technology, an innovation contains an implicit but decisively important trade-off between the conventional allocative efficiency and the size of the choice set which offers opportunities for major breakthroughs in output and related magnitudes. Institutional expedients for such speedy technological improvements are the principal component of dynamic efficiency and their absence is a possible, and even likely, reason for underdevelopment. The trouble with the neoclassical parable is in that it deals with innovations only after the fact, once they are already adopted (Pejovich 1987, p. 463 and 1989, p. 58), while institutions fostering innovations and growth of knowledge represent some of the most powerful promoters of development. Again, the sources of growth are to be sought in an area which is assumed away in the neoclassical analysis.

A frequently voiced critique, the *fourth* one in order, of neoclassical theory is centered on its treatment of the firm as a black box (Pejovich 1995, p. 174). The firm is given a sort of the will of its own. It is only people that have will and take decisions. Without taking into account the motivation structure within the firm and the way the individuals respond to various stimuli, the responses of the firm to exogenous changes cannot be understood and some important possibilities of development inducing changes might go unnoticed. This argument in fact goes down to the importance of the contractual arrangements within the firm and to their contribution to the overall efficiency of the economy.

To summarize, the truly important factors of failed and/or currently slow development are contained in the control system, the one providing the managerial impulses and control services, the system whose contribution and the costs (transaction costs) have in the mainstream theory been largely ignored. Enumeration of these factors will be helpful. *Firstly*, production function should not reflect just the technological ties but also the intrafirm contractual arrangements. Some of these arrangements, when tied to the absence of valuation of resources, or to their inadequate valuation, could completely or partially devalue and thus in the economic sense annihilate a part of existing national wealth. *Secondly*, to arrive at a true perception of the overall economic efficiency, along with the usual costs and effects of the production system, one has to take into account the contribution *and the costs* of the control system. Ignoring the control system, particularly the transaction costs, one loses sight of the changes in institutions which can pave the way to economic growth and social development. *Thirdly* the choice set cannot be taken as given nor can its expansion be incorporated into analysis only after innovations are implemented; the really high priority is to explain, i. e. endogenize the flow of innovations and understand its immense contribution to the development potential of the economy. *Fourthly*, the firm does not have its own conscience nor does it possess its own will; it is the individuals in and around the firm that take decisions and account for the firm's behavior. The gains in productivity are not a matter of specialization of independent organizations but result from the successful internal contracting among the organization's members.

The critique of the neoclassical school is reviewed here not because of the conviction that it spells out the definitive scientific truths but because it serves well as a source of

inspiration regarding the factors of underdevelopment. It is also a fruitful source of hypotheses regarding the levers of development policy capable of producing the needed turnaround and subsequently maintaining the economy on the trajectory of stable and sustainable development. Thus, in its extreme form the neoinstitutional critique goes as far as to ignore and deny the impact of the existing technology, whereas the utilized techniques and knowledge incorporated in them are certainly among the factors accounting for the observed differences in performance. It is easy to imagine economies with identical all elements (resources, tastes, location...) except technology and find differences in output directly related to differences in applied techniques. After all, no two processes with identical technology can be found and in every applied technical solution there is an inevitable stochastic element caused by the idiosyncrasies of place and time. An uncompromising rejection of the firm as a black box seems also to be a form of scientific extremism which is hard to perceive as warranted. Not infrequently one is in the position to observe conflicts between the firms in which they behave as conscious entities with strong and monolithic will, while in other types of behavior it seems to be possible and even convenient to approximate their response patterns by treating them as endowed with will and passion. One should not forget that the empirical models based on the neoclassical theory went a long way in explaining economic realities and that econometric specifications deriving from neoclassical relationships displayed significant explanatory power.

In defense of neoclassical analysis one might add that it could represent a good approximation of economic relationships not only in situations in which the transaction costs are low but also in a much wider class of situations in which they exhibit a fairly high correlation with the production costs. No one can deny the fact that the neoclassical analysis has long served and still serves as a rich source of analytical tools without which other schools, including the neoinstitutional, could hardly operate and produce their own analytical insights. Another important point to note is that the neoinstitutionalism and the related schools are not that fundamentally different from the neoclassical paradigm: both fundamentally rely on the truly basic maximizing archetype as a manner of articulating the presumed all-pervading human rationality (Bates 1995, pp. 41-4; Toye 1995, pp. 66-7 and, particularly Stein 1995, p. 124, noting explicitly that neoinstitutionalism does not fundamentally challenge the mainstream thinking in Economics). In both paradigms it is the rationality that accounts for the observed or presumed outcomes of human interaction. Different are only the setups and the conditions under which the rationality, taken for granted by both approaches, comes to the fore. One could also defend the neoclassical school for its immense educational performance: all those who advocate its epochal demise have learned their analytics and modes of reasoning from neoclassical (text)books. After all, before learning how to run one certainly has to learn how to walk.

Despite the reluctance to go along fully with the neoinstitutional and related critiques of the neoclassical theory, they do represent a rich source of ideas about the determinants of the present, far from satisfactory, state of Southeastern European economies and societies and a convenient indicator as to the possible solutions of their endemic modernization obstacles. One is really in the position to review a rich panoply of policy options against the backdrop of what new approaches to development have revealed as lacking in the mainstream economics.

### *2.3 Institutions and Behavior – A Preliminary Elaboration*

Not surprisingly, institutions are defined in various ways, but, perhaps surprisingly, the alternative definitions very much converge to the same semantic core. Thus, North (1995/1990/, 3) defines institutions as the rules of the societal game, or, more formally as "...the humanly devised constraints that shape human interaction". Institutions, of course, relate to individuals, but even more so to variously structured organizations and North (p. 5) quite appropriately defines organizations as the "groups of individuals bound by some

common purpose to achieve objectives". The principal purpose of institutions is to provide structure to the rich interplay of human ventures and actions, to provide a coordinating framework to varying human endeavors and thus to reduce the uncertainty in economic and social life. Lukic (1988, p. 397) defines an institution as a set of legal norms concerning a given social relation or a quantitatively limited collection of such relations, whereby the norms rest on the same basic principles and could as a rule be classified into broader categories of institutions pertaining to differing levels of social hierarchy. Thus there are higher and lower rank institutions: e. g. the institution of marriage is a member of the broader class of the institution of contracts, whereas the latter class belongs to a still wider category of legal acts. One is struck by the narrowness of this definition: it encompasses only the formal, legal acts and leaves out the informal behavioral standards, such as ethical norms and customary rules in general. For the purposes of this analysis the most convenient will be a slight modification of a definition provided by Pejovich (1995, p. 30): the institutions represent a set of legal, administrative, ethically based and customary arrangements to coordinate, order and streamline the repeated human interactions. Crucially important is the fact that institutions, by contributing to coordination of actions of independent decisionmakers, reduce what Neuberger and Duffy (1976, p. 25) call endogenous or systemic uncertainty. It is also apposite to note that *repeated interactions* are pointed out as the area of activity that is being coordinated by institutions. That means that *not all interactions are being coordinated in this way, but just those which occur with sufficient frequency.*

Creating institutions is not a costless exercise and, as a matter of general principle, institutions arise if and when their effects, the contribution they make in various ways to social product or other socially valued factors, exceed their costs. That also means that a lot of interactions, those occurring with insufficient frequency, will not be regulated institutionally but in some other way or not at all. It seems that the reasoning developed by Barzel (1997/1989/, chs. 6 and 8) on the formation of property rights could be extended in a straightforward way to the institutions in general. Worth of note is the fact that this broader definition encompasses both formal (legal and other statutory arrangements) and informal rules of game. Formal rules are statutory regulations and define the political system (the hierarchical allocation of authority, the collection of decision-making prerogatives, the civil liberties and human rights), the economic system (property rights and contracts), and the protection system (judiciary, police, military) (cf. Pejovich 1995, p. 31).

Institutions define the set of social actors – including, of course, the set of economic agents (what could be called the organization structure) –, the allocation over actors of decision making authority, including the set of inalienable individual rights (the decision-making structure), the motivation or incentive structure for decision-making and the information structure for making decisions (cf. Neuberger and Duffy 1976, pp. 23-72 for a somewhat different taxonomy). All four components are important and are multiply interrelated. The features of the actors merge into the general groundwork of their behavior, the allocation of decision-making authority defines the constraints within which the actions of various actors have to be located, the motivation structure determines the strength and the desired direction of these actions and the information structure provides (some of) the cognitive inputs for these actions. The key element in any institutional structure is the individual freedom – the untouchable area which cannot be intruded into under any circumstances (Hayek 1998/1972/, ch. 1, particularly pp. 19-21) – because it fundamentally affects the set of ventures and all other kinds of actions that a society is capable of undertaking and thus features as a general determinant of the most widely conceived mobilizing power of any society.

Among various kinds of freedom the most important from the point of view of this analysis is certainly the set of economic freedoms (cf. Lewis 1955, pp. 78-101) which are

basic for the ability of a society to accumulate the economically relevant knowledge and thus to achieve and maintain a high rate of technical progress as a key to the stable, lasting and sufficiently rapid economic development. Among the dimensions of economic freedom Lewis particularly emphasized the scope of individual vs. collective action, as the latter, while facilitating certain societal tasks and being irreplaceable for some such duties, seriously constrains the total quantity of operations that can be performed in a society and at the same time greatly dilutes the motivation for these operations. He also strongly stresses vertical mobility and the freedom of markets, i. e. the degree to which the space is provided for unobstructed making of economic transactions. The central role in this context is played by the ownership rights which can be interpreted as the embodiment of a set of crucially important freedoms – the freedom to possess, to commit what belongs to somebody to a wide range of entrepreneurial ventures, to use what one possesses and to reap the fruits of what belongs to someone. It is understood that all these prerogatives are within the limits of law. Another thing to note is the fact that the ownership rights are not only the institutionalized forms of freedom, but are at the same time the material basis for a wide array of freedoms in other areas of life. The first test of the progressiveness and the social rationality of a given set of institutions is the degree to which they provide for various freedoms and guarantee their maintenance.

The ownership rights play a key role in all the above mentioned dimensions of the institutional framework. It is up to the owners to decide in what form they will combine and organize their resources including the manner of combining resources which belong to different owners. Such multiply owned collections of resources are institutionally formalized as various types of companies (Vasiljevic 1999, pp.9-17). The institution of ownership is also known to be the principal source of decision-making power in the market economies – the prerogatives to direct and control have either the owners themselves or the persons empowered by them. The rights contained in the bundle of ownership undoubtedly constitute the set of the strongest ever created incentive devices because it is only the ownership that establishes direct connection between the authority to decide, including the actual acts of decision-making, and the consequences of decisions. With clearly defined ownership rights the consequences fall exactly on the loci of the decision-making, which implies that rewards are closely tied with efforts and the resulting productivity (cf. Lewis 1955, pp. 57-69) and also that the risk ultimately falls on the property of those who decide. The latter feature could be termed a rational institutionalization of risk.

At last, ownership appears to be of crucial significance even in the constitution of the information structure. The reasoning here is a little more subtle. The purpose of the information structure is to provide signals as to what economic alternatives are the most attractive from the point of view of the individual decision-maker and, by certain chains of implication, from the standpoint of the society at large. Such informational signals are provided not by any set of prices but only by the set of *competitive* prices. To have the right prices, one has to have competition. On the other hand, competition is possible only if there is sufficiently strong motivation for competition and such motivation can only be secured by clearly defined and effectively protected private ownership rights. (The detailed elaboration of the relevant arguments is contained in Lavoie 1985 and is presented in a less sophisticated way but much earlier by Hayek 1980/1948/, ch. VI, von Mises 1950/1935/ and Hoff 1981/1949/). The above reasoning should make it apparent that properly articulated rights of private ownership, exerting their influence through competition come out not as a sufficient but just as a necessary condition for getting the right prices as signaling devices leading to an efficient allocation of economic resources.

Important elements of the overall organization of the society are *the organizations in the narrow, technical sense of the word*. The latter, despite the fact that they are frequently

referred to as *institutions* are, as pointed out earlier in this section, properly defined by North (1995/1990/, p. 5) as the groups of individuals bound by a common purpose to achieve objectives. North (p.7) perceives a permanent interaction between institutions and organizations. Organizations arise as a response to opportunities created by institutions and contribute greatly to the directions and speed of institutional change. Institutions in turn determine the scope for development of organizations and, in particular, the change of their forms and the unfolding of their legal formalization. As noted above, the forms of organizations have themselves to be taken as one of the dimensions of the institutional order. They are a major determinant of the costs of the control system, but are, at the same time, simultaneously – and, indeed, to a large extent – determined by these costs. These costs obviously influence the other three features of the control system as well. But, contrary to what is asserted by North (1995/1990/, p. 12), one could not say that institutions matter (only) when it is costly to transact. The Alchian's (1999) Fishlandia example, commented on in the previous section, clearly shows that, under assumption of zero transaction costs, alternative institutional arrangements produce vastly differing allocational outcomes. Thus, private property rights lead to the maximization of the social product, whereas their absence leads to the rent dissipation. A way of acquiescing to the North's assertion could perhaps be to postulate that the private property rights themselves could be introduced only at a cost and next to treat these costs as a component of the transaction costs. This rather contrived manner is not particularly appealing from a pragmatic point of view. The other North's assertion about institutions not being necessary in a world of complete information also seems to be contradicted by the Fishlandia example in which differing arrangements produce glaringly different outcomes in an environment of complete *certainty*.

#### 2.4 Institutional Ordering of the Complementary Spheres of Social Life

The life of a society can be segmented into several large and largely non-overlapping spheres which exhaust all of the society's major functions. The term *largely non-overlapping* is intended to convey the idea that the spheres are *not* completely disjunct, but that certain nonempty intersections among them don't blur their basically clear and unequivocal demarcation. These areas partly coincide and logically derive from a number of fundamental human (collections of) rights and freedoms and partly derive from some standard interrelationships which are regularly established among the humans and are a lasting part of their daily existence. The area of human rights and freedoms is rapidly evolving and continually changing so that it is rather difficult to provide a transparent and selfimposing classification. As one settles for a satisfactory – at least to some extent – classification, new items appear for which not a convenient pigeonhole can be found in some obvious way. It becomes possible and apposite even to speak about various *vintages* of human rights: Pihler (1999, p. 260) recently identified four generations of such rights. Individual rights and freedoms are predictably emphasized *the basic rights*, but one also notices that *collective rights* are more and more frequently mentioned. The distinction between the positive and negative rights is another relative novelty in the treatment of the human freedoms. Collective and, in particular, positive rights are not always easy to conceptualize. The first ones are in some instances difficult to conceive because the individuals are, to paraphrase Buchanan (1977, pp. 14-5), natural units of consciousness and, indeed, the unique and nonsubstitutable "sources of value" (Buchanan 1985, pp. 249-51). The second ones are even harder to incorporate into a coherent system of rights because they imply satisfaction of some categories of needs for which no resources may turn out to be available, thus further implying the need for coercive expropriation of those who have created the corresponding economic values. Yet, it is evident that a large number of persons may happen to be – as far as some dimensions of social status are concerned – in the same situation and that both their needs and their rights can coincide in that dimension. As for the positive rights, one could perhaps refer

to the idea of the social contract and the Rawlsian (1997/1971/, pp. 12, 19, 136-42) veil of ignorance, with the idea that, confronted with an uncertain future, the rational individuals will agree to define a level of standard below which no citizen will be allowed to fall. It must be admitted that various “economic”, “social”, “cultural” and similar rights are not coherently spelled out, no practical and feasible way of their fulfillment has been articulated and one is forced to conclude that, more frequently than not, one is unable to incorporate them into an architecture or rights that would have firm logical and functional foundations. Small wonder that the authors specialized in such rights and indoctrinated with the message contained in them gloomily state that these rights are just articulated in a declaratory manner and that the governmental obligations related to their realization are not specified (Pajvancic 1999, pp. 40, 47). In any case, despite numerous logically untenable and practically unimplementable rights, the number and scope of rights permanently expands and citizens are less and less treated as “subjects” and more and more as emancipated members of community which is democratically run and where the question of rights is fundamental to shaping its organization and its institutional order.

With all these caveats and, in particular, with awareness that some rights shade into unclear and ill-specified categories, one could perhaps delineate seven large areas of rights, freedoms and normatively defined interpersonal relationships. They are simultaneously the areas of institutional ordering and sustained development of institutional arrangements. The areas are (1) the right to life and protection of life and limb as well as the elementary security of persons, (2) the right to personal freedom encompassing a number of derived individual rights, (3) the right to safeguarding human dignity and self-esteem, (4) the right to own material and other economically relevant resources formalized by what is known as the collection of property rights, (5) the right to participate in the collective decision making operationalized through the well-known political rights, (6) a rich and versatile conglomerate of interpersonal relations and corresponding rights embodied in them, such as marital and parental rights and obligations, and, lastly, (7) the set of economic, social, cultural and similar “rights” for which it is not always certain that they represent rights in the strict sense of the world.

Area (1) contains what Hayek (1998/1972/, p. 26) has formulated as the legal status of a protected citizen whose right to protection derives simply from his being the member of the community. This set of rights includes the right to be protected from all forms of violence, in particular the governmental violence in the form of maltreatment carrying the danger of corporal damage. Protected is not only physical but also psychic integrity of a person. Prohibition or torture, rape, experiment *in vivo* and similar assaults on body and psyche is implied. Area (2) includes first of all the immunity against arbitrary arrests the right to privacy and the right to protection against any unauthorized intrusion into the sphere of strictly personal affairs. The right to protection against the unnatural sexual treatment and rape is included into this collection. The same goes for the right to protect all kinds of personal information which does not affect other persons. The prohibition of some forms of discrimination and unequal treatment before the law could perhaps be classified into this group. Area (3) includes the right to fair and dignified treatment in all dealings with the governmental agencies, particularly those authorized to apply the coercive measures. Some components of the right to privacy and the prohibition of some forms of sexual violence could conveniently be classified into this category. Ban on all forms of humiliating punishment also belongs here. The next segment, termed area (4), consists of the well known property rights, which Pejovich (1995, p. 65) cogently defined as the rules formalizing the relations among individuals arising from the existence of scarce goods and the need to allocate them in view of competing needs. These rights first of all pertain to the protection of private ownership, as its legal protection logically and functionally enters the very definition of ownership; unprotected

ownership ceases simply to be ownership (Madzar 1992, especially p. 458). Offering possibilities to conclude a multitude of extremely variegated contracts, providing legal provisions where the contracts fail to specify fully the relationships between the parties and, in particular, protecting the contracts and ensuring their implementation is one of the key components of property rights as just defined. Some authors postulate the right to entrepreneurship and analogous economic initiatives (Stankovic 1999) and it is apparent that such rights should be included into this category. More generally, the right to choose the jobs as one finds fit, together with pursuing whatever activities one chooses without stepping outside the law, as well as, even more generally, all rights embodied into the right of ownership, clearly belong to this bundle of rights. The inheritance rights, too, belong to this bundle. The broad segment of rights designated as area (5) encompasses the usual active and passive electoral rights (i. e. the right to vote and to run for public offices), the rights to petition, public gatherings, political initiatives, organized protests and the right to be accurately informed on political and other relevant events. The freedom of conscience, conviction, thought, beliefs (religious and otherwise) and expression of one's own culture in the language of his choice undoubtedly belong here. One could classify here the right to turn to various international organizations for the protection of legally formalized human rights. The protection against discrimination and unequal treatment in universally and non-selectively formalized legal procedures is mainly to be classified under this heading. The rights (and obligations) grouped under the heading (6) don't call for additional comments, except that the sphere of the legal regulations, as opposed to free contractual stipulations, is in this field perhaps relatively bigger than in most other areas. Area (7) doesn't call for additional comments either, but one should perhaps point to the fact that it could be, and usually is, covered with a dense network of institutional arrangements even though most items in this category could not qualify as the rights in the strict sense of the term.

Seven described areas are intended to cover the entirety of human life – above all the life of the individual, but at the same time the vast area of the complete social life, through endless and impossible to enumerate interactions with other individuals. The institutional scaffolding of a society is equally immense as it covers the enumerated areas and countless interactions proceeding within and among them. Each area has its specific institutions and there are institutions straddling two or more areas, as well as those binding the entire society into a unique functional whole. But, for institutions which are primarily tied to certain well specified areas – and such are the most numerous – it is important to recognize where they belong and what their primary functions are. One, for instance, could not go along with Pejovich (1995, p. 65) in asserting that the right to vote is a property right, with an attempt to justify this by the statement that it would be wrong to separate the property rights from human rights. It is true that property rights cannot be separated from the human rights because the former are a subset of the latter, but that is certainly not the reason to identify the rights from another area of human rights with the property rights themselves. Property rights occupy the entire area 4, while the right to vote belongs to area 5 in the above described taxonomy.

Institutions are largely specialized, but they are also interdependent. As will be revealed in the sequel, the widest and the most comprehensive definition of institutions is adopted here. As opposed to approach taken by Lukic (1988, p. 397), who narrows down institutions to just the set of written, legally formalized rules, the approach adopted here follows that taken by Pejovich (1995, p.30) and North (1995/1990/, pp. 3, 6) in conceiving institutions as the set of both formal *and informal* rules regulating those components of human behavior which consist in more or less regular, repeated interactions. The written, legally formalized rules are just the tip of an iceberg, a small part of an incomparably larger set of rules, the vast majority of which are informal and *not* legally sanctioned. While accepting the informal rules as a major portion of the institutional superstructure of any

society – without such an approach it would be impossible to explain the repeated failures to transplant laws and constitutions of the advanced countries into civilizationally less developed environments – the further classification of rules will be different from those that are followed by other authors.

Along with recognizing that most institutions belong to well specified areas, it is equally important to take cognizance of their fundamental complementarity and of the fact that they mutually support, or fail to support, each other. That should come as no surprise. As far as formally enacted, legally formalized rules are concerned, they come out of the same parliamentary and legislative machinery and it is only natural that they exhibit certain common characteristics. As for the informal rules, they come out of the same set of *mores*, the same culture and, again, some easily recognizable common traits are only to be expected. Complementarity means, among other things, that the failure for institutions to be established firmly and the rights to be protected in one area endangers the realization of rights in another: the inadequate protection of life clearly endangers full realization of property or political rights and the lack of political rights and freedoms is an unequivocal danger for property rights and personal security. And so on. The rights and freedoms in practically all enumerated areas, particularly those in which they can be unambiguously defined, are interdependent in the sense that their full realization presupposes the realization of several bundles of rights in other areas. Even though an all-out attempt to upgrade all rights simultaneously is dangerous because societies don't have sufficient knowledge and information for such an overextended engineering, the isolated ventures to promote just some isolated areas of rights are, on the sheer account of their interdependence, even more hazardous.

#### *2.5 Formal and informal Constraints: Ethical Norms*

Institutions, viewed as the rules regulating human behavior, are operationalized through various kinds of norms. Following Lukic (1988, p. 201), but departing from his narrow concept of institutions as only those rules which are legally formalized and backed by the state's coercive apparatus, the norms are defined here as the rules regulating human behavior and accompanied by the sanctions of one form or another. The sanctions can be legally established or else they can emanate from some sort of more or less clearly expressed social pressure. As indicated in the title of this section, the basic classification of norms is into formal and informal. The formal norms are the legal norms. Informal norms are further subdivided into ethical (moral) and customary norms. This subdivision is important as it delineates two clear-cut categories of norms. E.g., the prohibition of incest could never be qualified as just customary nor would this adjective be appropriate. It will be shown in the sequel that ethical norms have much deeper roots. On the other hand, there is nothing profoundly or otherwise moral in the customs of countless settlements to have regular yearly, quarterly or otherwise fairs or celebrations. These norms, too, help coordinating human actions, economic or non-economic.

Lukic (1988, pp. 201-20) has provided a careful and detailed analysis of legal norms. His analysis can easily be extended and suitably modified so as to apply to informal – moral and customary – norms as well. The norms are generally divided into two components: the disposition and the sanction. The disposition is the precept for a well-defined form of behavior. It is usually conditional and contains two elements: the hypothesis of the disposition and the command as to how to behave. The command is valid only if the hypothesis is fulfilled and holds true. The sanction also contains two elements – the hypothesis and the measure to be applied. The hypothesis of the sanction is the failure to follow the command or to acquiesce with the prohibition contained in the disposition. Such failure is called the delict. The meaning of the norm comes down to putting an actor into the situation of having to choose either to obey the norm or to suffer the consequences. Some norms are unconditional and apply universally; their disposition then consists of only one element. The example of such a

norm would be the obligation of all citizens to obey the constitution and the laws of the country. The example of the standard, conditional norm would be the duty of any citizen whose income exceeds a certain amount to pay taxes and the threat to suffer prescribed punishment if he doesn't oblige. The hypothesis of the disposition is an income in excess of a prescribed amount, the command is to pay taxes, the hypothesis of the sanction is the failure to pay taxes and the sanction is the punishment prescribed by the law.

In view of the identical structure of the disposition and the sanction, the sanction can be interpreted as a sort of secondary disposition: if the primary disposition is not obeyed – i. e., if the hypothesis of the sanction is fulfilled – there follows the punishment. Some sanctions are administered by the government and some are performed by the corresponding actor himself. One who has violated the traffic rules is most likely to pay fine of his own free will (the second case); if not, the government will find way to collect the money by force and it will cost him more (the first case). Such punishments as death penalty are administered by the state. Regarding their content and substance the dispositions can be either commands (“parents are obliged to raise and educate their children”), prohibitions (“one may not take other people’s property”) or empowering (“citizens are entitled to protection of their property”). Viewed as devices ordering bilateral relations the norms empower one (X claims money for the house he sold to Y) and define the duty for another actor (Y is under obligation to pay money for the house bought from X). Some dispositions can themselves be dispositive: the parties have, within the limits of the law, the freedom to arrange their relation they find fit, but if they don't make use of this advantage, the legal provisions will apply. Some norms are formed on the basis of what is called legal standards: such are injunctions to behave like a good *pater familias* or to behave in accordance with public morality. The agents who are obliged by the norm may have the choice from among several ways of fulfilling their duties. The scope for choice may have also those who define the obligations for other agents. Clearly, the latter position is the one of power, while the former is far from it. Discretionary power is associated to the latter position, while one could speak of the dispositive dispositions in connection with the former. Occasionally, the sanctions take on a dispositive form, too: the actor is in the position to chose from among alternative ways of being punished.

The norms naturally fit into a hierarchical structure. There are norms of differing degree of generality, starting with very narrow and specific norms and ending with the norms of utmost generality. Specific norms bundle together into the more general norms, hierarchical layers of norms are formed in the obvious way and, in the end, all norms merge into a magnificent whole represented by the legal order, i.e. moral order or order of customary regulations. The norms are generated by legal acts which also fall into hierarchical structure, the acts of the higher order providing the framework and representing the sources of the acts of the lower order. Thus, one finds a bewildering multiplicity of legal acts, starting with constitution as the highest, going through the laws of varying generality and significance and ending with the countless number and variety of contracts and various bylaws, including those which in fact represent the internal legislation of business and other organizations. A similar though far less succinctly ordered pyramidal structure can be observed on the set of ethical and customary norms.

As opposed to legal norms, ethical (moral) norms evidently imply a series of serious acts of evaluation of the behavior of our fellow-citizens and, in particular, an uninterrupted series of acts of self-evaluation. Ethical norms, similar to the legal norms, generally involve disposition and sanction. Disposition commands that under certain conditions (the hypothesis) certain things must be or may not be done (the precept taking the form of order or prohibition). If the disposition is not obeyed, the sanction follows. In this case the sanction is not exclusively imposed from outside, but can take the form of self-imposed punishment. As for the outside sanctions, they are most frequently imposed in the form of disapproval and

contempt, but the acts of violence and physical maltreatment are not excluded. The self-imposed sanctions are in the form of bad conscience or remorse. While recognizing that the moral rules *are* the norms of behavior, Lukic (1982, pp. 100-2) denies them the property of constituting a part of the institutional order. As indicated above, the opposite approach is adopted here. Lukic (1982, p. 104) observes that the morals are best recognized by self-prescribed and self-imposed duties which frequently run against the deep-seated natural instincts and urge.

Ethical norms are firmly tied to the notion of good and evil, which is one of the elemental features distinguishing man from other forms of life. The most effective in this context appears to be the abstract determination of the notion of good. It could and perhaps should run along the lines of the Kantian categorical imperative: the concept of *good* is implied in the behavior following the principles and rules which could be adopted as generalized, universal norms of behavior. The concrete substance of the good behavior does not acquire particular significance: the thing that matters is not *what* acts and deeds should constitute good behavior but *how* it is determined, on the basis of what principles it is derived. Ethical norms are then the components of the categorical imperative imposed by reason. Moral thus boils down to an unconditional order to do good for the sake of good itself, without any traces of instrumental motivation. No justification is needed for the moral outside the ultimate ethical order itself. Moral norms are self-justifying. Internal ethical coercion is the principal reason for moral behavior. The Kantian notion of moral is partly opposed and partly supplemented by the conceptual architecture effected by Durkheim who added the external pressure to the set of forces accounting for the observance of ethical norms. In this modified and combined optic, moral would be both autonomous (self-imposed and depending on internal imperatives) and heteronomous (imposed by the society as well and relying for its observance on social ostracism). Some authors speak about the social processes of *interiorization* whereby the externally imposed norms become embraced by conscience and self-discipline and the heteronomous character of the moral gradually takes on autonomous marks. This eclectic, synthesizing approach finds two distinct roots of the moral norms: one in the disinterested individual himself who consciously opts for the elevated and abstract notion of the *good*, and another in the society which in various ways *imposes good behavior* and perhaps instrumentalizes, in all likelihood indirectly, ethical norms in its very survival.

In a very long and extensively elaborated list of internal – i. e. autonomous and self-imposed – and external – i. e. heteronomous and imposed by the society – distinguishing features, Lukic elaborates the basic tenets of moral norms which unambiguously set them apart from other, legal and customary norms. Among the internal features, i.e. the elements of self-imposed obligatoriness of the ethical norms, Lukic (1982, pp. 110-8) identifies (1) the lack of how ever conceived conditionality, i. e. the categorical and absolute character of these norms, (2) the fact that they incorporate *values* and ultimately reduce to value judgments, (3) the acceptance of *good* as the supreme moral value, (4) the existence of a special moral sentiment, (5) the instantaneous activation of the moral urge, (6) the pressure on the inferior part of human nature in the sense of opting for choices which run contrary to some basic instincts, (7) the fundamental *humanity* of the norms distinguishing man from other forms of life and (8) remorse as a sanction for the failure to follow the commands contained in the norms. The conspicuous characteristic of the moral norms, referred to above, is their heteronomy which coexists with their just elaborated autonomy. They are not just a matter of the unilateral and uninduced opting for the abstract idea of *good* and the corresponding operationalization of that noble choice through practical action but also a sphere of social pressure and informal coercion to behave in the socially approved ways. The heteronomy of these norms derives from moral sanctions which Lukic (1982, p. 119) divides into specific and non-specific. Specific sanctions are moral *contempt*, defined as a very strong disapproval

of given acts combined with the negation of basic human qualities on the part of the delinquent, and moral *disgust* defined as an extreme feeling of unease on the occasion of such acts. The non-specific sanctions, frequently caused by the specific ones, comprise the avoidance of any relationships with the perpetrator and even ostracism. The public expression of contempt and disapproval as well as attacks on life, limb and property also belong to the non-specific sanctions.

A last remark, which for lack of space will be just briefly outlined, concerns the purported rootedness of ethical norms in reason. In a comprehensive and imaginative elaboration Hayek (1990/1988/, ch. 1) analyzes what he calls the cultural evolution in which the ethical component plays the central role. The evolution of morals and culture Hayek sees as a decisive way in which the destiny of the societies is being shaped through the suitable adjustments to the changes in the environment. It is these adjustments that, in Hayek's vision, determine the fate of the societies and civilizations, and the development of reason comes about as a consequence of this more basic process. It is to be noted that the functional and, to some extent, causal relation, conventionally believed to hold true, is diametrically reversed: it is not the reason that generates the ethical standards and norms but the other way around.

#### *2.6 Further Considerations of Informal Constraints: Customary Constraints and Societal Culture*

The customary norms are largely non-sanctioned and spontaneously created. The countless decisions of the bewildering number of decision-makers can only give the expected, objectively realizable effects if they are to some degree coordinated. As a matter of principle, the effects of any decision depend on the decisions taken by the same actor before and, even more so, on the currently and previously taken decisions of other actors. It is not possible to assemble information on such a large number of decisions of other actors and even on the own decisions of a given agent. The informal constraints automatically and necessarily arise as a means of coordinating such a large number of decisions, absent the capacity to take them into account directly. The informal rules arise with the property that, if all concerned follow their precepts, their decisions will be reasonably or at least tolerably coordinated. Formalized, legal rules have, of course, the same effects, but for a number of reasons legal formalization is costly and in many instances not even feasible. It is probably true that, with written and formalized rules amounting to some kind of capital requiring resources *and formal knowledge* to be created, the informal rules are relatively more frequent in less developed countries. However, their frequency and significance in developed countries should not be neglected: as Macalay (1996) demonstrates with impressive documentary evidence, statutes and other formal rules are just sparsely strewn islands in the ocean of informal arrangements which usually arise in the course of long lasting business relationships. These unwritten and unformalized agreements display tremendous versatility and are properly known only to those who have formed them and use them on a daily basis. The exact way in which the rules manage to coordinate decisions is not easy to decipher, but following some common recipes or formulas seems to have significant coordinating power. One does not have to assume that all situations automatically and unavoidably generate rules sufficiently efficient in coordinating the decisions – we are perhaps in the position to observe only those constellations in which the appearance of such rules *did happen*; other constellations have vanished and are out of our universe.

The other important aspect of the evolving of informal rules is the limited capacity of the decision-makers to identify the really good decisions. The first limitation is their modest cognitive capacity; the world is unbelievably complex and our ability to come to grips with it is modest if not negligible. Also limited is the capacity to collect and store information, as well as the capacity for its retrieval. To be effectively used, information has quite frequently to be transferred and the capacity of the communication channels is clearly limited. What to

say about the limited and occasionally more than inadequate algorithmic capacity? With all necessary information assembled and computing devices ready, we may find ourselves in the situation of not knowing how to proceed and what to do with it. These are also the reasons because of which some commonly observed rules might spontaneously arise simply to alleviate the cognitive, informational and algorithmic difficulties which could otherwise prove prohibitive. The (common) rules provide shortcuts and reduce the dimensions and the size of the really hard, not infrequently insurmountable problems that otherwise would have to be confronted. The Hayekian ideas of catallaxy (1990/1988/, pp. 98, 112) and spontaneous order (*passim*) could evidently be of help here. Spontaneous order does not have to arise under all circumstances and one should never forget that the *spontaneous disorder* is also an obvious possibility (Buchanan 1977, ch. 2, particularly pp. 27-30), but there evidently exist rules which generate both order and disorder. Even if rules generating order arise, there is no guarantee that they will be efficient (North 1995/1990/, pp. 7, 14, 44-5, 51-2). However, the verdict of (in)efficiency evidently depends on the criterion adopted, but the very survival of constellations based on institutions proclaimed to be inefficient must somehow speak in favor of them. Configurations with small sets of players could perhaps – and, indeed, under strictly framed assumptions – be coordinated by each player attempting to act on the predictions of what other players will do in the course of the game, but as the number of players increases there seems to be no alternative to the Hayekian construct.

The truly significant contribution of the neoinstitutional theories is the recognition that individuals and their organizations may continually operate with grossly inadequate, in many respects distorted models. No theory can be satisfactory in the utmost important operational sense if it takes no account of what, as a matter of principle, seems to be the most limited thing in daily doings of social agents: our knowledge and understanding and even our ability to learn. Pejovich, North and multitude of other authors rightly insist upon the fact that decision-makers' perception of the world more often than not is highly imperfect and that one can not confidently expect even the existence of a feedback through which their models of world would be persistently improved. We may be born dumb and in the same state terminate our lives. A Serbian saying has it: the young is mad and the old is stupid. This is why established patterns of thought, the conventional models and the stereotypes arise. There is a clear parallel between institutions and the standard, conventional cognitive forms: institutions facilitate coordination, economize on information processing and decision-making and thus streamline the behavior of independent agents. Cognitive stereotypes economize on the cognitive efforts and costs and substitute a ready-made, if erroneous, picture for a more realistic representation which can only be arrived at after a painstaking delving into the intricacies of surrounding realities of a complex universe. This is also where ideology – defined long ago by Marx as *false consciousness*, despite its being not unavoidably but just most frequently *false* – fits in. North (1995/1990/, p. 23) defines ideology as “subjective perceptions (models, theories) all people possess to explain the world around them”. Ideology shortens the involved trajectories of understanding just as institutions reduce the need for information while simplifying the task of decision-making and contributing to coordination of decisions of uncounted number of autonomous agents. The two are necessarily interrelated: by simplifying the cognitive operations, ideologies and stereotypes reduce the need for information and facilitate the formation of rules, whereas institutions, by directing the actions of the individuals and organizations undoubtedly affect the cognitive agenda and to some extent steer the process of acquiring the new knowledge.

Thus, societies evolve, among other, spontaneous rules which take the form of informal customary norms and, on the other hand, develop ideologies and stereotypes of thought which simplify, distort and in a way coordinate the thought processes. An intriguing question for further research is whether such coordination, based on insufficiently accurate or

even false perceptions of world and erroneous models of reality, can bring positive economic (and/or other) effects. The pressing need to coordinate somehow the decisions is the objective force leading to the formation of rules and the emergence of institutions, while the need to decide rather quickly, certainly before *all* potentially relevant features of the given situation are fully – whatever the word might mean – understood, leads to stereotypes and ideologies. Both processes may be driven by factors other than institutionalized sanctions: the failure to conform will result in decisions being out of the line with the generally adopted pattern of decision-making and a sure loss comes as a consequence. Conformity in thinking and acting seems to be directed and forced upon the agents by a set of what might be qualified as positive incentives: if you want to achieve the desired results, better go along with others.

Customary norms are embedded into *the culture* of a society and largely overlap with it. After designating culture as the bedrock of informal rules/constraints, North (1995/1990/, p. 37) defines it as heritage containing socially transmitted information. He then further reverts to a definition from the literature according to which culture is conceived as the intergenerational transmission, through teaching and imitation, of knowledge, values and other determinants of individual and social behavior. A much more detailed, more comprehensive and more refined definition of culture is given in Haitani (1986, p. 27): it represents the sum total of learned behavior that is inherited by communicative interaction and shared by the members of a society. As such it comprehends values, behavioral norms (permeated evidently by ethical precepts), beliefs, attitudes, knowledge, arts, myths, customs, rituals and technological knowledge. Culture helps enormously in a world of uncertainty and cognitive hazards. The reasonably realistic assessment of our conceptualization of the world can only be obtained if one takes into account the costs and vagaries of struggling with information. The world we live in is fundamentally different from the idealized world in which information is either assumed away or taken for granted.

Culture defined as a motley heap of conspicuously variegated unwritten laws, usages, customs and informal normative rules brings in the elements of behavior which under no circumstances could fit the conventional maximizing models. North (1995/1990/, pp. 20-1) has cited a number of authors who explicitly bring in the altruism as pervasive behavioral assumption. A strange kind of identification problem arises here. Altruism or its semblance can fit quite well the strategy of maximizing the purely financial results and other narrow economic effects. The reputation of trustworthy behavior attracts the customers, brings new business and contributes to earning money. Being honest is under reasonably stable and ordered conditions an important part of the avenue leading to large wealth. The merchants who dominated the Serbian XIXth century cities were widely acclaimed for their honesty, but that was part of the manner of doing good and successful business. Is the altruistic behavior an alternative to pursuing the lucrative goals, an irreconcilable contradiction to it, or just a subtle means in the hands of the actors oriented towards maximizing the financial gains? How does one distinguish the commercially driven and financially inspired motivation from the Kantian allegiance to the abstract *good* as such? Be it as it may, the purely maximizing models can't account for all facets of behavior and it is again the institutions and culture as their bedrock that one has to turn to. A much broader analytical framework is called for to explain the behavioral patterns of business units, not to speak of other types of organizations.

### *2.7 A More Detailed Description of Culture*

Being such a heterogeneous collection of widely differing elements such as customs and unwritten rules of behavior and ultimately representing the source and basis of all written, formalized laws, culture deserves a somewhat more detailed description. Such a description is admirably provided in the cited book of Haitani (1986, pp. 27-31). To bring some sort of structure into this to a degree entropic area, Haitani breaks it down into four classes of elements: values, beliefs, attitudes and ideologies. One is really tempted to add to this one

more element, namely the positive knowledge. Such an enlargement of the definition of culture seems desirable especially in view of the fact that Haitani (p.27) in his explicit enumeration of the components of culture gives technologies as a part of it. A *value* is defined as any desirable end or means. In its abstract form, i.e., taken as a standard of desirability, it is taken to guide human action. Wealth, power, freedom, justice, equality, truth, life and honesty could be adduced as obvious examples of values. Values naturally divide into *end values*, including those which are attributes of things that are desirable in themselves as well as those which are referred to as deontological values, and *instrumental values* which are in the service of achieving the ultimate, the end values. The values in the first set are called *goals*, whereas those in the second set are called *means*. The division between the goals and the means is not unequivocal. Some means are so highly elevated that they are treated *and called* the goals, whereas some goals are instrumental to achieving the higher order goals and should, strictly speaking, be qualified as means. If and when shared by a number of persons, the values become group values, and if shared by practically all members of a society, they become the social values. Group values fall into a natural hierarchy ranging along a continuum and starting from those shared by the largest number of the members of society down to strictly individual values. It is a philosophical question whether the values shared by the largest number are the most important or supreme as opposed to some alternative criteria of ranking. A separate category of *dominant values* is singled out in this context as the set of values which are “shared by the majority of people with a high degree of intensity over a considerable length of time” (p. 28). The dominant values of a nation constitute what is occasionally called *the national character*.

The second class of objects within the broad realm of culture are *beliefs*. A belief is equivalent to the individual perception or the subjective model of the world, as defined by North (1995/1990/, pp. 17-8) and Pejovich (1995, pp. 29, 35, 54). A belief may or may not pass the test of critical scrutiny; conditionally speaking, it can be true or false. Values and beliefs interact in that the beliefs are affected by values (one who values equality highly may be tempted to believe that any degree of inequality of income and wealth in the long run leads to blatant inefficiencies and to the ruin of the national economy) and values are affected by the beliefs (one who believes that the free trade enhances the welfare of the humankind is likely to place it high in the *hierarchy of values*). Values and beliefs thus appear to be closely intertwined into large not-easy-to-distinguish complexes in which the direction of causal ties is hard to decipher.

The third element of the ensemble of culture is the collection of *attitudes*. The word is taken to mean a predisposition of mind to respond, approvingly or disapprovingly, to surrounding phenomena – objects, situations, changes or intellectual positions. Nationalism, xenophobia, inclination to an eager acceptance of novelties and tolerance are examples of attitudes. Haitani perceptively observes (p. 29) that an attitude is a broader concept than an *opinion*, which is a concrete way of reacting on a specific issue or phenomenon, and that it is at the same time a more narrow concept than *value* which represents a general stance whose ambit transcends specific phenomena or situations. The kind and substance of predispositions hang on the underlying values and beliefs: if someone’s attitude toward the Montenegrins is inimical, that may be the result of his putting the value of loyalty very high in the relevant hierarchy and of his belief that the Montenegrins, particularly after their endeavor to separate themselves out of Yugoslavia, are not terribly loyal.

As for *ideologies*, the word has a wide spectrum of meanings, starting with a concrete program for political action up to something largely synonymous with value orientation. Roaming over such a wide spectrum, Haitani (p. 29) fixes himself to the definition of ideology as “a *value orientation that advocates or legitimizes a relationship of political power and/or economic interests between social groups*”. The contemporary mainstream

ideology seems to consist of individualism, pluralism, democracy, competition and free enterprise. The common thread binding all these value components is that society should not interfere with the life of the individual and should not obtrude his free choice in politics, business and other areas of life. Out of fashion is the opposite ideology that the working class as a group should expropriate the other, antagonistic group, the capitalist class in order to free itself from exploitation and to achieve its collective emancipation. The purpose of ideologies is to promote, rationalize and legitimize political and/or economic relations between and among social groups. As Marx repeatedly emphasized, the ideologies serve, among other, to persuade those outside a given group to accept the legitimacy of a given set of social relations and thus indirectly but effectively serve as levers of power and political rule. It turns out that an ideology is loosely bound, open-ended set values, beliefs and attitudes endowed with certain advocative quality. If deprived of that quality, an ideology ceases to be ideology and lapses into a passive value system. One could hypothesize that the Southeasteuropean societies have for centuries had non-ideologized value systems whose latent political potential became activated only in the XIXth century when politically dormant value systems turned into ideologies and soon thereafter into massive popular movements.

More often than not, ideologies appear as lacking logical consistency and intellectual coherence. Their cognitive content, as a rule, leaves much to be desired. The postulates embodied into an ideology reflect distorted perceptions of reality and embody what a group of people believe or want others to believe. "Often it is the emotive content of the ideology that works as a glue to hold together its illogical, irrational and deceptive elements" (Haitani 1986, p. 30). Yet, it is not possible to say that any society could go about without ideology. Most, if not all, social actions contain an element of choice. The concrete type of action cannot be determined by the scientific reasoning alone nor simply logically derived from a certain collection of facts of life. Being simultaneously a lot of other things, ideologies also appear to be some sort of a summary or a surrogate of the peoples individual *and collective* tastes and needs. Just as the optimum of the consumer cannot be located without taking into account his preference scheme, the pattern of social decision-making and acting in general cannot be determined without ideologies expressing in the last analysis what societies really want.

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Institutions have thus turned much more numerous, versatile and ramified than one would expect at the first glance. The rules in which they are embodied and through which they are articulated are extremely variegated. Three sets of such rules, representing clearly distinguishable but not strictly disjunct sets, have been identified. These are (1) laws and other statutes classifiable in a considerable number of categories, (2) ethical norms possessing an unusual quality of self-implementation and self-supervision, and (3) a truly manifold and diversified set of customary rules which came into being in the course of centuries and proved their pragmatic value through an agelong practice. The major trait along which these rules can be distinguished is the manner of their enforcement. The legal norms are enforced by the coercive power and actions of the government, the only organization with the legal monopoly on the use of violence. Ethical norms are enforced partly by the internal mechanisms of conscience and moral urge to opt for *good* and act in accordance with the categorical imperative. Customary rules are largely self-enforced and followed on the account of the fact that it simply pays everyone concerned to act in accordance with them; acting in line with customary norms appears in a vast number of situations to be the only way to coordinate one's own decisions with those of the others, which is, on the other hand, the precondition for such decisions to bring the desired, objectively achievable effects. If I want to sell a pair of oxen, I'd better take them to the village fair on one of the days the fairs are taking place; otherwise there will be a small likelihood of completing successfully the transaction.

While the principal mechanisms of enforcement are generally specific to each of the three described classes of norms and rules, they are by no means exclusively tied to “their” appropriate classes. Thus, obeying the laws carries with it an unequivocal moral connotation and the custom of following the legal norms contributes to coordination and brings obvious practical, including financial, benefits. Neglecting ethical norms brings not only remorse but not infrequently separating out of the relevant social groups and even ostracism; the acts of violence and physical sanctions are not excluded either. And customary norms are evidently laden with ethical content and, again, are here and there enforced through the acts of collective violence. Customary norms are not that far removed from the laws, the best evidence of which is the fact that customs are recognized as one of the most important sources of law (Lukic 1988, pp. 249-51).

The three-legged classification of the rules constituting institutions goes a long way in helping to understand the vagaries and serious difficulties of institutional change. The reforms and all other forms of social engineering are only capable of acting on one set of rules belonging to a much broader set of institutions. Namely, it is only the legal rules that can be acted upon. But they are just a small part of the sum total of rules that regulate the functioning of any society. The metaphor of the iceberg has already been used and should be invoked again to underline the fact that legal rules are just a tiny fraction of all the rules prevailing in a society. Changing just legal rules cannot obviously be an effective way of affecting the institutional overhaul of a society. As other rules continue to operate in a more or less unchanged form – or, if they are changed, the change proceeds as a result of completely different set of mechanisms and follows different operational principles – the resulting effect cannot, as a general principle, be particularly impressive. For having a real turnaround in the way in which a society functions the transformation of a *much larger set of rules* would be necessary. However, organized ways of changing ethical and customary rules do not exist. The only known recent attempt to change the ethical basis of a society was the well known Cultural Revolution of Mao Tse-tung, but it turned out to be a spectacular failure. Hence there follows a simple and evident conclusion: the limits of reforms and social engineering are a fact of life, institutional reforms cannot be pursued at will, there are serious constraints to be taken into account. Moreover, in designing the institutional change the existing ethical base and customary infrastructure of the society has to be counted with. Otherwise grave inconsistencies between the legal norms and the rules belonging to the other two sets will arise and the end result is likely to prove a disappointing failure.

### *9. Southeastern Europe: The Case of Historical Lock-in of Institutional Development*

The preceding eight sections, which turned much more extensive and wordy than anticipated, are meant to provide a general methodological platform, a set of analytical tools and a broad backdrop against which more specific traits of economic and social development of Southeastern Europe will be considered. Little was said that could be considered as a concrete analysis of Southeastern European economic and institutional realities even though the part of analysis dealing with the possibilities of institutional and civilizational stagnation, as well as the part considering the hazards of perverted social developments had a more than accidental bearing on the complex, untoward and occasionally calamitous history of Southeastern Europe. The sequel of this text is intended to be much more specific. Its purpose is to identify the institutional constraints on the Southeastern European development drawing on the repertoire of concepts and the methodological toolkit developed in the previous sections.

### *3. Institutional Backdrop of the Southeastern European Development: A Case of Historical Lock-in*

As was indicated in the introduction to the first part of this study, its purpose was to provide a general framework and an analytical toolkit by means of which broad social

determinants of development could be analyzed and, as it were, to introduce the language in which the versatile development phenomena could be dealt with. This second part is intended to be noticeably more specific. It is meant to be as closely tied to the Southeastern European realities as possible and to contribute to an understanding of the development obstacles in this part of the continent in a more concrete way. The focus is, of course, on those determinants of economic and social development which can be illuminated through the conceptual tools and analytical procedures of the institutional analysis. The implication of the approach taken in the study as a whole is that it is the institutional sphere that contains the most powerful factors of the overall development. It is thus hoped that the most exciting elements of the development story will be told by concentrating on the structure and evolution of the underlying institutional order. So far little has been said that could be considered as a concrete analysis of Southeastern European economic and institutional realities. The abstract character of the analysis presented so far is readily discernible even though the part of analysis dealing with the possibilities of institutional and civilizational stagnation, as well as the part considering the hazards of perverted social developments, had a more than accidental bearing on the complex, untoward and occasionally calamitous history of Southeastern Europe.

### *3.1 Initial State as a Determinant of the Options for the Future Development*

The first thing to note is that the initial states of any collection of observed societies unavoidably vary in a wide spectrum and along a large number of dimensions. That is true not only for, however chosen, present, but also for any moment of historical time. Careful analysis could demonstrate that a large part of developments observed in the past could to a significant extent be explained by the tenets of the relevant initial positions from which the societies had to make their hazardous ventures into development of their economies and the associated modernization of their institutional scaffoldings. It would, of course, be a fatalistic fallacy to assert that future developments are uniquely determined by the initial positions. There is always scope for choice and the calamitous interplay of the unforeseeable contingencies. Initial state is, first of all, a repository of the constraints on the paths of future development: the choice is generally nonremovable, but at any time it can only be done within certain, in this case dynamically framed constraints. In addition to being a repository of constraints on the trajectories of future movements, initial states are the stockrooms of historical individual and collective memories. This societal remembrance affects greatly whatever choices are being made within given constraints. The influence goes both through the system of preferences, including collective predilections and ideologies, and the available knowledge which generally proves to be the ultimate constraint on human action.

Much of what constrains the present activities and future changes is closely associated with history which in the case of Southeastern Europe evidently plays a much bigger role than elsewhere in Europe, at least with respect to developmental constraints and the civilizational lock-ins which are such a conspicuous part of Southeastern European realities. History matters (1) as a determinant of the present state, (2) as a storage of collective memories, and (3) as a way of getting to where the systems are now – to the extent that this way determines the manner of muddling through in the future. The ways and manners likely to come forward in the future are certainly not independent of the ways having taken place in the past. This appears to be true even if the learning effects and the influence of the inherited knowledge are abstracted from.

A major determining characteristic of the Southeastern European history is its remarkable discontinuity. The lands in this area have spent some five centuries under the Turkish yoke. Two features of this alien rule seem to be significant. Firstly, most of the time spent under the Turks was in the declining stage of the Turkish empire, i. e. in the phase in which the empire had anachronistic and development stifling institutions. Secondly, the centuries spent under the Ottoman empire were crucially important from the point of view of the secular development

in the rest of the continent: those were either the centuries of unprecedented modernization of the Western Europe or the centuries of sustained preparation for it. The Proustian loss of time is bad in itself, but having lost those particular centuries appears to have disastrous consequences in the light of the global development experience. Those were the years lost not just for the acquisition of real resources and accumulation of capital, but also, and more importantly, for the accumulation of knowledge. Dynamic implications of falling behind in the acquisition of knowledge has dynamic implications which probably span centuries and produce a civilizational lag which may take centuries to compensate or might even turn not to be compensable at all. The differences in the development levels, formed in the course of the last couple of hundreds of years, exhibit a marked persistency and, while convergence tendencies and change of rank in the of the development levels do occur within the set of advanced countries and regions, there is a steady deepening of the gaps in *per capita* incomes and other magnitudes between the developed world as a whole and the more or less compactly cast underdeveloped world (Barro and Sala-i-Martin, pp. 414-24, 455-61).

Another characteristic of societies long ruled by an alien power – and in this part of Europe that happened to be the same Asiatic empire – is a relatively weak ethical structure within the framework of the global society. To begin with, being enslaved could not be seen as an environment particularly conducive to the strengthening of morals. It is only natural to see a considerable broadening of means that can be “legitimately” used against those who oppress you on the ethnic and the religious basis. The Serbian folk poems are full of praise for the *haiduks* who plundered and killed the travelers and merchants, provided only they did it, among others, to the ruling Turks (cf. the famous poem *Vujadin, the Old Man*). The supremacy of Turks over the Christians was such that any Turk could have dropped into any Christian house and stay as long as he wanted, helping himself with food, drinks and the female members of the family (Dzadzic 1987, pp. 124-55). Dzadzic (p. 124) points out that the number or written testimonies of various forms of violence, particularly those touching the dignity of the people, is remarkably rare. He hypothesizes that this might be due to a peculiar form of self-censorship, demonstrating how painful these memories are and how gigantic an effort had been made to suppress them somehow. Dzadzic then nevertheless goes on citing a large number of historically recorded instances of gross violence committed by the ruling Turks against the Christian Serbs, including in particular the cases of drastic dishonoring. In such a situation the establishment of morals must have been discouraged on at least two accounts. Firstly, moral sentiment, to use A. Smith’s and Lukic’s (1982, p. 113) term, is very likely to weaken or even to be entirely discarded in face of such brutal moral disgrace; a man with badly hurt dignity is unlikely to develop a keen sense of moral duty. Secondly, The feeling of anger and revenge will probably inspire the use of means which largely transcend the realm of what is usually considered as morally permissible.

The next important feature of social life likely and bound to be distorted is the stance toward the law. The effective laws had, of course, been those introduced and upheld by the alien oppressive, exploiting and disgracing power. Breaking such laws must have become and remained a matter of patriotic obligation and peculiar moral duty. Obeying the laws, in turn, must have been perceived as a matter of collaboration with the oppressor and acquiescence to what clearly appears to be an attack on your wealth, life and honor. The tradition of disrespect for law and direct opposing to it seems to be an unavoidable product of such a broad social situation, of such a, to use the Malraux’s syntagm, *condition humaine*. Such developments in the sphere of social psychology have, again, long run implications. Once the denigrating stance toward the law is adopted, there is no guarantee that it will not shade into the new age, the one following the national liberation and the establishment of the independent and in many respects modernized state. The legacy of the inimical perception and reception of the law is a long run liability weighing heavily upon the prospects of proper modernization of the

society and, by implication, on the institutional preconditions for successful economic development. An additional difficulty is the heritage of a motley mixture of various legal systems, moral codes and customary arrangements. While there might appear certain processes of cross-fertilization and synergic interaction, it is not too hazardous to conclude that the effects of inconsistency of these versatile components will prevail and that their mismatch almost inevitably leads to chaotic and destructive tendencies bearing unfavorably on the coherence of societal arrangements and the prospects for stable and sustained progress. One may make a further step in the elaboration of the relevant detail: not only are there likely to appear inconsistencies *within* the sets of legal, moral and customary rules as defined in the preceding sections and summarized at the end of section 2.7, but one should expect the inconsistencies *between* those sets: moral rules would quite likely find themselves at odds with legal arrangements and both could with some likelihood find themselves in opposition with customary schemes. The conflict between legal arrangements, on the one, and the sets of moral norms and customary rules, on the other hand, is much more likely than the conflict between the moral dicta and customary regulations. This fact sets severe limits on all types of social engineering in the form of legal reforms. If the newly enacted legal documents don't have their support in the informal norms and behavioral standards, the likelihood of the new legal acts letting roots in the social fabric is very low indeed (Pejovich 1999).

### *3.2 The Significance of the Paths Having Led to the Initial States*

It is easy to recognize the importance of any initial state in which a society finds itself in a given moment of historical time. That remains true despite the fact that not all dimensions of the initial state and not all ways in which they interact with the current development processes may be clearly seen. However, it is not just the initial states that matter, but equally important appears to be also the way and the path along which the system reached a given position. Two systems with equal initial positions but different ways of arriving at them will generally have different development potential, different prospects and opportunities for future evolution. Thus, history matters. To recapitulate and reemphasize the points made in the previous section, it matters (1) in the obvious way of being the self-asserting determinant of the given initial state, (2) as a repository of information, knowledge and experience generated by the path of the past development, and (3) as the resultant of the ways of getting to where the system found itself and of the means used to implement the past transitions. The means and ways used and learned in the past are likely to be used in the future and to determine to an extent the developments to be followed in the coming years.

The first and perhaps the most important characteristic of the past development, seen as a determinant of future events, is the variability of the path, in particular the degree to which it is strewn with severe and destructive shocks and filled with the complex and unpredictable twists and turns. One could talk about the sum total of changes that have burdened a given history, especially of the amount of adverse changes representing a part of collective culture and historical heritage. The lack of stability of the past development and of the smoothness and continuity of the corresponding dynamic trajectories appears to be a particularly heavy handicap regarding the quality of the inherited institutional setup and also with respect to future institutional development. The adjustability of institutions and flexibility of the entire social order depend in an essential way on the collective memories and the past experiences in organizing various parts of the society to overcome the existential threats and challenges. To bring forth the crucial aspect of the impact of instability on the performance related qualities of institutions, if changes are frequent, abrupt and too much out of line with past experiences, the periods of adjustments are short and the spells spent on learning about the new circumstances and inventing the ways of confronting them are too limited to give any collectivity a serious chance to shape a proper arrangement duly tuned to the new situation. If, because of sudden and generally unpredictable changes, the intervals in

the course of which the new institutions are to coordinate the decisions of the collective actors *are too short*, then clearly highly effective institutions cannot be expected.

Out of the reasons accounting for such a fact worth mentioning are two. Firstly, in an overly short time it is simply impossible to design the high performance institutions because such institutions take time not only to be built and enacted or socially accepted, but also to be prepared by preceding observation, reflection, experimentation and gradual adjustment to the newly emerged realities. By far more importantly, to the extent that institutions are not a matter of conscious design but a product of slow and very gradual adjustment to the survival needs of a community and a matter of very broad and long lasting experience, the *sheer time* emerges as the basic precondition of the formation of institutions, particularly those which themselves successfully pass the test of time and performance (Schoenfelder 2001, p. 6). As for the consciously engineered institutions, one could talk even of some sort of a lag preceding all above enumerated operations, starting with observation and ending with activation of the new arrangements. Namely, to make it purposeful at all to undertake all these activities, the concerned actors will have to convince themselves that the newly arisen change will *last*: it certainly doesn't make sense to adjust to changes which are ephemeral and which will soon be replaced by other constellations. Secondly, all these activities imply costs and their undertaking has to pass some sort of, perhaps implicit but nevertheless necessary, cost-benefit analysis. Cost depends on the magnitude and the type of adjustment; the benefits depend upon a host of determining factors, but among the most important of them is certainly the length of time during which the benefits are expected to be reaped. If changes are frequent, large and unpredictable, the periods over which the benefits would be forthcoming are too short and hardly any compensating factors can reverse the unfavorable result of the conceptualized cost-benefit calculation. The conclusion is thus clear: the frequent and big changes make it both unworthwhile and impossible to affect the appropriate institutional adjustments to such changes; the volatile historical situation makes it practically impossible to arrive at and maintain the high quality institutions.

The above reasoning has an easily identifiable implication. In order to be able even to entertain a hope of having well designed and effectively performing institutions, one has to have a fairly stable, even development, without too many and too powerful shocks, a development with relatively smooth and – at least and in a way – piecewise continuous trajectory. This requirement should, of course, be read as a metaphor rather than a mathematical statement. The smoothness of the trajectory is clearly not a sufficient but just a necessary condition for arriving at the efficient – whatever the term might mean – institutions. One thus arrives at an important conclusion having an unmistakable bearing on the entire region of Southeastern Europe. Due to its turbulent past and volatile history, Southeastern Europe had little or no chance to create high quality institutions, no matter what criteria of evaluation are. The necessary condition for such a state of affairs – reasonably long spells of relatively peaceful and stable development – was lacking. The state of affairs was quite to the contrary. The sufficient condition for *not having high quality institutions* has more or less permanently been a feature of the social situation in this part of Europe. Southeastern European history contains the principal answers to the key question of institutional deficiency and civilizational lag of the region. History did not give the region the chance to develop the set of modern, performance oriented institutions and thus to align itself with the historically more fortunate West. This simplified statement will probably have to undergo a number of qualifications, one of the most important being the feedback influence of institutions on the development itself. Yet, there is reason to expect that the basic message will survive because there is abundant historical evidence that the past shocks and historical traumas have by and large been externally generated and that they, not impacts of institutional feedback, dominated in the interplay of the grandiose secular forces within the large scheme of history.

Another way of expressing and substantiating the basic idea of the lack of, conditionally speaking, historical continuity and stability as a source and cause of institutional drawbacks in Southeastern Europe is to observe that, in the atmosphere of general volatility, very few repeated interactions took place. Such interactions are few in number because the exogenous changes and external shocks bring new situations and with them new types of interactions. Whatever class of interactions is looked at, the interactions cannot be numerous in a spasmodic pattern of historical changes which implies very short homogenous periods between successive exogenous shocks. Moreover, even if some type of interactions survived a shock or more of them, that would be equivalent to changing the type of interactions: the same interactions under significantly changed circumstances cease to be the same. Frequent attacks of the incomparably more powerful external forces and long periods of enslavement have produced long periods of exogenously imposed primitive organization of economic life. The basic feature of such organization was an extremely low volume of exchange, with large segments of economic life without any exchange at all. It is evident that in such environments contracting practices had very little chance to develop and the paucity of contracts led in turn to slow or entirely missing development of institutional framework facilitating and regulating exchange. This would be the way in which history had a direct bearing on growth and ramification of economic institutions.

The described pattern of historical evolution, accounting for slow or altogether missing emergence of rules and institutions, could also be relied on to explain the long tradition of authoritarian rule, tyrannical government and personalized regimes in Southeastern European lands. If the rules are defective, grossly incomplete or entirely absent, the governance vacua are automatically and inevitably filled with the personalized power relationships and the rule of man substitutes for the rule of law. The famous Ciceronian dictum *Non sub hominem sed sub legem* is exactly reversed. The rule of man over man has an obviously disastrous effect on morals. In fact, only equality before the rules can facilitate and favor the strengthening of the morals as the liberty under the law provides the necessary security to follow ethical imperatives and decline to acquiesce to unprincipled compromises. Since the authoritarian ruling elite has always the option of either applying the laws or not applying them, the very function of law becomes perverted. Rather than constraining and controlling the political power, law becomes one of its mightiest instruments.

### 3.3 *The Implications of the Past Developments: Experiences of Serbia and Greece*

The *sub hominem* type of social relationships generates the evidently unavoidable concentration of political power which distorts the behavioral motivation in a way which is analogous to the monopoly in economics. The political system becomes overtly rigid and the ruling establishment irreplaceable. The political elite controls the populace instead of being controlled by it. The political rules profoundly change their nature and the way they function: they grow into an elaborate mechanism of controlling the people, converting them into compliant *subjects* and preserving them in the psychological frame and the behavioral pattern of *obedience*. Whatever laws exist are selectively applied and their incompleteness and contradictions between and among their parts and wholes make it impossible to act in accordance with such laws. Everybody becomes guilty, as effectively asserted in the famous novel *The Monk and the Death* by M. Selimovic, and the guilt is not only internal and subjective but also objective and legally demonstrable. When everyone is guilty, everyone can be arbitrarily and at will punished and hence everyone has to be obedient and can be effectively controlled. Again, being obedient not to the rules but to the personalized constellations of political and punitive power is a mechanism of killing the dignity and undercutting the morality in the society at large, which in turn destroys one of the pillars of institutional architecture of any society.

History provides abundant evidence to corroborate this statement. The famous Serbian publicist, literary critic and social writer S. Markovic (1946/1872/, pp. 40, 46, 53, 71) enumerates many instances and manifestations of low morality: the mentality of obedience rules supreme (p. 53), the war plundering was a natural, widely accepted way of personal enrichment and of acquiring the office of a local boss (p. 63), when summoned to the court "...they seize the rifle and take to the woods" with ample evidence of contempt for the court (pp. 70-1) and, worst of all, "...the stealth, the plunder and the homicide, only if done to the Turk, in times of peace as well as of war, were considered as moral acts" (p. 40).

Southeastern Europe is an area in which, over long stretches of history, the laws have been not only unjust and cruel but also unobservable because of their inconsistency and conspicuous remoteness from the facts and the relationships of life. The disobedience with respect to law was practically imposed and forced upon the people. That provides an additional, in a way structural reason for the low standing of law and the long tradition of its neglecting. Where the law is being neglected as a matter of daily routine, the chances for institutions to take hold and to matter are slim indeed. Institutional underdevelopment becomes a kind of societal destiny. The absence of the rule of law and the secular strengthening of the personalized power has over centuries been the institutional basis of strong statism and widespread governmental *dirigisme* in all spheres of social life. Oversized and widely ramified government has turned into destiny of all Southeast European countries. Many components of their history reduce to the narratives of this or that type of governmental interventionism.

Svetozar Markovic has also provided a telling and impressive testimony of the causes and consequences of excessive and oppressive *etatism* in the modern Serbian history (starting at the beginning of the XIXth century). The important point emerging from his considerations is that the oppressive and authoritarian character of the Serbian national state, which practically gained independence by Sultan's edict of 1830 and later, more fully and formally, on the Congress of Berlin 1878, was inherited from the Turkish rule. The Turkish governmental machinery, designed to rule over the oppressed Christian subjects, was simply transplanted into the new arrangement. It was tuned to regulating the relationships among various layers of bureaucracy and affirmed across the board the techniques of bossing the people rather than the citizens' rights and the institutional guarantees of responsibility of the government to the electorate. Markovic (1946/1872/, p. 94) considers this a deadly blow to the democratic aspirations of the people. He had in mind the magnificent and unrepeatable which surfaced in the ill-articulated form in the glorious First Serbian Uprising back in 1804. Namely, the entire Turkish hierarchy of ruling *over people*, rather than *on behalf of them* as well as *in full responsibility to them* was simply transplanted into the new realities. The state treasury was coincidental with the sovereign's personal purse (the sovereign was the famous Duke Milos, who eventually wrought out independence more by bribes and diplomatic means than by the armed struggle, even though the arms have eloquently spoken as well).

Both the Duke and the members of the newly emerged governing elite thought the Sultan, not people, was the ultimate source of power. All of them treated people in the Turkish style, i.e. not as a source of sovereignty and the central element of responsibility but as a set of ordinary objects of ordering and governing, to be exploited and bossed around. The members of the elite fought against the Duke not to safeguard the citizens' rights and freedoms but just to extract for themselves as much political power as possible (p. 85). In the reckless fights for political supremacy people were typically neglected and in turning to the Sultan as a source of sovereignty all kinds of immoral means and ways were used (p. 84). The members of the political elite, called *the fighters for the constitution*, were characterized by a *barbaric mentality* (Markovic 1946/1872/, p. 100) and thought that the only purpose of the new political arrangement was simply to replace the Turks and make sure that people are

obedient and caught into a network of permanent subjugation. Conspicuously absent was the very idea of inalienable human rights and freedoms as well as the respect for individual dignity and its unrepeatable uniqueness. Serbian lands and the entire Serbian people were treated by the ruling elite as “a gift of the Sultan who gave them (the people – Lj.M.) as his property to the captains, the local lords, the councilors and rest of the gentry. The only thing that happened is that the Serbs came instead of the Turks to rule, and that is all there is to it – and people had just candidly to obey...” (Markovic 1946/1872/, p. 100). The other side of the coin was noticeable absence of the feeling of obligation, formalized or not, on the part of people toward the dignitaries of the newly created state: the years of national emancipation (the first decades of the XIXth century) turned out to be a period of frequent uprisings both against the Duke and the lower level dignitaries. These lower echelon nobles were themselves almost steadily fighting against him (Markovic 1946/1872/, p. 88). Summarizing, despite people’s ardent desire for order and justice, they were given armies of bureaucrats (p. 98), organized into oversized and slow grinding machinery and structured so as to facilitate the rule over people, with most legal arrangements framed to regulate the relations among the bosses rather than protecting the freedom of the citizens.

Greek historic experience is another important piece of evidence which can profitably be drawn on. It vividly demonstrates that legally formalized, officially promulgated institutions, being just a part of a much wider regulating structure, stand little chance to succeed if they find themselves incompatible with the rest of the structure, particularly with a wide variety of customary norms and standards. The lack of success may also result from the absence of certain political preconditions. To the extent that the newly designed institutional machinery finds itself at odds with the general morphology of power structure, it may be rejected as a sort of alien tissue and never be able to actualize itself in the expected way. As elaborated to some detail in Minoglou (1995, pp. 261-3), the configuration of political and social power was not consistent with the set of new, democratic and modernizing, institutions in the sense of having a global system capable of producing the results comparable to those recorded in mature democracies. Property rights were rudimentary and the group of property holders was relatively weak, the urban dwellers and other citizens paying the above average taxes were scattered throughout society and poorly organized, the general level of political and fiscal culture was quite low and the society as a whole was remarkably weak in protecting itself against the growing bureaucracy and the coercive state giving their deep imprint to the entire nexus of social relationships. As nation building, just as in the case of Serbia, was an extremely costly venture, resources consumed by the state had to be substantial.

#### *3.4. Further Discussion of the Greek and Serbian Experience*

The Greek problem was primarily the glaring inconsistency between the set of modern political institutions and the social structure, with power configuration inherited from the past. Two avenues to solving the problem opened themselves: high taxes and incurring foreign debt. Due to the vagaries of political competition, particularly to parties vying for political support by promising the alleviation of the tax burden and being partly true to it, the second alternative was heavily relied on and Greece quickly became one of the most indebted countries of the world. There is still a saying in Serbia: that man is as heavily indebted as Greece. This country appears to have been the case of a modern, democratic governance superstructure not having been able to produce socially and otherwise acceptable results because of the weak economic and social foundations on which that superstructure was crafted. Minoglou (1995, p. 255) reports that immediately after the declaration of independence (London Treaty, 1832) protecting powers arranged for a 60 million gold franc loan, with 60% of its nominal value being withheld to cover the initial interest and amortization payments. The loan, very much similar to the subsequent loans, was used to pay generously the oversized bureaucracy and foreign troops, as well as to finance other war-

related expenses. All of these were components of the current consumption whereas prospects for generating sufficient export earnings to service the debt were practically nonexistent. Greece defaulted in 1843 and for the next 47 years was banned from the international capital market. Greek sovereignty was severely circumscribed, if not eliminated. Despite an interim attempt to raise another foreign loan, Greece was not able to approach the capital market until 1879 when the debt settlement was finally reached and the ban on using foreign finance removed. But the state, much for the same reasons, continued to struggle with severe financial difficulties and eventually, after nine years the International Financial Commission (IFC) was set up and imposed upon Greece. As far as the freedom to formulate and implement macroeconomic policies was concerned, this was equivalent to putting Greece under the protectorate of this international body. The IFC continued to run the country in the important dimension of formulating and implementing macroeconomic policies for the next twenty years. Much of the statehood, painfully and with the force of arms wrought out from the Turks, was lost, as it were, behind the back of the nation, through financial transactions and diplomatic maneuvers.

The Greek case even suggests the idea of the existence of strictly economic preconditions for the institutions of parliamentary democracy. The three big powers, the guarantors of the Greek independence, provided for a monarchy without constitutional limitations. However, the Greek society, spontaneously democratized through the national liberation struggle, dismantled the monarchical shell and, inspired by the ideas of the French Revolution, introduced a set of modern, parliamentary institutions. This is where the contradiction developed between the political superstructure and the insufficiently structured society, including, in particular, its poor and stunted industrial base. Minoglou speaks about *failed parliamentarism* (1995, p. 261) on account of inconsistency of the rapidly modernized political architecture with the broader, largely traditional social base. The interplay of the suddenly liberated democratic forces was too demanding and actually unsustainable by the weak economic substratum. The prevalence of politics over economy produced a peculiar mechanism, akin to that described by De Jasay (1985, p. 259), through which the parties compete by offering publicly owned resources to raise the living standard of the populace and thus to enlist the sought political support. Increasing public debt is actually equivalent to consuming the commonly owned resources because it is the *collectivity* of the future tax payers that are to bear the burden of servicing.

Predictably created and immediately observable was the corresponding economic outcome: a poor and undeveloped institutional framework produced quite an inefficient allocation and utilization of resources. Unequivocal indications can be found that the poor performance of the institutional machinery was largely due to the mismatch between the newly implanted Western contrivances and the distinctly traditional surrounding devices, including the endemic *culture* reflecting domestic idiosyncrasies. Many forms of organizing activities and many types of contracts cannot fully assert and affirm themselves in the environment of structurally different, mostly traditional regulatory rules. Schoenfelder (1999, p. 2) points to a more than indicative fact that a number of Balkan countries (Bulgaria, Romania, Serbia) adopted legal systems of West-European descent around 1850 but “never really managed to put these systems to life”. The combination of a widely ramified network of contracts and a weak machinery of their enforcement led to all kinds of opportunistic behavior generated by the systemic failure. It further led to a deplorable waste of resources as well as to all-pervading failure to use investment and other opportunities. This institutional weakness is analogous to the above described political weakness consisting of a combination of overdosed working democracy and the resulting weak democratic state.

History provides plentiful evidence of the importance of institutional causes in accounting for the economic underperformance of Southeast-European countries. Minoglou

(1995, p. 254) enumerates four factors constraining the inflow of foreign direct investment, which might be seen as a proxy for general readiness to spur development and to modernize: scanty and backward property rights in agriculture, the thinness of the rural labor market, the legal framework for foreign investment and the refusal of the state to grant attractive public work concessions to potential investors. It is characteristic that out of four adduced factors only one appears to be of a structural variety; the remaining three are either institution-bound or policy-related.

The other and perhaps much more important lesson to be drawn from the experience of all Southeastern European lands, as exemplified by Serbia and Greece, is that economic development and industrialization *are not* the only goals that have been pursued nor the only societal needs to which institutions are to be attuned. One of the big alternatives is the *nation building* which could be taken as a proxy for something incomparably more important, namely the *national security*. The latter is a fundamental need arising at practically all levels of social organization and is closely tied to the idea of national liberation and national dignity. It should be apparent that security and economic growth are not perfectly aligned, that conflicts in pursuing the two are bound to arise and that one should expect clear and irremovable trade-offs between the two strategic social needs. While giving modest results in economic growth and modernization, the relevant institutional framework might have been excellent from the point of view of security and, moreover, might generally have been perfect from the point of view of *both criteria*, provided the proper weights are attached to them in a synthetic objective function. The experience of Greece is illuminating in that respect. Throughout the first part of the XIXth century, and to a considerable extent during the second part, the property relations were not developed with a view to strengthening the institutional base of a modern market economy, particularly its motivation structure, but with the strategic objective of creating a unified marked as a foundation of national unity and monolithic statehood; potential economic effects were lost to the higher political aims of forging a lasting and powerful polity (Minoglou 1995, p. 263).

Weak societies – those with poorly institutionalized property rights, with weak and ineffective owners, with powerless political organizations, feeble nongovernmental associations and understrength civil society – are, as a rule, characterized by relatively strong governments and tough, vigorous bureaucracies. This fundamental feature of the newly emerging Southeastern European societies was the true intellectual obsession and a major source of inspiration of the greatest Serbian XIXth century social thinker S. Markovic. Most of his work, and particularly his seminal book on the development of the Serbian society (1946/1872/), is devoted to demonstrating the proposition that bureaucracy represents the dominant social force and that the entire social structure could be seen along the contradictory and antagonistic grand relation between the bureaucracy and the rest of society. *Etatism* becomes the prevailing configuration of social interdependencies and stamps its lasting imprints on all important segments of social life. The dominance of the state and the bureaucracy not only prevents the liberation of the society, exemplified, among other, by the market economy and the pluralistic polity, but also leaves a lasting heritage preventing the democratic emancipation of the society for a long future time to come.

The development of capitalist institutions is prevented by the long shadows of the past – by the tradition of the governmental coercion and bureaucratic rule which produced the patterns of organization, behavior and thought difficult to counter even in the contemporary venture of transition to a modern, open society. *Etatist* structures occasionally come about as a result of curious historical accidents. One such is persuasively described by S. Markovic (1946/1872/, pp. 49, 62-3, 65). The Serbian society was subject to the Turkish rule and was a set of collectivities of equals with traditional and highly developed local autonomy. Had the Turkish rule been abolished in one or two years, as it seemed at the beginning of the liberation

struggle, such an *even* social structure would have been an ideal social basis for institutions of the democratic rule in the ambit of the entire society. That, however, didn't happen. The struggle dragged on for some fifteen years, enough for a ruling military elite to spring up. That elite was the beginning of an undesirable stratification of society, for differentiation and lasting forms of inequality among its members and for relations of dominance and oppression to be implanted as permanent features of social organization. Irretrievably lost was the magnificent initial opportunity for a democratic system to grow on the traditional foundations of deeply rooted equality.

The inherited situations following the initial attempts to modernization, undertaken in Southeastern Europe in the course of the XIXth century, halted development. The states arrived at are – both at structural and institutional plane – such that just removing the impediments is not enough. Distortions of prices and markets generate distortions in the institutional sphere, which then carry over into the political relationships and the balance of social forces. Such configurations then become powerful obstacles to the long awaited institutional reforms; the deadly feedback is unmistakably at work. History matters – and, indeed, in the most disagreeable way.

### 3.5 Cognitive Limitations on Southeastern European Development

Human action is not the only but certainly is, and has always been, one of the most important determinants of development. Hopefully this statement preserves some relevance despite the fact that one might be tempted to ask questions about the determinants of the human action itself. Some relevance is hopefully preserved even though the term *action* cannot for this context be quite satisfactorily defined. It is a matter of everyday experience that one set of actions conditions another set and/or defines the constraints for a third set of actions. It is not easy to be precise in defining the effects of any (set of) action(s), no matter how it is defined and it is even more difficult to delineate with any degree of reliability the wide ramifications of given actions. Leaving aside such conceptual refinements, it will be accepted as a fairly certain proposition that human action affects development(s) at all levels of social organization and that the action itself may and will depend on a number of factors which have clear relevance for the speed and directions of evolution of variously defined segments of the society and of the society as a whole. Action is important as an autonomous driving force and as a medium through which other relevant factors assert themselves.

The basic insight on which one can build many analyses of economic and social change is that people and their groups act not on the *true facts* – whatever the meaning of the two words – of reality but on their perception (or reception) of it. The bewildering complexity of the world around us, the modest capacity to comprehend it and to see through the regularities of its functioning, the highly circumscribed ability to collect and process information, the algorithmic limitations and the computational constraints – all of these plot to make it impossible to weld a coherent and reliable picture of the world. North (1995/1990/, p. 8) speaks of the *mental constructs, imperfect subjective models* and even *incorrect models*. Pejovich (1995, p. 29) points to an amazing variety of observed behaviors and speaks of them as "...evidence of the individual's subjective perceptions of reality". Actions that have been taking place in the long series of past periods have relied not on the above indicated *true facts*, but on the delusions and fallacies, on the seductive shadows of these facts. There is a big and occasionally dangerous distance between the – how ever defined – true picture of reality and the models of the reality formed by our feeble and stunted cognitive and information processing capacities.

While being unavoidable and universal, the distance between the "truth" and the reality, it, however, is far from being the same in all environments and all cultures. It is accepted as a sort of axiomatic truth that the larger this distance, the less efficient will be, *ceteris paribus*, the economic and social processes under review and the slower and less

beneficial will be the overall social evolution. In particular, with a large distance between the objects and processes, as parts of reality, and their subjective, mental and cognitive, projections, as the intellectual reflections of the world, one should expect a low secular rate of growth and a considerable lag in the level of how ever defined development. If there is at all a single comprehensive factor which could account for a huge lag of the southeastern part of the Continent with respect to the advanced societies, the first candidate would have to be a small quantity of knowledge and low level of capacity to expand it. Southeastern Europe has an extremely unfavorable geographic location, the one which boils down to a real handicap exactly regarding the availability of knowledge, the prospects of expanding it through absorption from the surrounding regions and the capacity to increase it in an endogenous manner.

Putting it very briefly and in a highly simplified way, the southeastern portion of Europe has during the entire course of the relevant portion of the recorded history been on the periphery of civilizations. In the Old Age it was somehow located between the two principal cultural centers – Rome and Constantinople – at a large distance from both of them. In the Middle Age it was again somehow in between: Constantinople was again one of the centers and thriving Western cities and lands played the role of another center. This part of Europe has throughout centuries been and continues to be the periphery of the developed and culturally advanced world. The first important element on which this untoward fact had to reflect unfavorably was clearly the amount and quality of knowledge and the chances of its sustained expansion. Inferiority of knowledge has a bewilderingly wide array of implications, the most marked among which are the slow advance of technology, haphazard and growth constraining institutional adjustment, as well as slow economic development producing ever larger societal welfare and civilizational lags.

In addition to the described secular distortions and deficiencies, occurring over long sweeps of history, one should take note of the purely technical drawbacks producing predictable distortions in the allocation of resources. The discrepancies between the images of the realities and the realities themselves give rise to multiple equilibria in the technical sense, most of which are highly inefficient. A large number of such equilibria produces a large probability of the economy getting stuck in one of them and being unable to extricate itself out of it even in the long run. Such fatal development entrapments are one of the ways of formalizing the depressing phenomenon of the long run stagnation of this part of the world over the long stretches of time.

Another approach to the widespread phenomenon of institutionally conditioned stagnation of economies and societies is to acknowledge the *public choice* (*Ekonomiska misao* 1998, particularly the Buchanan's contribution, pp. 167-78), rather than *public interest* perspective of political processes and to recognize individual and other *partial* interests as a factor determining the formation of institutions. Institutions emerge to a large extent as a result of interplay of dominant groups with unequal bargaining power. These groups are not motivated by any variety of general interest but by their very concrete separate aspirations. Each of the groups strives to further its own interest, but the outcome is the resultant of the sum total of actions of all of them. The groups, too, have imperfect and distorted models of reality and their moves may not reflect their true interests. To the extent that better moves are more beneficial from the point of view of separate group interests – there should exist clear motivation to learn as fast as possible so as to avoid counterproductive behavior patterns. In a markedly volatile environment, as has been the case in the Southeastern Europe, the chances to learn are much smaller than in the more stable environments and the process of formation of institutions may verge on something best characterized as chaotic and unpredictable. This is why a well founded endogenous theory of institutions is hard to come by anywhere and in

turbulent environments of Southeastern European type such a theory comes close to being impossible. Yet, a few general observations could perhaps be drawn.

A high concentration of political power, as has largely been the case in Southeastern Europe, greatly reduces the measure of control of the rest of society over the politically dominating social forces. The situation is akin to the monopoly in the economy – it produces the analogous distortions. The events which disperse overly concentrated power are as a rule mighty democratizing turnarounds: a divided and differentiated governing elite generates a mechanism of internal opposition and imposes behavioral checks on itself. The generally highly centralized Southeastern European governments have acted as a brake on building democratic institutions and slowed down the process of civilizational emancipation. The long awaited and perhaps never completely achieved decentralization of the ruling establishment profoundly changes not only its mode of functioning but even its motivation structure. The behavior directly opposed to what is impressed upon collective memory as the prevailing pattern of the non-democratic past becomes politically profitable and imposes itself as a way in which the (now) competing political factions increase their public recognition and support. To sum up, overly centralized states in Southeastern Europe have greatly impeded the process of democratization and, by implication, building of institutional infrastructure for a modern market economy. The overdosed governmental interventionism has produced institutional and political structures, as well as the configurations of social power, which in a long run context prevent democratic emancipation and the institutional adjustments to the needs of the market economy.

### *3.6 Institutions, Politics, Ideologies and Culture*

Understanding the failed Southeastern European development calls for a close examination of all the four elements inserted into the title of this subsection. The changes in physical and monetary aggregates depend on the manner of functioning of the market(s) and on the unavoidable non-market interventions undertaken in one way or the other by the state. The functioning of the market and even the functioning of the government, including the thrust and efficiency of a considerable segment of economic and related policies, depends on the broad and widely ramified institutional framework. Institutions provide, among other, motivation structure, coordination devices and the set of policy instruments whereby economic flows can be acted upon in a purposeful way. The institutions themselves are, in turn, implanted in another wide and highly indented set of political power relations and the resulting processes. Within the set of institutions one distinguishes formal and informal institutions, whereby the latter represent a broad framework, a sort of a bedrock of the former. Both institutions and, in particular, politics are closely related to and influenced by ideologies as "...the subjective perceptions (models, theories) all people possess to explain the world around them" (North 1995/1990/, p. 23). Both at the micro level of individual relations and at the macro level of group interactions ideologies provide stylized, always highly simplified explanations "...colored by normative views of how the world should be organized" (p. 23). There is plenty of evidence that the ideas matter a lot and that ideologies deeply affect the choices, particularly collective choices made at the higher (and the highest) levels of social organization. De Aghion and Ferreira (1995, pp.218-20 and 223-7) made an interesting attempt to demonstrate that an implicit and subtly hidden ideology made an important contribution to the interpretations and recommendations even of such an intellectually influential institution as the World Bank.

All of the elements mentioned so far – markets and policies, formal and informal institutions and ideologies are highly intertwined and partly embedded in each other, such as markets in institutions and the formal institutions in the informal ones. But all of these are embedded in something even broader and more general, a medium hard to delineate and along many dimensions simply diffuse. That expansive and all-pervasive medium is the *culture*.

North (1995/1990/, p. 37) sees culture as "...socially transmitted information and ...a part of heritage" affecting deeply the way in which the mind processes information. In offering a more formal definition North relies on Boyd and Richerson and determines culture as "the transmission from one generation to the next , via teaching and imitation, of knowledge, values, and other factors that influence behavior". Culture is a wide and deep universe in which developmental processes and all kinds of social change take place. It embraces just about everything and affects in many ways and decisively all developments that characterize a society and predetermine its economic and, more broadly, civilizational destiny.

These considerations make it possible to visualize a complex, even though not quite symmetric, hierarchy. Hierarchy is defined through the idea of embedment. Thus, markets are embedded in institutions, so that, e.g. it appears impossible to arrive at a set of regularly functioning and efficient markets without a whole range of institutions, including in particular a well ordered and independent judiciary. Depending on the availability of historical time, especially on whether one can identify the Gerschenkronian syndrome of latecomers, only a part of institutions can grow out spontaneously. Spontaneous formation of institutions takes much time. Southeastern Europe is a conspicuous latecomer and it has not had time to let and see a spontaneous, evolutionary growth of institutions. The amount of social engineering, needed or otherwise, was in Southeastern Europe relatively much higher than in the now developed parts of Europe. That fact has made her institutional development highly uneven, occasionally perverted and always extremely hazardous. Social engineering stumbles up against a formidable constraint: the lack of knowledge to conceptualize, design and implement *big* changes in organization at the level of large segments of the economy and society and at the level of the system as a whole. Latecomers are simply incited to, and even forced into, excessive amount of social engineering. The trouble with such a strategy is a high probability of breakdowns and catastrophes. Such catastrophes did happen to Southeastern European countries more frequently than elsewhere. One should think of the Greek state bankruptcies or the tragic Serbian destiny in the course of the First World War. The latter can be seen as a consequence of the overly ambitious approach to building the nationhood and the political, military and institutional engineering associated to it. The epochal demise of the socialist socio-economic system is the most recent example of the overall, systemic catastrophe.

The real trouble with overdosed engineering, which regularly comes in combination with severe limitations on the available knowledge and insurmountable constraints on information gathering and processing, is that only a small subset out of a large and versatile collection of all kinds of institutions can be acted upon in any socially meaningful way. Such are, of course, legally formalized institutions in the form of various statutory arrangements. Such arrangements are either enacted in the parliament or formally brought in other authorized bodies of the most broadly defined state. The difficulties arise in connection with an obvious impossibility to act upon other institutions, whose informal character makes them inaccessible to the political authorities. The last spectacular, and spectacularly unsuccessful, attempt to shape in a planned and conscious way the immense sea of informal institutions was the "Great" Cultural Revolution in China. Experience has proven the impossibility of engineering of the vast and muddled array of informal institutions, not to speak of the of the hard-to-delimit and fuzzy quicksand of customs, mores and habits of thinking known under the common name of *culture*.

Khan /1995, p. 71) introduces the idea of the performance ranking of institutions being specific to the political settlements within which the institutions operate. This could be seen as a manifestation of the fact that political settlements are a matter of choice on a higher level and that these choices predetermine the type of institutions appropriate to them. It is as if the alternative institutional arrangements are classified into several subsets and that each choice

of settlement uniquely determines the subset out of which the arrangements can be chosen. Given the choice of the settlement, the subsets of arrangements are neither interchangeable nor marginally substitutable. That would further imply that efficiency of various sets of institutions could not be measured with the same yardstick. Each arrangement could be evaluated only with respect to its own political framework in which it is embedded. The peasant holdings in some Indian region, socially stratified into a system of castes could not be compared with the American farms which are an outgrowth of an individualistic, equalitarian political structure characterizing democratic political organization.

The specificity of institutions to broader political arrangements puts into a broader perspective the strategic issues of governance and its timely or otherwise adjustments to changing circumstances. If, say, kinship ties modify essentially the functioning of the market and if they are a sort of a choice variable of higher order – a kind of meta quantity – then the efficiency of the market can only be evaluated *within* the class of arrangements corresponding to *that* meta choice and compatible with it. Political settlements in, turn, are embedded into *culture* as a much broader category, even though they are far from being uniquely determined by it. This is, again, the way in which culture enters not only as a determinant of institutions, but even as a qualifier in the difficult task of their evaluation. It turns out that to the hierarchy of choices there corresponds a hierarchy of evaluations. One comes up against another conceptual difficulty in evaluating the alternative institutional arrangements: they turn out incomparable as a matter of principle. This just adds on the already identified difficulty connected with the trade-offs: looking just on economic performance is narrow and one-sided because the institutions, in addition to securing some level of economic efficiency, have additional important tasks, such as national security or lasting peace among the neighbors.

The relevance of the distinction between the productive, wealth augmenting behavior, on the one, and the redistributive, rent seeking behavior, on the other hand, is evidently beyond any dispute. The two kinds of behavior spring out of the corresponding – functional or dysfunctional – institutional arrangements. The question to be investigated is whether the division between the productive and the rent seeking behavior cuts across meta choices of political settlements and even wider choices of broad cultural patterns. The point to note is, however, that this or that type of behavior is not only a matter of the current motivation structure but is also *learned* in the course of time. The exploitative orientations and practices are thus only partly determined by the current motivational mechanisms; the other important determinant is the culture itself. A further point to note is that the eventual introduction of the transparent, performance rewarding, and thus fair institutional arrangements requires, as noted by Stein (1995, p. 113), a change in the mode of thinking. Clarifying the property relations, as a strategy of institutional straightening of the society implies therefore a change of culture and possibly turns out to be dependent on it. Again, reshaping institutions is much more than just adjusting the laws. The changes have to cut much deeper into social fabric. If they don't and if they don't do it in the right way, the entire venture of engineering the desired institutional order is likely to falter and ultimately to fail. The relevance to Southeastern Europe – and, indeed, to both its historical experience and to the crossroads at which she finds itself now – should be apparent.

### *3.7 Some Region-Specific Determinants of Culture*

The volatility of the economic and social environment due to a far above average exposure to external shocks has been identified as the key distinguishing trait of the Southeastern Europe, a feature that sets it apart from the rest of the continent. The historical turbulence has made it both impossible and unattractive to invest into institution building and to strive to a set of lasting and stable rules of economic and social game. The disarray in the institutional sphere and some fuzziness of the public perception as to what types of behavior are to be adhered to have emerged as a predictable result. Serious coordination problems and

an overall lowering of the efficiency of all economic and non-economic processes has come out as an ultimate consequence. The same can be said about the culture as a most general class of phenomena in which formal and informal institutions are embedded. The historical turbulence makes it impossible for a set of lasting and recognizable cultural patterns to be organically formed and, particularly, to stabilize and to start functioning as a most general orientation in designing and adjusting the human action. Notably important is the fact that a stable culture has not existed as a means of coordinating the bewildering multitude of moves of the widest possible variety of actors in an unavoidably – at least to some extent – decentralized decisionmaking environment. One might safely hypothesize that such numerous and conspicuous *attempts at centralization* in the underdeveloped countries could have been the result of the absence of coordinating devices of formal and, particularly, informal institutions. But even more than from the inadequate institutions the urge toward the prominent centralization could have resulted from the absence of the coordinating workings of culture.

The largely ephemeral character and the fuzziness of cultural patterns is one of the determining peculiarities of Southeastern Europe and, at the same time and therefore, a singularly idiosyncratic reason of her underdevelopment. Having relatively stable institutions and the set of cultural patterns as a wider medium embedding them is an indisputable advantage. This is not to say that an excessive stability bordering on the lack of change is an ideal to be striven to, an undeniable blessing. The other extreme, the lack of change and flexibility, is equally damaging because it prevents timely adjustments. But the epochal trouble of Southeastern Europe has steadily been the excess of exogenous shocks and of brutally forced change which prevented her to enjoy reasonable spells of peace and tranquility needed to form a set of formalized institutions, ethical standards, customs and patterns of belief and thought which would, taken together and seen in all of their complexity and interdependence, provide a basis for a better conceived, more coherent and, therefore, more effective action at all levels of social organization.

It has also been established that, due to the long centuries of alien rule, the unyielding tradition of contempt for law and the refusal to respect it has evolved in Southeastern Europe. That alone is sufficient to make both decentralized decision making and societal policies ill-coordinated, anemic and ineffective. As laws are among the most significant coordinating devices, the inimical reception of laws leads directly into the nexus of chaotic interactions and dire inefficiency. The rejection of laws also favors pervasive rent seeking and all kinds of redistributive behavior. It is only through the laws and the analogous informal institutions that people and organizations are prevented from appropriating what rightly belongs to others – having, after all, been produced by them – and, at the same time, turn to productive behavior as the only way of raising their wealth and welfare. Cultural stereotypes are significant as the deep going, fundamental mainspring of laws and the determinant of their general orientation and quality. This is why, in inquiring about the causes of the wealth of nations, one has, among other, to delve into their spiritual texture, their thought patterns and their deep-seated value orientations.

Evolving of mental constructs and habits of thinking favoring *productive rather than redistributive behavior* is one of the avenues leading into the successful ventures of sustained increase of the wealth of nations. In addition to the degree of fostering the productive action, another quality of the subjective models of reality (*mental constructs*) of utmost importance is, clearly, the degree of correspondence to the reality itself. In Southeastern Europe this correspondence, conditionally speaking, the level of truth, has generally been noticeably low. That alone accounts for a great deal of inefficiency. With high costs of the control system (the transaction costs) the need arises to create institutions to reduce uncertainty through collecting and organizing information, which is also a way of correcting the models of reality and

arriving at a more accurate approximation to the truth. But, again, with frequent changes exogenously forced upon the system it is not possible to revise the models. It is not even profitable to generate new knowledge as the objects to which the knowledge refers are not likely to last sufficiently long. As a consequence, the old models, despite being grossly inadequate, stubbornly persist. The curiosity of the phenomenon is that sticking to the dated, evidently imperfect models may prove a quite rational decision since the benefits of correcting the model would not roll long enough to justify the investment into revising the model. The slow and incompletely adjustable model of realities does *not* provide a sound basis for timely and rational institutional adjustment and that, of course, turns out to be a steady and powerful source of inefficiency. In the last analysis, frequent exogenously induced changes make for a generally much lower level of efficiency – how ever it appears to be defined – as compared to more stable and gradually evolving environments.

In addition to discouraging the acquisition of knowledge in general, the exogenously disturbed and highly volatile situation in the Southeastern Europe has profoundly influenced *the type of knowledge acquired*. More favored were the pieces of knowledge likely to have short-term relevance and less attractive was the knowledge promising solutions of a long run nature. As the character and structure of knowledge strongly affect the directions of institutional change, this relation, too, favored slow institutional adjustment. But adjusting slowly and incompletely solves in a way the problems in a shorter term perspective at the cost of a permanent and dangerously widening cognitive discrepancy. The discrepancy translates into the gap between the institutional structure as a whole and the underlying resource and technology base of the society. The incidence of the gap becoming a recurrent feature of social development is only to be expected; one is entitled to speak about *gaps* as an accompanying trait of the social change in Southeasteuropean lands. Such threatening gaps prepare the ground for massive compensatory adjustments, i. e. revolutions. The revolutions, again, have their own hazards connected once more with the scarcity of knowledge. No society has sufficient knowledge and information to design to any degree of adequacy and safety spectacular jumps in its organization. The high likelihood of catastrophe is the price of the accumulated *failed institutional adjustments*, which then call for a very big compensating adjustment. As was noted in the preceding section, such catastrophes did occur in Southeastern Europe and the danger is far from fictitious.

Once the society settles with a thin and meagre basis of knowledge and opts for the corresponding inadequate institutions, the untoward situation tends to perpetuate itself. The social strata benefiting from the perverse (inducing rent seeking rather than productive behavior) institutions gradually come into existence and turn into powerful social force *interested in perpetuating the socially irrational arrangements*. Moreover, the process of institution building – though to considerable extent decentralized, particularly at the level of informal institutions – cannot rely prevalingly on the decentralized initiative. Institutions by their very nature concern and affect a large number of actors. Huge externalities are an expected and unavoidable consequence of the multiple and complex interconnectedness of the actors through the institutions. Institutions also, once formed, provide guidance and coordination signals to many agents covering large segments of economic and, generally, social activity. Thus, a marked phenomenon of indivisibility occurs as well. Other types of decision making imperfections of decentralized processes of institution building can easily be identified. It can be safely concluded that the decentralized mechanism of institution building is fraught with the full range of imperfections, and, indeed, to much higher extent than the ordinary economic processes occupying so much the attention of economic theorists.

As Adelman argues to some detail (1995, p. 247), collective action is imminent even in the early stages of formation of any institutions, the state steps in and adopting constraints on the behavior and accompanying standards of conduct turns unavoidably into a political

process. The theory of state, more than the theory of decentralized decision making, becomes relevant to the explanation of the process of institution building. That conclusion, in turn, ties in with the empirical fact that the governments in the Southeastern Europe have, as a rule, been primitive, anachronic, corrupt and rent seeking. Inefficient government seems to have been a part of general underdevelopment of the Southeasteuropean societies. With stunted governments – which, among other, have obsolete and generally inadequate *knowledge* one can't expect impressive performance in forming and actualizing rationally structured and socially useful institutions. The full circle seems to have been completed.

Relating the overall efficiency to the congruence of the institutional framework and the underlying resource and the technology base brings into the forefront the need for timely institutional adjustment. As noted above, the discrepancy between institutions, on the one, and technological and resource configurations, on the other hand, cannot but be considered a source of economic waste and overall inefficiency. For the reasons elaborated above, Southeastern Europe has suffered an extraordinary institutional rigidity. It has suffered from a dangerous malaise which, following the North's (1995, p. 26) terminology, could be diagnosed as the lack of *adaptive efficiency*. Dragging ostensibly behind the events has been the cause of abysmally low performance all over Southeastern Europe, but it has at the same time been the consequence of too large a number of these events, of their largely exogenous nature and, above all, of their shocking and destructive character. The sources of the improvements of the economic lot of Southeastern Europe are evidently in the improvement of the adaptive efficiency as much as they are in the enhancing of conventional allocative efficiency.

### *3.8 Idiosyncratic Nature of Institutional and Social Change*

The unfavorable initial state and the constraints on the improvements along various dimensions of institutional development are closely associated to and largely the consequences of the peculiar way in which institutional transformation, as well as social change in general proceed in the not quite usual circumstances of Southeastern Europe. Throughout her turbulent history this region of Europe has been rocked by a series of rarely interrupted and, at the same time, powerful and destructive exogenously generated shocks. These shocks have, of course, produced frequent and deep-going changes, but such changes have been forced upon the region, divorced from the regional objectives and policies and, by implication, out of line with social needs and preferences of the relevant participants. Thus, a strange combination of excessive volatility and institutional and social rigidity came out as a final result. The situation has been distinctly changeable as far as the exogenous sources of variation are concerned and, in a curious way rigid, as far as the changes consciously induced from within are concerned. There have been many changes imposed from outside and exceedingly few changes initiated from within. Historical evidence corroborates this proposition. The major changes are associated with externally imposed, often traumatic shocks and modernizing changes engineered through deliberate policies are sparse and cautious. The resistance to change can be easily discerned from the wide fields of national culture: it is well known that practically the entire XIXth century Serbian literature is extremely conservative, inimical to innovations and prominently laden with nostalgia for some sort of a “golden past” (Skerlic 1934/1910/). The marked conservative bend of the entire national culture has become a sort of an invariant of its long run development and has survived up until the present time. A recent analysis offers persuasive argumentation of its giving undeletable imprint to the present state of mind of the society at large, as well as being simultaneously responsible for the tragic ethnic conflicts in the course of the last decade and the bloody disintegration of the former Yugoslavia (Jovanovic 2001). Such an orientation is rather easy to explain by invoking the fact that changes in the past have, as a rule, been very painful and traumatic and that they *as such* have left deep markings in the collective memory.

It is only natural for any collectivity energetically to reject whatever has produced painful experiences in the past and to develop a sort of conditional reflex manifesting itself through a sustained defense against all noticeable changes. The same syndrome of distinctly low receptivity for changes has much more concretely and with persuasive empirical evidence been observed in the last decade, whereby the lack of readiness for change has been pointed out as a possible explanation for the slow unfolding of reforms (Madzar 2000). An additional reason for the rejection of changes has to do with uncertainty. If changes are frequent, large and exogenously driven, they are necessarily unpredictable and the general atmosphere largely created by them is the one of extreme uncertainty. As a consequence, the rate at which future benefits, resulting from the change, are discounted is very high and the cost-benefit analyses of the desirability of changes are likely to give negative verdicts.

Endogeneity of institutional change, which can be established only in a broader political economy approach, is still another reason for institutional rigidities of the Southeast European societies. Institutions produce, or decisively influence, a certain pattern of development, which affects the social structure (the “class structure”) with accompanying configuration of power relationships among the most influential social groups. The distribution of power is the basis of political processes grinding out the changes in the existing institutional order which again produces further political changes through underlying impact on the rhythm and pattern of development. Among the groups with especially strong influence on the reshaping (or preserving) the inherited institutions the most prominent appears to be the business community, which has frequently wrought out particular changes (or lack of them) in both institutions and policies. Such was the case in Indonesia after 1870, when the business community, having been averse to governmental interventionism, had forced the government to adopt visibly more liberal economic policies (Booth 1995, p. 289). The cycle institutions–development patterns–power relationships–political process–institutions is thus closed and with resistance to change, generated by typical Southeast European turbulences, the cycle may acquire tough stability repeating itself over and over again. The societies are thus locked in with a set of practically unchanging institutional arrangements and with low ability to adjust even to the crucial changes in resources and technology.

The stochastic component in the institutional development should not pass unnoticed. It weaves into the institutional change at all links of the chain making the cycle described in the preceding paragraph. But the most likely location at which the described developments take on a pronounced random character is the economic development whose stochastic disturbances produce changes in income distribution and power relationships and, further on, the political changes with unmistakable institutional reflections.

As a matter of highly versatile mechanisms through which they are generated, institutional changes can and do come about spontaneously, a feature which takes on the character of a general law when it comes down to the informal rules. However, the spontaneous formation of institutions requires much more time than there was available in Southeastern Europe. Frequent and deep going changes in the environment did not allow sufficient time for the institutional changes to be gradually shaped, nor did they leave sufficiently long time horizons to reap the resulting benefits and to recuperate the costs of change. Consequently, the government had to step in and to take over the hazardous task of modeling the institutions. The formal institutions had by the logic of the environmental turbulence to take a much more important role than in the societies less shaken by the external traumatic shocks. But that in turn meant that the quality of governmental intervention had to surface as the decisive determinant of the quality of institutions. *Mali corvi malum ovum*: that simply led to the only imaginable situation in which a poor government could have produced only an equally poor institutional (dis)order. The government, far from being equal to the

historical task confronted on the eve of modernization, became the institutional destiny of the Southeastern European countries. The institutional failure largely overlapped with the failure of the government as an institution charged, among other, with the institutional reconstruction of Southeastern European societies.

Khan (1995) speaks of two types of governmental failure. He terms them the failure of type I and the failure of type II. The type I failure is defined as badly designed or even detrimental governmental *action*. Type II failure is defined as the set of undesirable consequences of the government's *inaction*. A major portion of the set of the type I government's failures has to do with the rent-seeking. The rent-seeking is, as it were, a balancing item of the transaction costs. Transaction costs are the principal source of the market failure, while rent seeking seems to be the chief determinant of the government failure. Transaction costs, wherever present, prevent gainful transactions. Rent seeking, on the other hand, prevents the government – burdened with the narrow, particularistic interests – from designing and implementing socially desirable policies (say, Pareto efficient actions in the sense of Buchanan's Pareto relevant externalities in Buchanan and Stubblebine 1987/1962/: amounting to improving the lot of some actor(s) without deteriorating the position of anyone else in the system). The trouble with the rent seeking is that it does not reduce to just transferring income from one set of economic agents to another. In attempting to wring out income from those who have already created it, special – if merely redistributive – activities have to be undertaken and *the real resources have to be expended*. Moreover, the easily seen allocative losses are incurred on both ends of the exploitative redistributive relation: the one that is hurt will exert himself less and the one who benefits will reduce his endeavor to create new value. The fact that some arrangements, while implying rent seeking in the area in which they operate, might reduce the transaction costs in another segment (or dimension!) in the system (Khan 1995, p. 75) – just further complicates both the analysis and the situation, probably augmenting the hazard of further losses on account of both market allocation and the governmental regulation.

In actual institution building processes the decision criteria for selection from among available alternatives are not macroeconomic and social but particularistic and group oriented. Institutions are not there to foster the increase of (defined the way one likes) social welfare, but to meet the interest of the competing groups. Those with the maximum bargaining (and otherwise) power will be in the position to adjust institutions to their narrow interests. In the Southeastern Europe that has traditionally been the state bureaucracy (Markovic 1946/1872/, p. 74 and ch. VIII). Consequently, the government has turned into a huge and mighty instrument of brutal across-the-board exploitation. The basic, in a way defining line of class division of these societies had become the one setting bureaucracy against the rest of the society. A telling illustration of this statement is the fact that the number of government's officials per 10,000 inhabitants was in Greece in 1907 roughly seven times higher than in Britain (Minoglou 1995, p. 263). In such broader social constellations, characterized above all by the governmental violence and brute force, it would be a miracle if a reasonably rational path of institutional development emerged.

### *3.9 Further Obstacles to Institutional Improvements*

There have undoubtedly been many possibilities of institutional improvements in the Pareto sense. But they have not been realized in the muddled constellations of social relationships of the permanently rocked and incessantly disturbed Southeastern Europe. Abstractly speaking, this could not have happened as the winners of any Pareto efficient change could have compensated the losers. Assuming for a moment that all relevant groups benefited from the proposed change and that the compensations were not needed, the lack of change could have been explained by the absence and/or the inadequacy of knowledge. But the crucially important fact is that the side payments have not been either offered or accepted

(cf. Khan 1995, p. 81). The problem is, at least partly, reduced to the failure to institute the payments and the question arises about the reasons of such failure. One possible answer, applicable not only to the present but also to the more distant past, is offered by Buchanan(1995/1991/). Buchanan speaks of the possibility of reform beneficiaries organizing themselves or accepting the idea of being additionally taxed to provide the financial means to compensate the losers. Since the politically induced and government engineered arbitrary redistributions *reduce value* and since the removal of these arbitrary encroachments on the market valuation would evidently *increase value*, there should be great motivation on both sides to reform the economy by eliminating political violence imposed upon it. That would be achieved through implied increase of wealth which would make everyone better off. Buchanan explains the absence of such market enhancing, value generating interventions by the unwillingness on the side of both potential winners and the losers to agree to them. The losers might hope to be able to form a majority coalition in the future and win what rightly belongs to them without having to bribe the beneficiaries of the arbitrarily imposed, politically implemented schemes of redistribution. The winners might have contrary expectations amounting to strong belief to remain able to preserve their political supremacy. The inconsistent, mutually opposed expectations in the political process thus appear as a factor preserving the contrived, quite arbitrary distributional arrangements and therefore inefficient allocational outcomes in the economy (Buchanan 1995/1991/, pp. 241-2).

While this reasoning may to some extent be applicable to Southeastern Europe, another factor appears to be much more important. The major winner in the politically created distortions in the sphere of distribution has been the governmental bureaucracy itself. The Southeasteuropean countries have not been in the position of having two or, perhaps, more sides involved in the distributional conflict and attempting to achieve their goals in the balanced and unbiased political competition, with neutral government ready to serve whoever comes out as the winner from this battle. Quite to the contrary, one of the competing sides has government on its side – or, better to say, *is the government* – and the chances of striking a deal leading to Pareto improvements, i. e. the chances of engineering meaningful reforms are thereby reduced to nothing. In a society dominated by the bureaucracy and the government the reforms in the style of Buchanan are almost bound to turn out to be impossible. The usual remedy against arbitrary political redistributions are constitutional constraints, growing organically in the course of (long) time and reflecting the wisdom of ages and generations. But that is exactly what has been missing in the institutional and social development of Southeasteuropean countries: the Proustian quest for the lost time has been a regime of functioning of the societies which has never allowed sufficient time for such constraints to be formed and strengthened. Moreover, with a mighty government and all other social forces weak and stunted, such constraints, even if they somehow come to be formalized, do not bind those who are in control of the electoral body instead of being controlled by it. The chances of separating the distributional feuds from the wealth augmenting market exchanges are slim indeed in such an environment and the allocational distortions, reducing the welfare of everyone are likely to persist.

The destiny of Southeasteuropean countries is akin to the destiny of the large majority of underdeveloped countries in that they are locked in an institutional universe which prevents growth and modernization and differs substantially and deeply when compared to the institutional arrangements of the developed countries. The situation could be termed and understood as an institutional trap out of which there does not appear to be an easy, or any for that matter, escape. The dysfunctional institutional setup is cemented by the particularistic interests whose perverse equilibrium could turn out stable even if the forces constituting it do not have the command over the government as the institution legally endowed with the monopoly of violence. But having the control over the government makes the incorrigible

institutional equilibrium even more stable. A double interdependence gets established: distorted institutions give ample food to entrenched particularistic interests and those interests further act as a powerful force solidifying such institutions.

The potential choices are further constrained by monopolies other than the just mentioned monopoly over the government's apparatus. The monopoly over information and the information generating and disseminating mechanisms are among the most powerful and far-reaching. Clearly, no effective, goal-achieving decisions can be taken without reliable and truthful information. Controlling information gives a handle – though an indirect one – on the decisions being based on it. Control of minds is thus superimposed upon the coercive physical control of bodies. Managing information also makes it possible to influence effectively the degree to which certain segments of the society can organize themselves in an attempt to defend their interests against bureaucratic encroachments. Reduced organizational capacity, achieved through the manipulation of information, greatly handicaps the nascent emancipation movements and perpetuates the power holders in their cemented positions.

In particular, the governmental machinery is used by the bureaucracy to bring under its control the mightiest levers of the control over the economy. These have traditionally been the state monopolies over some basic necessities and a number of articles with very low elasticity of demand, the foreign trade licensing on both export and import side, administrative control of certain price together with the privilege to ration the corresponding commodities whose markets are thrown out of equilibrium and, more frequently than not, extensive and complex controls over foreign exchange flows. Putting large enterprises, the collection of which is by no means reduced to natural monopolies, under governmental direct control has also been one of the traditional handles on the economy and the society at large. This, of course, gave the state bureaucracy the control over a considerable number of the top managerial positions, as well as the lower level jobs. The latter has been and still remains significant in the economies with structural disequilibria in the factor markets. In such markets the mobility of labor is drastically reduced or nonexistent, competition does not equalize the prices for resources of equal productivity and getting hold of particular jobs is a clear privilege. Whoever has the control over such jobs has a mighty tool to control the people's destinies. The command over financial flows gives the incumbent political forces a great advantage over their political competitors, the political scene becomes asymmetric in the sense of having a dominant force prevailing over all other factions and the entire political system becomes overly rigid. The resulting situation of the political establishment controlling the electoral body instead of being controlled by it means the end of democracy despite all the formal attributes of the standard multiparty arrangement.

Despite the powerful conservative forces and numerous political currents working for the preservation of the *status quo*, it occasionally happens that the entire petrified structure collapses and the system shifts to a new equilibrium. This could be called a revolution or a revolution-like turnaround. Few general propositions can be given concerning such epochal political shifts, but Southeastern Europe is the place to watch for some common features of these spectacular transformations and to draw at least tentative generalizations. The recent momentous demise of the socialist institutional setup is a case in point: this part of Europe was severely shaken by this global concussion. The cause of the political change seems to rest with the overall change of the political balance. The messy, grossly inefficient, largely exploitative societal superstructure collapses because all concerned turn out destitute losers and even its beneficiaries lose interest to defend it against the opposition to the regime. The seeds of the destruction of such forceful, exploitative arrangements are as a rule contained in their inefficiency and, indeed, in their infancy. The lack of efficiency condemns it to the loss of support of its even the most ardent supporters. The system with no relevant political factions and no significant social forces to defend it evidently cannot have a future. The

trouble with such pattern of social change is the late coming and the very magnitude of such change for which adequate knowledge and sufficient information cannot be accumulated. Again, the risk is too high, the ability to counter it is manifestly incommensurate with the hazard and the likelihood of the catastrophe (again) continues to loom large. The Southeastern Europe is a region of ruins and downfalls. That sets it apart in relation to the rest of Europe. That untoward fact surfaces as one of the key causes of its institutional weaknesses and its belated civilizational emancipation.

### 3.10 *The Process of Institutional Change: The Constraints and Determinants of Deviations*

The purpose of this section is to elucidate a number of factors constraining and deflecting the change – the factors which might be taken as a preliminary to the now popular notion of *path dependence*. Path dependence is an analytical construct of rather recent origin (cf. Dalago 1999, pp. 110-17), but there is no difficulty in applying it to the past developments and to use it as an instrument of research and exegesis of the modernization failures in the past and their deep behavioral and civilizational roots. Path dependence deals with those institutionally induced aspects of behavior which are related to the changes of the institutions themselves and, in particular, relates to *the impediments to change* and the peculiar, not necessarily desirable *directions of change*. Thinking in terms of institutions affecting their own future development takes on a truly general significance and leads one to the conclusion that, as far as the economy is concerned, the past can be made intelligible only as a story of institutional evolution (Harris *et al.* 1995, p. 10). The choice of the new institutions, i. e. the path of institutional development itself, is deeply affected by the fact that such choice has to be made within the existing institutional setup inherited from the past. The initial state acquires a particular significance in this context, too, as a determinant of the feasible choice of the future states and an important factor influencing the whatever concrete future state is arrived at. The market structure, the factor price ratios, the level of land rents and interest rates, the degree and type of taxation, income distribution and its possible exploitative distortions, the orientation of economic and other policies, the general philosophy of the state action and its role in the society – all of these and many other elements are the attributes of the initial state influencing significantly the dynamics of the system and the path of institutional transformation.

A part of the institutional structure are the rules of changing the rules. As the higher order rules are predominantly state engineered, the process is by the nature of its structural foundations strongly affected by the fact that it leans on the coercive power of the state and makes it possible for some subsets of economic agents to extract resources from the rest of the society. This is where one-sided involuntary interventions impinge upon the market transaction, divorcing the distribution from the production and creating distortions that reduce value and annihilate wealth. This is why institution building necessarily spills over into the province of the governmental intervention, while the change ceases to be economic and becomes eminently political. This appears to be especially true in traditionally bureaucratic and government dominated region of Southeastern Europe, where the state has been demonstrating a strong inclination to intervene routinely even into the fields which manifestly do not belong to it.

Until some two decades ago there prevailed a romantic and obviously naïve view that institutional *development* can only unfold in the form of the institutional *progress*. The view relied on – as it came to be revealed, truly impressionistic – belief that life itself had dealt on a permanent basis verdicts on various institutional arrangements and, as a consequence, the survival of the fittest had to be at work. That, however, has not been the case: the world is overpopulated by institutions which leave so much to be desired, at least from an economist's point of view. In fact, some seemingly absurd and intolerable institutions persisted over long

series of decades and centuries. The question naturally arose as to why these monstrosities persist and, again, Southeastern Europe is the region particularly inspiring such thoughts and bewilderments.

The answers are many and this section, despite being entirely devoted to them, will not cover them in an exhaustive way. The first, not necessarily the most important, is *the conformity*. The prevailing *mores* are shared by many people and are deeply ingrained in their way of thinking. All have invested in learning the existing habits and, once having mastered them, are disinclined to invest again time, effort and resources to learn a new set of rules. Being deeply ingrained in the social conscience, these rules acquire a certain ethical significance and weight. Going against the commonly shared rules becomes offensive and carries the risk of castigation and ostracism. *Consuetudo est altera natura* and the threat of punishment and ostracism makes it individually unattractive to make any attempts to modify them. Sticking to the prevailing rules becomes thus individually rational irrespective of possible social gains and big global effects derivable from an eventual overhaul of the entire set of the behavioral standards. This seems to be a clear case of a contradiction between the logic of the individual choice and the rationality from the broader societal point of view.

In Southeastern Europe the degree of conformity has probably been much higher and this conflict much more profound because of her distinct collectivist tradition. Much has been written on the syndrome of collectivism in the past and a great revival of this line of thinking occurred in the context of the study of transition and of alternative paths of modernizing the ex-socialist societies (Sekulovic *et al.* 1997, pp. 401-6). *Social genotype* is widely believed to have been forged in the spirit of collectivist value orientations. In fact, collectivism can be seen as a rational response, a true survival characteristic of the Southeastern European societies which spent a good deal of their history under the alien rule and in such circumstances faced the hazard of being swept off from the historical scene. Security has under such conditions had to be the principal individual and collective preoccupation and institutions had to adjust to that fundamental need and to reflect the urge to survive in face of the existential threats. The threats were both physical – amounting to the risk of extermination – and cultural – converting the population to Islam and forcing it to lose its national identity. Security and defense are clear cases of pronounced external economies and public goods. Protection against the enemy is best secured by joining forces with all who are on the same side of the battle line and who face the same existential threat. While individual arrangements may be the best from the point of view of economic efficiency, it is clear that collective solutions are superior when it comes down to defend life and body and, particularly, to preserve ethnic or national identity. If and when security matters more than efficiency, it is desirable and rational for collectivism to prevail. Economic efficiency is sacrificed to a higher need and the institutional order turns out optimal in a generalized perspective despite being inferior in the light of much narrower criteria of economic efficiency. The evaluation of institutions being conditional on the broader political settlements comes here on its own.

Before turning to the path dependence *sensu stricto*, it is apposite to briefly review a few other factors accounting for the societies sticking to evidently imperfect and even irrational institutions. The *first* reason of such institutional conservatism is the above mentioned configuration of particularistic interests of various groups. Institutions are to a significant extent the resultant of the global interplay of the powerful effectuations of such interests, whereby the groups don't strive to forge socially beneficial institutions but try to wrench out the devices that suit best their narrow interests. Institutions thus don't reflect how ever defined social rationality but the concrete constellations of power relationships among the relevant groups. *Secondly*, the seeming irrationality of institutions may turn out spurious. No society can have separate institutions for separate needs and, being largely indivisible, institutions serve a broad and diversified set of needs simultaneously. Some needs may have

an equal or even higher priority than economic necessities. While serving simultaneously other needs, institutions may actually be poor in the narrow economic perspective despite being optimal in the broader context of all needs they happen to serve. One such need was separately treated in the preceding paragraph. *Thirdly*, institutions are frequently contorted in order to effect certain coercive redistributions which could not be achieved through other, more transparent means (Buchanan 1995/1991/, p. 244). Institutions thus serve as a camouflage for redistributive encroachments to the benefit of particularistic groups and at the cost of the rest of the society. *Fourthly*, the unappealing movement of the system through the space of alternative institutional arrangements could be a simple result of the constraints embedded in the initial state: the directions of institutional change which might be perceived as desirable may simply be infeasible or the costs of transition associated with them might exceed the expected benefits and the change might not pass the simple cost-benefit test.

A part of constraints are those relating to cognitive capacity and information: the relevant actors may simply not be able to design and may not know how to implement the changes perceived as desirable. *Mutatis mutandis*, the same goes for information. It is important to note in this context that many changes which might look perfectly conceivable and implementable in an *ex post* perspective could actually be beyond the reach of the feasible in the relevant *ex ante* perspective when the needed actions had to be planned and the accompanying decisions taken. This is the context in which two sets of factors brought out by Dallago (1999, pp. 116-7) deserve mentioning. *Firstly*, network externalities and strategic complementarities make for multiple equilibria all of which cannot be equally attractive, no matter what evaluative criteria are chosen. *Secondly*, with limited cognitive capacity and distorted mental models the relevant agents are not able to locate the superior equilibria; quite to the contrary, being forced to rely on the past experiences and the sloppy generalizations of what data they had been able to record and preserve from the past, they chose options closely located within their narrow intellectual horizon and miss the opportunities offered by distant global optima.

Cognitive imperfections resulting in multiple equilibria could, as a matter of principle, be ameliorated by intensifying various forms of social communication – educational activities, dissemination of knowledge, public debates, exposure to international cultural influences and other ways of educating the public. However, the low level of these activities is part of the definition of the underdevelopment and it would be inconsistent to expect them to flourish in the multiply depressed, culturally sullen Southeastern European environments. There are also deeper problems in the area of multiple equilibria induced by the cognitive imperfections and informational deficiencies. At the level of fundamental epistemological difficulties one should point to the generalized identification problem which consists in the well known fact that a variety (in fact, infinity) of equally testable and equivalent models may turn compatible with available empirical evidence. They turn out equally efficient when it comes to explaining the underlying realities and may, at the same time, have radically diverging policy implications and lead to glaringly different practical decisions. Empirical testing does not provide a basis for discriminating among them and they invoke incompatible or opposed actions. If these actions are interpreted as endeavors and ventures directed to the institution building, still another layer of indeterminacy leading to multiple equilibria can be established. Namely, the set of models, mutually consistent or not, can under certain circumstances lead to the same set of formal institutions, but these institutions may in different environments produce different results. Implication is that variegated and varying environments call for differentiated and evolving institutions. The same set of institutions cannot be optimal for differing environments, whether they are differentiated by resource availabilities, technologies, the flows of impacts from international surroundings... A third dimension of indeterminacy derives from the fact that the formal institutions are just a

(smaller, perhaps minor) part of total set of institutional devices; it is only natural to observe that the same set of formal institutions, combined with widely differentiated informal institutions, has to produce commensurably differentiated results, as it is reasonable to expect the optimal formal institutions to vary depending on the, again widely diverging, informal institutions with which they will be combined.

Another set of reasons of institutional blockade or changes which don't pass the test of economic, or some more broadly defined, rationality is associated to what might be called the second-order imperfections of the corresponding decision-making mechanisms. As pointed out in section 3.8, institution building is, just like production and investment, fraught with externalities, indivisibilities, public good spillovers, principal-agent relations and other imperfections of decentralized decision making in a milieu of widely ramified and far-reaching interdependencies. In fact, the interdependencies in the sphere of institutional engineering are much more pronounced than in the area of production and investment and the imperfections should be much more discernible. To the extent that institutions grow out of a densely interwoven set of decentralized interactions, they have to display many deficiencies quite apart from the fact that for most of them economic efficiency is not the only evaluation criterion. Unavoidable implication of the failure of the decentralized decision making system is to push the process into the state ambit. But, the counteracting influences are easily detected. Firstly, the state can't get involved into the vast process of the formation of informal institutions where decentralized processes, no matter how deficient on an abstract plane, have to be relied on. Secondly, the state has its own collection of failures and there is no presumption of its being superior to the decentralized alternative on an *a priori* basis. The state, with its public choice syndrome, is likely to be less efficient in this field than in the field of production and investment. This inferiority in one field as compared to the other is caused by a set of reasons which are analogous to the corresponding inferiority of the market based processes of institution building compared to the performance of the same processes in the allocation of resources in production and investment. The Southeasteuropean tradition of pushing many tasks into the hands of government cannot help much because all that amounts to shifting the important functions from deficient or non-existing markets to the decision making mechanisms under the auspices of heavily bureaucratized, traditionally coercive and generally corrupt government.

### *3.11 Path Dependence as an Obstacle to Change and a Cause of its Misdirection*

The essential ingredient of the path dependence analysis is the idea of – sufficiently powerful to be relevant – groups fighting for their particular, largely incompatible and frequently opposed interests. The behavior of the groups cannot be explained without explaining of – representative or not – individuals, so that one identifies a facet bordering on the traditional theory of decentralized decision making and drawing amply on its results. One starts with the decision making actors with their preferences, goals, attitudes, incentives and choices, then adds to that their opportunities, rights and constraints, including in particular the constraints on the available knowledge and information to end up with strategies, computational capabilities and behavioral patterns.

Among the reasons accounting for the path dependence the basic one seems to be investment in the system specific capital, particularly the specific human capital (Dallago 1999, pp. 110-2). Specific capital is sometimes impossible to redeploy and, when possible, that could be done only at high cost and considerable loss of value. Having invested into adjustments to a specific institutional setup, economic and social agents acquire motivation to preserve the resulting capital. That can only be done by avoiding change altogether or else by endeavoring to create particular types of change which leave the system in the neighborhood of the initial state. Alternatively, only those types of change are generated which are in some sense functionally related to the initial states or compatible with them. This is the way in

which the dependence is introduced between the successive states and that is all there is to it when speaking about path dependence. System specific assets cannot be redeployed without significant loss of value. By striving to protect the value, the interacting agents introduce a conservative bias into the system and *endogenous change*, i. e. change coming from within the system becomes less likely and, if and when forthcoming, it becomes bent to the existing arrangement. Low *cognitive* standards and incompatibility of the mental models formed by the relevant actors about underlying realities lead, as emphasized above, to multiple equilibria. The path dependence locks the models into the set of low level or otherwise inferior equilibria, leaving the high performance equilibria far out of the reach of the dynamic process of institutional transformation conceived as a series of successive adjustments.

System specific capital and path dependence as its logical and functional corollary are necessarily inefficient. Inefficiency is logically implied by the fact that the system either adjusts incompletely or adjusts in the inadequate way. The adjustment is, namely, determined *not* by the character of exogenous change to which the adjustment is needed but by the specific features of the initial state. In view of the uninterrupted exogenous changes, the logic of adjustment based on anything else but the change itself produces by definition inefficiencies. The widely diagnosed and generally recognized conservatism of Southeastern European societies automatically generates microeconomic and system-wide inefficiencies, which have represented an unclouded feature of all economies and societies in the region. This is at the same time one of the reasons because of which reliance on decentralized and spontaneous formation of institutions was neither desirable nor possible. That left the state with its system-wide engineering as the only alternative. The heavily bureaucratized state of the Southeastern European type evidently had its more than usual share of public choice failures and the countries in the region have permanently been in the position of having to choose between highly imperfect decentralized mechanisms of institutional adjustments and an exploitative and corrupt state. Whatever the choice, the outcome is unfavorable.

There are a few specific traits of the Southeastern European social environments which have produced a distorted and in many ways ineffective set of procedures grinding out institutional adjustments. For one thing, the general level of knowledge was extremely low and the engineering of legally formalized institutional changes could not have been anything but poor and inadequate. This steady feature has further been exacerbated by the fact that institutional lags and general civilizational delays had as a rule called for big jumps in the adjustment of inherited institutions. Big jumps in the institutional reshaping of the society require, however, disproportionately high quantities of knowledge. The Southeastern European societies have thus permanently been in the situation of being in especially big need of an important prerequisite of the development process which has traditionally been among the least available. This fundamental asymmetry has been one of the invariants of the traumatic development experience of the region of Southeastern Europe. The second specific factor of what – at least from a strictly economic point of view – looks as distorted development is the very fact that institution building has been guided by other than economic needs and priorities. The principal among these has been the state and nation building and the associated ethnic survival and collective security. To the extent that institutions come in undiversifiable and indivisible blocks serving a multitude of social needs, they clearly cannot be optimal from the standpoint of any of these needs taken in isolation. The third peculiarity of the process of institution building in Southeastern Europe is the obsession of the leaders in practically all of these countries with power and the ways of amassing it in the shortest possible time. This comes out as undisputed Turkish heritage: having just exited a political rule based on crude force, the new leaders continued in the same style, the only one that had been known to them. There is ample evidence that they saw themselves playing the roles of the recently toppled

alien masters and treating their own people as no more than mere *objects* of governing, manipulation and exploitation (Markovic 1946/1872/, pp. 84-6, 98-102)

The interactions among different groups are relevant in this context, too. Southeasteuropean societies came out of the Turkish rule as rather homogenous collectivities with high degree of equality and with strong local autonomy in regulating their affairs. However, the prolonged liberation struggle produced, among other, significant social stratification. The new national elite surfaced in the process (Markovic 1946/1872/, p. 49). That was the seed and the beginning of a wider social stratification. The group interests developed and there followed their differentiation with respect to both the desirability viz. the speed *and* the directions of change. To put it in a dry and formal way, the value of transition changes, measured by the discounted sum of the expected future benefits for different groups, varied noticeably across the groups. One of the possible and even likely outcomes is the stalemate, a halting of even modest changes that otherwise could have been made.

A further feature of the situation, leading to paralyzing the group action and social change in its totality, are the institutional voids resulting from the external shocks and producing changes not intended by anyone. These voids dissolve whatever property rights have existed prior to exogenous changes forced upon the system. With diluted and partly eliminated property rights the relevant agents are not able to estimate the costs and benefits of the possible changes, they can't compute the best options at reasonable cost, their cognitive incompetence becomes even more pronounced and the change, to the extent that it depends on human action and does not fall upon societies in the style of a natural disaster, becomes even more difficult. Institutional stagnation cannot but produce the stagnation in all important walks of life, including the economy. All these developments make the systemic change individually unprofitable despite its desirability and urgent necessity from the point of view of the society as a whole. Looked at in this dimension, the stalemate is one possible result of the partial decentralization of decision making in developing the institutions (such decentralization is a corollary of the statement that the group actions matter in shaping the final outcome) and the conflicts of interests at various levels of social organization. Such conflicts of interest are a natural consequence of the fact that the institutions have the usual characteristics of public goods, whereby – again – the publicness manifests itself at various levels of the social organizational hierarchy. Apart from this, the diversity of time horizons and their generally short length often leads to situations in which a broad collection of institutional changes is faltered by distinctly inconsistent and mutually nullifying decisions. To the extent the change would have to come from them, it will not be forthcoming; to the extent it happens to be engineered by the state, these agents will resist it and make it slower and more costly.

The especially important characteristic of the path dependence is the fact that it mostly reflects the influence of the most powerful groups and the configuration of their preferences and interests. The power of the relevant groups is a defining feature of the old system. It is through the power of the groups that the old systems of institutions determine the new ones and that the path dependence becomes the crucial determinant of the unsatisfactory institutional development in the Southeasteuropean countries. The future comes to be a hostage of the past. As the power has traditionally been concentrated in and around the government and since the state bureaucracy has persistently held the commanding positions in the Southeasteuropean societies, it is only natural to find out that the entire social development bears heavy and easily recognizable imprints of the state interventionism and the administrative reign. Cognitive inadequacy and informational constraints provide another channel through which the past heavily influences the future, making again for path dependence. The available knowledge determines the intellectual horizon of both decentralized actors of institutional adjustments and the system-wide agents of institutional

engineering working under the governmental auspices. The design of the institutions-to-be cannot be far from what already exists, the ideas concerning the alternative arrangements cannot but be conceptual shadows of the existing institutional mechanisms.

Faced with the systemic uncertainty likely to arise from the regulative voids resulting from major changes, the actors rely on old ways of coordination. Such behavior recreates the old institutions and gives an alternative way of establishing the path dependence. Especially important in this context are the informal institutions which are subject to gradual change anyway; their evolutionary change binds successive arrangements into coherent wholes which also make for – or even represent – the path dependence. The conservative bias of consciously designed, purposefully engineered institutional adjustments, which in Southeastern Europe come as a reaction to too frequent and too big exogenous changes, additionally strengthens the inclination of local institutional developments to distinct and persistent path dependence. Legacy left by past investments represents a strong conservative force under all of circumstances but it seems to have been and continues to be especially strong in Southeastern Europe. Besides the already mentioned traumatic shocks in the past, the painful and costly disturbances that have produced the conditional reflex of avoiding and resisting any type of change, there are endemic reasons of rejecting the change which have to do with the modest levels of income and wealth. Poor individuals and groups cannot accept the substantial risks which are associated with significant change because in the case of failure the resulting loss bites into the biological substance, into very existence of individuals and groups. It is also true that any loss of value associated with the redeployment of resources following the changes is much more difficult to sustain at low income levels. Southeastern Europe has seen many episodes of defending the system specific capital at all costs in the face of involuntary changes generated by exogenous forces. The result of such a behavior under adverse circumstances seem to have been broken, piecewise continuous paths, to use a mathematical metaphor. Such paths in the multidimensional institutional spaces have exhibited an unusual combination of two contradictory characteristics. The frequent and large jumps gave them a recognizable appearance of extraordinary dynamism, while the continuous portions exhibited an equally recognizable conservative bent.

### *3.12 The Role of the State in Southeastern Europe: Creating Institutions for a Market Economy*

The institutional interdependencies between the state and the market are well known. Creating institutional preconditions for a market economy is a matter of governmental policies. Not a small number of markets appears to be simply created by the state policies. The market movements themselves produce pressures for certain types of government's reorganization and for specific economic policies. The influences are two-sided and the large and complex set of interactions between the state and the market weave themselves together into a nexus of multiple interdependencies which is at the heart of any economy, be it rudimentary and underdeveloped or highly modernized and market based. Governmental policies and market processes are distinctly complementary in large areas of their interacting, but there are other areas in which they are alternative devices to be relied on and where a recognizable relation of substitutability becomes established. Besides policies supporting and even creating the markets, there have surely been the policies suppressing and even destroying the markets. No unequivocal conclusions about the direction of influence of certain factors at work can be drawn.

The only safe statement to propose is that strong influences there have been and that their consequences remain far-reaching. A multiply tested piece of common stock knowledge is that a truly democratic state *can* serve as a basis of a market economy despite the fact that not a small number of cases can be found in which non-democratic governments served very well as bases of the high performance market systems. European tradition – which

undoubtedly may be taken as relevant for the Southeastern European development prospects and choices – clearly leans towards democracy and provides ample evidence about *democratic states* serving as institutional fulcrums of the market economies. Southeastern Europe has added another important and much more specific experience. If not subject to hard budget and financial discipline, the state fails despite being democratically structured and being embedded into a multi-party political framework. The Greek experience is in that respect illuminating: soft budget, conditioned by overambitious objectives regarding the state and the nation building, leads to public bankruptcy, to loss of sovereignty and to the state's ceding its functions to some alien organization. For better or worse, that profoundly changes its role in the economic process and even more in the grand political choices and national strategies. Such turnarounds in the state's role in the broadest and truly strategic public issues undoubtedly have a powerful feedback on the workings of the market and its mobilizing potential and allocative efficiency. Hard budget at the level of the state and governmental use of resources could be understood as the key constitutional precondition for a sound and sustainable democracy; financial disorder undermines the very foundations of the democratic system and ultimately leads to the demise of the democracy itself. This does not come as a surprise: the crucial preconditions for many institutional mechanisms and organizational devices, such as various incentive schemes, have to be provided for *outside of those contrivances themselves*. Whether democracy will work in the expected and desired way depends on a number of things that have to be fixed outside democracy itself.

By shaping institutions, by setting the rules under which various economic actors will be able to interact and by regulating the conditions under which various economic operations will be conducted (Toye 1995, p. 63) the state clearly exercises a decisive influence in the economic processes. As repeatedly emphasized, the state has to step in when it comes down to many instances of institutional reshaping because the alternative decentralized devices of institutional adjustment suffer numerous and deep "imperfections of second order". The resistance to change, evidenced at the level of the broadest decentralized social base and induced by the traumatic experience of the imposed and forceful past changes, is also an important reason for the state having to intervene in the processes of institution building. The third reason for the state's intervention in the field of institution building is the above described (section 3.1) conservative bias caused by the centuries of alien rule in all of the Southeastern Europe. The alien reign produced an inclination to rely as little as possible on the formal rules and to regulate all walks of life by informal rules deeply ingrained in the people's tradition. Such bias, together with the informal rules being less flexible under the foreign mastery, produced an institutional rigidity which, in view of the needs for adjustment brought by the modern times, had at times to be broken in by the energetic intervention of the state. It was implicitly hoped that the failure of the state, at least in some segments of institution building, would be less than the failure of various decentralized mechanisms of institutional adjustment.

The evaluation of the role of the state in Southeastern Europe depends crucially on the underlying theory of the state. From the point of view of the strictly functionalist theory, particularly the one centered on narrowly defined economic functions of the state, the governmental policies and the ways in which the role of the state was generally exercised, will be graded with quite a low mark. However, if one accepts not this narrow point of view, germane to the *new institutional economics*, but an incomparably wider standpoint, characteristic of the *old institutional economics* (Stein 1995, p. 128), one comes out with a radically different evaluation. The old approach ties the government not just to providing conditions for maximizing the economic performance but sees it as a provider for a much broader set of social needs. The government in this view introduces and guarantees a generally conceived *order* which regulates many areas of social life, including those

conceptually and functionally located very far from economic processes and transactions. As indicated earlier in a different context, while catering to such a broad spectrum of social affairs, the government cannot be expected to be as efficient in any given field as it would be had just that field been in the center of its preoccupations. This mode of thinking does not focus on primarily economic institutions but looks at them in their totality and even defines them in a way which in the present perspective looks somewhat exotic. Namely, institutions are thought of as “settled habits of thought common to the generality of man” (Stein 1995, p. 128).

Different historical circumstances evidently bring different epochal agendas and different collections of the cardinal tasks that have to be performed for a long future to come. To such widely differentiated and continuously varying composition of the weighty historic tasks there certainly has to correspond a differentiated and varying mix of institutions primarily focussed on this or that sphere of social life. Southeastern Europe has throughout her recent history faced the epoch-making tasks of nation building and organization of state and it is in the light of that fundamental fact that the *overall* performance of Southeastern European states has to be evaluated. In the historic circumstances which mark the epochal turn of the entire society the state is confronted by the complex and occasionally almost insoluble task of having to foster *competition* in some areas of social interacting and *cooperation* in other areas. Thus, building the institutional base of a market economy clearly calls for putting in place devices promoting *competition*, while the nation building largely boils down to a cooperative enterprise. Having to lay the institutional foundations for these two diverse types of behavior is a great challenge for any state, not to speak of the nascent and in many respects quite undeveloped states in Southeastern Europe. Moreover, it is beyond doubt that the overall efficiency of performing these widely differing sets of functions must be considerably lower in comparison to a setup in which such two-pronged overall position didn't exist. Or in which it, at least, did not impose itself so forcefully.

Another disparity in the historically imposed tasks of the state came from the necessity of catching up with the more advanced European countries. Economic backwardness and a hovering civilizational lag made it imperative to set the tasks of mobilizing all available resources in attempting to accelerate the development in most areas of life. Such task either did not exist or had a much lower weight in the composition of commitments of other countries and their governments. Having a more versatile set of assignments or having one of them weigh so heavily in the overall agenda certainly reduces the effectiveness and reflects unfavorably on the overall performance. The very high demands on the governments have definitely contributed to their strengthening and probably to their coercive characteristics. This may have had adverse feedback effects on the performance itself and contributed to the end result falling considerably short of expectations. If one adds to this that the catching up function must have put heavy demands on the knowledge and expertise, the scarcest resources in the region, than the general picture of complexity of the task of modernization and the modest chance of coming to grips with it successfully – comes out even more clearly.

In view of the enumerated difficulties it is not surprising that much of what the governments did for the promotion of growth of the economies in the region had left much to be desired. Worthy of mention are two major drawbacks. Firstly, the incentive structures have most of the time been irrational. Small markets, large chunks of the economies being outside the markets altogether, insufficient integration into the wider international economic areas and diversion of a good portion of the highest quality human potential to political and administrative activities, not to economic entrepreneurship, created monopolized structures with poor valuation of resources and deficient incentives as to the options on which to engage them. The other prominent feature of the established machinery for mobilization and allocation of resources was excessive interventionism of the state, overregulation of economic

activities, too many issues on which governmental permits had to be obtained and, generally speaking, heavy bureaucratic regimentation of all important walks of social life. Administrative overregulation, together with wrong signals from a closed and incomplete market, additionally burdened with government made monopolies, created a macroeconomic environment in which (1) the signals to which the market agents were supposed to react had, as a rule, been faulty, and (2) the actors had not been able to respond timely and appropriately even to such signals because of the many constraints imposed by bureaucratic overregulation. These are some of the fundamentally important institutional constraints on the development of Southeastern European economies, the key elements to which to turn in an attempt to explain the conspicuous development lag and the modest success of the endeavors to bridge it over.

This is the context in which the power and the role of the groups should be invoked again. The groups are generally the agents of institutional development attempting persistently to adjust changes of institutions to their own interests, pushing the – how ever defined – general interest into the abyss of irrelevance. The groups are the medium through which the interdependence between the real economic changes and institutional adjustments is introduced. To the extent that they influence institutional change, the groups seize a more favorable position in the distribution of income and become more wealthy and powerful than in some alternative scenario. They also adjust the institutional solutions so as to facilitate their own aggrandizement and consequently acquire advantages not only in the distribution but also in the production and investment. With thus secured increase of income and wealth they presumably additionally increase their social power and political clout, making themselves still more effective in further steering of institutional change. The process takes on typical cumulative features.

The role of the groups in developing institutions in the Southeastern European countries has been rather specific. The governmental bureaucracy has by far been the most powerful group, taking over all commanding levers of the society and preventing other groups to form themselves and strengthen, not to speak of their significant influence in shaping institutions. For better or worse, the group influence could be diagnosed as inconsequential. That certainly has reduced the typical group induced deviations in institutional development, but on the other hand has increased the probability of strategic hazards and large failures because of the centralized bureaucracy working unencumbered, without constraining and balancing corrections coming from the alternative power centers. The groups might have exerted some influence in the field of informal institutions, but that is an ocean of rules and standards which only gradually evolves and in whose slow, organic development no separate social force can produce a discernible influence.

The strong influence of the state brings up again the important subject of the state failure. Leaving aside the serious question of “*the failure with respect to what, as compared to what alternative*”, one could assert that the problem of the state failure is the more important the more pronounced the intervention of the government in various spheres of social life. It is of some interest again to remind of the Khan’s (1995, pp. 71-3) classification of the state failure. Khan’s type I failure is measured by the loss of the performance of the existing institutions as compared to the superior performance of some alternative *feasible* institutions. If the system delivers 100 units and its institutional restructuring would raise the performance to 140 units, the quantitative measure of the type I failure is 40. Type II failure is an attribute of the transition paths and is measured by the excess of the cost of transition along a given (actual) path over the cost along some alternative transition path. The Southeastern European experience is certainly dominated by the type I failure. The reasons are two. Firstly, all over the region the economically inefficient institutions have prevailed most of the time. The difference between what has been achieved on the basis of actually prevailing institutions and some alternative setups must have been large. This statement should be

qualified by the above emphasized facet of institutional arrangements: they had to serve a much broader set of objectives than the purely economic ones and broader than in the rest of European countries. Allowance should be made for achievements along the dimensions corresponding to other objectives and for the fact that serving a versatile set of goals reduces the, no matter how measured, overall performance. The type II failure could not have been significant in the Southeastern European history. The reason lies in the fact that most changes have been exogenously imposed and forced upon the societies and their policies. The policy makers have generally not had ample alternative transition paths to choose from; the dynamically defined opportunity cost could not have been high.

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This brings the study to an end. As transpires from the its structure, the strategy of inquiring into institutional constraints on the Southeastern European development is two-pronged. The general discussion of institutions, their significance and the way they come to be formed, makes up the first part of the study. The second half is devoted to applying the conceptual and analytical tools, developed in the first part, to the economic evolution and institutional experience of the region of Southeastern Europe.

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