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INFORMAL INSTITUTIONS AND ECONOMIC PERFORMANCE

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Abstract *Using the critical analysis of the literature,the paper brings into focus the role of informal institutions on economic performance. The main conclusion drawn from the analysis is that economic performance is structured on the optimal functioning of institutional arrangements in which informal institutions are of particular importance by catalyzing decrease transaction costs, requiring judicious contracts, in order to promote a climate of trust between economic and the entire society.*

Key words:
informal institutions, trust, transaction cost, economic performance
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1. Introduction

Several studies underline and strongly argue that the gap between different levels of development of countries cannot be attributed to resource endowment and geographical position but to the key role played by the quality of institutional environment (formal/informal).

In the taxonomic approach to formal (laws) and informal (culture, traditions, religion, ethics, trust) institutions in North's paradigm, institutions are the path through which uncertainty is reduced by providing a stable structure to daily life. Our study aims to underline the relationship of deep interdependence between economic performance and informal institutional framework by formulating specific criteria on which this relationship is structured (Tamilina and Tamilina, 2014; Banović, 2015). Some of the ideas of this article have already been presented *in extenso* in a previous study (Clipa, 2013).

The study emphasizes that institutional arrangements evolve based on variable geometry referring to the harmonization and cooperation of formal and informal institutions (Hagedorn, 2015). When formal institutions work inefficiently, the informal ones become *second best* as they reflect the anachronistic behavior based on the opportunism of the socioeconomic relations between individuals and organizations.

2. Literature review

First, we should mention specific features of formal institutions that bring a certain trend (more or less sinuous). It should be noted that that the category of informal institutions includes traditions, customs, moral norms, religious faith that overcame the test of time (Pejovich, 1999). In other words, informal institutions are passed from one generation to another in more or less modified forms representing an *old ethos* projected to present time by means of specific mechanisms (imitation, learning).

In terms of enforcement, if formal institutions benefit from state's involvement in all aspects related to institutional internal structure – legal and court system, the informal ones correct the eventual non-compliance with a specific prescribed behavior by means of public opprobrium, exclusion from society, destruction or even loosing public reputation (Gottesman, 2014).

Basically, these informal institutions generate a set of constraints influencing the individual behavior in attaining one's goals and impose a specific social order consolidating the propagation of trust with direct consequences on the decrease of transaction costs and stimulation of trade relations.

Fear of possible social exclusion, the devastating effect of loosing reputation channel human behavior in accordance with prescribed social norms, even though they violate many times the opportunism that people many times show in attaining their goals. Therefore, informal institutions through their societal incentives may lead to a better social coordination, improved trust in trade relations among businesspeople, reduction of activities viewed by society as being illegal, reduction of manifestation of opportunism.

However, we should observe if the effects of loosing reputation or being excluded from society are *pervasive* in any type of society and have the same intensity. In closed traditional human societies, in which it is likely that human actions will be repeated, the loss of reputation and social exclusion play an especially important role as a *sui generis* mechanism of avoiding the appearance of the well-known dilemma of the prisoner in adopting a social behavior.

But, to make the reputation mechanism fully functioning, there appears a need to complete cumulatively certain conditions referring to perspectives of existence of repetitive interactions in society, a specific system of information exchange among participants in business operations together with the *actual* punishment of those who break the rules.

As socioeconomic operations go beyond the setting of traditional society, informal institutions start losing their initial role of building social cohesion (and implicitly economic performance through the decrease of transaction costs) and there starts to be felt a need for formal institutions and their enforcement. Therefore, informal institutions become a complement of formal ones (Raiser, 1997; Wu *et al.*, 2014).

As shown above, we may state that advanced societies require a complex well-defined set of formal and informal institutions as an initial foundation for stimulating economic performance. Our claim needs, at least, two additional clarifications.

On the one hand, the introduction of new formal institutions may generate additional costs related to organizational infrastructure supporting them and, on the other hand, if these institutions are not in harmony with the informal ones (as *old ethos* causing a path dependence in North's view), there may appear an institutional blockage.

We believe that the impact of institutional arrangements on economic performance varies from one country to another depending on intrinsic force of formal and informal elements functioning as more or less efficient constraints for the socioeconomic behavior (Fukuyama, 2014).

Consequently, relatively recent literature (Williamson, 2009) divides the institutional arrangements into four categories: institutional arrangements characterized by strong formal and informal institutions, arrangements characterized by weak formal and strong informal institutions, arrangements characterized by strong formal and weak informal institutions and institutional arrangements with weak formal and informal institutions.

The correlations established between the four categories of institutional arrangements and the gross domestic product of countries characterized by such arrangements show that countries belonging to the first two categories surpass, in terms of gross domestic product per inhabitant, the countries from other two categories.

When formal and informal institutions are strong, the risk of having an institution (formal or informal) not stimulating economic performance is partially eliminated, the two categories of institutions acting in a complementary manner. Changes will appear in an institutional arrangement with weak formal and strong informal institution, namely, informal institutions replace the formal ones by introducing into their constraints behavior stimulating economic performance.

Countries in which prevail weak informal institutions are not able to induce constraints stimulating economic performance even if they have strong formal institutions. The explanation may lie in the fact that often such formal institutions are borrowed from countries with developed economy that do not function in the economy where they have been transplanted. Therefore, even if the institutional transplant is seen as a viable alternative meant to stimulate economic performance, when it does not rely on the pre-existence of strong informal institutions, the expected results do not appear immediately.

In our view, the institutional transplant in this case is just an illusory solution to economic challenges faced by a country, the quality of its informal institutions remaining the most important aspect. The axiom according to which formal institutions should be harmonized with the informal ones and should create an articulate combination (institutional arrangement) becoming the main premise of economic performance. Taking into consideration that the replacement of informal institutions often occurs incrementally, the lack of harmony between the informal and formal aspects should lead to a loss of legitimacy by the latter. From a different perspective, some authors (Helmke and Levitsky, 2004) analyze the impact of formal and informal institutions and discover four main ways in which it operate. Thus, the two categories of institutions may be complementary, reconcilable, competing and substitutable in terms of two criteria: the degree of convergence of socioeconomic results specific to the institutions and the *de facto* functioning of the formal institutions.

Informal institutions are complementary to formal ones when there is a high degree of convergence between the two and the formal institutions are efficient. The second category reflects a situation when the institutions may be reconcilable if we take into account that despite a high degree of divergence, they continue to co-exist generating though initially unforeseeable effects. The two institutional categories may be competing when formal institutions are inefficient against a background of high degree of formal-informal divergence. We see a state that fails to enforce its own laws whether due to lack of interest of those in charge, or due to apparently high costs associated with legal infrastructure (jurisdictional inability).

At this stage, informal institutions may replace (substitute) the formal ones, becoming a *secon-best*. It occurs when business operators choose to enforce contracts outside official institutional mechanisms or when the creation of formal institutions may involve additional costs (Popov and Roosenboom, 2013). We may therefore witness a prevalence of informal institutions in less developed societies due whether to inexistent or inefficient formal institutions (Jütting, 2003). In this case, these institutions appear spontaneously as a solution aimed to solve specific problems of a society.

We may therefore witness a prevalence of informal institutions in less developed societies due whether to inexistent or inefficient formal institutions (Jütting, 2003). In this case, these institutions appear spontaneously as a solution aimed to solve specific problems of a society (Chen *et al*., 2014; Aldashev and Platteau, 2014; Volonte, 2015). In this scenario, having an increased legitimacy, informal institutions become predominant in society by imposing future economic behavior.

If the constraints generated by these do not stimulate economic performance, governing authorities may opt for designing new formal arrangements by transplanting (importing) new formal institutions specific to developed economies.

The design of new formal arrangements could have a high degree of legitimacy, if they are in line with the old ethos (traditions, culture and religion). As these depart from the old ethos, they start suffering from the lack of legitimacy which becomes recurrent in case of imported institutions.

Also, the implementation of new formal arrangements may require specific intermediary (secondary) (formal) rules harmonizing them with the pre-existent informal framework. Such secondary rules agglomerate even more the legal and jurisdictional system, leading to a general perception of legislative instability.

The stronger the collision between formal and informal institutions, the higher amount of secondary rules will be needed for their harmonization. The compliance with the new set of main and secondary formal rules may be translated also in a variable degree of increase of transaction costs, at least, on short-term. If the institutional import generates negative effects, a pertinent solution may be represented by measures aimed to change informal institutions. As we have mentioned, their change often is a difficult and it is hard to destroy informal archetypes built by societies.

More than that, some authors believe that informal institutions have a tenacious ability to survive (Collins, 2002), lacking a coordinating center that would make the change easier by modifying the rules of the game.

Firstly, the changes undergone by formal institutions prepare the trend of informal structural mutations. As informal institutions are endogenous to formal institutions, a change in the design of formal institutions may impact the informal institutions and the incidental variations in enforcing formal rules impact the costs and benefits of joining informal institutions that enter into competition or replace the rules (Helmke and Levitsky, 2004).

Informal institutions may change as a response to the transformation of conditions that initially generated such arrangements. Non-linear evolutions in the geo-political area (wars) may generate changes in resource allocation and changes in the balance of power in a community, weakening the actors that had benefited earlier from an informal institution and strengthening those fighting for change (Knight, 1992).

Other authors also suggest that formal institutions may change the informal ones, stating, for instance, that the rules (laws) forbidding smoking in public places caused a decrease in the inclination towards this vice. But, we believe that the explanation does not lie in the prevalence of formal institutions but in the transformation occurred in the informal institution – the awareness of more and more people of the benefic effect of quitting smoking and the demythization of the vice as being *bonton*. Consequently, a formal institution just set this trend producing a cultural change with an impact on consumer behavior. (McAdams, 1997). As an informal institution, culture does not play only a key role in consumer behavior but it is also responsible for the existence of inefficient institutions in promoting economic performance.

3. Characteristics of informal institutions with impact on economic performance

The differences in economic performance remain due to failure to adopt new forms of economic organization, failure that may be attributed to culture, viewed as a set of defined interpretative and subjective models used by individuals in a society as a means to give shape and perceive reality.

Through its founding elements (informal norms, customs, traditions, values), culture creates barriers to institutional change stimulating the persistence of inefficient practices that have a direct impact on maintaining high transaction costs causing the decline of economic performance. This is a devastating long-term impact as eventual change aimed through the introduction of new formal institutions benefic for performance is diverted by their collision with the informal rules deeply entrenched in social relations and existing economic institutions. There are four foundation elements of culture that through their constraints upon individual socioeconomic behavior define the premises for performance promotion: trust, self-determination, respect and obedience. If the first three are viewed as incentives for generating socioeconomic relations, the last one inhibits the inclination towards risk-taking as a *sine qua non* premise of efficient entrepreneurship.

The first element, trust, influences transaction costs. When individuals trust each other, transaction and monitoring costs decrease and property rights are much better protected and it is not necessary to maintain their formal protection. (Williamson and Kerekes 2008). Lack of trust leads to the increase of transaction and monitoring costs, to the decrease of interaction between individuals and appearance of timidity towards engaging in trade exchanges.

The second element, self-determination, expresses in a quantitative form the degree to which the individuals of a society have (or at least believe they do) control over their own actions. The more individuals perceive their success as being the result of their own actions, the more important for them become the incentives for professional development or for investments related to their property rights.

If people are convinced that they have control over their own lives, they will do more to improve their living conditions, showing a pro-active and reciprocal attitude. The determinants of such attitudes may be of natural or formal nature. Undemocratic societies with low economic performance will never generate self-trust but only resignation.

The third cultural element, respect, refers to the way in which individuals of a community are tolerated or not by the people outside it. Economically, a high degree of tolerance contributes to the fluidization of exchanges with outsiders and therefore to the expansion of goods and services market. We should underline that respect is associated with morality structuring (economic) behavior inside and outside a group (community). Morality inside a community contributes to the social cohesion of a group, spreads trust, leading to lower transaction costs (Nguyen, 2015). If morality does not appear also outside this community, the opportunist behavior will have direct consequences on transaction costs freezing a big amount of potential trade exchanges.

A limited morality (internal) is specific to traditional communities dominated by hierarchies and trust and cooperation appear within limited societal frameworks (group, tribe), transaction costs being low and deals take place within the group. To the opposite, outside the group, low lack of trust and respect towards members of other communities are the rules governing the community. Therefore, in these communities transactions are rare as costs of monitoring or obtaining information and implementing contracts are high. Also, the propensity towards investments, promotion of technical progress, trade exchanges is low.

In a society lacking morality, the institution of market is replaced by occasional relations based on friendship and kinship established among members of the same group. We believe the respect (morality) is a key factor for general economic growth.

The last element, obedience, may be an obstacle for promoting economic interactions between individuals as it is on the opposite side of self-determination, it inhibits the manifestation of individualism in terms of peoples' opportunities to choose and take-risks.

Finally, economic freedom, as the *summum* of individual rights (based on unlimited rights), needed to engage in business activities based on the guarantee (enforcement) of property rights, lies at the origin of economic performance – as some authors observe "from Adam Smith up to now, or even earlier, economists argued that the opportunity to choose and provide resources, business competition, trade with others and guarantee of property rights are the main ingredients of economic progress." (Haan and Sturm, 2000)

But, economic performance cannot be imagined outside trust (as a feeling of safety associated with honesty, good faith, somebody's sincerity). It is the miraculous ingredient of institutional framework in a market economy and it encompasses, on the on hand, trust between business partners, inhibiting opportunist behavior, and, on the other hand, trust towards institutions that stimulates collective action, implementation of rules and lies at the core of transaction costs (Algan and Cahuc, 2013). This is due to the fact that each transaction includes in itself a certain degree of trust and economic lagging behind of some countries may be explained by lack of mutual trust (Raiser, 1999). The climate of trust promoting economic exchanges contributes to avoidance of uncertainty that is generated by the *free-rider* of individuals in their desire to take advantage of profit associated with opportunist behavior.

In this context, the notion of trust needs some clarifications. Firstly, we come across a form of *attributed* trust specific to family and kinship relations, predominant in subsistence economies (Zucker, 1986). Secondly, there is trust built among individuals not belonging to the same community in repetitive interactions (transactions). It is the predominant form in economic interaction. The third form is specific to circumstances when individuals take part in trade exchanges having only limited information about each other.

In this case, three scenarios are shaped. Actors do not conclude transactions due to informational asymmetry, incomplete information and fear that they will be deceived. Potentially, both parties loose by not going ahead with the deal. In the second scenario, the two parties make the transaction but just one party wins, the party deceiving the other party. There will be no other transaction between the parties and the exchanges will be limited.

Still, despite the two scenarios, the transaction may take place, both individuals winning as they show a generalized level of trust as a key element of a modern economic system. But, the generalized trust will appear only when the second type of trust appears – trust built among individuals within repetitive interactions (transactions) without their belonging to the same community.

Generalized trust appears and extends in society when it is stimulated by the official channels, state and due to informal institutions that ensure social safety. The causal link between the propagation of generalized trust in society and the quality of formal (protection of property rights) and informal institutions (the incidence of bribe giving and receiving) has been already validated empirically (Zak and Knack, 1998).

On the other hand, this form of trust plays a key role in efficient functioning of official enforcement mechanisms, at least for two reasons. Firstly, the state (the judicial system) faces numerous problems related to obtaining information about the behavior of business actors in cases under trial in courts and there is a risk of reaching decisions without having conclusive proofs, or contrary to reality. Secondly, normative enforcement involves punishment that depends on the legitimacy and credibility of state institutions.

The arbitrariness in the interpretation and application of laws should be eliminated, formal and informal institutions should be harmonized together with the implementation of all measures required for the realization of justice despite incomplete information regarding the behavior of business actors. People's lack of trust in legal and judicial system leads to a crisis of legitimacy and credibility; statutes and contracts fail to be enforced under these conditions. Such crisis may be long-term if we take into account that trust is an informal institution, relatively sensible to exogenous factors and it is hard to change (Roland, 2005).

But, a high degree of trust in society may lead to the increase of efficiency of the legal system, a better enforcement of the tax law and to imprinting a negative trend to corruption, the information being replaced by trust (La Porta *et al*., 1997). The propagation of trust in society will lead to the decrease of contract monitoring and enforcement costs, low level of law suits in courts. If transaction costs are low,, the saved capital may be directed towards various investments, funding research and development expenses, promoting technical progress, so, coherent strategies may be developed aimed to stimulate economic performance.

We believe that we should focus on the relation between equity capital and the process of innovation (Nikolic, 2015). We believe Putnam (2003) did the pioneering research in this area He identifies in his research social organization as being important for governance efficiency and civic management. In his vision, the individual's participation in social networks is the main indicator of equity capital and is the basis of trust among people; social networks making trust *transitive* and omnipresent. In a society characterized by a high level of trust, transaction costs are lower, with a higher likelihood of contracts to be executed, trust being associated with the opportunity for individuals of a society to be more inclined towards risk taking.

Equity capital is a vital ingredient in the process of innovation, it creates the premises for the reduction of costs related to distribution of information, to the reduction of transaction and contract enforcement costs and it saves resources for funding research and development expenses.

CONCLUSIONS

While for formal institutions, enforcement is made by the state through official channels, for the informal institutions, the enforcement is made by shutting off the formal mechanisms by means of social exclusion and loss of reputation.

Economic performance cannot be imagined outside trust (an informal institution), a miraculous ingredient of institutional infrastructure in a market economy. This concept includes, on the one hand, trust among business actors, inhibiting the opportunist behavior, and, on the other hand, trust in state institutions, stimulating collective action and enforcement of laws. Also, it is the basis for decreasing transaction costs as each transaction in itself includes a degree of trust and economic lagging behind of some countries may be explained by lack of mutual trust. Trust in economic exchanges contributes to the avoidance of uncertainty that originates in the *free-rider* of individuals who are interested in taking advantage of their opportunist behavior.

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