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# Institutional Competition in the Post-Soviet Space

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*Abstract:* Institutional competition is often discussed as an instrument of market creation and preservation in transition and development economies. The post-Soviet space offers an interesting case study for the analysis of this problem: increasing international investment flows and absent policy coordination establish an environment for intensification of institutional competition among jurisdictions. Nevertheless, in the post-Soviet world the quality of institutions seems to remain low. This paper deals with potential effects of interjurisdictional competition on institutional quality in the post-Soviet space while addressing two levels of analysis: rational choice factors (economic inequality and learning effects) and interplay of formal and informal institutions (perception of free markets, trust to the public authority and interaction of deep and shallow institutional levels).

## 1. Introduction

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

From the point of view of the theory of the institutional competition the relations between the governmental structures and the private actors can be described as a "market for institutions, social orders and public policies" (Kerber 1998). The government offers certain goods (institutions) to private actors, charging a fee for their consumption mostly in form of taxes. Unlike a closed economy, where a government's monopoly on this market exists, in an open multi-jurisdictional economy the market for institutions is a competitive one, i.e. institutional competition creates a mechanism, which allows individuals to influence governmental decisions in order to create formal institutions, which reflect their preferences. If institutions provided by the government do not correspond to the expectations of private actors (either because of rent seeking, or lack of knowledge), they leave the jurisdiction ("exist"), thus worsening the taxation basis, economic wealth and political power of the incumbent, who start searching for more appropriate formal institutions.

In the current literature regulatory institutions (like environmental or social standards) are in center of discussion. Nevertheless, the idea of institutional competition is often used for the market enabling institutions (Levi, Prakash 2003) like property rights and contract enforcement. Thus its normative conclusions are applied for the studies of post-Socialist transformation, where institutional competition could help to develop institutional framework for functioning markets. Institutional competition is an important element of the "market preserving federalism" of Weingast (1993), which is influential in the studies of federal states in transition and in developing countries, e.g. for Russia, China or Brazil. The World Bank Development Report (2002) proposes the intensification of interjurisdictional competition as an important method of improving the quality of institutions in developing and transition economies. It is of great significance for countries with unsatisfactory results of institutional transformation in the 1990s, like Russia and several other CIS members. The transition of these countries led to establishment of "inefficient equilibria" and "institutional traps" combined with poorly functioning markets.

This paper addresses the problem of institutional competition in the post-Soviet world in greater detail. In the first section it provides empirical evidence for potential environment for institutional competition in the CIS, discussing the role of Russian foreign direct investments in the region. The next two sections offer two perspectives on potential effects of institutional competition on institutional quality in the CIS. The first one is based on the rational choice analysis and deals with potential demand for institutions from the point of view of transaction costs and power asymmetries. Our results are mixed: both demand for good institutions and the bad institutions seem to co-exist in the CIS. The second perspective deals with the role of informal institutions and their interplay with formal rules. One can conclude, that in the short run informal institutions seem to reinforce the inefficient institutional equilibrium, although in the long run situation may differ. The next section offers a brief conclusion, while the last section discusses potential policy implications.

## 2. Cross-Border Investments in the CIS

The role of institutional competition in the post-Soviet space at first appears dubious. A necessary precondition for the institutional competition is free movement of capital across national borders, which is given in more advanced integration areas like the EU, but is problematic in the CIS, where many countries use different forms of restrictions for cross-border capital transactions. Low success of governmental integration projects (as compared to other integration groups worldwide) also makes institutional competition in the CIS questionable.

However, if other factors of the post-Soviet development are taken into consideration, the region surprisingly seems to meet many preconditions of the institutional competition debate. The transaction costs of the cross-border FDI do not seem to be high: the region is still united by the developed social integration factors, like the Russian language as the lingua franca, common values, informal interpersonal communication networks, common mores and ways of doing business etc. (see Sterzhneva, 1999) even if compared with Europe. The borders between states have remained transparent for capital and labour flows as an attempt to survive the appearing economic shocks of disintegration, which were of significant importance for the post-Soviet republics, as well as a manifestation of lacking capacity of new governments to create an efficient control over cross-border transactions.

As a result, there are huge cross-border factor movements in the CIS. Labour migration has played an important role for many post-Soviet economies during the 1990s. A recent trend (which I focus on in this paper) is that the cross-border investment flows skyrocketed since 2000. While in 2000 the overall Russian investments in the CIS (according to the date of the Russian official statistical authority) accounted for about US$ 130 mln., in 2006 it made out US$ 4,128 mln. One should be aware of the fact, that in 2006 the structure of Russian investments in the CIS changed significantly as compared to the previous years due to large investment inflow in Ukraine. In 2006 this country was also the main recipient of Russian investments worldwide. Currently it constitutes about 85% of the overall investment stock of Russia held in the CIS, which accounted for US$ 3.8 bln by the end of 2006. Note, however, that the increase in investments is mostly associated with the position “Other investments” in the Russian statistics, and therefore does not directly reflect the corporate activity. However, there are still reasons to believe that Ukraine is currently the leading CIS country from the point of view of Russian investments attracted (applying some indirect evidence based on marker surveys). Moldova ranked second with 5.5%, and Armenia third with 3.3% (the regional distribution of the Russian investments in the CIS seems, however, to be highly unstable and change significantly during the last years). Moldova is also the leading country if the foreign *direct* investments are considered. CIS accounts for about 26.6% of the total Russian foreign investment stock.

There are good reasons to believe, that even these optimistic figures systematically underestimate the Russian investment activity in the CIS. The origin of investments can often be hardly identified correctly; moreover, the statistical authorities often not properly record investment flows. There are three main reasons for this fact. First, the Russian corporations actively use offshore companies and intermediaries to organize the investment flows. For example, Cyprus and British Virgin Islands have been traditional “intermediary” jurisdictions for Russian investments in the CIS. Recently even some CIS countries became “bridges” for Russian investment expansion (like Moldova for Russian telecom investments in Uzbekistan). Second, traditionally the field of international investments in the CIS has been dominated by shadow schemes, which did not play an important role for Russia’s investment activity in industrialized countries. According to a study by Crane, Peterson and Oliker (2005), foreign investments from the offshore jurisdictions, which could be “suspect” of having Russian origin, exceeded formally registered Russian investments in Ukraine by more than 200%. Russian business has important positions in regions like Transdniestria and Abkhasia, where the control of the central governments is absent and hence no reliable statistics is available. Third, the data provided by Russian and CIS statistical authorities often differ significantly: in 2000-2004 Kazakhstan’s estimate of Russian investments in this republic exceeded the Russian data by more than three times. Hence, alternative estimates of investment activity could be helpful. According to the UNCTAD databank on M&A (as reported by Vahtra (2005)) and MMBA International Business Association, mergers and acquisitions in the CIS made out about one half of the total number of the M&A deals of Russian businesses in 2000s.

The main industries where Russian FDI is concentrated are telecom and oil and gas sector. The latter seems to be an evident goal of Russian businesses, since oil and gas corporations play the dominant role in Russia’s economic structure and, hence, have potential needed to be actively involved in investment activity abroad. Moreover, this field remains heavily influenced by political factors. On the contrary, Russian Big Three telecom companies' involvement in the CIS seems to be mostly driven by purely economic considerations, while Russian investors currently control the dominant share of the mobile service providers market in the CIS. It is worth noticing, that Russian big business constitutes only one segment of the overall Russia's investment activity in the CIS (moreover, it is only the most "visible" part of the overall investment activity). Other main actors include wealthy individuals and small companies without significant presence in Russia, but with important role in the CIS. These investors are driven by a multitude of factors, including ethnic networks and specifics of legal framework in the CIS. In several industries (like oil refinery in Ukraine) Russian companies enjoy a quasi-monopolistic position. Anyway, Russian investments seem to have the pivotal position in the CIS much more often, than in any other region where they are present. Crane, Peterson and Oliker (2005), Libman and Kheifets (2006) and Libman (2007) provide a detailed account of the main actors of the Russian FDI activity in the CIS. Yudanov (2000) points out, that the "all-union community of enterprises" originating from the Soviet past happened to be more stable, than the union state itself, and demonstrates the trend towards regeneration. However, in several industries (like mobile services) the impetus towards bottom-up integration of the region is obviously supported by the current economic development.

On the contrary, CIS investments into Russian economy are still less important. By the end of 2006 the accumulated investment stock accounted for US$ 1.06 bln, i.e. about 27% of Russian investment in the CIS. The main countries of origins are Tajikistan (36%) and Kazakhstan (33%). However, in case of Tajikistan the position is mostly formed by portfolio investments, and in case of Kazakhstan by other investments. Tajikistan's position could be caused either by links created through very active labor migration or by "reversal effect" of the Russian big business' involvement in the republic (e.g. in the power utilities and non-ferrous metals). On the other hand, the position of Kazakhstan reflects the relative strength of its economy. Companies and (especially) banks from Kazakhstan perform an active investment expansion strategy in the CIS.

Hence, on the one hand, the borders between post-Soviet states still remain transparent enough for movement of capital. On the other hand, the formal integration structures created by the post-Soviet countries (either the CIS or the subregional groups established to substitute the inefficient Commonwealth) also proved to be less efficient than expected. Despite magniloquent declarations post-Soviet states could not even implement a wide free trade area; numerous international bodies do not have the necessary authority to create an impetus for economic integration. Hence, absent policy coordination makes changes of institutions in order to attract mobile factors of production more likely. This institutional competition, however, is marked by the *fundamental asymmetry,* influencing the overall economic and political structure of the CIS: it is mostly dominated by the FDI of *Russian* corporations. Obviously, CIS countries compete for investments from other regions of the world, but this issue is beyond the scope of this paper. How does the strategic behavior of governments seeking for mobile investments influence the quality of institutions? The next two sections present two alternative approaches to this issue.

## 3. Rational Choice Factors of Institutional Competition

In the current theory of institutional competition it is normally assumed, that the preferences of individuals are given and that private actors prefer institutions with lower transaction costs, which are defined as "efficient" institutions[1]. The theoretical literature on the government-business relations in the post-Soviet space is to a certain extend ambiguous, whether this demand really exists. In fact, a widespread point of view is that the problems of economic reforms in the 1990s were caused by low demand for efficient institutions by emerging private business. Generally speaking, two rational choice explanations apply. The first argument proceeds from the fact, that the post-Soviet economic systems were characterized by extreme concentration of property. Sonin (2003) and Polishchuk and Savvateev (2004) demonstrate that the demand for weak protection of property rights may result from inequality in the society. More rich and powerful agents can invest in a private protection system. Under a deficit of public protection, rich agents can gain from redistribution due to improper protection of property rights, because they have a significant advantage over the weaker agents. That's why they become natural opponents in improvement in public protection of property rights. Guriev and Sonin (2007) place this discussion in a political economic setting and show that weaker protection of property rights also results from bargaining between dictators and oligarchs.

If formal property rights are absent, the economy turns in the endless redistribution cycle and permanent power conflicts between different groups of interest (which exists in the most CIS countries either in a "hidden form" of in states with higher concentration of state power like Russia or Central Asia or more open in countries like Ukraine (Valasek, 2007), where elements of political competition are more pronounced). Of course, competition for power exists in any economy: however, the question is, whether it takes form of an efficient market competition for the consumer or is based on permanent redistribution struggle between influence groups. Economic effects of presence of multiple power groups in society competing for dominance can be disastrous, as the literature on the "voracity effect" (Lane and Tornell, 1996; Tornell and Lane, 1999), although Piccone and Rubinstein (2005) provide a model where competition for power generates Pareto-efficient outcomes. In the post-Soviet world "voracity effect" is obviously present and preventing the efficient economic development. Moreover, even if inequality is ignored, Hellman (1998) and Polterovich (1999) describes a situation of partial reforms in transition economies, when incumbent actors, receiving special rents from non-completion of reform process, support the stability of inefficient institutions.

The second argument focuses on the issue of learning costs. Any individual compares his sunk costs in learning the structure and the functioning of the old institutions and the adaptation to the old "rules of the game" (e.g. bribes, licenses etc) with the advantages of the new rules. It is possible, that the sunk cost will be higher, than the gains, and individuals decide not to change the status quo, or, at least, not to invest in political activity to improve the situation. In that way the path dependence strengthens the effects of other factors inducing demand for "bad" institutions. For an entrepreneur preference for old institutions could be connected with competitiveness. In a bureaucratic environment with high market entry barriers, the first mover has important advantages, because he has already passed the bureaucratic environments. He prefers any worsening of institutional environment (e.g. higher entry barriers), because they prevent him from newcomers in the market.

One could probably claim that the existence of demand for bad institutions is currently mostly accepted by the studies of the post-Soviet world. A more difficult problem is whether the

[1] In this paper the term "efficiency" is used in its narrow sense as transaction-cost-minimization for the purpose of compliance with the general institutional competition literature, although other definitions are possible (Hayden 2005). Last section discusses the applicability of this definition more closely.

situation changed after the initial stage of transition, and, after initial accumulation of wealth, corporations are more interested in protection of property rights and reduction of transaction costs. Following Greif and Latin (2004), the question is whether the mechanisms described above were not only self-*enforcing* (i.e. constituted an equilibrium), but also self-*re*inforcing (increased the range of parameters for their stability). On the one hand, accumulation of wealth, even if it follows from redistribution, increases the demand for property rights, thus making this mechanism not self-reinforcing. But on the other hand, the redistributive networks can include broad groups of population and become intransparent, hence increasing demand for redistribution. The same is true for the learning costs: the longer an institution exists, the higher the costs of its transformation are. Libman (2006) shows that in different countries of the CIS different constellations were possible.

As institutional competition replaces supply-side monopoly on market for institutions by competitive order, the demand-side factors become more important. Therefore institutional competition shifts the market power to the demand side on the market for institutions ("exit power" (Beck 2001)). Hence, the "shift of demand" from "bad institutions" to "good institutions" is crucial for the evaluation of the effects of institutional competition. The situation is, however, more difficult. Institutional competition is associated with internationalisation of business activity, which has several distinct effects. On the one hand, the "exit" of efficient companies can strengthen the "voice" of inefficient companies. After most efficient companies leave the country, the remaining inefficient ones become the main income source for politicians and bureaucrats (legally and illegally) and get a larger impact on the politic decisions. A crucial issue is of course how rents for the government are generated. If "exit" reduces rents, the governments are likely to change their attitude towards institutional reforms. If, however, rents are relatively independent of "exit" (what is especially true for resource-abundant economies, like those of the CIS, see Gandhi and Przeworski (2006) for a similar analysis), the "exit" is ignored and effects of institutional competition are insignificant. Finally, the costs of "exit" can be correlated differently with preferences for institutions (for example, at an early stage more mobile companies can be exactly intermediaries enjoying the main benefits of "transition rents"). Moreover, an inefficient equilibrium resulting from the open economy includes asset striping, large capital flight (or "exit") and low quality of institutions. The same individuals, who use the "exit" option to secure their wealth gained from assets in the jurisdictional with law quality of institutions, support with their "voice" option the "bad" institutions (see Mummert, Mummert, 2000). Given the asymmetry of the post-Soviet institutional competition, where Russian companies (more or less directly depending upon resource rents) dominate, one can hardly expect positive effects from this direction.

The second argument implies that the corporations use their investments as an instrument to transfer knowledge and better practices. It is an often point mentioned that the multinationals export their national models of regulation to the new locations of their industries and stores. For example, the business strategies of multinationals in respect to different national standards in their host countries can represent the original "national" model derived from "varieties of capitalism" reproduced abroad via corporate culture, management appointment system, incentives etc. (Pauly and Reich, 1997) Once again, asymmetric structure of the CIS is of central importance. The major "promising" factor from the post-Soviet investments is that the Russian economy mostly demonstrates better institutional performance, than the rest of the CIS. Hence, asymmetric structure of institutional competition is likely to ensure higher quality of institutions. There are only few exceptions. Kazakhstan has formally implemented many "second-generation" reforms, which still fail in Russia (power utilities liberalization, amnesty of capital, reforms of communal sphere, banking, pensions system etc.). However, exactly Kazakhstan is the second important source of FDI in the CIS (following Russia). Armenia is also a certain exception with extraordinary good institutional performance (Iradian, 2003)[2]. Kyrgyz Republic used to be the leader of institutional reforms in the early 1990s, but later demonstrated a worse performance. However, in many cases Russia is more advanced, than the rest of the CIS, and therefore Russian corporations act as an instrument of import of more efficient institutions. There is evidence (mostly based on discussion with CIS and Russian managers) that Russian assets often prove to be more efficient, than owned by local or even international corporations (cf. Crane, Peterson and Oliker, 2005). Libman (2006a) also provides some quantitative evidence with this respect. A large problem is, however, that the relative institutional advancements of Russia are not given: assuming low success of catching up reforms, other countries of the CIS can achieve higher institutional quality. In this case the asymmetry is going to make a negative influence on the link between institutional competition and quality of institutions.

However, anecdotal evidence also suggests, that demand for bad institutions can exist in the post-Soviet institutional competition. First of all, as Russian corporations have significant experience in working with "shadow" schemes, it continues using this experience abroad and thus "export" inefficient institutions or applies their experience of intransparent institutional systems as a competitive advantage. Russian businesses ability to act in a very instable legal environment is often pointed out by the observers. Obviously, they use this opportunity, thus "switching on" the self-enforcement mechanism of an institutional trap. There are many cases of intransparent "shadow" investment schemes used by the Russian corporations in the post-Soviet world. May be the most notorious is the case of two *Gazprom* subsidiaries in Ukraine *Eural TransGas* and (since 2004) *RosUkrEnergo* established to resell the gas of Turkmenistan. It is officially incorporated in Switzerland with 50% of the shares under the control of *Gazprom* and 50% represented by a nominal shareholder *Raiffeisen Investment* without any clear information as to who could own the shares (the assessment vary from organized crime to different political groups in Ukrainian and Russian elite and *Gazprom* or *Naftogaz Ukraine* officials). After the gas war in Ukraine, *RosUkrEnergo* received privileged rights of gas supply to Ukraine and partly to Europe. The Ukrainian case is the most notorious, but not unique example of demand for bad institutions. It looks like these inefficient schemes are often even preferred by the Russian investors. For example, the second public tender on the large Ukrainian metallurgical plant *Kryvorozhstal* in 2005 is often considered as one of the seldom examples of completely transparent privatisation in the CIS. Russian investors, although very interested in the plants and active during the former tenders, rejected to participate (see e.g. Inozemtsev, 2005). Replacement of Russian business practices in the CIS discussed in the previous subsection has a double effect. On the one hand, they may be superior to what exists in the post-Soviet world, as discussed above. On the other hand, however, the model exported is also an example of the "institutional trap". For example, in their fight over Kyrgyz telecom asset *BiTel* Russian and Kazakh investors (and later Russian companies *VympelCom* and *MTS*) resulted into seizure of the company's headquarters by an armed group in police uniform, which rejected to follow the orders of the minister of internal affairs (in the post-Soviet world directly in charge for the police).

[2] It could be partly explained by the theory of systemic vulnerability, originally developed for the Eastern Asian nations. It states, that three factors are relevant: pressure of a "large coalition" on the government, absence of natural resources and external threat (Doner, Ritchie, Slater 2005). Armenia actually meets all three criteria.

Finally, most post-Soviet countries face the problem of permanently increasing corruption. Corruption has a double effect on institutional competition. On the one hand, it is likely to increase the benefits for the governments from attracting capital and economic growth. From this point of view corruption is just an additional tax (price of institutions), which reduces to the marginal benefits of institutions in turn of the competition process. This effect seems to be present e.g. in the competition between Indian states (Allen et al., 2006). But, given the fact, that the actors of institutional competition are mostly not abstract "governments", but individual agencies and administrations, it is likely, that the competition takes form of "protection" of privileged enterprises from rivalry agencies, which leads to overall decline in taxation and underproduction of public goods. Libman and Feld (2007) find evidence of this process for the regions of the Russian Federation; similar effects for the CIS in general can also be present.

## 4. The Role of Informal Institutions

### *4.1. Informal Institutions: Working Definition*

The majority of the studies in the theory of institutional competition focus on *formal institutions*, i.e. institutions enforced and designed by external authority (Redmond, 2005, p.666), in this case by the government. It is clear, that exactly this type of institutions can be used in order to improve jurisdiction's competitiveness in the interjurisdictional competition. For studies of transition and developing societies it is important to analyze the problem of interaction between formal and informal institutions under institutional competition. Hence, the over-optimistic point of view on institutional competition view may be challenged by the (more realistic) assumption, that the preferences of individuals on the market for institutions (their perception of norms) are defined by informal institutional framework.

The definition of formal institutions in different fields of institutional economics is partly controversial, and the boundaries between formal and informal institutions are often vague (see Hodgson, 2004, for critical reception of distinction between formal and informal in new institutional economics). These institutions could include *direct norms of behavior*, like conventions. The conflict between formal and informal institutions as alternative sets of norms of behavior is one of the most often discussed problems in the modern transition and development economics; for example, the failure of transition in the post-Soviet countries is explained by inconsistency and interaction between the formal and informal norms (e.g. Voigt and Kiwit 1995; Leipold 1997; Raiser 1997 etc.). From the point of view of institutional competition it is reasonable to focus primarily on the other side of informal institutions: their function as *perception rules,* which govern the individual's attitude towards formal institution.

For the purposes of this paper I use a very narrow definition of the formal institutions as institutions set and enforced deliberately by the government. From this point of view, informal institutions develop in turn of a spontaneous evolution of the society without (direct) government's intention. Their origin is of emotional, religious or ideological nature (Leipold 2000); they may have no manifestation in written documents and are ensured by the self-control or (un)organized supervision by private actors (Kiwit and Voigt, 1995). The major aspect of informal institutions relevant from the point of view of this paper is that they include certain notion of objectives of governmental regulation, which is used to judge concrete norms incorporated in law and other parts of formal institutional framework. These evaluation criteria comprise three major aspects:

- General attitude towards the government, or institutional vertical trust, i.e. the readiness of individuals to believe that changes in formal institutions initiated by the public authority may have positive impact on their life;
- "Shallow" notion of socially acceptable results of functioning of economic mechanism and economic behavior, e.g. concept of justice, freedom, relation to wealth, profit seeking, entrepreneurship etc.
- "Deep" notion of socially accepted economic behavior. Unlike the "shallow" level, which is consciously accepted by individuals, this "deep" level includes norms, which define the socially accepted situations of deviant behavior, when individuals may break prescriptions of formal and shallow-level informal institutions. The differences between "shallow" and "deep" level could result from strong concentration of power in the ideological sphere as "defensive patterns of behavior" in Sztompka's (1993) sense. For example, the general "entrepreneurship hostility" on the shallow level can be combined with practically omnipresent shadow entrepreneurship on the deep level. An institutional conflict between the shallow and the deep levels is probably one of the most important factors that make human behavior in concrete situations unpredictable for an outsider (and probably for the actors themselves).

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

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

Therefore the most important feature of the informal institutions from the point of view of this paper is that they (1) do not change by order of the government and (2) change only in a long term. In a short term perspective perception of formal institutions is given. In the long run informal institutions change and the restrictions described do not exist. The distinction is similar to that between the short-term perspective of product markets (when individual preferences are given) and long-term, evolutionary view (when individual preferences evolve). However, outcomes of short-term institutional competition and the existence of a multi-jurisdictional environment by itself influence the direction of evolution of informal institutions and create an indirect causal relation between initial informal institutional framework and long-term results of competition of formal institutions.

Of course, it is important to find out at least a possible idea for what a "long run" and a "short run" mean in the evolution of perception of norms. In some cases centuries are necessary to change the people attitude towards certain institutional frameworks. It may be possible that in a globalized world with intensive flows of ideas the velocity of the evolution of informal norms increases, but this hypothesis requires empirical evidence, which is (especially in case of the deep-level institutions) controversial.

One should obviously mention, that informal institutions can differ significantly across the society and different groups of agents. In fact, one of the features of the post-Soviet transition was exactly the process of "segmentation" of the society into groups with different informal institutions. However, a more detailed discussion of this issue is beyond the scope of this paper.

### *4.2. The Interplay of Formal and Informal Institutions Change under Institutional Competition*

If informal institutions are included, the outcomes of the short-term institutional competition can differ from the expected "efficient" outcome in terms of transaction costs. The major limitations of the institutional competition, which exist in the short-term perspective, result from the three elements of the informal institutional framework as defined above.

Deficit of vertical trust in the society could lead to rejection of any institutional innovations of the government. The vertical mistrust (like trust) can be institutional, i.e. independent from concrete incumbents. If individuals have always suspected their government, any change of institutional environment is considered to be worse than the existing equilibrium. In this situation individuals support *existing,* and not *better institutions.* In case of institutional competition environment "exit" is a reaction on *any institutional changes,* and not on *worsening institutional environment* in terms of transaction costs. The ability of the government to attract mobile factors of production by *changing* institutional environment is reduced; a better way to prevent "exit" is to maintain the existing institutional balance, even if it is not optimal (and is perceived as not optimal by people). Other point is, that in case of low vertical trust investments and labor migration are consciously organized via informal channels (to avoid government's attention) and thus lead to support of less efficient institutions of the shadow economy as an untended result. The governmental attempts to limit the expansion of shadow economy with softening the restrictive regulations do not improve the situation because people do not believe in reforms; coercive measures against the informal sector make the formal institutions even less appropriate for the private actors and only support the expansion of the shadow economy (i.e. formal outcomes of institutional competition support illicit economic activities).[3]

"Shallow-level" notions of socially accepted economic behavior determine individual's preferences on the market for institutions in a more direct way. In a real world the economic

[3] One should notice that legality and extralegality of economic agents can hardly be considered a dichotomy in the post-Soviet world. A more realistic interpretation is to consider a business strategy a "mix" of legal and extralegal instruments changing over time, but relatively stable from the point of view of shifts of formal rules. Moreover, informal rules were also consciously designed by entrepreneurs, who could only partly rely on old behavioral patterns.

efficiency of institutions is not the only goal of individual decision-making (i.e. market convention is not the only order of worth). Aims like social justice, sustainability of tradition or industrial efficiency could be more important for individuals. This situation is natural; however, it is possible, that the informal institutions lead to the rejection of entrepreneurship, or supports destructive or unproductive kinds of entrepreneurial activity (Baumol 1990). They also can predestinate the acceptance of higher governmental interventions in the economy or a more active arbitrary redistribution on expense of the private initiative (as it is often the case in the transition or development economies, like Argentina or Russia). In this case individuals evaluate different packages of institutions provided by different government not from the point of view of their (transaction cost) efficiency, but considering their effects on other social values. *If individuals prefer institutions with lower efficiency, these institutions will survive.* For example, excessive entrepreneur-hostile governmental interventions with redistributive purposes could be supported by inflow of mobile production factors (e.g. labor and even capital), and the support of entrepreneurship is "punished" by "exit". The government's learning via institutional arbitrage can only fix the existing institutional preferences of individuals.

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

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

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

A general problem of the post-Soviet countries is that they have a very low level of vertical trust (World Bank, 1997, Raiser 1997, Raiser 1999, Oleinik, 2005a), as well as a sophisticated interrelation of formal, deep and shallow-level informal institutions (Ledeneva 2001) with a strong support of governmental redistribution, hostility towards entrepreneurship and private initiative (Voigt and Kiwit 1995; Brunner 1996, Latov 2003) and association of individual initiative with disorder (Rosenbaum 2001) at the level of the shallow institutions, as well as support of "shadow practices" and unproductive entrepreneurship at the deep level, which have dominated the whole economic system for decades (Kordonskii 2000, Timofeev 2000) and are still important for entrepreneurial activity, as well as for other aspects of life (Kliamkin and Timofeev 2000, Ryvkina 2001). Combined with (at least, possibly) intensive institutional competition, these features of the informal institutions yield the expectations for less efficient (in terms of transaction costs) outcomes of economic transformation. From this point of view one could expect, that at least in the short run informal institutions are more likely to counteract the emergence of demand for good institutions and, hence, influence negatively the outcomes of institutional competition.

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

The rivalry between states has different forms in an interdependent international economy – from traditional military conflicts to strategic trade policy and competition for larger share of global markets or for political influence. However, the most important factor is that a more efficient economy is crucial for development of this international influence in all cases. Transaction-cost-efficient institutions matter for economic growth and economic power. In the short term factors like natural resources may give countries with worse institutional frameworks additional competition advantages; but in the long term the role of institutions becomes more important. Therefore there is an impetus for institutional modernization even if there is no demand for better institutions (or demand for worse institutions) from bellow. The more intensive the international competition, the stronger is this impetus[2]. From this point of view the Schumpeterian (Schumpeter 1912) approach is especially interesting. Unlike the mainstream economics, it denies the dominance of the demand side over the entrepreneur. On the contrary, the entrepreneur is assumed to be able to create demand for his new product. Therefore political entrepreneurs practically „create institutions of markets" for unwilling peoples.

Interrelation between societies and economies is also a factor, which makes more efficient institutions important. An open economy is a significant source of external shocks in different forms, because government's ability to control cross-border transactions is limited. Obviously societies with overall lower costs of coordination and information transmission between interacting agents have a higher degree of adaptation and can better sustain these shocks. As informal institutions determine institutional choice at the level of formal institutions, societies with more efficiency-oriented informal institutions, higher institutional vertical trust and smaller gap between shallow and deep-level institutions have better chances to create institutional framework, which allows them to sustain volatility of an integrated economy. Therefore from this point of view of the Hayekian sociocultural evolution exactly these societies survive. Besides, invidious comparison is typical not only for governments, but also for individuals (that is the nature of what is called yardstick competition (Besley, Case, 1995) in economics and institutional isomorphism (DiMaggio, Powell 1991) in sociology). That is why cross-border flows of information can change people's attitude towards appropriate behavior schemes on deep and shallow level. Obviously, the opposite process of convergence of more efficient institutions "to the bottom" is possible, given the rent-seeking desires of elites even in the countries with relatively high quality of institutions and additional instruments obtained through the institutional competition (see Oleinik, 2007).

The influence of invidious comparison and external shocks can weaken the short-term negative effects of informal institutions for the outcomes of institutional competition. Any government in the multi-jurisdictional system has to deal with the problem of institutional modernization from the point of view of international competitiveness and to try to enforce (even with coercion) better institutions; because of the mutual interdependence of formal and informal institutions this politics in turn changes institution's perception. The sociocultural evolution in presence of external shocks also leads to diffusion of more efficient institutions. In the environment of institutional competition less formalized environment can even support the increase of quality of institutions: since for the change of informal institutions traditional political economy blockades do not apply, it is possible, that the informal rules happen to be even more flexible, than the formal ones. At least, this argument (flexibility of informal rules in an environment of institutional competition) is sometimes used to explain the rapid growth of the East Asian economies.

However, two factors run contrary to the possible long-term effects. First, due to diffusion of inefficient norms in a short term, there could be lack of efficient norms to imitate in the long term or the costs of imitation could exceed its advantages. A fundamental contradiction appears: without efficiency-oriented thinking, institutional competition leads to diffusion of inefficient institutions, without institutional competition and open economy efficiency-oriented norms' perception is hardly to appear. This issue does not seem to be crucial for the modern developing and transition economies because of the existence of the Western experience. However, at this stage cognitive problems occur. An example of the post-Soviet world could once again demonstrate this idea. Furman (1995) shows similarities between the development of the post-Soviet economy and politics and the ideological visions of a capitalist society, which dominated in the USSR. The reforms have unconsciously implemented a cartoon with corrupt parliament members and illicit business activity – as in the Soviet textbooks. Actually there is evidence that post-Soviet leaders really perceive Western societies using the "Soviet glasses" (see Furman 2004). Analogous misinterpretations can result from the short-term inefficient outcomes. This problem can be solved by long term learning process, but the temporal coincidence between this learning and the "long term" of evolution of informal institutions as defined above is ambiguous. Besides, implemented cartoons are also a source for learning – even a more important and visible, than foreign experience. As a result confidence in possibilities of import of institutions goes down.

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

It is even possible, that important institutions apparently similar to the original ones perform a completely different function. This situation may be called "institutional pseudomorphism" (Yevstigneev 1997). Woodruff (2000) discusses this problem, separating between the transactional and the judicial levels of market institutions in post-Soviet countries. His thesis is, that Russia's effort to complete integration into the world economy leads to creation of market institutions (like money or property rights in corporations) on the transactional level (where these rights are traded and exchanged), but the judicial level (where these rights may be executed, e.g. in form of participation in a shareholders' meeting) does not exist. According to Pappe (2000), a share in a Russian company means a claim, but not a guarantee of participation in the corporate decision-making. The institutions of "pseudomorphism" are "rules of the game" which contradict the "meaning of the game" and in that way destroy the game or change it so, that it becomes a new game with new rules (Sukharev 2004). Individuals sharing the institutions of pseudomorphism, begin to believe, that the formal meaning of these institutions and their real social function are always identical, and that is why mistrust any institutions with the same appearance (as post-Soviet citizen often mistrusts any election, any entrepreneurship or any post-Soviet integration projects). Institutional pseudomorphism, deficit of trust and misinterpretation of imported institutions can effectively block positive influence of invidious comparison and sociocultural evolution on informal institutions. Therefore inefficient outcomes of institutional competition can remain significant even in the long term. The initial state of informal institutions determines not only their short-term influence, but also paths of their long-term evolution. The lack of trust and systematic misinterpretation can ruin any attempts to get out the inefficient institutional equilibrium.

In the post-Soviet world the long-term factors influencing the changes of informal institutions seem to play an important role. The invidious comparison became especially important given the increasing political-economic competition between different (external and internal) agents for influence in the post-Soviet space. The social integration is obviously an important factor facilitating the yardstick competition in the CIS. Moreover, CIS countries form a "natural group of comparison" for experts, citizens and elites – due to their common past and common problems. In fact, one indeed observes strong reaction of post-Soviet countries on economic and political changes implemented by their neighbors. It is sometimes claimed that the whole modern Russian policy is motivated by the experience of Ukraine in 2004. However, crucial specifics of the invidious comparison yardstick competition are that the process is *not* asymmetric: on the contrary, recently Russia often reacted to changes in other countries. However, problems of institutional pseudomorphism obviously play an important role. Moreover, it is always questionable which agents are more likely to learn. One cannot exclude, that exactly the beneficiaries of transition rents learn faster to avoid changes potentially threatening their power position and rents. In fact, learning costs for relatively rich individuals seem to be lower, although the specifics of political regimes inverts this advantage (Egorov and Sonin, 2006). Recent theoretical work (Schnellenbach, 2007a) shows that individuals are often reluctant to invest their effort in learning about complex economic policies. Finally, barriers for learning (and capital movements) are endogenous. Darden (2001) shows that the membership of post-Soviet states in integration groups strongly depends upon the "economic ideas" dominating their elites (i.e., informal institutions). Hence, the groups of countries more likely to communicate with each other are already “sorted” according to the specifics of their institutions. From this point of view the first factor (absence of examples for imitation) can play a certain role.

## 5. Preliminary Conclusion

Summarizing the major points of the analysis above, the ability of institutional competition among jurisdictions to improve the transaction-costs-quality of the formal institutions depends upon the evolution of the rational choice motives for the demand for good institutions and interplay of formal and informal institutions. From the first point of view different countries of the CIS and corporations experience different patterns of development. However, in the resource-abundant CIS countries the effects of institutional competition are also limited by relative increase of power of “remaining” business groups. Empirical evidence seems to be mixed: while in some cases investments are associated with transmission of “best practices” and are attracted to locations with good institutions, other investment projects are associated with corruption and use of shadow practices.

If informal institutions are taken into account, in the short term perception of formal institution and of the government determines the institutional choice by private actors, which becomes more influential in the competition process. In the long term external shocks and invidious comparison may change the situation, but because of the effects of institutional pseudomorphism this positive effect can be limited. Therefore the institutional competition requires a system of informal norms regulating perception and valuation of formal institutions to be efficient. Otherwise institutional competition cannot improve the quality of formal institutions (measured from the point of view of transaction-cost efficiency) and even stabilizes inefficient equilibrium.

This nexus of formal and informal factors at least partly explains the failure of economic reforms in several developing and transition economies, e.g. the post-Soviet space. Unlike other studies, which focus either on internal factors of several countries or on interrelation between the these countries and the global actors, this paper tries to uncover the less discussed problem of interrelations in the whole post-Soviet space as a region consisting of a number of independent states with strong economic ties but uncoordinated economic policies. An advantage of this approach is that it goes beyond the standard thesis of “imperfect import of formal institutions” and “incongruence of formal and informal institutions”. The first approach focuses on rent-seeking behavior of bureaucrats and politicians, the second – on “resistance from bellow” to the new imported institutions. In the framework discussed in this paper these two points of view are combined: the egoistic behavior of incumbents is at least partly result of their participation in interjurisdictional competition, which in turn is determined by the informal institutions; the latter change in turn of the development of formal institutions and institutional competition in the long term.

## 6. Normative Implications

The normative judgments are very difficult, if perception of norms is introduced, because any assessments also depend upon valuation norms. From the point of view of Weber’s freedom from valuation of norms (*Werturteilsfreiheit*) principle (see Weber 1968), social sciences may not rank values or make any statements regarding their importance, e.g. if people prefer less efficient economy, it may not be (scientifically) characterized as “bad”. Therefore similar positive outcomes can be lead to different normative statements. In this section I am going to consider two alternatives of evaluation of institutional competition performance.

First, the most obvious way of working with the outcomes of the positive analysis is to use the problems of the "demand side" of the market for institutions as reference points to find out an "institutional corridor" of informal institutions, which could yield better outcomes in terms of formal institutions. Here several factors should be considered. From the point of view of rational choice perspectives, "institutional corridor" depends entirely on the evolution of the demand for institutions. There are several factors able to generate the shift from the demand for bad institutions to the demand for good institutions. One the one hand, the transition can be related to natural changes in economic environment (like need for replacement of assets or change of generations in the business management); however, important factors are increasing demand for stability from the business owners and the transnationalization of businesses (implying integration of the business elite in the international business community). Although internationalization alongside the old networks of the "all-union community of enterprises" or new clan economies hardly changes the behavior of businesses, their interaction with global multinationals and foreign investors can be instrumental for the establishment of the demand for good institutions (however, reservations from the point of view of negative convergence option should be taken into account). Moreover, the demand for good institutions increases in societies with lower concentration of economic power by a small group of businesses and the reduction of voracity effect: therefore effective antitrust policy combined with establishment of clear rules for market competition (along the ideas of the *Wettbewerbsordnung* of the German Ordoliberal school) should be an important factor supporting demand for bad institutions. Since learning costs accumulate over time, the timing of reforms becomes crucial. Finally, the relatively high role of resource extracting industries reduces the positive effects of institutional competition: hence, development of innovative sector and consumer services can be an important factor of transition.

If informal institutions are taken into account, a central factor in the success of the institutional competition as instrument of ameliorating the quality of formal institutions is the development of vertical trust in the competing jurisdictions. Trust is crucial for short-term effects of institutional competition. It also prevents formation of long-term pseudomorphism effects. This feature is similar to the ordinary markets, where deficit of trust and information asymmetry lead to inferior outcomes, when all actors assume the opportunistic behavior of opponents and lack of ability to prevent or control it). That is exactly what one can see in the post-Soviet world. In the international economic relations due to (systematically) higher transaction costs the development of trust could be a more difficult task, than within national borders. Economic integration could theoretically act as an instrument of trust creating and signaling (see Fernandez Portes, 1998), but in the post-Soviet case the pseudomorphism effects also dominate its institutions. An alternative, available only for limited number of countries in a very long term, theoretically could be the EU accession, but its prospects remain now unpredictable. Therefore trust is till the most important factor for post-Soviet transformation. The second factor of critical significance for (especially) short-term and (partly) long-term effects of institutional competition is the acceptance of market order of worth for evaluation of government-business and government-society relations. It does not mean, that the market conventions should play an exclusive role in this sphere; however, if their influence is insignificant the chances to improve the quality of institutions via institutional competition are low. The third (long-term) factor, which could be important from the discussed point of view, is the intensity of "invidious comparison" (on both governmental and social levels) and of external shocks. If these factors are significant, the pressure of modernization necessity and sociocultural evolution is stronger. The increasing intergovernmental political rivalry in the post-Soviet space in the recent years 2004 and 2005 could be therefore a positive factor influencing the results of institutional competition in this region.

However, this "efficiency-oriented" approach has certain important drawbacks. Firstly, it is questionable, whether the economists may derive values for their analysis (e.g. transaction cost efficiency) from theoretical constructions if they do not have anything in common with dominant social values of the population. The *Werturteilsfreiheit* thesis states that it is important to distinguish between the values of economic efficiency as applied by the researcher just to measure and to compare different economic institutions, and the values of population and of politicians underlying their real action. In the social world there is no clear gap between the observer and the observed object, as in the natural sciences, but the social scientists still have at least to try to achieve a higher degree of objectivity (Wallerstein 1974). It is reasonable for the positive analysis: the main expectations from the institutional competition are connected with improving the transaction cost efficiency; therefore exactly this aspect is to be discussed more closely. Nevertheless, the *normative* significance of these statements is questionable.

Secondly, the efficiency measure of reduction of transaction costs as indicator for quality of institutions is also ambiguous. It is clear, that sometimes institutions have an ambiguous effect on transaction costs or even reduce costs of transactions for within a given group increasing them for the transactions between these individuals and the rest of the world. Furthermore, there can be no "ideal" institutional frameworks, and each nation could develop its own "comparative institutional advantages" (Hall, Soskice, 2001) to meet specific culturally and historically embedded expectations of its people. Finally, economic opening out and multi-jurisdictional environment support policy diversity due to these comparative advantages. (Franzese, Mosher 2002). So, for example, lower entrepreneurial activity and higher redistribution do not necessarily represent lower efficiency. That is exactly the issue of the Varieties of Capitalism literature, which claims, that different combinations of institutions may produce efficient organizations of society due to institutional complementarity effects. From the point of view of this approach, the absence of "diffusion of efficient norms" as described in the previous sections, does not really represent any drawback for economic development, but just the normal case of differences among institutional frameworks.

The limitations of this approach are rather of a specific, than of a general nature. The Varieties of Capitalism approach was originally developed to deal with different paths of developed countries (e.g. Rhine capitalism vs. Anglo-American capitalism etc.). In case of transition and developing economies (like the post-Soviet space) it is still possible to argue, that there is a generally higher level of transaction costs in economy, which leads to important problems (associated with poverty, lower growth etc.). Moreover, absence of certain market enabling institutions makes the functioning of *any* capitalism in these countries impossible or leads to what may be called "pessimistic equilibrium" based on mutual mistrust (Oleinik, 2005a). A certain "transaction-cost quality" of institutions is sill needed for markets to function. From this point of view the issue of institutional transfer remains important for these countries, i.e. the convergence of institutions is still important. Therefore the quality of institutions in terms of transaction costs should be discussed. Moreover, even despite the demand for bad institutions by the majority of population of these countries, its peoples still do not accept the existing equilibrium (and the recent events in Ukraine demonstrate it excellently). Thus the problems of applicability of institutional competition as instrument of developing more efficient institutions are still relevant. Nevertheless, even if case of the post-Soviet world the issues of the Varieties of Capitalism are important, in particular because they focus on possible specifics of potential models of capitalism in the transformation countries. It is not sufficient to evaluate changes just by comparing them with given set of “ideal institutions”, it is rather helpful to focus on internal interrelations and effects of the evolving set of institutions. Furthermore, alternative orders of worth can be important, especially in the public sphere.

Finally, it is possible to take the Schumpeterian perspective and argue, that the problems of the demand side are actually omnipresent in economic and social life. Thus activity of the supply side, i.e. of the political entrepreneurs is able to challenge the inefficient equilibrium, even without any effort of the demand side. By applying this approach it is especially important to understand, that the political entrepreneurs “creating demand” by “offering supply” of new institutional sets are not limited to current political and economic elites. They could also include NGOs and opposition parties, as well as other social structures. However, Schnellenbach (2007) claims that the Schumpeterian entrepreneur is an extremely rare occurrence in political system, which is more likely to be dominated by path dependence preferences. Does the current wave of rapid political changes in the post-Soviet world including Georgia, Ukraine and the Kyrgyz Republic or attempts of catching-up economic reforms without political changes in countries like Russia or Kazakhstan represent this Schumpeter-type effects? This question requires further careful discussion and observations, and the answers will obviously differ from country to country.

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