



Associazione Studi e Ricerche
Interdisciplinari sul Lavoro

Working Paper n°2/2012

**FORMAL AND INFORMAL INSTITUTIONS: TOWARDS A BETTER UNDERSTANDING OF A
COMPLEX RELATIONSHIP. SOME CASES IN THE LABOUR MARKET.**

Sebastiano Fadda

Anno 2012

ISSN 2280 – 6229 -Working Papers - on line

ASTRIL (Associazione Studi e Ricerche Interdisciplinari sul Lavoro)

I Working Papers di ASTRIL svolgono la funzione di divulgare tempestivamente, in forma definitiva o provvisoria, i risultati di ricerche scientifiche originali. La loro pubblicazione è soggetta all'approvazione del Comitato Scientifico.

esemplare fuori commercio
ai sensi della legge 14 aprile 2004 n.106

Per ciascuna pubblicazione vengono soddisfatti gli obblighi previsti dall'art. 1 del D.L.L. 31.8.1945, n. 660 e successive modifiche.

Comitato Scientifico

Sebastiano Fadda
Franco Liso
Arturo Maresca
Paolo Piacentini

REDAZIONE:

ASTRIL
Università degli Studi Roma Tre
Via Silvio D'Amico, 77 - 00145 Roma
Tel. 0039-06-57335751; 06-57335723
E-mail: astril@uniroma3.it
<http://host.uniroma3.it/associazioni/astril/>

**FORMAL AND INFORMAL INSTITUTIONS: TOWARDS A BETTER UNDERSTANDING
OF A COMPLEX RELATIONSHIP. SOME CASES IN THE LABOUR MARKET.**

Sebastiano Fadda

Contents:

1. Redefining Institutions.....	4
2. Formal and informal institutions.....	8
3. The evolution of economic institutions and the interplay between “formal” and “informal” ones.....	10
4. Some cases in the labour market.....	19
5, References.....	24

1. REDEFINING INSTITUTIONS

This investigation that we are going to start requires a clarification of the concept of economic institutions. None of the prevailing definitions can account for the empirical evidence that “similar rules can create different behaviour and outcomes” (Eggertsson, 1990) and that similar behaviours can come out of different rules (as many features of transition economies are able to show). A definition consistent with such empirical evidence may be one that refers to economic institutions as *actual (and relatively stable) patterns of behaviour of economic agents (considered as individual or as organisations) shaped by rules and provided with sanctions* (Fadda, 2000).

The most current definition refers to institutions as “set of rules” that structure social interactions in particular ways¹, and they are often seen as “constraints” to the maximising behaviour of economic agents. It is certainly true that “new institutional economics”² is not at ease with the rational choice maximising behaviour, which implies perfect information and no transaction costs nor uncertainty. In fact, the model of bounded rationality and satisficing behaviour looks more appropriate in order to host an institutional approach. Nevertheless, it is more appropriate to consider institutions not just as constraints, but as forces which set an altogether different process of decision making. Both for individuals and firms, saying that their choices are shaped by institutions means above all that institutions generate new parameters for decision making, they define new processes of choice, and not just introduce additional elements of knowledge and constraints in the same, universally valid, decisional maximising or satisficing process. “When observing concrete behavioural events, institutional economists see economic agents first and foremost as socially conditioned beings, as members of groups who evince habits of mind and patterns of behaviours reflecting *the actual “web of rules” (both formal and informal)* patterning group life within the concerns of which they are a member. That is to say, institutional economists perceive an economy populated not by “economic man”, but by “socio-cultural man” (Ramstad, 1993).

The ability of institutions to determine *what individuals want to achieve* is of paramount importance, particularly with reference to developing countries, and can be considered strictly tied to the notion of capabilities put forward by A. Sen.(1997) Choices are determined to a large extent by what we want to do, and this is determined by capabilities, which therefore are to be considered as part of the institutional set up.

¹ Knight (1992): “institutions are “sets of rules which structure social interactions in particular ways. For a set of rules to be an institution, knowledge of these rules must be shared by the members of the relevant community, or society” (p.3). D. North (1990), p.3, says that: “Institutions are rules of the game in a society, or, more formally, are the humanly devised constraints that shape human interaction”.

² See, on the topic, Dugger (1990)

Another limit of the prevailing views about institutions is that they are seen as “transaction costs minimising devices” (for instance, Nugent J. 1989, but also North 1990 and 2005). Actually, they don’t need to be so. Transaction costs reduction (let alone minimisation) is not what institutions are for. Such a cost reduction may be a by-product of behavioural expectations created by routines, or institutions, but their “raison d’etre” lays in their ability to obtain satisficing results with reference to a wide range of parameters (which could be: power, prestige, wealth, approval, and so on) even at the price of being “inefficient” as far as transaction costs are concerned. Because of the variety of parameters which individuals use in order to evaluate the “satisficing degree” of their routinised behaviour, institutions cannot be considered as pursuing (either by evolution or by design) a transaction cost minimisation objective.

Quite opposite, it depends exactly on the very institutional set up whether or not transaction costs reduction is the target of individual and firm’s action. Parental chains, for instance, or rent seeking activity, or power, could shift the targets of action towards other directions. It is institutions that determine whether transaction costs or other elements are relevant in shaping the organisation of production and exchange, and not viceversa.

Still more, the very idea that the emergency of firms is grounded on some sort of transaction costs market failures, is deeply questionable in itself, both because productive efficiency of firms can be raised through other means³ and because the factory system might as well persist although inefficient if the institutional structure allows it to exist in order to let people in *power* gain at the expense of others⁴. Also, the dichotomy between market regulation and hierarchical regulation based on the comparative efficiency of an extra transaction taking place within the firm or in the market, has to be overcome. First of all, because there are elements of hierarchy in capitalist markets (*power*, for instance, and not only *market power*) and elements of market in hierarchies (consider a firm in a tense labour market); secondly because a plurality of regulation models and inter firm co-operation models take place in the real world⁵.

In conclusion, economic institutions have to be freed from the character of external constraints to maximising behaviour and have rather to be considered as patterns of behaviour having nothing to do with the rule of maximisation.

³ For instance, specialization, continuity of association, direction (Demsetz H.1974) or coordination and motivational elements (Simon H. 1991), or by mere virtue of the “authority” of the principal (Pitelis C. 1993), and other elements stressed by evolutionary theorists of the firm.

⁴ See with regard to this aspect the well known Marglin, 1974

⁵ See Powell W. 1990 and Elg U., Johanson U. (1993). See also: Lundwall B. 1993,

Economic institutions are patterns of behaviour actually felt as “rules” by economic agents⁶ in their productive and exchange relationships. These “rules” can derive from a great variety of elements. Power could be one of these elements. Friendship, group or clan loyalty, tradition and many other motivations can be the driving forces of choices and of the decision making process of individuals. When sets of rules are bounded together and are followed by a set of agents which acts economically as a single agent, we have organisations. Organisations can therefore be considered as sets of institutions.

Productive activity, economic exchanges, access to economic resources and distribution take place according to these rules.

It is clear then that rules can be called “institutions” only in so far as they actually shape the patterns of behaviour of agents. This qualification allows us to overcome the definitional distinction (or opposition) between institutions as “rules” and institutions as “patterns” of behaviour. A pattern of behaviour which does not conform to rules cannot be called “institution”, and on the other hand sets of “rules” which do not give rise to patterns of behaviour are not to be considered institutions. We could define therefore institutions as “*patterns of behaviour shaped by rules provided with endogenous sanctions*” (Fadda, 2002). The stress being on the *pattern*, rather than on the *rules* that shape it.

The main implication of this definition is that institutions do not pre-exist to economic systems, they are not superimposed to markets or whatever mechanism of co-ordination of economic activity. They are “humanly made” within the economic systems, They are *the actual way* in which the economic system works, *the way* in which economic activity is organised, *the way* in which economic exchanges take place, *the way* in which agents are co-ordinated. They are not the “rules” of the game; they are “the” game, which would not exist without a set of rules.⁷

We can also conceive institutions as co-ordination mechanisms, in so far as they express the rules followed and applied by economic agents, but without attaching to this “coordination” any specific aim or target, such as transaction costs minimisation, or productive efficiency increase, or macroeconomic equilibrium generation, or anything like; in fact they might as well fail to co-

⁶ This may be considered equivalent to the notion of “rules actually followed by agents”: “a social rule (which) cannot come into existence except if shared by a group of agents”, W. Elsner (2009), although I put the stress on the pattern of behaviour rather than on the rules that shape it.

⁷ in this sense, J.H.Searle, (2005): “Driving can exist without the regulative rule requiring right or left; the rule regulates an antecedently existing activity. But chess cannot exist without the rules, because behaving in accordance with (at least a sufficient subset of) the rules is constitutive of playing chess” (p. 9)

ordinate economic activity to any of these ends. If one scope could be envisaged for institutions, it would be to define the structure of power *relationship*.⁸

The above definition helps us to disentangle from frequent confusions which can be found in statements as the following:

“Even when the rules of institutions are the same, the enforcement mechanisms, the behavioural norms, and the ideology of the actors involved in these institutions may well differ in subtle but important ways, making for considerable variation in the effectiveness of institutions”⁹

This statement seems to be based on a false distinction between institutions as set of rules and patterns of behaviour as something different from institutions. When the author of the statement speaks about the possibility of “behavioural norms” being different from institutions and making for different effectiveness of institutions, he is viewing institutions as a mere set of rules; which can obviously be either effective or ineffective. But talking of “ineffective” institutions is a contradiction in terms if institutions are, according to our definition, considered as the actual patterns of behaviour. What may be ineffective are the rules, but rules are not, as we have said, by themselves “institutions”.

Where the above confusion probably comes from is simply the fact that in some cases institutions (that’s to say the actual patterns of behaviour), are based more on informal than on formal rules.

When economic institutions are conceived as “actual patterns of behaviour of economic agents shaped by rules” they in fact can be conceived as sets of routines. Routines are actually standardised sequences of actions that economic agents put into being when faced with problems to which they must give an answer with their behaviour. Some of them have the force of an implicit contract, some are codified in contracts, some carry the force of law; most do not, but nevertheless, for several reasons, routines have stability, as Nelson and Winter have shown in their work (Nelson, 1982).

Let us recall now the main implications of the above definition:

In the first place, institutions, or routines, are actually substitutes for, and not constraints to, rational choice: they can provide “satisficing”, rather than “optimising” results (and as long as they produce “satisficing” results they are able to last).

Secondly, transaction costs reduction (let alone minimisation) is not what institutions are for. Such a cost reduction may be a by-product of behavioural **expectations** created by routines, or

⁸ “The essential role of human institutions and the purpose of having institutions is not to constrain people as such, but, rather, to create new sorts of power relationships”, *ibidem*, p. 10

⁹ Nugent, 1989, p.2312

institutions, but their “raison d’être” lays in their ability to obtain satisficing results with reference to a wide range of parameters (which can be power, prestige, wealth, and so on) even at the price of being inefficient as far as transaction costs are concerned. Because of the variety of parameters which individuals use in order to evaluate the “satisficing degree” of their routinised behaviour, institutions, routines, norms cannot be considered as pursuing (either by evolution or by design) a transaction cost minimisation objective.

In the third place, routines represent a saving device on learning, both of individual and organisations. Rather than going through the lengthy and complex process of acquiring and elaborating information in order to invent each time the appropriate strategic behaviour when faced with different contingencies, following the pattern of behaviour traced by routines allows the use of a tested shortcut in order to obtain a satisficing result.

Finally, routines may be considered as influenced in their origin (and also in their persistence? This is one of the problems we are going to deal with later) by values, in so much as these are relevant in the cognitive process out of which routines emerge.

This final statement contains two new concepts which are relevant for the dynamics of change: cognitive processes and values. but before dealing with them it’s necessary to introduce another element: the distinction between “formal” and “informal” institutions.

2. “FORMAL” AND “ INFORMAL” INSTITUTIONS

Here we come to the second qualification concerning the definition of institutions. Economic institutions are actual patterns of behaviour of economic agents (individual or organisations) shaped by rules provided with endogenous sanctions. The question is: what kind of rules?

The answer cannot be but: all kinds of rules, in so much as they are shared, or, in any case, followed by a group of agents. Therefore, what lies behind institutions is a combination of different sources of “normative power”. The distinction between formal and informal sources may be accepted for matter of convenience, in order to separate the ones which originates from legal, administrative bodies and are therefore codified in bills, laws and official acts, from those which do not. But no substantial differences exist in the structure of their functioning. In fact the ones which are not codified in laws may in some cases have also a very formal structure (think of religion, or church, think of mafia with his rigid formalised structure, think of political parties and their agreed ways to sharing access to economic resources...).

The distinction made by Rawls (1955), according to which the violation of formal canons invites punishment while the violation of informal ones only invites disapproval, does not seem to hold if we think, for instance, of mafia or of some family systems in which punishment follows disapproval, or of some retaliation mechanisms in oligopolistic game behaviour; and, besides, disapproval may be a form of punishment in itself.

Enforcement cannot either be considered as a distinctive feature (Kandori,1992) mainly because the so called “informal” institutions might be accompanied by much more effective enforcement procedures than the formal ones (for example, enforcement of the formal norms in the field of tax evasion is much weaker and less effective than the enforcement of informal norms regulating racket payments tailored according to actual income.) and secondly because the very notion of enforceability is in itself intrinsically tied to the notion of “institution”, being an essential component of it. If we have a “rule in form” which is not a “rule in use” (Ostrom 2005) we can hardly consider it as an institutional feature.

Patterns of behaviour (institutions) are therefore shaped by a bundle of norms, whose interplay can take several forms. Holding to the distinction between rules with a formal base and rules with an informal base we could have at least these possible combinations:

- formal and informal rules perfectly coincide;
- formal norms prevail over informal, in the sense that the patterns originally based on different informal rules are either modified by formal rules or are considered illegal and repressed successfully;
- informal norms prevail over formal ones, in the sense that patterns of behaviour are actually shaped by informal norms, and either these are bound to influence and modify the formal ones or simply they coexist, with the latter being ineffective. The enforcement of formal norms can in these cases be either too costly or impossible.
- finally, informal norms may simply parallel formal ones, filling spaces that are empty and actually shaping patterns of behaviour that are not regulated by formal sources, as it is often the case in developing countries.

The relative weight of the two different sources, formal and informal, in influencing and shaping the individual and collective behaviour essentially may be considered as depending on the pay offs associated to each of the different norms. In this sense it all depends on the relative strength of penalties and rewards, and in this sense the whole institutional structure may be viewed, as D. North does, as a system of incentives and disincentives, provided it is clear that all these come up from different sources of “normative power” and not only from official, or formal, ones.

The main implication at the empirical level is that when comparing institutions, or when correlating institutions to economic performance and economic development, we cannot simply refer to formal rules. We must refer to *patterns of behaviour* as determined by the combination of formal with informal rules. For instance, one thing is to measure the international openness of a country by looking at the behaviour of exporter and importer, another thing is to do it by looking simply at the rules of liberalization. With the latter we have a measure of potential openness, with the former a measure of actual openness.

Corruption is another example. It could be a break of the rules, but in some cases it may be a stable institutional feature as long as it is a standard behavioural pattern shaped by informal rules.

Failure to take account of the difference between rules and patterns of behaviours may be very misleading when comparing institutions, and could make impossible to derive from such comparisons any indication about the changes required to foster economic development.¹⁰

3. THE EVOLUTION OF ECONOMIC INSTITUTIONS AND THE INTERPLAY BETWEEN “FORMAL” AND “INFORMAL” ONES

a) Stability of institutions

Tracing the origin of a current institutional structure is not an easy task, since it is the result of an historical process of evolutionary kind that doesn't allow for a deterministic chain of causality, and it's beyond the scope of this essay,

Surely three factors play a decisive role in this process:

- a) the state of technology
- b) the relative *power* position of various groups of agents
- c) values and “beliefs”

¹⁰ A comparison between Russia and China is a case in point. “China still retains a socialist legal system while Russia has a regime of private property rights in place. Despite the absence of formal private property rights, Chinese entrepreneurs have felt sufficiently secure to make large investments. In Russia, by contrast, investors have felt insecure, and private investment has remained low...despite a formal legal regime that is much more in line with European norms than China”. Rodrik D., Subramanian A., Trebbi F. (2002)

Whatever their historical origins, once established, institutions model from the roots the behaviour of agents, structure their life, and tend to persist. Institutions are not ends in themselves, but means to reach social goals. As long as they are “efficient” their permanence is self sustained; when they become “inefficient” they become candidates for change.

But the notion of “efficiency” has not to be understood “a la North”. Rather, institutions have to be considered efficient as long as they are able to provide satisficing results for the dominant group of agents in a variety of targets, among which transaction cost minimisation can be but one of the lot. If other targets are satisfactorily reached, the institutional structure can persist stable in spite of being “inefficient” under the transaction cost criterion. Still more, it could even persist in order to be inefficient in that sense. In this way a new category, *power*, enters not only in the determination of stability, but also in the definition of “efficiency” of institutions.

Something on this line seems to be found in the following statement: “Institutions are prescribed or proscribed patterns of correlated behaviour and attitudes that coordinate life in community. They specify – as codes, rules, laws, customs – what can and cannot be done. When these prescriptive arrangements are perceived as failing to provide adequately for the flow and quality of real income, given the level of understanding evident, the community has a problem. Resolution of the problem consists of recasting that part of the institutional structure understood to be the source of the impairment”. (Tool, 1993, pag.122).

Of course it is important to establish the characteristics of the group of agents for which the results are “satisficing”. It could be the “majority” of the community, it could be the ruling class, it could be the groups that hold economic power. (Knight 1992, Levi 1990, Fadda 2000).

b. Prevailing explanations of institutional change

We shall briefly consider now some of the main approaches to the explanation of institutional change.

The first approach is based on the principle of competitive selection. This approach can be attributed to North and Williamson. According to it, a process of competitive selection will eliminate inefficient institutions which will be replaced by efficient ones. Changes in relative prices (or, possibly, changes in tastes) would be the main factor capable of turning an efficient institution into an inefficient one. Here the notion of efficiency is strictly related to minimisation of transaction costs. Apart from the lack of structural explanation provided for the factual persistence of inefficient institutions which they admit (should it be attributed to “external” “institutional” factors which interfere with free competition among “institutions” we would come back to the problem of

defining institutions), the very notion of efficiency based on the view of institutions as maximising or optimising devices makes this approach unconvincing. Neither the origin of institutions nor their stability seem, as we have already mentioned, to be linked to this notion of “efficiency” of institutions.

A second approach relays on the notion of path dependency. “Lock in” and “path dependency” belong to the category of self reinforcing mechanisms which are typical of evolving complex systems. These mechanisms fit well with the evolutionary view of the economic process and are found in authors such as Arthur, Winter, Nelson. They can also be traced in Veblen, who “viewed institutional change as a continuing process. At any point in time the institutional structure is composed of habits of thought and behaviour that emerged from earlier adaptations to changes in the objective circumstances of the community. Institutions of the present period are, therefore, determined by past patterns of adaptation. Consequently, the institutional structure is always in a sense obsolete with respect to the current technological situation, and further adaptations are required. But the adaptation itself produces a new set of circumstances that requires further adaptation and so forth.” (Bush, 1994)

A third approach (Schotter 1986, Sugden 1998) sees rules and institutions as equilibrium solutions to repeated games. According to this approach, institutions are not “sets of predesigned rules, but rather unplanned and unintended regularities of social behaviour (social conventions) that emerge “organically” (to use Menger’s term). “Institutions are outcome of human action that no single individual intended to occur”, and “the important point to realize is that rational social agents, through a process of individual utility maximisation, can evolve sets of rules by which to conduct their lives” (Schotter, 1986). A flavour of Veblen’s and evolutionary approach can be found in this view. But there are some significant differences. First, the aggregate outcome is still seen as the result of “a process of individual utility maximisation” (which implies perfect rationality and perfect information); second, the view of institutions as equilibrium solutions to repeated games faces the well known problem of the existence of different, and some Pareto inefficient, equilibria. But the crucial point is that this view doesn’t make it easy to explain change: preferences are taken as given and so is the connection between possible behaviours and pay-offs. If we allow for agents to have only a fuzzy knowledge of this connection we must resort to some memory and expectations derived from past experience, if we assume perfect knowledge of clear-cut connections, than we must consider them, in the same logic, as the result of previous games. In the first case we run into problems of cognitive nature, in the second we face what Hodgson calls “a problem of infinite regress”.

A fourth approach is that of “propagation process” (Witt, 1989), which is actually an extension and a generalisation of the game theory approach, with the addition of interdependence among the agents. Through an analysis of the different kinds of interdependence, the case is put forward in which the conflict between interests of individual agents does not allow for an unintended institution to be created or maintained; in this case some form of organised collective action becomes necessary.

The last approach that we take into consideration is the one of “institutional design”. According to this approach, institutional change is the result of a kind of social engineering that plans, designs and imposes a set of rules (and therefore institutions) to a society of individual agents. The theoretical and implementation problems posed by this approach are enormous: they range from the choice of the appropriate institutional arrangements capable of getting the desired outcomes in terms of conduct of agents and economic performance (Hurvitz 1979, Schmiebler 1980), to the problems of actually replacing old institutions with new ones (Croskery 1995, De Bruijn 1995). There may also be the problem that “the rule makers lack the knowledge of the social technology required for making the desired reforms” (Eggertsson, 2009). Since “actual institutions” are not simply the set of designed rules but the result of the combination between these and social norms of informal nature, it is true that this approach may boil down to “designing a game of “game form” for social agents to play”, where “the question is: what is the best game (or institution) to have people play so as to satisfy some exogenous given objective function?” (Schotter, 1994 *Ullman*). This shows some similarity with the second approach previously mentioned, but the similarity ends here, since according to this view the emergency of norms, or institutions, is stimulated, anyway, exactly by a “set of predesigned rules”.

As it can be seen from this short exposition, all these approaches do not say much about the origin of the impulse that sets in motion the process of institutional change. Quite often reference is made to adaptation to “changing conditions”. It is certainly true that, as Nelson puts it, “customs, standards and routines almost all change over time as *conditions change and require some adaptation*” (Nelson, 1994, p.251) and that institutions can be considered as emerging from adaptation to “*objective circumstances*” (Veblen, in Bush 1994) , but the relevant point is exactly to identify *what* are these “objective circumstances” and *how* they operate in order to set in motion the process of change. This is the question that has to be examined if a full understanding of the dynamics of institutional change has to be reached and if guidelines are to be found for a policy directed to obtain changes in economic institutions.

The above approaches provide some possible interpretations of the mechanism through which the process of institutional change goes on once it has been started, but not of how it starts. Perhaps one can trace in them two elements which may be considered as triggers of the process of institutional change. One is the change in relative prices, stressed by North; the other is technical progress, along Veblen's suggestion. But both of them are sharply exposed to crucial objections. Changes in relative prices need not be considered the triggering element if maximisation is not assumed as the foundation of agents' behaviour (in addition, changes in relative prices might also be viewed as consequences of changes in preferences); technical progress is surely one of the most relevant triggering elements, but it needs qualifications: in particular, it cannot be considered as exogenously given.

According to the view that we are suggesting in this paper, the fact which calls for replacement of current institutions is their inability to provide "satisficing results" for the group of agents which is in *power*. This inability may occur as a consequence of four main facts:

- *changes in available technologies* (for instance, steam engines, transports, information and communication technologies). No doubt the diffusion of steam engines, the evolution in transport technologies, the progress in information and communication technologies provide the case for inability of old routines to get satisficing results; but it has to be noted that historically the evolution of technologies has been strongly influenced by the interest of dominant groups, rather than being an autonomous self-sustained process¹¹.

- *changes of the groups in power*, that is a change in the balance of power, or a change in coalitions, be they brought about by democratic processes or by violent events like revolutions or coups.

- *changes in interests* (let us not introduce preferences for the moment) that may occur within the same existing dominant groups. All of these cases provide a change in the perception and in the framing of new problems and therefore call for new patterns or behaviour, new routines, new institutions.

- a fourth starter of a process of institutional change may be found in the *change of values* (Fadda 2002). which can inspire both an activity of "institutional design" or a change of rules of informal nature.

When the more powerful groups are set in motion to introduce new behavioural patterns and new rules in order to pursue their interests, two cases may be distinguished. The first one is when a

¹¹ Several studies (Marglin, Bloch, Braudel) follow this view.

change in the balance of power among the groups has taken place; the second is when the same power group readjusts the institutional set up in order to better pursue its new interests.

The first case, when considered in the frame of democratic systems, opens the problem of how a change of the groups in power may occur¹²; the second leaves two possibilities open: either the existing dominant group acts on its own impulse after realising that new contingencies require more adequate institutions to pursue its interests, or it is forced to “negotiate” new institutions by the contrast with the informal norms accompanied by an unbearable cost of a coercive maintenance of the old institutions.

In both cases these processes are complex and are marked by deep conflicts between those who are “to gain” from the change (and therefore work to favour it) and those who are bound to lose from it (and therefore resist it).¹³

The building of new institutions can therefore either emerge pragmatically as unintended result of self interested interactions, or be the planned result of intended actions. The former has more to do with the informal dimension of institutions, the latter more with the formal one, although this distinction is subject to those qualifications which have been mentioned above in this regard. In any

¹² As Ayres puts it: “The essence of democracy is not the fact of majority rule, but rather the process by which majorities are formed”, Ayres (1971). Great attention to this kind of problems is given in: Foster J. (1991)

¹³ This statement might give the impression of a tautological reasoning of the kind: “existing institutions are the most convenient, if they change, that means that convenience has changed”, which reminds of Matthews’s statement: “at any given time institutions are about as efficient as they can be” (*The economics of institutions*) p.907). Actually, it is not so, if we consider that in this view *convenience* is a measurable concept based on the present value of future gains originated from the change, with reference to different agents or groups, and that its evolution depends on several factors such as distribution of power, information, new technologies, and so on. Nevertheless, more precise measuring techniques have to be elaborated. On these lines see: Knight J., *Institutions and social conflict*, Cambridge U.P., 1992 and Levi M. (1990), For a formal treatment which may be considered not distant from this approach, see also: Hurwicz L. (1987), Justin Lin (1999).

case, this process implies an inventive capacity that from a cognitive point of view corresponds to a “creative” activity based on a process of the “problem solving” kind.

This process of change goes on through a combination of the following three passages. The *subtraction* of old elements (some particular institutional arrangements are dropped), the *addition* of new elements (new arrangements are inserted in the old institutional structure), the *permutation* (the nexus, or the sequences, or the relationships between the elements of the institutional structure are changed). These passages take place in course of time, through a complex interaction between agents, who slowly modify their behavioural patterns, and, as it has been said, in a variety of interactions between formal and informal forces.

As far as the role of values is concerned, this has to be viewed within the chain: “values → attitudes → knowledge → patterns of behaviour” (Fadda, 2002)

Values stand behind attitudes in the sense that they are the cultural base on which attitudes are founded (Churchland, 1995). Values are standards of judgement, or, as Sen puts it, preferences, tastes, of “higher order”. They can also be considered as structured sets of conceptions which are transmitted historically and through which men communicate and develop their knowledge. Being so, they function as guidelines for the formation of attitudes, which in turn influence the accumulation of knowledge by inspiring the encoding and the memorisation of information. Finally, knowledge is the basis on which routines are created and behaviour is shaped (Fadda, 2002)

A temptation at this point may arise to treat values as preferences, and therefore to assign to a set of values the same role of a set of preferences, which through indifference curves allows the individuals to make rational optimising choices. But it need not be so. In the neoclassical paradigm preferences are considered as given, and this may make them look similar to values and generate some confusion. It must be observed, though, that it’s not possible to consider values as arguments of an objective function as it is for preferences, because values and preferences belong to different planes. Values are on a higher plane. In fact, the behavioural rule of utility maximisation through a utility function itself has to be considered as belonging to the plane of values, and therefore values cannot be the arguments of a utility function.

Besides, and more fundamentally, preferences cannot be considered exogenously given in the economic system. It would be impossible for the individual to have a given knowledge of the sets of preferences relative to every possible single binary set of goods, nor for the entrepreneur to know all the details of its production function. As a matter of fact the information is not only limited, but also, not surprisingly, derived from experience and in this case “preferences, rather than determining choice, may be a product of the process of choice” (Loasby, 1999; see also Mistri

2000). When this is applied to institutions, preferences must be considered endogenously produced by the pay offs obtained by the agents from their behaviours (Bowles 2004). Values, on the contrary, can be considered as directly influencing decisions and choices through the above mentioned consequential chain.

Everybody can see the relevance of this point for less developed economies; development theories themselves are fundamentally influenced by values (Myrdal, 1968, Sen 2001).

Once the chain “values - attitudes - knowledge - patterns of behaviour” has produced its effects under the stimulus of new contingencies (coming from some of the reasons mentioned above), old institutions (or elements of them) are replaced by new ones. That is because, to use Sugden terminology, “conventions and norms evolve together, with the result that people come to believe that they ought to act according to those conventions that have become established.” (Sugden, 1999). Sugden arrives at this conclusion assuming that current norms are explained by evolutionary game theory and that much in the same way their evolution has to be explained. But we can maintain that new patterns of behaviour become routines, and therefore new institutions, even if the creation of norms follows a path which is not a game theoretic one. A path of “problem solving” has cognitive implications in which past experience and mental models play a fundamental role¹⁴. If we suppose that values are connected with these mental schemes, then values are brought into play as forces capable of influencing and orienting the process of formation of behavioural norms.

c) The interplay between formal and informal

Since in the process of establishing new “prescribed patterns of behaviour” (that is how new institutions come into being), as we have already said, formal and informal forces come into play. An interaction between the two arises, which is open to evolution towards different final results. In fact, the process may take one of the following turns:

- Formal and informal norms and institutions perfectly coincide. In this case no conflict arises: the actual patterns of behaviour, that is the actual set of interactions between agents, are regulated by the formal systems of rules, and they evolve simultaneously.

¹⁴ Mental models were first analysed by Bartlett (1932, 1958); they are also referred to by North (2005)

- Formal and informal norms diverge, but the first prevail over the latter. In this case in the process of time either the informal norms undergo a change and adapt themselves to the formal ones, or they become illegal and are successfully repressed.
- Formal and informal norms diverge, but the latter prevail over the formal ones. In this case the patterns of behaviour are actually shaped by informal norms. In the process of time either the formal norms adapt themselves to the informal ones or they simply coexist, with the formal rules remaining unapplied: their enforcement might be in these cases either too costly or simply impossible;
- finally, informal norms may simply coexist within a frame of formal ones, filling spaces that are empty and actually shaping patterns of behaviour that are not touched by formal forces.

In this process of evolution of institutions, institutional design for innovation may be activated. But the actual institutional structure does not necessarily correspond perfectly to the one which has been designed. Actual patterns of behaviour may differ from patterns designed by formal rules.

In conclusion, a change in values is a sufficient condition for the change in institutions provide it affects the social and economic forces which, given the balance of power, are capable of implementing it. In any case a change in value is a strong incentive toward institutional change, but it is not, by any means, a necessary condition. Institutions may change through the process that has been described above, even when values remain unchanged, when new situations appear which make existing institutions “inefficient” in the above sense . Unchanged values remain in this case the paradigm of reference for the complex process of problem solving which leads to replacement of old routines. The old distinction between instrumental and ceremonial values (Tool, 1993) loses importance in this framework, because it relates to the substantive content of values and not to their procedural role.

A final question must be raised at this point: whose values are relevant for the process of institutional change? When in a society there are different groups with different cultures and values, the question is important because values have different weights according to the weight (the power) of the group they belong to. The answer is obvious: the relevant values are those of the groups who have sufficient size and sufficient *power* to prevail over others. In this way a change in the balance of power between the groups of society may lead to changes in the institutional set up not only via the change in the economic interests to be protected, but also via the change in the socially relevant values associated with the change of the groups in power.

4. SOME CASES IN THE LABOUR MARKET

Let me now make some hints to show how the interaction between formal and informal rules can operate in the field of labour market institutions. This field of analysis is one in which much research, both theoretical and empirical, still needs to be done.

We shall start by considering what can be seen as the fundamental “interests” of the two agents involved, which can be derived from the utility and profit functions of the two. The interests of the worker are connected to the level of wage and to the level of his effort: $U = u(w) - c(e)$, while the interests of the employer are mainly connected to the level of output and to the level of wage:

$\Pi = \pi(y - w)$. They have therefore conflicting interests: what for the worker is a cost (his effort and his working conditions) is a gain for the employer, and what for the employer is a gain (the level of output) is a cost for the worker (in terms of his effort).

Formal rules (legislation and collective bargaining) regulate the economic exchange between the two in terms of effort (for instance, working hours, levels of output, working conditions) and in terms of pay (wages, fringe benefits). Usually this bargain trades stability of employment against fluctuations of wages (implicit contracts). But while a sector of the labour force is employed according to these rules (Piore’s primary market) another sector, although not belonging to the black economy escapes these rules and is employed according to informal rules less favourable to the workers (more or less Piore’s secondary market). Clearly the reason of the difference between these two “patterns of social interaction” lays in the difference in the relative power of the groups involved.

The primary market needs stability of the working force, owing to technology and stability of demand, and requires organized and skilled workers, while the secondary market lacks these characteristics.

Whatever the origins, the co-existence of a set of formal rules and a set of informal rules which regulate the labour market has to be acknowledged. Now the question is: what kind of interaction, and what kind of dynamics is produced by this co-existence?

If we look at the labour market in Italy (but something similar has happened in other countries in Europe), we see that the process has gone in the direction of absorbing a great deal of the features of the informal rules into the domain of the formal ones. What once were “atypical” labour contracts have more and more become “typical”. In other words, the legislation has made “formal” many of those rules that earlier were “informal”; the value of the utility function of the worker has worsened.

while the value of the profit function has improved. The so called “flexibility” has gone so far as to admit more than fifteen kinds of labour contracts, with less stability, lower wages and worse working conditions than were allowed by pre-existing formal rules.

This new institutional setup of the labour market has surely been made possible by a change in the relative power of the two actors. The process of economic globalization, the growth of unemployment and the weakening of trade unions are at the roots of this change. Fluctuations of the level of production and industrial restructuring, on the other side, have made necessary to move the cost of labour from a quasi fixed cost to a variable cost and to lower the “adjustment costs”. But the institutional change has again gone further than the formal legislation: the employment of labour force at lower wages, lower social security, worse working conditions and high degree of instability has spread all over the market, well beyond the cases allowed by the law. At this stage, therefore, the formal set of rules is still different from the actual patterns of behaviour of the agents.

In fact, something has also changed on the plane of values which have supported the process: the attitudes towards labour, profits and rents (financial and not financial) have changed under the effect of media, often in the hands of those who would take advantage of the change.

It is also possible to consider the impact of this institutional change on the performance, not to say on the structure, of the economy. The new institutional set up has made profitable labour intensive technologies and labour intensive sectors that wouldn't have been profitable otherwise, with the double consequence of slowing down the path of innovation and of positioning the industrial system in the backward area of the international division of labour.

Another case in point is given by the existence of the black economy, that is the totally informal section of economic activity. When formal institutions for regulating the production activity are lacking, as it often is in underdeveloped areas, the working of the whole economic system is based on patterns of behaviour established by informal rules.

When, on the contrary, a well defined set of laws and regulations exists for structuring the patterns of behaviour of the agents engaged in production, it is the purpose of avoiding these rules that gives rise to the informal sector, which is preferred to the existing formal one. It should be noticed that in this case the content of the economic activity is not illegal in itself (as it would be in the case of criminal activity); but what is illegal is the fact that the activity is done without complying with formal regulations. In this case the relationships between workers and entrepreneurs, and also between firms, are “ipso facto” regulated by informal patterns, which may be more or less structured and stable, and more or less dependent on occasional balances of relative power. In this

way entrepreneurs can obtain either gains in productivity (work at home, moonlighting, temporary work, unsafe working conditions) or avoidance of taxation, social contributions and bureaucratic rigidities.

This is a case of co-existence of patterns of behaviour based on formal rules with patterns based on informal rules, and the situation seems prone to last forever (two equilibria?) in so far as : a) the enforcement of formal rules is too costly or impossible; b) informal rules are preferred by the agents, especially if workers see a convergent interest in working informally in terms of net real wages or in terms of doing an activity they would not be allowed to do as a second job; c) linkages are established by the formal sector with the informal sector by buying inputs (goods or services) from it or by subcontracting; d) legal incentives (penalty and rewards) are not enough to make agents abandon the informal sector.

.The case of the “industrial districts” is also interesting from the perspective of the labour market. Here several functions in the labour market are pursued through informal patterns and networks of relationship among the agents rather than through formal procedures established by law.

Let us consider, for instance, selection and recruitment of workers .The ascertaining of skills and abilities of employable workers by way of formal recruitment procedures with formal certificates could easily turn out to be more costly, lengthy and relatively unreliable in comparison with informal procedures based on reputation and on the widespread circulation of information typical of local labour systems.

Similar advantage derives in the field of learning and human capital accumulation from the intense informal network and interaction among the agents of industrial districts. Rather than formal education, years of schooling, or attendance of training courses, it is the “learning on the job”, the continuous exchange of expertise, the contacts and the high mobility among different firms that enhance the skills of workers. The greater flexibility of production, the lower presence of routinized behaviour, the intense forms of “coo-petition” that are typical of the industrial organization of small firms in “industrial districts” are particularly favourable to the development of “problem framing” and “problem solving” abilities.

Finally, “agency problems” between employers and employees are more easily solved in such a context because of the reduction of asymmetric information and the role of emulation and reputation, which discourage opportunistic behaviour and enhance labour effort more than what monitoring techniques or other formal devices are capable of doing.

To sum up, the evolutionary development of shared patterns of behaviour based on common values, attitudes and mental schemes, rather than on formal rules, has produced an institutional structure far

better than the one produced by formal rules as far as the economic performance is concerned (Fadda, 2001). In fact, formal rules aimed at creating an institutional structure similar to that of the industrial district have been designed and established in other territories, but due to the lack of corresponding informal rules, the actual patterns of behaviour have not changed significantly. The declared hope in these cases has been that in the long run the actual patterns of behaviour would be influenced by the formal rules. A result which is not granted at all.

Another interesting case shows how the same formal rule established in order to create a designed institutional mechanism can be twisted to activate an actual institutional mechanism completely different. In the agricultural and building sector in Italy the law makes the access to unemployment benefits conditional to having been regularly employed for a minimum number of days in the year. This rule has shaped the behaviour of agents in the following way: employer and employee agree to simulate a labour contract for a temporary job of such a length of time. The employer pays social contributions and tax, but no work actually is done. In this way the employee becomes entitled to the unemployment benefit, and once he gets it he pays back the employer for the expenses plus a fraction of the benefit for the collaboration. What has to be noticed is that the same rule does not produce this pattern of behaviour in regions other than southern Italy. This is a clear case in which the same formal rule produces two different institutions, in the sense of pattern of behaviour actually followed, owing to the existence of different informal norms.

Wage bargaining institutions are another field in which the relationship between formal and informal rules can be observed. In Italy collective agreements for the private sector and legislation for the public sector have given recently a big push towards decentralization and, in this context, toward establishing a link between the level of wage and the performance of the firm or of the single worker. Without entering into the details and the complexity of the structure, it is worth noticing that, particularly for the civil servants, the law requires that part of the wage be determined according to an evaluation of the result of the individual worker. These rules have been introduced some years ago, but the actual structure of the wage bargaining has not changed significantly: in fact, in the private sector the decentralization and the link between wages and results have been applied to a very limited number of workers, while in the public sector everybody has been judged worthy of the entire fraction of the salary linked to the result.

As a consequence of this failure to change the pattern of behaviour, the law has been modified by adding the obligation to rank every year the civil servants into three levels: the first one should include the best 25%, the second one the medium 50% and the bottom one the last 25%. The last

class should get no financial reward. The problem seems therefore compulsorily solved. But it is clear that if the actual patterns of behaviour of the agents remain unchanged, ways will be found to neutralize the rule. Nothing, for instance, seems to prevent a rotation of all the civil servants between the three classes in different years.

Interesting cases can be found in many other institutions of the labour market. Let's recall the case of discrimination against women, which takes place without breaking the rules against discrimination, in force of the consolidated patterns of behaviour of agents; or the case of employment protection that can become ineffective through the twisting to this end of other rules (autonomous work, economically dependent work, training stages and so on) whenever the agents have the power to do so.

Surely further work has to be devoted to explore the interaction between formal and informal components of labour market institutions and to carefully understand the dynamics of their change, not only for the sake of understanding but also for the purpose of designing appropriate and effective labour policies.

Two provisional conclusions seem possible to be drawn at the moment. One is that old habits and informal norms in the labour market (as elsewhere, as the literature on transition shows) are prone to survive the change of formal norms and to coexist with them. The second conclusion is that when the divergence happens to disappear it seems more the formal side converging towards the informal, rather than the other way round. "Institutional designers" and "reformers" should take most account of this.

REFERENCES

- Ayres (1971), *Towards a reasonable society*, Univ. Of Texas Press, 1971.
- Bartlett F., *Thinking*, Allen & Unwin, 1958
- Bartlett F., *Remembering*, Cambridge University Press, 1932
- Bowles, S., *Microeconomics: Behaviour, Institutions and Evolution*, Princeton University Press, 2004
- Churchland P., *The engine of reason, the seat of the soul*, MIT Press, 1995
- Croskery P., *Conventions and norms in institutional design*, in: Weimer D., *Institutional design*, Kluwer Academic Publishers, 1995
- De Bruijn J., *Policy networks and governance*, in: Weimer D. (ed.), *Institutional Design*, Kluwer Academic Publishers, 1995
- Demsetz H. 1974, *Industry structure, Market rivalry and public policy*, Journal of law and economics, n.16, 1974
- Dugger, W., *The new institutionalism, new but not institutionalist*, Journal of economic issues, June 1990
- Eggertsson T., *Economic behaviour and institutions*, Cambridge University Press, 1990
- Eggertsson, T., *Knowledge and the theory of institutional change*, Journal of Institutional Economics, 2009, n. 2
- Elg U., Johanson U. , *The institutions of industrial governance*, International Studies of Management and Organisation, 1, 1993.
- Elsner, W., *The process and a simple logic of “meso”. Emergence and the co-evolution of institutions and group size*, in : Journal of Evolutionary Economics, July 2009
- Fadda S., *Economic development and institutional change: towards a new frame for analytical and policy purposes*, WIDER, Mimeo, 2000
- Fadda S (2002)., *Does the change of economic institutions require a change in values?* Paper presented at a seminar on “Values and Institutional Change”, Copenhagen, January 2002. W.P. n 28, Roma Tre University, Department of Economics, 2002
- Fadda S., *Istituzioni economiche ed economia delle istituzioni nei sistemi produttivi locali*, in: Argomenti, 2001, n. 1
- Foster J. (1991), *Syllabus for problems of modern societies: the theory of institutional adjustment*, in: Journal of Economic Issues, 1991, n15

- Frey B., *Institutions and Morale: the crowding out effect*, in: Ben-Ner a., Putterman L., (ed), *Economics, values and Organisation*, Cambridge University Press, 1998
- Holland H., Holyoak K., *Induction*, MIT Press, 1986
- Hurvitz L., *Inventing new institutions: the design perspective*, in: American Journal of Agricultural Economics, 1987, n. 2
- Kandori, M., *Social norms and community enforcement*, in: Review of Economic Studies, 1992,
- Justin Lin (1999), *An economic theory of institutional change*, in: Barlow C. (ed.), *Institutions and economic change in South East Asia*, Edward Elgar, 1999.
- Knight J., *Institutions and social conflict*, Cambridge University Press 1992
- Levi M., *A logic of institutional change*, in: Cook K., Levi M. (eds), *The limits of rationality*, The University of Chicago Press, 1990
- Loasby B., *Industrial districts as knowledge communities*, in: Bellet M., L'Harmet C., *Industry, Space and Competition*, Edward Elgar, 1998
- Loasby B., *Knowledge, Institutions and Evolution in Economics*, Routledge, 1999
- Lundwall B. 1993, *Explaining inter-firm cooperation: limits of transaction-cost approach*, in Grabher G. (ed.), *The embedded firm. On the socioeconomics of industrial networks*, Routledge, 1993
- Marglin, S., *What do bosses do?*, Review of radical political economics, 6, 1974
- Mistri M., *Economia cognitiva*, Cedam, 2000
- Myrdal G., *Asian Drama. An inquiry into the poverty of nations*. Penguin books, 1968
- Norman D., Rumelhart D., *Exploration in cognition*, Freeman San Francisco, 1975
- North D., *Institutions, institutional change and economic performance*, Cambridge University Press, 1990
- North D., *Understanding the Process of Economic Change*, Princeton University Press, 2005
- Nugent J., *The new institutional economics and its applicability to development*, World Development, 1989, n. 9
- Ostrom E., *Understanding institutional diversity*, Princeton University Press, 2005
- Pitelis, C., *Transaction costs, market and hierarchies*, Blackwell 1993
- Powell W., *Neither market nor hierarchy: network forms of organizations*, in Straw B., Cummings I. (eds.) *Research in organizational behaviour*, JAI Press, Greenwich, 1990
- Ramstad Y., *Institutional economics and the dual labour market theory*, in Tool M. (ed.) *Institutional economics, Theory, Method, Policy*. Kluwer Academic Publishers, 1993, p.186

- Rawls J., *Two concepts of rules*, in: *Philosophical Review*, 1955, n. 69
- Rodrik D., Subramanian A., Trebbi F., *Institutions Rule: the Primacy of Institutions over Geography and Integration in Economic Development*, NBER Working Paper n.9305, 2002
- Simon H. 1991, *Organizations and markets*, *Journal of Economic Perspectives*, 2, 1991
- Schmedler D., *Walrasian analysis via strategy outcome functions*, in: *Econometrica*, 1980, n. 48
- Schotter A., *The economic theory of Social Institutions*, Cambridge University Press, 1981
- Schotter A., *The evolution of rules*, in: Langlois R. (ed.), *Economics as a process*, Cambridge University Press, 1986
- Schotter A., *Ullmann – Margalit*, in: *The Elgar Companion to institutional and evolutionary economics*, Edward Elgar, 1994
- Searle, J.H., *What is an institution?*, *Journal of Institutional Economics*, 2005, n.1
- Sen A., *What is development about?*, in: Meier G. – Stiglitz J. (eds), *Frontiers of development economics, The future in perspective*, The World Bank and Oxford University Press, 2001
- Sen A., *Editorial. Human capital and human capability*, *World development*, 12, 1997
- Simon H., *Theories of bounded rationality*, in: Radner C., (ed.) *Decision and organisation*, North Holland, 1972
- Sugden R., *Normative expectations: The simultaneous evolution of institutions and norms*, in: Ben-Ner A., Putterman L., (ed.) *Economics, Values and Organization*, Cambridge University Press, 1998
- Tool M., *The theory of instrumental value: extensions, clarifications*, in: Tool M. (ed.), *Institutional economics: theory, method, policy*, Kluwer Academic Publishers, 1993
- Vanberg V., *Rules and Choice in economics*, Routledge, 1994
- Williamson O., *The economic institutions of capitalism*, The Free Press, 1985
- Witt U., *The evolution of Economic Institutions as a Propagation Process*, in: *Public Choice*, 1989, vol. 62