



UNIVERZITET U NIŠU
EKONOMSKI FAKULTET
Časopis "EKONOMSKE TEME"
Godina izlazenja XLVII, br. 2, 2009., str. 1-25
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INSTITUTIONAL ROOTS OF ECONOMIC PERFORMANCE
- A Review of the *Law, Informal Rules and Economic Performance*
by Svetozar Pejovich¹ -

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1. Introduction

The notion of institutions encompassing not only formally enacted rules but also informal guidelines of acting and behavior is indeed a relatively recent one. Tradition, value systems, collective memories, religious affiliations and most generally conceived of culture...has with significant delay been recognized as a major determinant of social evolution at large and economic development in particular. The culture, analytically articulated by the term *informal institutions*, has of late been accepted as a basic determinant of an impressive range of successful development experiences and, more importantly as a major constraint on economic development in the environments in which it had been slow and inhibited. The acceptance of institutions as a fundamental determinant of development seems to have been recognized with particularly long delays in the societies in which they proved to be the most critical growth impediment. Serbia certainly belongs to that curious circle of countries. Only occasionally and almost marginally have informal institutions been pointed out as a persistent, truly long run obstacle to growth processes, a barrier which is to stay here for an undetermined time. Such remarks have been made in the context of

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UDC 347.195; Originalni naučni rad

Received: April 12, 2009

¹ *Law, Informal Rules and Economic Performance – The Case for Common Law*, with contribution by Enrico Colombatto, published by Edward Elgar, Cheltenham, U.K. and Northampton, MA, USA, 2008.

sceptical references to culture as a hindrance to development and modernization (Sekulović 2004, pp. 47-54, 65-6; Golubović 2007, pp. 119-24). Nevertheless, the wide area of the impact of culture in general and of the separate components of informal institutions in particular remains insufficiently researched and largely misunderstood. This new book by Pejovich fills therefore a disturbingly persistent void and comes as a helpful aid in understanding the dynamics of development and modernization in general and of the growth obstacles in underdeveloped countries in particular.

2. Organic Nature of Institutional Development and the Role of Informal Institutions

Informal institutions are much wider and more encompassing than usually perceived analytically elaborated. They permeate every little crevice of a society and determine in a subtle and mostly invisible way many of its daily functions and important changes. Metaphorically, they can be thought of as a deep seated vegetative nervous system, strongly affecting much of what is being consciously undertaken and officially programmed. One of the frequently asked questions, and one that had only rarely been answered in a fairly complete and satisfactory way, relates to the reasons that had made it impossible to transplant institutions from the developed to the less developed countries and thus enhance the latter's development making for a long sought for convergence of individual economies' development paths. It turned out that informal institutions constrained the formally traced out institutional development in at least two ways that ultimately blended to one. Firstly, informal institutions used to impose constraints on what formal institutions could let roots and survive once they are transplanted from more advanced economic and social environments. Secondly, they acted as a powerful constraint, and thus as a determinant, of the effects the imported formal institutions generated in this new setting. Copying the U.S. constitution in a number of Latin American countries proved futile because a set of much more important, though not clearly visible rules were lacking and centering on written and formally adopted legal acts proved useless and pointless.

This book can be seen as a treatise on unavoidable interdependency between the formal organization of a society and its informal, just partly visible and widely ramified value systems, decision criteria and behavioral standards. The set of formally established norms is just a tip of an iceberg of a much broader multitude of unwritten standards with multifarious interconnections between the two weaving them together into a

Institutional Roots of Economic Performance - a Review of the *Law, Informal Rules and Economic Performance* by Svetozar Pejovich -

comprehensive whole. The „tip of the iceberg“ cannot be modified in an arbitrary way, particularly not independently of what is located in its numerous lower layers. Least of all can it be reshaped independently of the deepest, the most fundamental substratum of the magnificent architecture of the entirety of precepts on which a society is made to operate. Among the ways in which this book can be read and understood one seems to be particularly interesting and attractive. It can be comprehended as a persuasive plea for a gradual, evolutionary approach in developing institutions and adjusting them to ever changing external circumstances under which economies and societies at large are made to operate. Big steps in institution building are beyond the reach human understanding and operational capability. We have some cognizance only of what has been experienced and tested through practical operations. We might dare to step cautiously a little outside of what has been practiced in life and understood through the immediate effects of what has been actually undertaken. The hazard of unpredictable and, as a rule, perilous consequences (cf. Lord Dahrendorf *et al.* ed., 2000, *passim*) is a steeply growing function of the distance taken from what has been practically encountered. Making big leaps into the unknown spheres of institutional design is a recipe for disaster.

The second reason for having to stick to steps of (very!) moderate size has to do with social constraints. The bigger the leaps in the institutional engineering, i.e. the bigger the steps into the uncharted territories of the landscape of the regulative and steering machinery, the more likely it is that some overriding interests in the observed society would be adversely affected. As such interests are usually combined with significant power to change and to impede the change, the attempt to transform significantly any segment of the institutional architecture is likely to falter as it confronts itself with such interests. Moreover, the very magnitude of the proposed changes might meet with the resistance of such interests because of the uncertainty surrounding such major shifts: the change could be prevented because of the sheer danger that something unfavorable to such interests could pop up even if no reason for such anticipation can be found in actual constellation of events. This is the way in which the second reason dealing with social constraints merges with the first one connected with cognitive limitations and the uncertainty emanating from it.

Pejovich sees the institutional development of a society as a compound multidimensional and multifaceted process. It does contain some components of conscious design and legal engineering, but its main components are reducible to evolutionary organic growth which nobody

controls and which are tested and selected by the frequently encountered survival tests (p. 10). Survival in fact refers to numerous institutionally differentiated communities whose particular communities enabled them to survive or forced to perish. The processes through which certain institutions survive and assert themselves as viable and efficient is controlled by no one and in fact not even thoroughly understood by anyone. It turns out to be one of those spontaneous processes which produce institutional improvements by adjusting institutions to a steady stream of exogenous changes of technology, resource availability and human preferences and subjecting them to uninterrupted verification of practical exigencies.

A part of building and adjustment of institutions is planned and formalized, but even that visible and officially documented component cannot be successful unless it is harmonized with the vast array of informal institutions. By insisting on gradual, organic and largely unplanned development of institutions Pejovich fits into a powerful, intellectually influential and philosophically refined stream of thought which emphasizes spontaneity of such development and insists on its remarkable survival characteristics. As such, Pejovich fits into an imposing pleiad of great economists and social philosophers. It is hard to read his work and not to think of such towering figures in economic and social thought as Hayek (1998/1960/, glava X, posebno ss. 142-4 i 1990/1988/, pp. 83-8). Equally reminiscent are Pejovich's analyses of the Popper's (1993/1971/, I, ss. 208-10, II, ss. 138-40) mighty idea of piecemeal social engineering and the need for any society to make it certain that, by undertaking small successive steps, it simultaneously adjusts the institutions and *learns*. Any development is at the same time a process of learning and this applies to institutional development perhaps more consistently than to any other aspect of the overall social development. Beside being a powerful means of generating and accumulating knowledge and information, the strategy of change through small, successive steps has one more significant advantage. It involves many people taking small and numerous decisions by taking risks upon themselves, i.e. by risking their own wealth. The magnificent strategy of big leaps and grandiose, epochal steps, on the contrary, involves politicians and state bureaucrats who decide – to paraphrase M. Friedman – on other people's wealth to satisfy, again, other people's needs.

Institutions matter enormously in the process of development in general and of economic development in particular. Pejovich is one of the few to have shown that economic development cannot be explained by the simple fact of expansion or even the availability of resources. An attempt to such an explanation would be tautological, to begin with. For, what else is

Institutional Roots of Economic Performance - a Review of the *Law, Informal Rules and Economic Performance* by Svetozar Pejovich -

ultimately economic development but expansion of resource availability to satisfy multifarious human needs. More importantly, a venture to explain social product as a measure of economic performance by the augmentation of resources generating it would open the further question as to what determines the very expansion of resources. To explain growth, one has to step outside the framework of resources and technology and to ask the crucial question: what it is that people do with available resources what are the factors determining the widely differentiated patterns of behavior. This is the point at which the institutions are inevitably brought into the picture. Pejovich puts it concisely and with peculiar clarity: „...institutions create their own behavioral incentives. Different incentives have different effects on transaction costs of exchange. Different transaction costs have different effects on the extent of exchange and the flow of innovation in the economy. And the extent of exchange and the flow of innovation are major determinants of economic performance“. The explanation is consistent and convincing: to explain the movements and events in the world of commodities and resources, one certainly has to step outside it. This distancing from the set of real flows and stocks to be explained is dictated by the abundant empirical evidence: the economies with the highest performance are the ones with clearly recognizable exchange promoting and growth stimulating *institutions*.

Institutions conducive of most rapid development are the ones which provide the greatest freedom under the protection of the law. Economic freedom – and freedom in general without which the narrower economic freedom is inconceivable – provides the largest number of the individuals with possibility to embark upon new ventures, to try out new ideas about the ways and means of creating value and to plunge on their own into the unknown. Freedom means that each is responsible for what he does and the individualized responsibility should imply that each is free and entitled to reap the effects of what he creates by discovering new products/processes/sources of supply/marketing channels and techniques... This amounts to most consistent mechanism of associating contributions and rewards, which is the best way of providing incentives for expanding the set of feasible economic options and generating value. Providing for the largest number of individuals allowed to innovate and incorporating the most powerful incentives for such activities into the social fabric is tantamount to creating the most dynamic system – the system that shifts resources to the most valuable uses and, more importantly, the system that accumulates knowledge, i.e. *learns* more effectively and more quickly than any conceivable alternative at the level of the society as a whole.

3. Definitions, the Use of Words and Precision in Formulations

The area covered by this book – culture, institutions, legal order, alternative judiciary and legal traditions, economic performance... – is very broad one and not easily structured. This is an area replete with multitude of words whose meaning is not precisely determined and which are so frequently taken for granted but understood in the widely diverging ways. Lightheartedly used and without necessary sharpening as to their meaning, the words become dangerous and come to be converted into serious hindrances. Rather than facilitating intellectual intercourse, the carelessly used words obscure and obfuscate the communication; by lacking clarity, the words transform themselves into the opposite of what by their very purpose they should be. Ambiguous and irresponsibly used words come out as triggers of so many fruitless and sterile polemics and misunderstandings deriving therefrom generate large bundles of induced misapprehensions making the discipline less transparent than it otherwise could be. All these complaints should be taken as a background to what should come out as one of the main points of this review. Pejovich is, namely, extremely explicit, unequivocal and straightforward in the terminology he uses. He is unusually, perhaps *uniquely* careful in using the words and, even more so, in exactly explaining their meaning and persisting consistently in adhering to the definitions once introduced. Some of his definitions will be elaborated in the sequel, but here it suffices just to name, by way of illustration, the terms he carefully defines: institutions, transaction costs, the rule of law, democracy, constitution, efficiency, equality, egalitarianism, collectivism, (methodological) individualism, common law, continental law tradition, resources, innovation...Even *capitalism* is defined and its various variants carefully distinguished. The ground is prepared to make the point: by defining precisely all these and many other widely used terms, Pejovich has made a great, though not conspicuous, service to the profession. He ventured to define, and thus brought great clarity into the professional discourse, the terms which others frequently use but gloss over carelessly and irresponsibly expand the twilight zone of partial understanding or direct verbal error. For more careful readers this book might serve as a reference manual, i.e. as a glossary in which the precise definitions of terms will be found. It is a source in which ascertainable are clearly set out meanings of words which others didn't care to define. By bringing clarity to the vocabulary, Pejovich has done a great service to the profession.

His definitions are more than just explaining the meaning of words used in his and other people's writings. They reflect his distinct, at least as compared to the mainstream economic thinking, theoretical reading of

Institutional Roots of Economic Performance - a Review of the *Law, Informal Rules and Economic Performance* by Svetozar Pejovich -

economic phenomena. His definitions are reflection of a specific paradigm (to use a fashionable word) which, of course, is not exclusively his but which – together with modern writers of the institutional economics, property rights and public choice school – identifies him as theoretically and analytically remote from what until recently used to be the accepted economic orthodoxy. This particular methodological stand is vividly revealed in his definitions of such basic theoretical concepts as *resource* and *efficiency*. As a preliminary notion he defines *scarcity*, another fundamental notion, as the property of a good consisting in the impossibility of getting some more of it without sacrificing certain quantity of at least one other good. *Economic efficiency* of production and allocation is then „expressed in the process through which voluntary interactions are carried out, **leading into the unknown**“ (underlined by Lj. M., p. 9).

One could wonder whether this is a definition of efficiency and even whether it is a definition at all. It certainly does not convey the meaning of the term; it just says that the thing to be defined is contained or „expressed“ in a particular process. But, despite the absence of the designation of content of the term, this is certainly a very effective, sharply pointed way of bringing out of the most significant, truly determining attribute of efficiency. Such rather indirect characterization of efficiency is also given on p. 105 where it stands that „efficiency...is judged by the openness of the process through which voluntary interactions are carried out“. This again is not a formal definition of the efficiency itself, but it certainly points out its fundamental trait, a feature conveying its essence better than even a complete formal definition would do. Most economists are used to thinking of efficiency as a specific quality of allocation of resources, a number of imperatives that have to be met in order to ascertain a process or result as efficient. Pejovich does not take such an approach. Declining to specify efficiency as a quality or as a feature, he even goes a step further and defines it in an evidently unorthodox way *as a process*. In this context „efficiency is defined as a process through which voluntary interactions are carried out, leading to unknown results“ (pp. 115-6).

The designation *unknown results* is crucial because it better than anything demonstrates the distancing from the conventional notion of efficiency: one certainly cannot define it through some relation between results and inputs if the results are unknown. Indeed they are unknown as a matter of principle because it is the processes and not results that are emphasized and being focussed on in this theoretical paradigm. Yet, one wonders whether it would be possible to define efficiency as a property of a process and not as the process itself. For instance, *Efficiency is a highly*

*desirable **property** of processes of allocation of resources which consists in the unobservable and unknown results being most consistent with the preferences of interacting actors due to the voluntariness of interactions.*

Focussing on processes means abandoning any pretension to making normative statements which would in the traditional way be centered on the results of economic activity. It also means that the notion of *equilibrium* is dispensed with in economic theorizing. This is where Pejovich joins the well known and in so many aspects precious Austrian tradition of observing and studying *changes, movements and adjustments*, i.e. *dynamic tendencies* rather than examining the properties of the system that has reached a state of rest. The state of rest is never achieved. Due to continuous exogenous changes rocking the system the parameters calling for adjustment uninterruptedly change; the speed at which the parameters change exceeds the maximum possible speed of adjustment of the system. The system cannot catch up with rapidly changing parameters and consequently equilibrium remains just an imaginary abstraction; the disequilibrium processes, not the states of rest of the systems constitute economic reality we confront. Such perception of reality has farreaching methodological implications and this is where the Austrian school made its magnificent departure from classical orthodoxy (cf. Menger 2008/1969/, *passim*, particularly pp. 51-7, 185-9, as well as extremely informative and knowledgeably written introduction to Menger's volume – Stojanović 2008, particularly pp. 11-14). One of the most effective ways of showing (at least some aspects of) the superiority of the Austrian approach is revealed again by Stojanović (2007, pp. 178-80) when he elaborates the Austrian views on price analysis. Equilibrium prices are never attained – thus Stojanović interprets the Austrian views – and analysing the „equilibrium prices“ means studying things which never come about in real life instead of investigating actually realized disequilibrium prices which are a conspicuous and inextricable part of living economic reality.

4. Property Rights, Rule of Law and Other Key Concepts

A number of known and widely accepted things are elucidated in a particularly transparent and educationally efficient way in this book. Such is demonstration of the significance of the assignment of property rights (pp. 13-15). Many will like the Pejovich's very definition of property rights – despite the fact, or perhaps on the account of the fact – that it has a distinct Marxist ring: these are the „rights /that/ define relations among men that arise from the fact of scarcity and pertain to the access to scarce goods“. The

Institutional Roots of Economic Performance - a Review of the *Law, Informal Rules and Economic Performance* by Svetozar Pejovich -

sequence of steps in the explanation of the significance of the property rights allocation is carefully selected and thoughtfully carried out. The first step is, as it should be, the concise but complete and exhaustive discussion of the Coase theorem. But the world does not rest on the foundations described by the assumptions incorporated in that theorem. At this happily chosen point Pejovich introduces two enormously important concepts: the *transaction cost* and the *impact of (allocating) the property rights on the value of physical objects*. The Coase theory comes out as just an expositional device while a legal superstructure – the assignment of property rights and all implied elements of their legal formalization – turns out to be a mighty determinant of the value of resources. The analysis here is simple and done by means of a straightforward arithmetical example; yet, it is incisive, deep and illuminating. For those who like getting considerable mileage out of not too big intellectual efforts this workout of interdependencies of legal and economic concepts will be appreciated as almost ideal. Pejovich exposition of these issues is *efficient*. The term here is used not in his but in the traditional sense: the reader gets a lot of understanding (the result!) on the basis of not such a big effort. The exploration here is reminiscent of the brilliant De Soto's (2000, pp. 44-5) deliberations on the role of legal superstructure in converting physical objects into capital. Especially reminiscent it is of his famous metaphor of the lake which, in order to deliver the precious potential power has to be complemented with a power station; the station is the metaphor of legal arrangements in the absence of which the lake (the metaphor of legally not formalized objects) cannot unleash its valuable energy potential.

All of us have definite notions of capitalism. And most of us believe that we could define it fairly accurately and without major difficulties. But should it come down to really defining it, we might discover that the thing is nearly not as simple as anticipated at first thought. Pejovich does it for us, and, indeed, in an unusually clear, precise and intellectually appealing way. He identifies four basic ingredients of capitalism, the components without which it cannot be imagined, not to speak about analytical usefulness of the concept. Here, again, the definition appears to be in a way indirect, not in the way of describing the semantic contents of the notion but by bringing out its key constituents. Though indirect, this manner of determining this frequently used term turns out effective and truly telling. His four ingredients strike one as almost self-evident, but if one were to identify them by himself, one would meet with difficulties to bring them forth in such a persuasive way. The component parts of capitalism, which simultaneously come out as its determining traits, are in Pejovich's conceptualization (1) private property

rights, (2) the law of contract, (3) independent judiciary and (4) constitution (p.41). Classical liberalism did not automatically amount to capitalist order but a number of changes had to be effected. These changes are almost as important as the defining features of capitalism: (1) strong enough formal institutions had to be developed to protect individual liberties (one is tempted to add *human rights*), (2) an institutional machinery had to be erected to protect the private property rights, (3) incentives had to be developed to reduce the transaction costs of exchange, and (4) competitive markets had to be developed and an institutional scaffold built to maintain them competitive for an indefinite time (p. 41).

Not a few readers will be pleased with the Pejovich's definition of the rule of law; the term is widely used but its precise contents are not widely known and the meaning of its components is not generally understood. Based on pathbreaking propositions of Hayek and Leoni, the rule of law is also defined by its components which are (1) the absence of arbitrary power on the part of the ruling elite so that no discriminatory laws are enacted favoring specific groups or even individuals, (2) equality before the law implying that all citizens, including the members of the political directorate, are subject to the same legal provisions, and (3) a well defined and consistently applied procedure for replacing the political directorate once its mandate is out; K. Popper would emphasize the peaceful character of this change of the ruling cluster. Apart from this, the rule of law protects competition, freedom of exchange and individual liberty. The constitution as the legal fulcrum of the rule of law performs itself a number of critically significant and irreplaceable functions. To begin with, (1) it serves as a guideline for all laws and other legal acts which have to be consistent not only with constitutional principles but in more important instances also with the letter of the constitution, (2) it protects the rights of individuals against all imaginable encroachings and, most of all, against infringements by the majority, and (3) the constitution is there „to eliminate or at least substantially contain the discretionary use of power“ (p. 68) by all branches of government and the associated state bureaucracy. This revives the memory of an extremely apt adage launched by late B. Horvat, which he coined based on some widely applauded liberal slogans: citizens are allowed to do whatever is not prohibited by law; the government officials, on the contrary, are permitted to do only what is explicitly provided for by the law.

The treatment of democracy and its relation towards constitutional provisions and basic principles deserves special emphasis. Pejovich is not particularly enthusiastic about democracy. This should come as no surprise in view of the fact that so many thinkers of towering profile and

Institutional Roots of Economic Performance - a Review of the *Law, Informal Rules and Economic Performance* by Svetozar Pejovich -

significance, including the pioneering figure of Tocqueville, had a similarly reserved and low profile stance. Reading this book will help one to understand certain fundamental features of social organization and its political superstructure. To begin with, democracy by itself does not and cannot protect individual liberties and human rights. That has to be secured by some other institutional devices. Deep and irremovable constitutional guarantees of these liberties and rights seem to be the only so far discovered and tried out in practice way of safeguarding these indispensable ingredients of a free society. Democracy needs free people whose rights are effectively protected on a lasting basis. People whose liberties are curtailed, who are not free to decide as they see fit and not allowed to participate in public debates cannot be efficient and worthy actors of democratic processes. Constitutional guarantees are also needed to prevent some possible and occasionally quite likely aberrations and abuses of democracy; without such guarantees, *exempli causa*, there is nothing to prevent the majority of citizens to vote *democratically* a set of decrees by means of which the property of the well-to-do citizens would be divided among those less endowed; and that would quite clearly be the beginning of the end of a civilized society. Constitutional guarantees are there to prevent democracy from undermining itself through its own *democratic* means.

Moreover, the democratic rules of the game are far from being uniquely determined. There are many sets of rules and not all of them are equally efficient nor do they fit equally to all, otherwise widely differentiated, social circumstances. There must exist a deeply laid down institutional groundwork, a set of rules which precede democratic processes and are above them, which will define the procedures through which democratic decisions will be made and choices effectuated. Constitutional rules defining democratic procedures are *not* enacted in the usual manner, similar to the enactments through which the ordinary laws are brought to life. Constitutional rules are created in (very) special ways, under unusual circumstances and by very special decision bodies, most frequently by constitutional assemblies called as a consequence of extraordinary needs. Thus there are two clearly distinct levels at which the macropolitical decisions are made. One is the fundamental, deeply placed level at which the rules of the game are shaped; one could hope that an all-encompassing social consensus could be reached on that. The other level is deciding within such constitutionally defined framework, playing the game by the rules formalized through the constitution. The importance of constitutional principles and wisely set rules of game cannot be overemphasized; hence the intellectual weight and practical importance of what has come to be called

constitutional engineering (Sartori 1997/1974/). On playing the game within the set of constitutionally set rules and on adjusting the rules to the changed circumstances and exigencies of time Pejovich had to convey quite a number of interesting thoughts which, however, cannot be recounted here. A review of a book cannot be a substitute for the book itself.

A few additional thoughts can be added nevertheless. Constitution has to reflect the fundamental consensus on how the political game should be played. Consensus is not an easy thing to reach, particularly in the societies markedly divided along certain lines, e.g. by being ethnically heterogeneous. This is why the constitution should not and in fact must not be broad, stuffed with material of little relevancy and extended into areas not having the constitutional weight in the sense of shaping the rules of the game. Encompassing just a few, but truly essential things, the constitution must be strictly and uncompromisingly selective. By not being selective, the constitution runs the risk of bringing in some issues not relevant to the constitutional purposes and yet divisive and imposing themselves as obstacles in reaching greatly needed consensus. But, along with being concise and selective, narrow pointed and sharply differentiated vis-a-vis the rest of the low priority legal material, the constitution has to be exhaustive. Exhaustive in the sense of defining the rules of political competition unequivocally and leaving no doubts as to the pertinent procedures for unfolding of various political processes.

An essential feature of any good constitution is a reliable provision for the division of powers. Political establishment armed with broad and even expanding authority is a grave danger in any society. The governmental machinery that goes with it is incomparably stronger than any other social formation or structure, whatever the number of people assembled around it. Should the political assemblage prove compact and monolithic, there will be no other creation, political or otherwise, in the society having sufficient power to tame the potentially alienable state. The only social force having sufficient power to tame the government is some part (parts!) of the government itself. This is the deep and unquestionable meaning of the division of powers. The explanation of the importance of such division belongs to the great merits of this book. The elaboration of this issue is the more important the less a country has progressed along the path of the division of powers. Having so far been unsuccessful in this rather peculiar political development, Serbia should be a fertile ground for such a doctrine. Disseminating the understanding of the division of powers could therefore produce valuable effects in this environment, of course to the extent that the ideas matter in the formation of the broadly conceived institutional

Institutional Roots of Economic Performance - a Review of the *Law, Informal Rules and Economic Performance* by Svetozar Pejovich -

scaffolding. One of the desirable features to be built into constitutional framework are „the high costs of changing the constitution“ (p. 81) to provide for its stability. Stability is an overwhelming issue which deserves to be dealt with in a separate paragraph.

As a core and, in a way, a postament of the legal system, the constitution has to share the basic normatively defined features of the legal order itself. As the most significant role of the legal order is coordinating decisions in a decentralized environment as the corresponding collection of laws can that achieve only by being stable, so the constitution itself has to be stable and, in particular, not be subject to frequent, sudden and unpredictable changes. In a legal order worthy of its name the constitution and the laws apply equally to everyone and the market participants and other agents in a society draw valuable information about decisions taken by others. In a world of interdependent decisions coordination is only possible if the decision makers have (feasible within the socially verified limits) information on the decisions of others; this information comes from the knowledge that all relevant social agents go by the same, generally known and equally applied laws. Pejovich strongly emphasizes the importance of the transparency and the stability of the constitution and rightly concludes that a highly desirable feature of the constitutional order is institutionally built in *difficulty of changing the constitution*. His illustration, taken from the USA constitutional order is startling and awe-inspiring (pp. 67-8): the initiatives for constitutional changes can be undertaken by a broad variety and a large number of actors, but the procedure of corresponding adjustment is so involved and to such a degree multi-tiered that a mere 6% of population can block the action and prevent the change.

Constitution is the central element, a real fulcrum of the rule of law. Pejovich could not have been more energetic and more persuasive – and this author could not have been more firmly convinced – in the passages devoted to the rule of law. As mentioned above he puts it before democracy and treats it as a precondition for sustained and lasting democratic order. Constitution and the rule of law precede democracy both in a logical and a functional sense. His opposition to the claims that democracy should be taken as a precondition of successful growth leaves no doubts regarding this issue and his refutation of such views could be taken as definitive. Rather than democracy, with its not easily predictable whims and idiosyncrasies, particularly if it is not constrained by well structured constitutional framework, he points out the rule of law, which can only lean on constitution and derive from it, as a major stimulus to rapid and sustained economic expansion. Referring to other authors makes his argument additionally

persuasive. Especially important is the rule of law as a source and guaranty of property rights which – as demonstrated to the necessary detail – if stable and well protected predictably channel resources into the highest value uses. As a core component of institutional arrangements in the economic field, property rights – again, if reliable and constitutionally protected – eliminate the otherwise unavoidable bias towards simultaneous exchanges. This is a way in which it enormously expands the range of accessible economic options and impressively raises the growth potential of the economy.

4. Common Law as a Basis of Institutional Framework of the Economy

Common law is deeply immersed into the huge expanse of informal institutions and represents a first natural step in their formalization. It should therefore come as no surprise that much space is devoted to it and that most of the keynote argumentation is developed around it. The author introduces two major, mutually juxtaposed traditions in the development of the modern legal system and describes the difference between the two with great clarity. Only the principal point of this juxtaposition will be brought out here. Common law is made by judges and develops continuously, organically and very gradually through concrete resolutions of the litigated cases. The precedents in the courts decisions have special weight. Legal knowledge and wisdom are systematically accumulated through the precedents. Precedents bind the judges and serve as obligatory guidelines for deciding all analogous future cases. Historically speaking, the common law outcometed its then-existing alternative of law merchant thanks to a number of advantages the principal among which seems to have been a peculiar kind of legal continuity. Rather than having „...in each recurring case...to enter upon its examination and decision as if all were new, without any aid from the experience of the past, or the benefit of any established principle or settled law“, the common law used systematically and in an orderly fashion the accumulated knowledge and experience of the, possibly long, past. In the practice of its rival law merchant „...each case would in turn pass away and be forgotten, leaving behind it no record of principle established, or light to guide, or rule to govern the future“ (from a rather important court verdict cited on p. 31).

The just pointed out differences between the common law and the law merchant illuminate quite well the differences between the two legal traditions, the common law and the continental tradition. The continental tradition is based on legal engineering, on having legislative bodies enacting important, comprehensive and frequently voluminous laws. Continental tradition involves big steps in legal formalizing various areas of economic

Institutional Roots of Economic Performance - a Review of the *Law, Informal Rules and Economic Performance* by Svetozar Pejovich -

and social life, it implies massive inroads into the unknown. It is therefore vastly inferior in dealing with uncertainty, it creates and suffers the hazards associated with big steps in social change. It loses the benefits of learning by making small steps and utilizing the information acquired at each step in designing the next one. In short, it loses all benefits of piecemeal engineering whose merits Popper (1883/1871/, Vol. I, pp. 208-10, 375-7; Vol. II, pp. 138-40) described in such a magnificent manner. Common law thus appears to possess two imposing advantages: (1) it draws its matter to be regulated directly from life and follows real events as closely as possible in an area of formal regulation of human relations, and (2) it is a system which learns intensely and continually and which, moreover, remembers what it learns in the course of time. Common law generates impressive quantities of knowledge and preserves it in a systematic way. Systems regulating human affairs are as a rule comparable through the amounts of knowledge and quantities of relevant information which they generate and preserve; on that account common law fares extremely well.

The author demonstrates that common law is efficiency friendly and, moreover, that it predictably tends to increase that precious characteristic in time. The demonstration of this efficiency friendliness and of its rising tendencies through time is simple, easy to understand and yet fascinating. Judges are motivated to augment and preserve their professional standing and not to have their decisions reversed by higher courts. The total set of precedents, along with a multitude of cases decided one way or the other, contains the current legal rules which are still in effect due to the very nature and role of the precedents. Judicially resolved cases are by the logic of the functioning of judiciary contested and relitigated. Inefficient rules are incorporated in not so well decided cases which stands a relatively high chance to be relitigated and reversed. Due to the higher costs, as compared to the costs implied by the efficient rules, the inefficient rules will be more frequently reviewed and face a bigger probability of being discarded. With more efficient rules having a higher probability of survival and with the inefficient ones being gradually eliminated, the system moves in time to higher and higher degrees of efficiency. The growth of efficiency is structurally built into the system. This is what makes the system itself and Pejovich's analysis of its dynamic efficiency friendliness so fascinating.

Yet, it looks that one could discover here little stretches for additional improvements. People don't contest cases because the rules implied by their resolution are inefficient in the sense of imposing „the costs...greater than the costs imposed by inefficient rules“ (p. 145). People contest cases, and thus call into question the inefficient rules implied by

them on account of them serving as precedents, not because of high costs and not because they are particularly obsessed with efficiency, but simply because they hold them as being unjust. When it comes down to courts, people are not after costs and efficiency but after justice. Fortunately, there is a strong and easily demonstrable connection between justice and efficiency. Justice calls for everyone being given what he rightly deserves and what could be more efficient than associating rewards with efforts, giving anyone what he deserves, what he ultimately has created and produced. The connection between justice and merit, i.e. between what is right and what is contributed by any given individual, is contained in the age-long, truly old wisdom. It is clearly expressed in the Latin adage: *Tria sunt iuris praecepta: honeste vivere, alterum non laedere, suum cuique tribuere*. The part underlined here expresses exactly the idea of justice being equivalent with individuals being rewarded in accordance with their productive contributions. Justice is efficient as well as is freedom development promoting. Justice turns out unmistakably efficient, though in a somewhat mediated way.

There remains a big and in a way unpleasant query. The entire book is a strong plea for acknowledging the informal institutions as a strategic, all-important determinant of economic development and social advance. Many propositions expounded in the books could be cited to support the author's insistence on informal institutions and inability of governmental action to realize the ardently desired economic expansion and general social advance. One citation will suffice: „Evidence supports the importance of informal rules. If economic development is merely a function of formal institutions and growth policies why has it been so difficult for so many countries to develop? How does one explain the fact that in multicultural countries some ethnic or religious groups consistently outperform others?“ (p. 155). A powerful source of efficiency is discovered in the process, driven by judiciary, by which the culture and tradition of a community are by means of precedents converted into formal institutions.

But, as strongly emphasized in Ch. 14, not all formal rules are development promoting and efficiency friendly. There are institutions which are utterly conservative, growth inhibiting and in some aspects even inhuman. One should only think of values and customs of some landlocked African countries or some countries in the Middle East. What benefit could have been derived by relying on such backward mores and behavioral attitudes? Would have Kemal Atatürk done better by not having destroyed – as it seems in a drastic way and by using a lot of (a threat of) force and coercion – the old customs and behavioral patterns and by attempting to lean

Institutional Roots of Economic Performance - a Review of the *Law, Informal Rules and Economic Performance* by Svetozar Pejovich -

his strategy of social improvements on the ancient ways and means of the ancestors? It looks as if relying on tradition is o.k. if the tradition is human and in a sense of high quality. But what do we do in the societies in which tradition is not a part of and not a way to the solution, but indeed the central *problem* and the key impediment to any kind of social advance? One is almost tempted to infer that there are lucky and (extremely) unlucky societies. In the first ones informal institutions are efficiency friendly and admirable in a number of other ways; in such countries even the formal institutions will tend to be superior as compared to other societies. In the latter countries, the *unlucky ones* neither formal nor informal institutions seem to be likely to demonstrate the needed quality. This sounds like the doing of the finger of destiny: in some countries outcome promises to be satisfactory whatever avenue of institution building is chosen; in other countries nothing works. Is this a fundamental questioning of the Pejovich's analysis?

In all likelihood – *not*. One line of defense would be that how ever gloomy, Professor Pejovich's description might amount to a fairly realistic account of the world and its dynamics. It is indeed true that traditionally trapped countries have remained underdeveloped for a very long run now. It is also true that many have made desperate attempts to extricate themselves from the bondage of backwardness, mainly through the actions of the state, by enlisting powerful bureaucracy and relying on coercive means. That, too, proved unsuccessful despite the fact that it looked for decades (and was believed by decades!) that it could work. Now that the world's socialist system has been swept by the winds of history, that looks quite persuasive. With or without such and such policies, who is underdeveloped will remain poor; and vice versa. The finger of destiny comes back into the picture. Yet, Pejovich opens a narrow, barely visible window of opportunity. By introducing the pathfinders and unconventional entrepreneurs into his conceptual framework he brings in the promoters of change, the actors capable of changing even the system of informal institutions. But one has to make sure that they don't get killed or devoured, just gulped down in the course of this noble undertaking. They need protection in a society in which human rights don't count, the liberties are unknown and the individual is nothing in comparison to collective. Here comes the most questionable point in Professor Pejovich's analysis. He assumes – better said requires – that the rule of law somehow be introduced. To effect this he is – obviously with grave and conspicuous reluctance – obliged to summon the government, i.e. the state. In order to make or allow the community to *chose* capitalism in a voluntary way, i.e. to move to capitalism without the use of force. He would

accomplish this by having the state introduce (somehow!) the rule of law „admittedly from above“ (p. 168). This is a sort of *deus ex machina* which should bridge the gap between growth impeding informal institutions and the principled determination – which most of us share – that no force and no brutality should be applied in the process.

Many will not buy this *deus ex machina*. Indeed, how likely it is to come about? Introducing the rule of law is by itself a major social change which has to be led and driven by equally respectable social forces. How likely are these forces to show up in a society where backward looking and tradition bound large social strata shape the behavioral patterns and decisively influence the perception of the world. What kind of democracy could give birth to the promoters of the rule of law in a society burdened by such heavy tradition? Some recent events are enlightening in that respect. The electoral victory of Hamas is a telling reminder of the fact that democracy might not be able to create its own preconditions, on which Professor Pejovich offered quite a number of very pertinent thoughts in this inspiring book. It looks as if the vicious circle is closed. There are no social forces around to engineer (in whatever way, provided it doesn't involve brute force) the rule of law; consequently the pathfinders will not be able (and will not dare!) to search new dynamic alternatives in a stagnant society; the informal institutions with heavy imprint of tradition will persist and that amounts to perpetuation of an environment in which neither informal nor formal institutions would be able to produce any sort of significant social advance.

But, suppose the *deus ex machina* gets activated in some miraculous way. What would the resulting scenario look like? It could take an awful lot of time for some vigilant minority to show up and to notice the appearance of legal security safeguarding the rights and freedoms. Another long time interval would be needed for them to convince themselves that the change is not temporary, not a fleeting light in otherwise dark surroundings. Some more time would be needed to start acting and a lot of additional time to move the margin of acceptable behavior. That is perhaps not task for just one generation, but is it logistically feasible for several generations to participate and to pass on the message and the operations under way from one set of hands to another? The upshot of these deliberations looks almost as gloomy as in the foregoing scenario in which these agents of change don't show up at all. Too much time has to pass before anything moves, be it by a tiny notch. The horizon of change is not quite infinite, but almost. For analytical purposes the two horizons might with little risk be taken equivalent.

5. Obstacles and Prospects of Societies in Transition

Much of what can be told on this subject is implied by the conclusions arrived at in the preceding section. The transition societies seem to be captured by the merciless grip of the hand of the past. Time dependency seems to work over exceedingly long periods. In a lecture delivered before the Serbian Economic Society professor Vukotich from the University of Donja Gorica said that transition had not been the task for just one generation. Several generations will have to burden the task and it remains to see how the performance will unfold with time. Informal institutions differ significantly among various transition countries. Throughout the book, especially in chapters 14 and 15, that far-reaching proposition is theoretically developed and empirically demonstrated. Informal institutions impose themselves as irremovable constraints upon the formal ones, the entire arrangements differ a lot, the functionings of these economies are set apart significantly and as a consequence their performances are conspicuously at variance. All these discrepancies are narrowly connected with history. The countries having belonged to the Western cultural circle have encouraging institutional developments and superior economic performance and in the countries having belonged to various shadings of the Oriental culture the situation is approximately the opposite with little hope to entertain. The situation of the imprisonment of the past is clearly evidenced: those who had institutionally distorted past are forced to struggle with similar difficulties nowadays. The road to prosperity leads through having had an emancipated, modernization encouraging past. The key to future progress is to be found in a particular history. But since, as the Greeks said, not even the gods could change the past, this finding hardly amounts to prescription for economic policy and institutional change.

Just to start moving towards capitalism, somebody will have to do something about it. It looks as if the system, the way it is structured now, will not set for capitalist values and the resulting institutional paraphernalia all by itself. That would only happen if the sole reason for past institutional stagnation had been a grave obstacle which is now all of the sudden removed. That clearly is *not* the case. Once the question of who is to push the existing anachronistic system towards capitalism pops up, most people think of the state. That in fact was the way in which *all* transition ventures have been initiated: it was through a colossal social engineering undertaking that the system was to be shifted into a state of extraordinarily reduced administrative steering and bureaucratic coordination. The general idea was to revert to the market coordination and thus decisively to reduce the

amount of engineering in the system. This entire enterprise amounts then to arriving at a monumental reduction of engineering (meaning central planning and the things associated to it) by means of an undertaking which is by itself a massive engineering venture! It should have taken a lot of courage to get to believe in feasibility of this oxymoronic business. The things that are logically contradictory have little chance to be well implemented in practice. Pejovich would probably say, and many of us would agree, that the entire grandiose action proved to be unsuccessful as it should have been predicted. More precisely, the mismatch turned out to be an increasing function of the gap between traditional culture with its informal institutions, on the one hand, and the panoply of modern market institutions, on the other.

The building of capitalism by the state, the imposing it „from above“ is a grand policy option which Pejovich decidedly rejects. Capitalism cannot be imposed through governmental interventions because it inevitably gets into a headlong collision with the (traditional) informal rules. The author is not willing to enlist the help of the state because, being a hardhearted liberal, he doesn't like the sound of it and is ready to dispense with it wherever possible. By the way, his position on the role of state is consistent and consistently *minimalist* (it is clearly articulated throughout the book and just by way of a sample pp. 130-1 and 158-9 could be cited). He only goes as far as to admit the „government to be strong enough to protect the rights of the governed...The necessity of transferring some...powers from individuals to...governments opens...to expand...the role of the state and...to wipe out individual rights“ (pp. 41.2). This is the point at which one could safely predict that the number of dissenters with the view just expressed is likely to be the greatest. It is interesting that a stand on the role of the state is taken in the article „Affraid to be free...“ which is happily incorporated into the book as an appendix to chapter 4. Buchanan seems to be a little more lenient towards the state when he says that the state should supply „...a network that functions within a collectively-imposed legal structure that protects persons and property and enforces contracts while at the same time financing those goods and services that are most efficiently shared among many users“ (p. 55). Being, among others, a public finance specialist, Buchanan cannot simply bypass a number of state functions that some of us could easily overlook. The point here could be that, despite difference in shadings, there is certainly no contradiction between the two views.

Being as much devoted as possible to minimizing the functions of the government, Pejovich himself appeared to be unable to bypass it. He had to turn to the government to provide the legal wheelwork of the rule of law, the *deus ex machina* discussed in the precedent section. At this point, it only

Institutional Roots of Economic Performance - a Review of the *Law, Informal Rules and Economic Performance* by Svetozar Pejovich -

remains to ask the question to what degree would that be feasible from a public choice theory point of view. All governments *love* interfering directly with resource use, they *adore* controlling all kinds of resources, both real and financial. The more, the better. What kind of noble government it takes to abstain from meddling with resources directly – the meddling which is such an abundant and sweet source of power - and proceed to create the rule of law architectonics which will not only deprive it of power but in many ways tie its hands.

The roadmap proposed by Professor Pejovich is a complex and very extended one: the rule of law, the effective protection of rights and freedoms, the appearance of the pathfinders ready to relinquish the old proven ways of work and life, the shifting of the margin of acceptable behavior, the joining in of other less enterprising members of society...How many decades would all this take? Perhaps Professor Vukotich was right in thinking of it as a job to be performed by several generations. Perhaps all this is true; due to hazards of an overdone engineering the alternative path could, beside being disastrous, take even more time. Especially if on adds in the time needed to amend the damages that are likely to be created by too much engineering which in all likelihood is implied by the alternative to Pejovich's path. Perhaps all that is about to turn out true, but it is too awful to be believed. Some of us will flee from this unpleasant picture without looking back. No matter whether it is true or not.

The upshot of the principal argument of this book is then to some extent disturbing. Some aspect of the main conclusion might appear to be in need of some additional clarification. The conclusion is on p. 168. It says that the rule of law, enacted „admittedly from above“, would produce incentives (and reduce transaction costs) „of freely choosing individuals to determine the direction of institutional changes“. However, that does not mean that they (who – pathfinders, i.e. pioneers, or people at large?) will chose capitalism. To the question of whether they will chose it the author gives an explicit answer: „I think not“. To remove any doubt about the character of the answer, Professor Pejovich adds equally explicitly: „The freedom of choice does not guarantee that individuals will chose capitalism“ (p. 186). But immediately after that, in the very next sentence, the author seem to have transformed himself into an essentially more optimistic observer. Here he says: „I conjecture...that, in an environment that guarantees the freedom of choice and private property rights, capitalism will win in competition with other types of institutional arrangements“. It looks as if we have two Pejovichs: the one that does *not* think that individuals will freely chose capitalism and the other one who believes that capitalism will

win in competition with other systems. Could all this mean that capitalism will prevail despite the disinclination of individuals to accept it and to lie with it? As for the present writer, it is kind of handy to have *two* such opinions: the first one is attractive because it is certainly more pleasant, and the second one has quite a different appeal on account of its being perhaps closer to truth. Of course, these are just assessments and conjectures; when it comes to matters of transition and to the choice of grand organizational alternatives for entire societies, no one can claim to be in the possession of the definitive truth.

6. Conclusion

Should one adopt the degree to which a book inspires thought and gives rise to new ideas as a criterion of its evaluation, then a very high mark would have to be awarded in this case. The inspirativeness of amount and breadth of insights /elucidations/ generated by the book has to do with both the matter dealt with and the author having launched this fascinating study. The subject matter of the book relates to grand issues of how to organize the very base of a contemporary complex society and will never lose its irresistible appeal. The author, on the other hand, is markedly uncompromising, opting for consistent and utterly clear solutions and always unequivocal in expressing his not always shared and not regularly acclaimed views. The price paid for such a stance is meeting with a multitude quite different and frequently opposite views, but the benefit reaped is consistency, clarity and elegance in analysis. The book can be seen as a sort of manifesto of capitalism. It goes most deeply into what is for capitalism most characteristic and could be taken as a set of its irremovable features. His views are firmly grounded in the basic insights on the very foundations of a private-property free-market economy and are articulated through the fundamental notions and truly contemporary results of institutional economics, property rights economics and public choice theory. Clarity seems to be the ideal which he persistently pursues. That is best revealed by his numerous definitions and accompanying elaborations. This is one of the rare books in which the author is well aware of what he is talking about and, more importantly, makes sure that the same goes for his readers. Especially appealing is his practice of defining frequently met and widely used words, the terms which most readers believe to be completely familiar with; the value of such precise and clear-cut definitions becomes evident only after the reader meets them and absorbs their distilled semantic content.

Analytically, this is not a demanding book. Those who are fond of high-brow mathematics and of lengthy and involved logical developments

Institutional Roots of Economic Performance - a Review of the *Law, Informal Rules and Economic Performance* by Svetozar Pejovich -

will not *on that account* be less than enamoured with what it offers on methodological and technical plane. However this should be conceived as a compliment rather than a critical remark about the book. Professor Pejovich is among those who have understood that methodology is not an end in itself but just a means, a set of tools for getting cognitive insights, i.e. reaching legitimate ends of scientific inquiry. The fact that a notable number of very deep, truly basic insights have been arrived at by quite simple methodological devices, such as arithmetic examples or analogies with other phenomena is a great virtue of this book and should be pointed out as an example to follow and imitate. The simplicity of presentation and appropriatedness of used analytical tools have made it possible to produce fertile and significant results in relatively straightforward and easily understood ways. The methodologically mature and pragmatic readers will be grateful for having been given the opportunity to learn a lot with less than commensurate effort. As pointed out in the introduction, this could be thought of as a peculiar and more than wellcome *efficiency*: the book makes it possible to obtain quite a number of results on the basis of not such a large effort. Pejovich is so good in instilling precious knowledge while *not* making life as difficult as one would expect.

The book is primarily analytical and argumentative. Yet, it is not reduced to mere logical deriving chains of theoretical expositions. It is nicely illustrated by brief historical sketches. These sketches are carefully selected and offered with outstanding sense of measure and style. They have two precious features: (1) they bring out truly important and interesting, above all relevant historical truths, and (2) they are extremely effective in the function they are destined to serve – they complement in a purposeful way the theoretical argument and brings it closer to the reader making it more understandable. The same can be said for empirical segments of his analysis: the data are carefully selected, expertly ordered and firmly built into his theoretical analysis. The empirical findings distilled from the data quite closely follow the theoretical argument and make it more persuasive. His simple, transparent and firmly grounded demonstration between economic freedom and development performance will be remembered for long by many readers. As will the fine point that it is an *increase in freedoms* rather than their level that accounts most accurately for the growth performance.

Regarding this empirical probing into the complex world of institutions the same can be said what was said for analogies and arithmetic examples as simple and yet effective ways of deriving the results: empirical analysis is simple but so pointed and adjusted to the general objectives of the study that, again, much is obtained on the basis of less than commensurable

effort. Speaking of the relation between abstract, theoretical analysis and, on the other hand, empirical findings, one should turn attention to an important cognitive fact on which Pejovich with such a valid reason insists. Namely, the wide spread fallacy of comparing the bookish models, i.e. theoretical contrivances, with the systems which have been tried out in economic life and practically exploited – should be done over with once and for all. The two belong to different worlds and must not be compared. The thing that exists is not comparable to the thing that has never existed except in the minds of the critics who were so *critical* to actual institutional realities and – in an epistemological sense – equally *uncritical* to themselves.

One last remark should close this review. Professor Pejovich has written an impressive lot on comparative economic systems, institutions, policies and broader social aspects of economic development. He has been active in this field for decades. Having accumulated an impressive mass of research findings and scientific insights he has acquired a deep understanding of the broadest social determinants of economic development. He is one of the few who have devoted their entire academic life to these broad yet crucial issues of economic evolution and social change. It is not an accident that he, being a lawyer by training and an economist by professional vocation, has been able to see more comprehensively and to understand more thoroughly such a broad area of study as the institutional determinants of economic development. His long work in the field quite predictably made him able to present his views and findings in an ever clearer, more orderly and more profoundly argued way. Many of us will eagerly wait for his next writings, convinced and ascertained that each new undertaking of his brings a host of interesting new results, formally presented in more and more polished, almost aesthetically perfected ways.

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**INSTITUCIONALNI KORENI EKONOMSKIH
PERFORMANSI**

- Pregledni članak o knjizi *Zakon, neformalne institucije i ekonomske performanse* Svetozara Pejovića -

Ovo je pregledni članak posvećen novoobjavljenoj knjizi naznačenoj u podnaslovu. Posebno su naglašeni važnost problemske oblasti kojoj je knjiga posvećena i elegancija i preciznost odgovarajuće obrade. Svesrdno je podržan u knjizi razvijeni opšti stav profesora Pejovića o institucijama kao kategoriji elemenata kojima se ima pribeci ako se na dosledan i netautološki način imaju objasniti determinante i mehanizmi privrednog razvoja. Različiti institucionalni poreci predvidivo generišu vidno izdiferencirane ekonomske performanse. Institucionalni razvoj je dugoročni proces tokom koga dolazi do selikcije institucija na osnovu njihove sposobnosti opstanka u konkurenciji sa drugim aranžmanima. Zdušno je prihvaćeno Pejovićevo insistiranje na neformalnim institucijama. Ove se institucije sastoje od vrednosnih orijentacija, tradicijom osveštanih načina ponašanja, kolektivnih sećanja i drugih elemenata široko shvaćene društvene svesti. Neformalne institucije deluju kao ograničenja na razvoj formalnih institucija koje su svoju pravnu artikulaciju dobile kroz dve velike tradicije u razvitku zakonskog poretka. To su kontinentalna pravna tradicija i sistem običajnog prava (*common law*). Prednosti ovog drugog sistema nađene su u njegovom organskom, postepenom razvitku i u njegovoj većoj sposobnosti da akumulira i čuva informacije i znanje. Ta prednost je stvar njegovog inherentno decentralizovane prirode. Završni deo rada posvećen je ograničenjima koja neformalne institucije nameću u procesu tranzicije.

Ključne reči: institucije, ustav, pravni sistem, svojinska prava, ugovori i obligacioni odnosi, vladavina prava, tranzicija.