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Essays on Institutional Coordination and an Alternative Taxonomy of Civil Society

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Statement of Candidate

I hereby certify that the work in this thesis entitled “**Essays on Institutional Coordination and an Alternative Taxonomy of Civil Society**” has not previously been submitted anywhere for a degree at this or any other University or Institution.

In addition, I certify that:

- All information and literature used are indicated in the thesis.
- This work was done wholly while in candidature for a research degree at this University.
- Where I have consulted the published work of others, this is always clearly attributed.
- Where I have quoted from the work of others, the source is always given with the exception of such quotations; this thesis is entirely my own work. I have acknowledged all main sources of help.

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ABSTRACT

Faculty of Business and Economics Department of Economics
Doctor of Philosophy

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This thesis integrates three independent research programs: a) the Austrian Economics, b) the Law and Economics and c) New Institutional Economics perspectives by introducing a conceptual model called *institutional coordination*, which is understood as a complex process of interaction between networks of *formal* and *informal institutions* (or *rules of the games*). The first aim of this thesis is to show how institutional coordination emerges from a *market-oriented* approach. The second aim is to describe how institutional coordination can be applied through the introduction of an alternative economic and sociological taxonomy represented via *structured, transitional and unstructured civil societies*.

The thesis has been divided into five chapters. Chapter I is a critical introduction that links three related essays presented in Chapters II, III and IV. Chapter II links the concepts of *economic entrepreneurship* and *institutions*. The aim of the chapter is to explore the concept of institutional coordination as an essential component for public policy analysis. The first hypothesis is that institutional coordination, between formal and informal institutions, is the key element for further studying the dynamics of the institutional framework. Then it discusses the significance of prior contributions thus revealing a secondary hypothesis: a new institutional analysis becomes weak when it avoids dealing with the role of institutional coordination; prioritising the formal institutional framework only as a tool to introduce a *utilitarian and constructivist social order*. Chapter III introduces a taxonomy of civil society as an alternative tool for new institutional analysis. It posits three categories of societies:

unstructured, transitional and structured. Following a *Ius Economics* approach and having the concept of institutional coordination as theoretical background, Chapter IV examines the case of the Peruvian pension system and its links with the unemployment insurance scheme (CTS) when there exists a large underground economy. Finally, Chapter V presents the thesis' conclusions.

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List of Publications

Chapter II

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Chapter III

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Chapter IV

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Preface

Ideas introduced by this thesis have been presented at seminars and conferences proceedings, which are indicated as follows

Chapter II

1. MÉNDEZ, R. (2014). Seminar of the Department of Economic History and Institutions I (Complutense University of Madrid) -Advanced workshop for permanent academic staff-: "*The economy of the formal and informal rules: F. Hayek and Douglas North*", March 19th.
2. MÉNDEZ, R. (2013). "Entrepreneurship, Institutions in a Changing Environment", URJC and IJM - VI Austrian Economics Conference, Conference Proceedings. May 22-23th. Available at: <http://www.juandemariana.org/estudio/6604/revista/vi/congreso/economia/austriaca/>
3. MÉNDEZ, R. (2012). Institutions, Economic Regulation and Functional Entrepreneurship: An Alternative model of Economic Development (organized by Externado University), Bogota-Colombia, August 23th.
4. MÉNDEZ, R. (2011). "Institutional Innovation, Deregulation and Competition in a Structured Society", *HDR Expo 2011*, Sydney: Macquarie University Faculty of Business and Economics Press, November 11th.

5. MÉNDEZ, R. (2013). “An Introduction to Institutional Coordination”, working chapter - *GLEA Lecture Series 2013 (Conference Proceedings)*, Bolzano-Italy: Free University of Bolzano (Faculty of Economics), German Law and Economics Association (Gesellschaft für Recht und Ökonomik e.V.) 11th Annual Meeting. September 13-14th. Information available at: <http://www.unibz.it/en/economics/GLEA.html>

Chapter III

1. MÉNDEZ, R. (2014). “Structured, Transition and Unstructured Societies”, URJC and IJM - VII Austrian Economics Conference, Madrid-Spain. June 11-12th, Conference Proceedings (forthcoming).
2. MÉNDEZ, R. (2013). “Structured, Transitional and Unstructured Societies: An Alternative Taxonomy to improve testing positive institutional interaction and the economics of rules”, Working Chapter - ISLE Conference 2013, December 12-13th, Lugano – Switzerland: University della Svizzera Italiana. Conference Proceedings published, paper available upon registration (digital version) at: <http://www.side-isle.it/ocs2/index.php/SIDE/SIDE2013/paper/view/1204>.

Chapter IV

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Overview

The economics of institutions as rules of the games and economic entrepreneurship have been analysed (Leff, 1978; Harper, 2003; Naudé, 2008). However, there is very little exploration that integrates three independent research programs: a) the Austrian Economics, b) the Law and Economics and c) New Institutional Economics perspectives. This thesis integrates these perspectives by introducing a conceptual model called *institutional coordination*, which is understood as a complex process of interaction between networks of formal and informal institutions. The first aim of this thesis is to show how institutional coordination emerges from a *market-oriented* approach (Boettke, 2012; Rizzo, 2011; Lingle, 2000). The second aim is to describe how institutional coordination can be applied through the introduction of an alternative economic and sociological taxonomy represented via *structured*, *transitional* and *unstructured civil societies*.

The thesis has been divided into five chapters. Chapter I is a critical introduction that links three related essays presented in Chapters II, III and IV. Chapter II links the concepts of economic *entrepreneurship* (Kirzner, 1978a; Baumol, 1990; Klein & Foss, 2010) and *institutions* or *rules of the game* (Ostrom, 1990; North, 1991). The aim of the chapter is to explore the concept of institutional coordination as an essential component for public policy analysis. The first hypothesis is that institutional coordination, between formal and informal institutions, is the key element for further studying the dynamics of the institutional framework. This chapter also explores a preliminary theory of *Production and Discovery of Institutions* from a different perspective than the one introduced in 2003 by Djankov et al. (which is concerned about capitalistic institutions represented as a basic trade-off). Then it discusses the significance of prior contributions thus revealing a secondary hypothesis: a new institutional analysis becomes weak when it avoids dealing with the role

of institutional coordination; prioritising the formal institutional framework only as a tool to introduce an *artificial social order* (Hayek, 2005). Chapter III introduces a taxonomy of civil society as an alternative tool for new institutional analysis. It posits three categories of societies: unstructured, transitional and structured. Chapter IV focuses on the damage done to institutional coordination through public policies lacking economic rationality (Cachanosky, 1997; Krause, 2007; Brooks, Davidson & Faff, 2003). Following a *Ius Economics* approach (Epstein, 2005; Ghersi, 2010) and having the concept of institutional coordination as theoretical background, this chapter examines the case of the Peruvian pension system and its links with the unemployment insurance scheme (CTS) when there exists a large underground economy. Finally, Chapter V presents the thesis' conclusions.

Chapter I

INTRODUCTION

Introduction

The economics of institutions (formal and informal economic, social, political and legal rules, or *rules of the games*)¹ and entrepreneurship (entrepreneurial discovery, or creativity and alertness, leading to further economic opportunities or uncovering new information about preferences, shadow prices and technology in conventional or non-conventional markets)² has been analysed by Leff (1978, 1979); Alston (1996, 2008); Hodgson (2001)³; Harper (2003); Naudé (2008) and Otáhal and Grochová (2010). However, there has been very little exploration that integrates three *independent research programs*: Austrian economics, law and economics, and the new institutional economic perspectives.⁴ Therefore, the primary contribution of this thesis to the existing economic literature is to integrate these independent research programs to further explore the concept of Institutional Coordination as a relevant variable for public policy analysis and its relation with a strong and structured institutional framework (North, 1990) and a “virtuous” (productive)

¹ When the term “formal institution” is used, it refers to the “public constraints” or “collective action” enforced by government. For informal institutions, the thesis refers to “private constraints.” Also, the term *rules of the games* includes areas that are independently explored by the institutional literature.

² In this thesis, “functional entrepreneurship” is primarily defined as a process of recognition and exploitation of upcoming market opportunities as traditional or non-traditional economic scenarios (e.g., political and legal markets).

³ According to Hodgson (2001, p. 296), “institutions are simultaneously objective structures 'out there,' and subjective springs of human agency 'in the human head'. Actor and structure, although distinct, are thus connected in a circle of mutual interaction and interdependence.” However, following a mixture of Darwinian and biological analogies, Hodgson later fails to identify the essential role of functional entrepreneurship in advancing institutional development (Boettke & Coyne, 2005). In contrast, this thesis was inspired by a different approach, wherein Hayekian spontaneous order is conceived as an alternative to Darwinism for social science.

⁴ Nevertheless, Krecke (1998), Cachanosky (1997), Ghersi (2010), Krause (2007), Boettke & Coyne (2011), and Manne (2014) exemplify a successful example to be followed in academia. In particular, in light of their statement that “context matters”, Boettke & Coyne are considered pioneers in analysing the degree of interaction between entrepreneurship and formal/informal institutions. The objective of integrating different research programs was inspired by the work initiated by the George Mason University (GMU) Program in Law and Economics and its scholars.

entrepreneurial function (Kirzner, 1979; Baumol, 1990 and Klein & Foss, 2010).

Moreover, a central theme of this thesis is that an alternative understanding of how the rules of the games link up, (or *institutional coordination*), is required to improve economic and public policy decisions. This research is an opportunity to integrate the above-mentioned perspectives from a broader viewpoint (*market process economics*) than that of the static economics of perfect competition and Pareto optimality. Recently, this objective has become an increasingly important topic of research for contemporary institutional and developmental economics (Boettke et al., 2008).

The thesis describes institutions as *rules of the games*⁵, which are produced to facilitate *voluntary cooperation* and *exchange of property rights*⁶ among individuals.⁷ These rules include legal, cultural and ethical norms as well as economic patterns of social and political interaction. The thesis then introduces

⁵ Douglass North (1990) defined institutions as *rules of the game*. However, following Alston (2008), this thesis describes an approach that identifies formal and informal social, economic, legal and political rules that are permanently immersed in complex and interactive processes (and consequently shape different kinds of human behaviour) as *rules of the games*. This is because social, economic, legal and political environments are ruled by specific characteristics influencing the development of institutions as a final output.

⁶ Nonetheless, the literature has increased dramatically, and the nature of “property rights” is currently open to debate. As property rights represent a foundational institution for developing social science, further exploration of their significance and relationship to institutional coordination are needed. In this regard, Brooks, Davidson & Faff (2003) stated that the literature still has three central questions that must be fully answered: What rights or institutions currently exist? What are the consequences of those institutions? Where and how did those institutions come into existence?

⁷ The framework proposed in this thesis for understanding *voluntary cooperation* and *exchange of property rights* differs from that of authors such as Oliver Williamson. In Williamson’s theory of economic governance, individuals are ultimately presumed to be economic agents that cannot trust one another. According to Earl & Potts (2011), this is a “top-down contract based analysis” claiming a hierarchical interpretation that can be described as a “Hobbesian (utilitarian) solution.” Therefore, the thesis departs from the Ostromian perspective, presuming that people can introduce collective agreements and that people can enforce these agreements without requesting central government support.

a conceptual model called *institutional coordination*. This conceptual model represents the work-horse (theoretical background) of the thesis and it goes further than other approaches where the interaction among economic, political, legal and social institutions has been considered without a multidisciplinary assessment –and built as a “relevant instrument” for other areas such as law, political science and modern sociology.

Institutional coordination is *a complex process of interaction between formal and informal rules influenced by human action* (both productive and unproductive entrepreneurship). The model differs from others that are concerned primarily with informal or formal institutions and departs from ideas such as the following: (a) individuals do not have direct control over the processes for the creation of institutions, and there is no guarantee that the spontaneous selection of institutions will be efficient in the long run; and (b) institutions never respond directly to individual purposes even when individuals are in conditions suitable for carrying out activities without *rational motivation* (Becker, 1962).

The first aim of this thesis is to show how institutional coordination emerges from a *purely hypothetical approach* and becomes pertinent for *mainline economics* (Boettke, 2012). The second aim is to describe how institutional coordination can be *grounded* (Glaser & Strauss, 1999) in the real world through the introduction of an *economic and sociological conceptual taxonomy* represented by the concepts of *structured, transitional and unstructured civil societies* (Méndez, 2013).

From a methodological point of view, the thesis takes a cultural approach, as has been proposed by Spiegel (1983), and is influenced by a *non-standard grasp* (Hayek, 1942), departing from logical inferences to introduce a *fundamental assumptions-assumed conditions model* (Machlup, 1955; Zanotti, 2010, 2011a).

The thesis brings together three related essays - Chapters II, III and IV. Chapter II links *economic entrepreneurship* and *institutions*, which are understood as a set of categories or rules of the games. The purpose of this chapter is to explore the concept of institutional coordination as an essential component of public policy analysis. The first hypothesis is that institutional coordination is the key element for a *theoretical consistent and comprehensive analysis of institutions* that seeks to improve economic and legal research based on the traditional *civil law system*.

Unlike other studies, Chapter II does not just describe institutional coordination as the process of the formation and application of rules at different levels (Williamson, 1985);⁸ it also considers the real consequences of activities undertaken by economic actors exercising *mercantilist behaviour* through *political entrepreneurship* (Gherzi, 2009). Chapter II also does not follow an *institutional competition–games theory* approach (Greif et al, 2004; Krause, 2007). Therefore, this thesis does not assume *differences of degree* between informal and formal institutions⁹, or *institutions and evolution* following either approaches from Hodgson’s “Social Darwinism” (1993) and Potts’s “evolutionary and complex theory” (2000, 2008), respectively;¹⁰ Moreover, despite the importance of property rights, Chapter II does not seek to introduce a technical assessment of the significance of formal and informal institutions (Williamson & Kerekes, 2011). This is because the emphasis of the thesis is on the interaction effects of formal and informal institutions, analysed from a pure *Ius Economics* perspective, as has been proposed by Hayek (2005) and developed by Cachanosky (1997) and Gherzi (1991, 2005). Therefore, the aim is not to engage in an empirical exercise that assesses the rules of the games in terms of the consequences of the prevailing legal tradition or as a limited

⁸ It refers to Oliver Williamson’s system of hierarchies.

⁹ Assuming *differences of degree between informal and formal institutions* is not the equivalent of there being *degrees of coordination among institutional types*.

¹⁰ However, ideas from both Krause (*Market and Institutions in Latin America*) and Potts (*knowledge grows*) have influenced the development of the critical thinking introduced in this thesis.

interface of law, politics and economics. Further, Chapter II shares the definition of formal rules as government-defined and enforced constraints, while informal institutions show the prevalence of private constraints. However, this thesis does not focus on related topics such as the unintended consequences of codifying informal legal rules or supporting statements, such as “formal institutions are only successful when embedded in informal constraints” (C. Williamson, 2009, p. 5).¹¹ Moreover, it avoids following most prior studies, which are fundamentally focused on the role of either informal rules or formal rules (Nee, 1998; Jutting et al., 2007; Meisel et al., 2007). Even though the thesis supports the notion that these academic efforts have contributed greatly to our understanding of institutions, those contributions have missed an important element: namely, the role of *institutional coordination* and economic and political entrepreneurship. This chapter (and the thesis) also avoids the use of a diminished conceptualisation of the rule of law that has been introduced by mainstream institutional economics (Voigt, 2009). This clarification is important, as according to mainstream institutional scholars such as Kirat (2013), the rule of law corresponds to the *ability of the government* to provide social order and security of transactions, and to establish efficient and uncorrupted administration officials.¹² In addition, even though it recognises the fact that the public institutional framework coexists with the private, the relevance of *good economic, politic and legal governance* and that institutional change requires a *long process of depersonalisation of social regulation systems* (Meisel, 2008), the chapter departs from the idea that the degree of formalization of rules is the most relevant variable for discriminating between institutions (Gherzi, 2010). Rather than it follows an approach where the formalization by statute is conceived as another

¹² This kind of narrow definition focuses on the primacy of formal rules. It involves a theoretical divorce between formal and informal rules and is incapable of recognising institutional coordination as a key element of a comprehensive new institutional analysis, despite the fact that it can be correlated with perspectives within institutional economics. However, this thesis is not an attempt to introduce a McCloskey-based *rhetorical economics* proposal.

mechanism for institutional capture and the empowerment of antidemocratic regimes (Lingle, 2000).¹³ Since this research follows an interdisciplinary approach it also attempts to rescue the *value of interplay among institutions*, or institutional coordination, as the significant variable (Boettke & Coyne, 2005).

Chapter II also adopts the “*meta*” concept of civil society, which is represented as a process of prevalent dynamic and free cooperation among individuals. Chapter II also explores a preliminary theory of *production and discovery of institutions*, but from a different perspective than the one introduced in 2003 by Djankov et al., where capitalistic institutions are represented as a basic trade-off between the costs of democratic government and the costs of an autocratic government. It is also important to explore the *determinants of institutional elasticity*, because these mainly correspond to the ease with which an institution can replace another institution. According to Gherzi (2005), the effects of social change can be foreseen in scenarios dominated by *underground economies*.¹⁴ Chapter II also develops a *secondary hypothesis*: that new *institutional analysis* is weak when it avoids dealing with the real role of institutional coordination in an economic, social, political and legal environment, and prioritises a *formal institutional framework* as a tool to reach *institutional predictability* and a *sustainable social order* (Alonso & Garcimartin, 2008). One flaw in the mainstream new institutional analysis (Alonso, 2012) is that it unintentionally supports a division between the *legal*

¹³ Chapter II (and the thesis) step aside from “experiments”, in which institutions are *narrowly categorized* and –sometimes- misrepresented to determine which ones are significant for economic performance (Acemoglu & Johnson, 2005; Acemoglu & Robinson, 2012).

¹⁴ For its philosophy of economic approach, this thesis follows *scientific realism* and not the dominant *instrumentalism*. In the same vein, a theoretical contribution may seek simultaneously to describe, predict and explain; however, the basic aim of this thesis is to *explain* (Maki, 1998). This is because, according to Hodge (2007), knowledge is unsatisfactory if it is confined predominantly to describing (empiricism) and/or predicting (instrumentalism). A modified form of instrumentalism can be categorized as more “inclusive”, but it will always defend the premise that all that matters is the accuracy of the predictions thereof. Our proposal does not aim to follow this pathway.

theory of the sources of law (Ross, 2007; Ghersi, 2007) and the mainstream *economic analysis of rules* (Posner, 1998; Kornhouser, 2002). This appears to be predominant in studies that argue for more governmental legislation in order to strengthen *institutional quality* that limits political and economic freedom for individuals and communities.

Chapter II is divided into nine sections. The first section explores the theoretical significance of institutional coordination and how several layers mediate the interaction of subjective preferences and production factors, including legal, social, cultural and political institutions or rules. The second discusses the relationship between institutions and civil society. In this section, civil society is presented as an example where *spontaneous order* prevails: that is, a highly complex structure not consciously designed by the government and comprised of *human interactions* carried out according to certain rules, habits or standards of conduct. The third section presents an explanation of how a lack of institutional coordination, or the *institutional coordination problem*, emerges. The fourth section introduces a discussion of the institutional *marginal rate of technical substitution* based on an analysis of institutional coordination. The fifth section considers the combination of formal and informal institutions and its relationship with institutional coordination, and the sixth section continues to explore the *determinants of institutional elasticity* and how they influence institutional coordination. It is assumed that institutional elasticity is determined by the potential for a formal institution to be replaced by an informal institution, and vice versa. The seventh section discusses the link between formal and informal institutions and the problem of legitimacy. Departing from the previous analysis, the eighth section continues the discussion of the nature of overlapping informal institutions and institutional coordination. Section nine takes the discussion about the relevance of institutional coordination further and introduces a new and complementary topic: the link between institutional coordination and the brain's reward system.

Chapter III introduces a conceptual taxonomy of society as a tool for the study of institutional coordination. The thesis posits three categories of societies: *unstructured*, *transitional* and *structured*. Despite Parsons (1968) contribution to functional sociology in the use of these three categories, the thesis does not favour the mainstream approach used in sociology but focuses on the idea that civil society is not primary an example of a *misbalanced, evolutionary and an autogenous process*.¹⁵ Our approach has its roots in Hayek's Theory of Spontaneous Order (1964). Furthermore, while this is a conceptual contribution, this alternative taxonomy represents a *discernible point of departure*, which could help researchers examine and categorize the relevant variables that affect the economics of rules and, consequently, related areas such as economic performance and growth (Mendez, 2013).

The categorization of civil societies as structured, transitional or unstructured seeks to become a useful theoretical tool for social science. However, in order to effectively achieve this aim, further studies might also be introduced via the assessment of matching proxies such as interpersonal trust, institutional quality, the perception of corruption and the strengthening of property rights (Greif, 1988; San Emeterio, 2006; Mendez, 2013c). Furthermore, an understanding of the categorization of civil societies as structured, transitional or unstructured might also be an important instrument for classifying the degree of institutional weakening and coordination.

¹⁵ According to Potts (2003), the idea that civil societies are primary an example of a *misbalanced, evolutionary and an autogenous process* is consistent with the approach followed by contemporary evolutionary economics, wherein "*some ideas are tested and found reliable. Others are tested and rejected, and then regenerated by new conjectures that are often variations upon those same rejected ideas.*" In addition, despite assuming that autogenous orders prevail for the organization of civil societies, our approach recognises the value of those contributions where social order is also "deliberately arranged". In recent years, it has been argued that there are multiple types of set of interactions among individuals (Ostrom, 1990). These sets of interactions may also describe as "deliberately arranged" (e.g. communal property). Such interactions allow coordination within a framework of private property. This fact introduces social scenarios where individuals freely (contractually) decide to participate or abandon.

This taxonomy introduced in Chapter III aims to illustrate that without dynamic efficiency, limited (rational) political governance and the contribution of functional entrepreneurship, institutional coordination cannot be achieved. Without these there will be a lack of associative cohesion and, thus, an unstructured civil society. Even though the interest in empirical studies varies among professions, this alternative taxonomy aims to create a degree of integration among different programs of research and *methodenstreit* approaches.

Since Chapter III attempts to bring together a large but disparate body of research topics in a more coherent research agenda (Heyne et al., 2009), it has been organized into three main sections. The first section examines associative structures and civil societies, which relate to our alternative conceptual taxonomy of civil society. The second section engages with the notion that a theoretical illustration of civil society also represents a misbalanced and evolutionary process (Hayek, 1960; Barry, 1982; Perez-Diaz, 2014). The third section discusses the purpose of an alternative taxonomy and conceptual proposal for civil societies, and introduces a preliminary attempt to implement a categorization.

Chapter IV focuses on the damage done to institutional coordination through public policies that lack economic rationality (Cachanosky, 1997). Following a *Ius Economics* approach (Gherzi, 2010), and with the concept of institutional coordination as a theoretical background, this chapter examines the case of the Peruvian pension system and its links with the unemployment insurance scheme (CTS) in a situation where there exists a large underground economy. The first aim of this chapter is to examine the implementation of alternative unemployment insurance and a pension schemes in Peru, through an institutional coordination approach (Méndez, 2013). Assuming a cultural approach in line with Spiegel (1983), the chapter departs from *Ius Economics*, which is understood as a continuous and interdependent interaction between

the legal and economic fields. This continuous interdependent interplay is significant for its impacts (costs and benefits) on an open civil society (understood as an evolutionary process governed either by *spontaneous orders* or by limited artificial governance mechanisms). Following Hayek (1964) and Barry (1997), this chapter conceives spontaneous orders as self-regulated or autogenous systems. In contrast, *artificial orders* are conceived as products that have multiple outcomes (positive and negative) and that are introduced by executive, legislative and judicial powers. In this regard, artificial orders would be limited by the complexity of the ability of their authors and capable of generating *institutional weakening* (Méndez, 2013c).

The second aim of the chapter is to describe some of the constraints (in terms of economic outcomes) that might affect governance mechanisms (formal rules) that are introduced to ensure the best interests of workers and retirees. It is from this second assumption that the chapter presents the following hypothesis: To what extent could a weak proposal to reform the current labour and pension legal framework cause more distortions in the process of institutional coordination? These distortions involve the presence of conflicts of interaction among rules (known in the civil law system as conflicts of *normative interaction*) Ghersi (2010). These include (a) the formal rules governing the Peruvian unemployment insurance system (Compensation for Time of Service or CTS) and other pro-worker mechanisms; (b) the formal rules that organize the pension system; (c) the proposed legal framework introduced to regulate an alternative model of unemployment insurance and the rules introduced for reforming the pension system; and (d) the informal rules and security mechanisms (informal unemployment insurance by way of the underground economy and the system of security and family protection).

In Peru, chronic conflicts of interaction among rules have been an important variable that has slowed institutional change and, thus, become a source of institutional weakening attributed by new institutional literature to the *failure*

of institutional transplant in a political, social, legal and economic scenario dominated by the *state of legality* (Gherzi, 2010; Lingle, 2000).¹⁶ Also, there might be a correlation with the damage produced by a set of *complex formal institutions or rules* (Epstein, 2005) that are responsible for producing higher costs in the labour market and in structurally related areas such as the pension system¹⁷.

The methodological approach in the chapter involves a combination of *forensic methodology*¹⁸ and *axiomatic-deductive analysis* (Zanotti, 2011). These approaches were selected due to the nature of an Ius Economics study, the small number of consistent reports and the limited amount of up-to-date data capable of contributing to formal technical analysis. Moreover, most of the Peruvian data is based on Metropolitan Lima, which does not allow an accurate description of the current situation in the country.¹⁹

¹⁶ The thesis of the state of legality assumes that nominally existing formal institutions “rule” social life. However, *these institutions do not restrict political and legal power, but reflect this power*. Therefore, what has happened in countries such as Peru is that formal institutions reflect power, rather than limit it. This scenario creates a context in which formal institutions become an instrument of oppression rather than one for introducing *fairness and justice*.

¹⁷ The *parallel model* that characterizes the current Peruvian pension system was established in the early 1990s as a result of a structural reform wagered by a *mix system* (public + private) rather than a *substitution model* (private instead of public). This meant that from 1992, the National Pension System (NPS) operated simultaneously with a private pension system (PPS) introduced through firms called AFP’s (private superannuation management funds).

¹⁸ Forensic methodology is a distinctive approach in social science and legal studies. It prioritizes the necessity of considering the source and reliability of information. In this approach, one must weigh all factors in decision-making and also undertake an initial inspection (deductive) of the facts by means of a tailor-made theoretical or conceptual model. Therefore, the fact that the researcher is considered responsible for following appropriate research protocols is prioritized: that is, the researcher must ensure that the objectives of the research project can be achieved satisfactorily despite the existing material limitations.

¹⁹ The need for greater quantity and quality of statistical data is a widespread demand in the Peruvian economic literature. The lack of consistency and irregularity of Peruvian data is caused not only by budgetary reasons but also by political ones.

The chapter has been divided into eight sections. In the first section, the concept of institutional coordination and its relation to the Peruvian case study are introduced. In the second section, a description of the economic and legal environment is provided. The third section then focuses on unemployment insurance (CTS) and recounts the major legislative initiatives that have driven the potential reform. The third section continues describing the technical barriers that restrict their reform and implementation are discussed. In the fifth section, the scope of the CTS is compared with public social protection mechanisms for unemployment insurance, as proposed by Peruvian experts arguing for reform of the system (Gomero, 2003; Jimenez & Cuadros, 2003; Garavito & Munoz, 2012). Finally, a proposal for institutional design focused on the market mechanism is described. The fourth section focuses on the Peruvian pension schemes. This section begins outlining the impact of the informality of social protection, the labour market and its relationship with institutional coordination. It also points out the similarities of governmental action in related areas such as unemployment insurance (CTS) and the Peruvian pension system. Furthermore, this section describes the new non-contributory scheme (Pension 65) and explains the impact of this scheme on institutional coordination.

Chapter II

AN INTRODUCTION TO INSTITUTIONAL COORDINATION AS AN ALTERNATE MODEL FOR INSTITUTIONAL ECONOMIC ANALYSIS

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Introduction

The main purpose of this chapter is to provide a conceptual and theoretical overview of the “state of the art” of the literature on *institutional coordination* or *positive institutional interaction* in correlation with an alternative understanding of the concepts of *functional entrepreneurship*²⁰ and *institutions* as have been proposed by Israel Kirzner (1978) and North (2009) respectively.

With regards to this, the specific objectives are: 1) To introduce a successful conceptual model for further qualitative and quantitative studies; 2) To introduce and describe the concept of institutional coordination; 3) To highlight the particular problems that arise when analysing some theoretical characteristics of those societies in correlation with the level of institutional coordination (its strength or weakening); 4) To briefly show the advantages of an alternative approach as a harmonizing instrument that aims to introduce different perspectives (such as *Institutional Quality*) as it has been traditionally understood by contemporary heterodox-market-oriented economics.

As the aim of this chapter is to develop the notion of institutional coordination, from an alternative perspective, it is important to understand that contributions from legal, sociological and non-standard economic theory are considered complementary. Interdisciplinary research focused on: a) the relevance of institutions, b) individuals interacting as complex and dynamic groups, and c) economic agents expressing the essence of the entrepreneurship function.

²⁰ Entrepreneurship is an essential concept for the development of the theoretical framework discussed in this chapter. The entrepreneurship function is defined here as the human ability to discover new entrepreneurial opportunities. According to Kirzner (1978a), the entrepreneurship function refers to every individual, not just another factor of production or a simple microeconomic concept, and is primarily related to the level of uncertainty in the market. Kirzner further suggests (but did not introduce any further exploration) that improving dynamism through informal institutions can reduce uncertainty.

These require a unified methodology as understood by classical economists like Smith or one of the fathers of the marginal utility approach, Carl Menger (1976). This is not a matter of “academic labels” or “fancy proposals,” on the contrary; this is essential to build a better explanation of how the interaction between functional entrepreneurship and institutions can affect a country’s economic performance and growth.

Therefore, in order to introduce the concept of *institutional coordination*, the relevancy of an alternative economic theory of rules to a successful economic assessment is explained. This thesis departs from the hypothesis that *institutional coordination or positive interaction* between and among formal and informal institutions is the real key element for a theoretically consistent analysis of institutions, or ‘rules of the game’. There is also a secondary hypothesis: a more conservative new institutional analysis is not comprehensive, in the sense that, it avoids dealing with the real role and relevancy of informal institutions. Instead, it favours the formal institutional framework in order to reach institutional predictability and a sustainable social order. This is illustrated by most new institutional²¹ and economic analysis of law research. Consequently, the role of formal institutions is analysed much more frequently (e.g., the rule of law, property rights, or patent law) while informal institutions are neglected, or less rigorously described (Alonso et al., 2008). With regards to this argument, Helmke & Levitsky (2004) have explained:

*“Consideration of informal rules is also often critical to explaining institutional outcomes. **Informal structures shape the performance of formal institutions in important and often unexpected ways.** For*

²¹ This thesis refers to Neoinstitutional and New Institutional analysis as conceptual synonyms. Nevertheless, it is possible to argue against it and start an interesting discussion from both methodological and applied perspectives.

example, executive-legislative relations cannot always be explained strictly in terms of constitutional design". [Emphasis and italics added]

Furthermore, according to these authors, informal institutions or rules are: "*socially shared rules, usually unwritten, that are created, communicated, and enforced outside of officially sanctioned channels*". Informal rules are essential for shaping formal institutional outcomes. According to Williamson & Kerekes (2011):

*"Informal institutions are those rules that shape human behaviour but are outside of government (...). **These private mechanisms** (...) guide everyday interactions and shape a way of life*". [Emphasis and italics added]

Also, this "shaping" appears more clearly in sensitive scenarios such as legislative and judicial politics, party organization, public administration and State building. In addition, we share the beliefs of Helmke & Levitsky (2004) concerning the idea that formal and informal institutions *interact in a variety of ways*. However, we do not adopt the same *two-dimensional* typology to describe institutional interactions. It means that our *model of institutional coordination* will not simply discuss: a) *The degree to which formal and informal institutional outcomes converge*; and b) *The effectiveness of the relevant formal institutions, that is, the extent to which rules and procedures that exist on chapter are enforced and complied with in practice*.

Our model also differs from C. Williamson's proposal (2009) on how formal and informal institutions interact. Our proposal aims to show that one flaw of predominant new institutional analysis is that it indirectly supports a separation and confrontation between contributions emerging from the *Legal Theory of the Sources of Law* (Ross, 2007; Ghersi, 2007) and "*traditional*" economic

analysis. Therefore, this chapter introduces an illustration where this separation is stopped in order to effectively integrate economic and legal analysis of institutions. Moreover, institutions have been presented as economic goods, which can be evaluated not only through the use of classic concepts such as marginal value and cost but also in terms of elasticity. Consequently, this chapter introduces a preliminary proposal where the determinants of institutional elasticity have been classified and roughly described.

Chapter II has been divided into nine (9) sections. Section 1 will explore the theoretical significance of institutional coordination and how the interaction of subjective preferences and production factors is mediated through several layers, including through legal, social, cultural and political institutions or rules. Section 2 will discuss the relation among institutions and civil society. In this section a civil society is presented as an example of *spontaneous order*, thus, as a highly complex structure not consciously designed by anyone and comprised of human interactions carried out according to certain rules, habits, or standards of conduct. Section 3 presents an explanation of how the lack of institutional coordination or the *institutional coordination problem* emerges. Section 4 introduces a discussion of the institutional *marginal rate of technical substitution* due to a consistent analysis of institutional coordination, which requires deciding the best possible combination between formal and informal institutions. Section 5 considers the prospective combination among formal and informal institutions and its relation with institutional coordination. Then Section 6 continues to explore the determinants of institutional elasticity and how it influences institutional coordination. In this section it has been assumed that what determines institutional elasticity is the ease with which a formal institution can be replaced by an informal institution and vice versa. Section 7 refers to the link between formal and informal institutions and the *problem of legitimacy*. Departing from the previous analysis, Section 8 continues to discuss the nature of overlapping informal institutions and institutional coordination.

1. The relevance of Coordination among Institutions

One of the main effects of the leading *neoclassical paradigm* within economic theory after 1850 was the “rejection” of aspects not considered as pure economics such as *pure subjective preferences* and *entrepreneurial judgements, functional entrepreneurship* with and without access to capital, knowledge and information, rules (institutions) formation, discovery or production, and others.

This was a great contrast to the thinking of the classical economists like Smith, Malthus, and Ricardo, who had stressed the importance of the social, cultural and political analysis of economic phenomena on a particular basis. According to Boettke and D’Amico (2010, p. 6):

“Classical economists saw the market as a process of competitive rivalry and dynamic entrepreneurial discovery. They placed importance on the economics of organizations and examined the political process with the same behavioural assumptions that they used to examine the market process.” [Emphasis and italics added]

However, interest in the interaction between the social-political environment and the economy (meaning a *humanistic approach*) remained attached to the heterodox tradition, specifically in later authors like Menger. According to Klein (2007, p.7):

“Menger favoured an approach that was deductive, teleological, and, in a primary sense, humanistic. (...), he was primarily interested in explaining the real- world actions of real people, not in creating artificial, stylized representations of reality.” [Emphasis and italics added]

In this regard, the theoretical deep fissure that has survived into the economic mainstream years later allowed modern-market-oriented heterodox economics to reach increasing notoriety (Roux, 2006). For these economists, economics was the study of purposeful human choice, the relationship between means and ends guided by complex rules: *institutional rules*.²² Inspired by this perspective, in this chapter we will consider that “*economics has to be understood as an exchange or the science of social exchange. More precisely, we understand economics as an exchange of property rights developed and guided by a set of formal and informal rules (institutions) and carried out by the entrepreneur in an evolutionary social context.* (Méndez, 2013, p. 157)”

Furthermore, economic approaches such as the Neo Austrian and the New Institutional were able to show that the interaction of subjective preferences and production factors is mediated through several layers, that is, through legal, social, cultural and political institutions or rules. Consequently, the difference in levels of performance and economic development among countries was better understood with a *coordinated institutional framework*, which denotes divergent levels of *productive* (Baumol, 1990) and *functional entrepreneurship* (Foss et al., 2010).

²² Generally speaking, it can be stated that society is ruled by two kinds of institutions: Formal (statutes, and others.) and informal institutions (customs, and others.). The Government, represented by the legislative, executive and judicial powers, introduces formal institutions or rules. These institutions are static and arise from the monopolistic power of government. Informal institutions are dynamic, and their legitimacy and enforcement are based on the need for social acceptance. Even though there is a difference between formal and informal institutions, there is also a level of interdependence between these sorts of institutions. Formal institutions create a fundamental social order and coordination, which is important for the development of informal institutions, whereas informal institutions reflect the level of social acceptance or rejection of the society's formal institutions. This scenario has been described as the “*competitive character*” of formal and informal institutions where a society will no longer recognize poorly developed formal institutions, and will progressively substitute them with new informal institutions. Formal and informal institutions cannot be isolated. We believe that a comprehensive new institutional analysis has to perceive the existing chains between both groups of rules. In this chapter, the complex chains created by formal and informal institutions will be referred as “*institutional network*”.

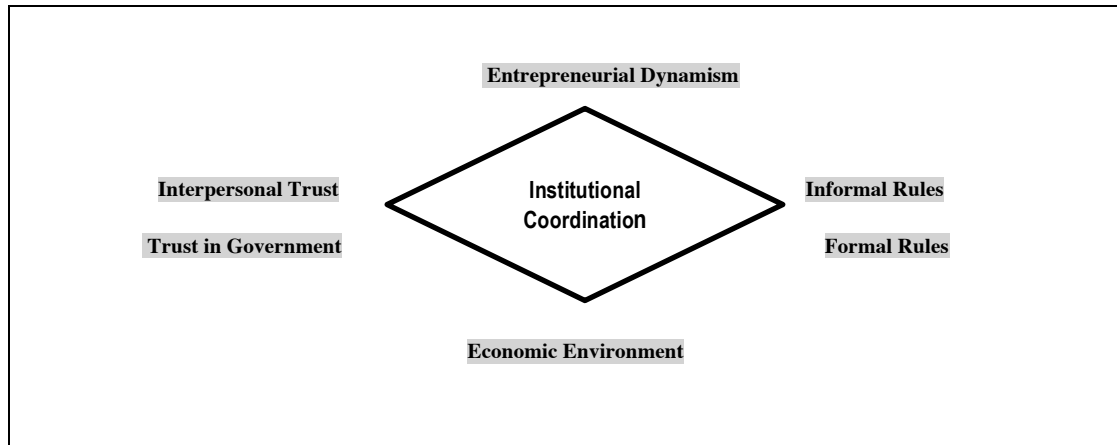
A coordinated institutional framework in close connection with the exercise of *functional entrepreneurship* is essential to introduce an incentive scheme that results in economic outcomes that can be categorized as efficient (this is, allowing social fabric to unfold in an atmosphere of low transaction costs) because it creates a structure to encourage economic growth. This also means that the institutional framework and entrepreneurship have shaped property rights and markets have provided an environment where competition (process of rivalry) can exist and flourish. Without the existence of entitlements or rights showing vigorous property rights, individuals could not invest in human or physical capital, develop or adopt new technologies or implement new ideas. When the institutional framework suffers from a serious lack of coordination it does not allow markets to flourish. This is attributable to its distortion by the ruling government (e.g. institutional capture), and therefore, resources tend to be allocated incorrectly creating *institutional diseconomies*.

These *diseconomies* can negatively impact on societies seeking to promote innovation through the market process and individuals looking to achieve “prosperity” in a context of voluntary cooperation and non-aggression. Consequently, an institutional framework that cannot prevent *social failures*²³ and *limit the power of government* by, for example, stopping perverse behaviour of economic agents such as politicians, bureaucrats or unproductive (mercantilist) entrepreneurs (Gherzi, 2009) will affect efficient growth, income creation and redistribution through the market process. Therefore, a framework of coordinated institutions matters because it helps to solve a key economic problem for agents: coordination of their entrepreneurial projects (entrepreneurial dynamism) and the development of specific productive

²³ According to Piskorski (2013), “*Social failures are social interactions that do not occur, but would make two or more people better off if they did. To understand the concept of social failures, imagine a world in which all people who would like to experience different types of interactions with each other can actually do so. In reality, not all such interactions will actually take place. Social failures capture the difference between interactions that do happen and those that should happen.*”

activities based on efficient economic calculation and affecting the economic scenario as illustrated by figure 1.

Figure 1: Criteria for Institutional Coordination



Beyond that, there is emerging consensus that the institutional framework plays a key role in shaping the growth (North, 1990) of developing nations (Acemoglu, 2005). In addition, it is important to consider the role that the institutional framework has in promoting economic change and sustainability, in other words, towards a statement that explains the differences in economic growth and development among countries with different social environments.

Although many economists agree on the objectives and the relevant role of the institutional framework -in general- the concept of institutions differs in economic literature. As a result, the definition of institutions is a currently open debate. According to Hodgson (2006, p.1):

“The use of the term institution has become widespread in the social sciences in recent years, reflecting the growth in institutional economics and the use of the institution concept in several other disciplines, including philosophy, sociology, politics, and geography.”

[Emphasis and italics added]

Following this, a brief literature review will show that multiple definitions exist, though many of them are extremely narrow, general or vague (San Emeterio, 2006). It is assumed that this topic is important because institutions are not simple legal statutes in *first and last social order* but are evolutionary mechanisms with a grade of homogeneity and temporal transcendence. Therefore, it can be stated that institutions vary in shape, size, importance and role, and are not stress-free to transplant or transfer (almost impossible in the case of informal institutions) from one country or region to another, differing significantly not simply among developing countries, but also in conjunction with those of developed nations. Furthermore, even in a formal sense they are problematic to define because they include rules or legal mandates (written laws) and dynamic rules that govern social interaction inside the social fabric (evolutionary rules as customs and social practices).¹

From a new institutional point of view according to Gagliardi (2008), in an effort to synthesize and extend their understanding, institutions can be classified into three categories. The first category considers institutions as the *rules of the game*. As it has been described by North (1990, p. 3):

“Institutions are the rules of the game in society or, more formally, are the humanly devised constraints that shape human interaction. In consequence they structure incentives in human exchange, whether political, social, or economic.” [Emphasis and italics added]

The second category, presented by Nelson’s previous research (1994), describes institutions as the *players participating in the game*. This idea is shown in the quotes by Aoki (2007, p. 9):

“Nelson identifies institutions with prominent organizations such as “industry associations, technical societies, universities, Tribunals,

government agencies, legislatures, and others.” [Emphasis and italics added]

According to Gagliardi (2008) this definition considers the role of those who have to enforce rules and ensure that individuals comply with them.

The third category considers institutions as the result of the self-fulfilling balance of a game. As observed by new institutional scholars (Argandoña, 1991), this apparently broad definition consists of two interrelated elements: a) perception of the players, and b) organizations that modify the game. In the same vein, and following previous research from Schotter (1981), Gagliardi (2008), has stated:

“(...) this definition considers institutions as the self-enforcing equilibrium outcome of the game (...). More precisely, institutions are made up of two interrelated elements: the beliefs individuals form on others’ behaviour and the organizations, which can alter the rules of the game.”

In regards to this last category, Aoki (2007) states that an institution represents a "*self-sustaining system of shared beliefs*". Aoki’s theoretical approach balances North’s view, since it barely focuses on the value of institutions or rules, but also the way that the game needs to be played or coordinated (second category). Therefore, it is necessary to also consider the degree of interaction among institutions (formal and informal) and its relevant *sub types* that can be rescued from Roman law and Civil law scholars (Gherzi, 2007).

The purpose of referencing institutional sub types is to save the general classification of *sources of law* used in the civil law tradition (continental European law). In that sense, we believe that more than one category of both formal and informal rules exist. Nevertheless, this fact has been extensively

studied by legal theory without necessarily and explicitly establishing a connection, even with contributions from modern heterodox economics. To understand how the players (individuals exercising functional -productive or unproductive- entrepreneurship) assume their key role.

However, to cope with a proliferation of interpretations, it is desirable to maintain a consistent view. In this regard, North's contributions (1991) should be understood as an early stages starting point. North (2005) describes institutions as "*humanly devised constraints*" which are due "*to structure the political, economic and social interaction.*" These human limitations can be divided into formal constraints (constitutions, laws, regulations) and informal constraints (involving taboos, customs, codes of conduct, social uses), in other words, manufactured restrictions that -as it was shown by Barry (1997)-, shape *spontaneous human interaction*. This conceptualization provides a valuable road map indicating how humans interact with each other as individuals or social groups (inside a complex political, social or economic process). That is, institutional studies have to be closely linked to ideas awaiting further development such as *institutional competition, institutional opportunity cost and a mixed theory (law and economics) of institutional evolution and change* (Méndez, 2011). These are important because even describing this phenomenon on a different basis the mainline new institutional analysis did not assume the existence of institutional competition. According to Meisel et al., (2007, p. 26):

"The system of regulation that continues to dominate the social sphere remains based on personal ties and relationships, observance of unwritten and strict norms (submission to authority, to tradition, and others.). (...) Confidence (in the relation to authority, the circulation of information, and the observance of rules) is produced and shared on an idiosyncratic basis, in other words, in the light of the intrinsic

characteristics of individuals or their membership to a group (...)".

[Emphasis and italics added]

1.1 The Essence of Institutions: A revision of customs from a legal approach

From a theoretical legal approach, customs that are the main mechanism to represent an informal institution are considered a source of law of formal nature. In Roman law they had been stated in two basic forms: a. *Don't harm anyone*, b. *Give to each his own*. Currently, in Civil Law family customs are described as constant repetition of habits. In addition, when customs represent or concur with legal standard features is called "legal or juridical customs". Those customs enforce behaviours and have become obligatory. Customs are legal for their perseverance, repetition and security. Following this approach a law has to state whether or not a social practice or custom is allowed. In this order of ideas, some Latin American and European Constitutions have empowered customs, recognizing them through the following Civil Law Constitutional principle: "*no one is obliged to what the law does not require, nor deprived of what is not prohibited*". Moreover, when a law is based on and arises principally from custom it is called customary law. Then, custom may have the authority to replace statutory when a "desuetude case" arises, if statutory law does not provide a legal alternative or if Constitutions or other top statutes agree to empowered customs. This idea has been followed mainly by the Civil Law systems (Laclaun, 1984). Consequently, in the Civil Law system, customs are understood as a formal source of law. According to Paricio (1995), this legal tradition classifies customs into three different types according to their relation with statutory law:

- a) *Customs Secundum Legem* (by law): The law recognizes customs or customs agree with a statute.
- b) *Customs Praeter Legem* (outside the law). - They create a customary

rule regarding a situation not covered by the law.

- c) *Customs Contra Legem* (against the law or "desuetude") – They are generated against the provisions of the law (statute), and therefore try to repeal it.

Conversely, for the Anglo-Saxon Common law, a system born and based on the case law rather than in statutory law, it is important to understand that customs have also a psychological approach.²⁴ This psychological approach is the belief that customs (social behaviour) establish a right and obligation to be carried out by individuals, communities or societies. Therefore, customs refer to an ancient rule for a particular space (regions or communities). In addition, customs are considered as the valid rule of law for an extended space (country). This idea has its origin in the Anglo-Saxon period. In this period, local customs formed most of the legal framework ruling a variety of matters such as family rights, inheritance, contracts, ownership and personal violence. Legal historians have discovered that Norman conquerors approved the legitimacy of those rules based on ancient customs (later known as customary law) and found a way to adapt the customary system of regulation to their feudal structure of government and juridical organization. Subsequently, after historical and social transformations, customs (formally called “customs of the realm”) finally became “common law”. In this particular scenario, a custom outside of common law was considered valid if and only if: 1) Customs had been practiced peaceably and continuously from time immemorial (as long as living testimony can recall); 2) Customs were confined to a specific locality and, therefore, could be defined as rule of law governing a specific community or region; and 3) Customs represented a mechanism showing reasonable, certain, and obligatory substance.

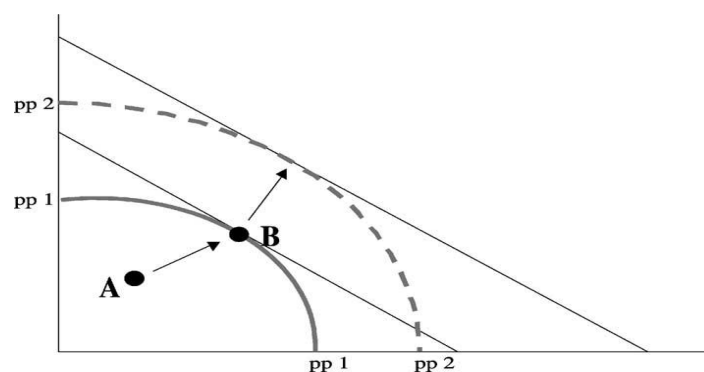
²⁴ This psychological approach is different from naïve psychologism used in economic science.

This juridical framework is useful for developing a theory based on informal institutions. Since a discussion of institutional coordination or positive institutional interaction shows the previously described interaction between customs types, it can be fully translated from an economic perspective and it keeps flexible cultural characteristics –in a framework ruled by an evolutionary perspective- where informal rules or customs retain their validity.

1. 2 Functional Entrepreneurship in terms of PPF

The Production Possibility Frontier (PPF) is a useful tool to show how the entrepreneur, when performing two essential functions for economic growth, is also helping to strengthen institutional coordination. These functions are: a. Productive entrepreneurship (Baumol, 1990) empowers current profit opportunities and eliminates inefficiencies. Therefore, an economy will move from an inefficient point (A) towards an efficient one (B) and will reduce the risk of lacking social cohesion by strengthening harmonious or positive interaction among institutions. b. Consequently, by introducing innovation, defined as the discovery of a new technology or new production process using existing resources more efficiently, productive entrepreneurship contributes to the shift of the PPF to the right: *achieving an increase in real output due to increases in productivity*.

Figure 2: Effects of entrepreneurship on the PPF



Source: Boettke y Coyne (2003), p. 74

According to Klein (2008), another key link between productive entrepreneurship, institutional coordination (positive institutional interaction) and economic growth is that productive entrepreneurship creates new market niches that require innovation (forming a virtuous circle or "win-win" process). Therefore, this pool creates opportunities and better uses of resources where institutions can be considered as essential vehicles that positively organize and facilitate economic development. In addition, productive entrepreneurship would then enable *developing economies* to successfully carry out further well-coordinated institutional changes (avoiding the risk of an irresponsible institutional transplant). Following a more predominant approach, these changes can be classified and understood as essential for keeping high standards of growth and economic development. *Developed economies, however, will successfully keep high economic rates and standard of innovation*, and therefore, continued economic and institutional dynamism (Acemoglu et al, 2012).

2. Civil Society, Institutions and Institutional Coordination

Civil society or associative human interaction can be defined as an *evolutionary process* and *dynamic collective structure* which is: a. spontaneous and thus not consciously designed by anyone; b. highly complex, since it comprises billions of people with an infinite range of goals, tastes, valuations, and practical knowledge; and c. composed of human interactions which basically refer to exchange (often expressed through monetary prices) and are always carried out according to certain rules, habits, or standards of conduct.²⁵

²⁵ The thesis does not subscribe a concept of society as a rigid, social order. Instead this research project refers to associative interactions among individuals (families and communities) and non-governmental organizations known as civil societies. Therefore, the thesis steps aside from a conception of society as a static and constructivist order. It means a social scenario that equips itself with rules through a centralised and primarily coercive process. Rather, the thesis focuses on how rules emerge as individuals strive to interact coherently. This dynamic scenario departs from a spontaneous process of adapting rules. It should not be confused with the

All such human interactions are motivated by the force of entrepreneurship, which continually creates, discovers, and transmits information, as it adjusts and coordinates the contradictory plans of the different individuals through competition and enables them to coexist in an increasingly rich and complex environment. In addition, these kinds of interactions are regulated through institutions. Then, the legitimacy and the dominance of these institutions will depend on the level of individual and collective acceptance and their capacity to adapt to social change.

Moreover, it is also essential to establish strong formal and informal institutions to maintain an organized and competitive civil society. This approach has been the mainline of new institutional economics. According to Chang (2011):

“Since the late 1990s, the view that poor-quality institutions are the root cause of economic problems in developing countries has become widespread. In accordance, the IMF and the World Bank started to impose many ‘governance- related conditionality’s’, which required that the borrowing country adopts ‘better’ institutions that improve ‘governance’.” [Emphasis added]

Furthermore, strong institutions can impact positively on economic growth and performance, but they also impact on social cohesion, dynamism and proactive individual interaction (Alonso et al., 2008). Societies with a harmonious interaction between formal and informal institutions can be categorized as structured societies. Specifically, structured societies reflect a social context where: a) Individuals can rapidly adapt themselves to their social context (*dynamic efficiency*); and b) Societies show the interdependence between

spurious entity of society reflecting an artificial social contract. Consequently, the thesis rejects the assumption that individuals might expect entitlements and whose ends individuals must serve (e.g. *political clientelism*).

formal and informal rules that we have called *institutional coordination* or positive institutional interaction. It is understood as a complex human interaction involving interdependence and rejection after a certain level of institutional confrontation. The possibility of institutional rejection introduced the concept of social or tacit *abrogation* and *derogation* of formal rules (Gherzi, 2007).

Alternatively, when the social fabric lacks strong and positive interdependence between formal and informal institutions, there emerges *social stagnation or institutional weakening*, which refers to an elevated lack of institutional coordination or negative institutional interaction. In this social context, individuals cannot adapt to social change and manifest negative social behaviour. It is proposed that the level of *institutional weakening* can be used as flexible feature to study and describe a civil society's performance.

Consequently, to assess welfare and keep efficiency in the analysis, it is desirable to incorporate several social scenarios, due to the divisions that occur in a *civil society* (García-Guadilla et al., 1997). Finding a way out of these "negative scenarios" is a challenge that can be undertaken through different "corporate forms" that express the prevalence of functional entrepreneurship. These different corporate forms cannot be regulated with a traditional bureaucratic approach. Instead, a strategic deregulatory reform becomes a priority, in the short term, to achieve institutional coordination. Similarly, as it has been stated in a previous publication (Méndez, 2011):

“Unlike the traditional concept of deregulation, strategic deregulation does not exclusively involve the process of revision, adjustment, and removal of specific laws and regulations by government that affect the business environment. Strategic deregulation is based on the principle of strong property rights and the prevalence of the entrepreneurship function. In addition, strategic deregulation also deals with the positivistic legal paradigm that assumes a necessity for proactive formal

rules (public policies) (Kelsen, 2001; Hart, 1980). At the other extreme, public policies from a strategic deregulation perspective focus on the lifting of legal and social barriers, which are negatively impacting the dynamic adjustment and performance of the institutional framework (North 1990). In addition, these barriers inhibit the capacity of individuals to adapt to social change.”

On one hand, the concept of institutional coordination introduces the idea of a *community of interest* or economics as an exchange of property rights. In this context, *social issues are not missing out the social fabric, but depend upon productive and functional entrepreneurship and an efficient social interaction* (organized by institutional coordination). This can be measured through a basic index of access to welfare represented by *legal stability* or *civic rationality*.²⁶ Hence, in a context with strong civic rationality, functional entrepreneurship will indirectly induce strong political governance. In some way, -following Weber’s approach (1964)-, coordination problems that are affecting the social fabric are fixed by auto-generated institutions and other social mechanisms.²⁷

On the other hand, institutions representing political governance are weak and their *weakening* open doors to forms of power where the crash among social groups (domination and social cost transferences) is permanently presented. Therefore, it leads to a scenario where political, economic and social stability is a derivative of the struggle among groups. Consequently, any scenario of social coordination is temporary in nature.

²⁶ This chapter defines “legal stability” or “civic rationality” as causally efficient motivation for public-spirited action.

²⁷ According to Weber's "Theory of Domination" (1964), it is possible to place the State as the most involved organisation (for political and taxation purposes) in the consolidation of legal certainty and resource use in the law.

This assumption considers that individuals have a propensity to seek social coordination (dynamic equilibriums), which is compelled to share links and generate different degrees of social interaction. This process also requires an institutional framework where interaction between formal and informal rules is functional.²⁸ All this can be framed within a cultural and *social cohesion*. If this process is added to the *individual and group aspirations*, it requires a degree of *institutional stability*, which is achieved to the extent that the functional entrepreneurship and the political and economic environment point to a *non-destructive competition context*.

Also, it is necessary to contemplate the capabilities of the social fabric presented as a dynamic combination of human resources permanently dedicated to cultural change and technological development. This is relevant to illustrate that without dynamic efficiency, limited (rational) political governance and the contribution of functional entrepreneurship, institutional coordination cannot be achieved and a lack of social cohesion will follow. Then, the so-called *unproductive entrepreneurship* manifested through mercantilist activities becomes an “*institutionalized activity*.” In this regards, Baumol (1990) has stated:

*“The basic hypothesis is that, while the total supply of entrepreneurs varies among societies, the productive contribution of the society's entrepreneurial activities varies much more because of their allocation between productive activities such as innovation and largely unproductive activities such as rent seeking or organized crime. **This allocation is heavily influenced by the relative payoffs society offers to such activities.** This implies that policy can influence the allocation of*

²⁸ As the main aim for building an alternative model in new institutional analysis is creating a functional relation between formal and informal institutions, we have to consider contributions that seek to estimate and understand the specific “performance” of informal institutions (not just formal ones). In this regard, Dreyer & Bie (2008), Domjahn (2011) and Park (2012) have introduced relevant contributions.

entrepreneurship more effectively than it can influence its supply.”

[Emphasis and italics added]

This situation affects individual and group aspirations (which in an opposite scenario have to be harmoniously and accessibly organized or materialized by the "*Volk*") and *inhibits* informal institutional arrangements from becoming formal arrangements (understood as stable and predictable social instruments for organization and control). In this regard, it can be suggested that coordination among institutional arrangements cannot be represented as a supply or activity carried out only by formal government bodies (Boettke, 2012).

Even in a traditional political scheme, where governments are considered responsible for organizing the dynamics within the social fabric, a formal supply of “Rule of Law” or “Rechtsstaat” (e.g. a constitutional network, treaty or code) cannot generate an "institutional framework" that will contribute to a structured civil society (Gherzi, 2010; Méndez, 2011). Therefore, the supply of formal institutional goods does not create its own demand and depends on an additional “mixture” of social elements to reach the “market equilibrium”, as it has been described by modern heterodox economic theory (Kirzner, 1976).

3. Institutional Coordination and Economic Agents

The Institutional Economics literature primarily states that economic agents and institutions affect each other in a reciprocal manner. Nevertheless, this seemingly simple statement would require accurately revising the differences in terms of interdependence and institutions. In addition, adherence to “path dependence”, the degree of freedom (granted to an economic agent in a specific scenario), and the way that coordination among institutional sub types, all influence (*actio* and *ratio*) the process of entrepreneurial decision-making (productive and unproductive entrepreneurship).

This is so, as different styles of analysis, characterize themselves in the way they place emphasis in singular aspects of the agents, and in the identification of associative characteristics, among other elements such as “social embeddedness” as proposed by Granovetter (1985). Thus, new institutional analysis and its complexity rise with the significance given to the amount of autonomy, allocated to economic agents to influence the network of formal and informal institutions.

Along this line, it can be stated that, attempts to create universal theories that follows an *optimum based on given preferences* (conservative rational-information models and static market structures) are very limited and not useful in the context of new institutional analysis.²⁹ Political scientists (Levitsky and Murillo, 2010), economists (Boettke, Coyne and Leeson, 2008) and legal scholars (Ross, 2007 and Ghersi, 2007) claim that, universal theories missing and analysis of institutional coordination, are illustrations that do not certainly represent an effective view of how agents and institutions coexist in a real world scenario. This is so, given to the fact that institutions exist as *complex phenomena*. On the one hand, institutions and institutional coordination involve dynamic multilevel structures dealing with multiple objectives, and on the other hand, institutions enclose subjective spirals of individuals’ neurological constraints (Camerer et al. 2005 and Bernheim, 2005).

Nevertheless, important differences about the interaction between economic agents and the interdependent character of the institutional network may be discovered when doors open to interdisciplinary approaches that rescue forgotten contributions (Ross, 2007). This is critical, if the target is to contribute to previous research concern about “why institutions matter”,

²⁹ In someway this idea has been shared by the different institutional economic traditions. This is so; despite these traditions comprise different methodological and theoretical approaches such as German historicism, American Institutionalism, New Institutionalism, Austrian Economics, Evolutionary Economics and others.

focusing on the connection between the dynamics of economic agents and their institutional environment described as a selection of both *unintentional* (private) and *intentional* (governmental) institutional constraints, showing also different levels of *civic rationality*.

As the economic agents compare the benefits and outcomes of institutional constraints, these agents choose the most convenient ones in terms of the economization of private costs, transaction costs and the accomplishment of its entrepreneurial activities (Becker, 1974). From this perspective, economic agents select the available set of institutional constraints as a mechanism for governance, in a way that its establishment and reinforcement depends on the characteristics of the prevailing framework and interpersonal micro arrangements.³⁰

Furthermore, from an institutional coordination point of view, the relationship between economic agents and institutions can be explained in terms of patterns of emerging interdependent processes of institutional interaction on the one hand, and individuals' action (forming trajectories of behaviour) on the other. According to Hodgson (2001), "*agents and structure, although distinct, are thus connected in a circle of mutual interaction and interdependence.*"

Moreover, current and future individuals' actions are *subjective in essence*; past actions by the same agents and by other related agents represent a *sample of historical experience providing cultural components to human action* (Mises, 2007).³¹ In this regards, institutions and institutional coordination are malleable

³⁰ Oliver Williamson contributions start from the assumption that *bounded rationality* governs the process of decision-making leading economic agents to select those institutional arrangement perceived as more convenient to save transaction cost.

³¹ History illustrates theory and cannot be envisioned as a project of relativistic social theory, subject to the randomness of the here and now, or any sort of fatalistic determinism. Therefore, despite individuals are all born in a world of pre-existing institutions, history only illustrates the resources and the restrictions and not the inside, which we think, we act and we create (Mises, .

by economic agents. These agents are the producers and at the same time, according to Hodgson (1998), “(...) *represent products of their circumstances*”. Therefore, institutions, institutional coordination and its environment guide and change with the actions of the agents.

3. 1 Three Levels of Analysis for Institutional Coordination

An inter-reliant interaction among institutional sub types reflects a wide approach, given that institutions display supplies of cognition, patterns for problem solving and cultural structures in an extensive wisdom. The conceptualization of institutional coordination is advancing, but has certain expected limits because of the complexity of the processes involved and its non-linear and undeveloped character. Theoretically, its strength lies in the amalgamation of *upward* (ascending causative practices) and *downward causation* (descending causative processes) as defined by Hodgson (1998).

These upward and downward directions are reflected in an exploration that does not suggest a general continuous integration but a specific description of interactions among institutions and the association with economic agents in different levels.³² This approach reflects the different characteristics of the agents (patterns of individual action) and the institutional sub types (systems of rules), in evolving arrangements of institutional coordination which can be analysed through specific but also interdependent levels, that represent the different ascending and descending causative and interrelated processes.³³

³² This analysis refers to level of coordination and, therefore, step aside from Williamson's scheme of *four levels of institutions* (2000). Williamson's model was built up to suggest that a highest level would show specific higher legitimacy and impose constraints on lower levels. At the end, this means that individuals would rather follow the higher ranked (hierarchy) system of rules.

³³ This is different than a hierarchical model as proposed by Williamson (2000) and Jütting (2003).

For example, it can be stated that habits and other private institutions of decision-making usually (but not exclusively) guide the first level of institutional coordination. This first level builds up patterns of behaviour prior starting a relationship with the available arrangements ruling the social fabric.

The application of more sophisticated arrangements, as legal or social enforceable agreements, involves a second level of institutional coordination. This second level covers all the immediate and mutual interactions among institutions. At this level, the rules of the system at the first level are clearly affected and they introduce incentives for generating individual strategies that stabilize the effect of the second level of institutional coordination in more compound layers of dynamic individual behaviour.

The third level comprises institutional coordination showing a clearer context of association between markets, communities and their macro environment that simplify or restrict multilateral interaction among institutional sub-types.

The existence of each level does not exclude the idea that what happened at one level is influenced by the others. All three levels are related with each other and also encompass the role of individuals as productive and unproductive entrepreneurs. Thus institutions at the first, second and third levels interact at the same time. Therefore, institutional coordination shows a process of the multilateral interaction focus on one or two particular layers. This theoretical scenario becomes clearer if it refers to existing interaction in specific social scenarios where for example a *desuetude* case arises.

Consequently, institutional levels can be represented in diverse forms of embeddedness and development. The relationship between the different levels represents ascending and descending constitutive causative processes. Intentional and unintentional processes of institutional formation and coordination support the previous analysis. This is so, on the one hand, as

institutional formation and coordination are based on the assessments and actions of the agents, and by the other, through the embeddedness and views of the agents living in a specific institutional structure.

4. The Coordination Problem: The Ius Economic Approach

A correlation among a normative (Legal and Constitutional Theory),³⁴ Socio-Political and Economic analysis is required to understand positive and destructive interaction among formal and informal institutions. In particular, destructive institutional interaction is a process where competition, overlap and displacement between formal and informal rules cannot be left outside the model. This process is referred to as the *coordination problem* and it is fed by *social disruption*³⁵ and characterised by leading societies from the structured to the unstructured category and vice versa (Méndez, 2014). The coordination problem is also relevant as this is not only reflecting the importance of institutions as "data" for private and collective action, but shows their impact in economic activity through the processes of their formation. Hereof, positive institutional coordination leads to extend "good order" into the market process and to endorse self-motivated productive entrepreneurship.³⁶

³⁴ From a legal perspective a formal institution is a rule intended to manage human behaviour according to principles such *public interest* and the *social contract* conception.

³⁵ This refers to alterations or breakdowns of social life, often departing from a community setting.

³⁶ The orientation of the individuals' actions and the (multilateral) harmonization of institutional interactions support the ordering of the activities in the higher levels of a society that describe the dynamics of the market process as a whole. The purpose of finding an adequate level and content of analysis for these actions might be expressed in the term of "degrees" of institutional coordination. The resulting degrees and their range of varieties in terms of characteristics and quality can be explained from different points of view, where "good degrees" help to reduce the global levels of transaction costs, lead to successful adaptation processes of productive entrepreneurship and create coherent structures of incentives; where the emerging or higher degrees of institutional coordination offer associative solutions with benefits for individuals' actions and an alternative that not (always) it can be established in lower levels of institutional coordination, and where the process of formation of the

At this point, to understand the relevance of the coordination problem among institutional sub types require recognizing how self-enforcing and self-diverging structures of institutional interaction can create diverse patterns of coordination. Because of coordination among institutions is not a synonym of a naïve Pareto static equilibrium but it represents complex social dynamics showing that the origin of positive interaction can derive from continuous and interdependent processes, where the private arrangements are an essential part of a formed social substance.

Afterward an important fact arises when considering a specific scenario regarding formal rules and institutional coordination. In contrast to what happens with informal rules, a formal authority prescribes formal rules and their noncompliance might involve a formal penalty or administrative fine. Generally speaking a formal rule imposes duties and confers “official” rights. In addition, it differs from informal standards of conduct in the following ways:

- a) Its *heteronomous character* (imposed by the government or other formal authority).
- b) Its *bilateral characteristics* (there is an agent –individual- compelled to meet the rule’s standard and another agent –authority- is enforcing them).
- c) Its *coercible approach* (rules are enforceable through sanctions and the use of formal power in case of breach).
- d) Its *external character* (compliance with the statute is the most important matter).

institutions can be more significant for the comprehension of the coordination than the description of its static way role.

However, formal rules (*ratio*) are not completely different to informal rules (*actio*). Both kinds of rules have a prescriptive character.³⁷ Therefore, formal and informal rules consist of a complex set immersed in an evolutionary process guided by the government and civil society. Conclusively, even if the collection of formal rules is often referred to as *legislation and regulation*, this peculiar characteristic does not deny the presence of a key coordination problem fed by social disruption looking to reach a state of *dynamic efficiency* as described above.³⁸

In addition, a discussion of the role of institutional coordination is characterised by the encouragement of institutions to ‘send a message’ (contextualized by the mainstream of Economic Analysis of Law scholars as “price”). This price reflects a state of equilibrium in the institutional framework and the absence of a “coordination problem” (as described previously). However, in the real world, individuals have to face the lack of institutional coordination and the impact of those institutions, which effectively guides human behaviour. Then, where coordination among formal and informal rules remains a problem, individuals cannot behave as price takers and the idealist presence of an institutional competitive market cannot be successfully supported.

³⁷ Therefore, “*normative principles*” can be described as an additional category characterised by their broad “*descriptive character*”.

³⁸ Agreements or contracts without a formalized support can be described also as informal rules. A formal framework often exists behind this particular category. However, its uncommon dynamics do not obey *ratio* but are finally supported by *actio*. In addition, an agreement can be changed rapidly to satisfy the interest of agents involved. A formal institution lacks a dynamic character. This sometimes explains their peculiar construction and it is represented by its cost structure.

Table 1: Institutional coordination effects

Institutional Coordination: YES	Institutional Coordination: NO
<p>If and only if, a “consistent” interaction between institutional types can be found. As a generic requisite, this interaction refers to a period of general institutional stability (reached by structured society in a context of institutional strength).</p> <p>Effective coordination among institutional types works with a society in order to reach social (collective) and individual objectives.</p> <p>Institutional Strength (description): Price, value and cost leads to positive and negative interaction.</p>	<p>Confrontation between institutional types as first step.</p> <p>This state of “lack of coordination” between institutional types refers first to transitional societies and then to unstructured societies. It also denotes to a degree of institutional weakening.</p> <p>Institutional weakening: Signs of non-competitive legal markets lead to alternative regulatory mechanisms (informal rules). Fragmented normative framework.</p>

In addition, it is important to consider that an informal institutional framework guiding human behaviour among individuals has been introduced by the Community and not by the State. The community is a social scenario characterized by strong long-term interaction among its members. This positive interaction is enhanced by elements like interpersonal trust and a common faith system (North, 1991). Also, the development of a process of long-term coordination among informal rules (informal institutions’ network) has helped to establish voluntary and cooperative ties. This is important because, despite the paths introduced by the majority of new institutional scholars, formal and informal institutional sub types cannot be isolated. We believe that a comprehensive new institutional analysis has to perceive the existing chains between both sets of rules. In this chapter, the complex chains created by formal and informal institutions will be referred to as a “*network*”.

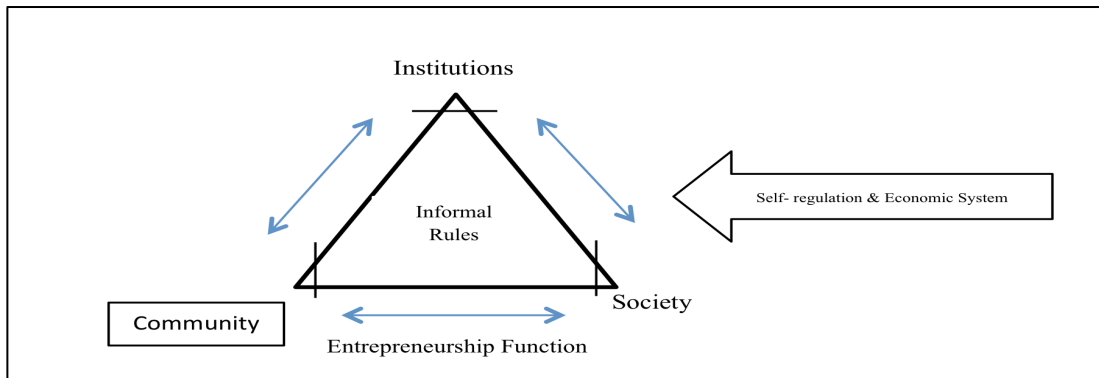
These restrictions are not the result of the State’s mechanisms of social control; nonetheless, they are the result of a complex self-regulatory process. This process is closely related to the particular and uncommon interaction in a social scenario primarily governed by informal institutions and it is related to the role of customs and other mechanisms of self-regulation organizing cooperation across civil societies. These mechanisms will grow naturally where the formal institutional framework cannot reduce transaction costs. Also, the relations

between economic agents and governmental organizations are characterised by high transaction costs, so economic agents have a strong incentive to move to the informal institutional framework. From a static efficiency perspective this represents a negative collective choice because outside the “formal market” individuals have to face corruption and negative entrepreneurship as the cheapest option to move from a state of lower satisfaction to one of higher satisfaction. Consequently we disagree with those views that suggest that institutions have to be policed only or mainly by centralized authorities. Therefore, as Schotter (1981) writes, it is always necessary to assume that an institution:

*“(...) is regularity in social behaviour that is agreed to by all members of society, specifies behaviour in recurrent situation and is **either self-policed or policed by some external authority**.”* [Emphasis and italics added]

In addition, a low transaction cost environment is the perfect place for the development of the *entrepreneurship function* because social and economic incentives come from a context where individuals trust the informal set of rules. Therefore, the informal set of rules represents an efficient incentive mechanism and a low transaction cost scenario, where individuals show their alertness or creative capacity. This capacity allows them to efficiently improve the allocation of rights (resources) from agents unable to discover new entrepreneurial options to agents capable of advancing the current system of production (Ostrom, 1990). However, this approach is contested by mainstream economics (Alonso et al., 2008) which considers that no efficient economic displacement could be undertaken in a context where informal institutions are leading an unconventional mechanism for social integration and expansion as it has been shown by the following figure 3.

Figure 3: Informal Institutions and Community Action



However, we argue that a successful analysis of the coordination problem cannot be mainly guided by a disputable empirical approach. Empirical studies focused on new institutional analysis usually lack an extensive understanding of the meaning and development of rules by complimentary areas of knowledge such as Legal Theory, Sociology and Anthropology. As Alonso (2012) has outlined:

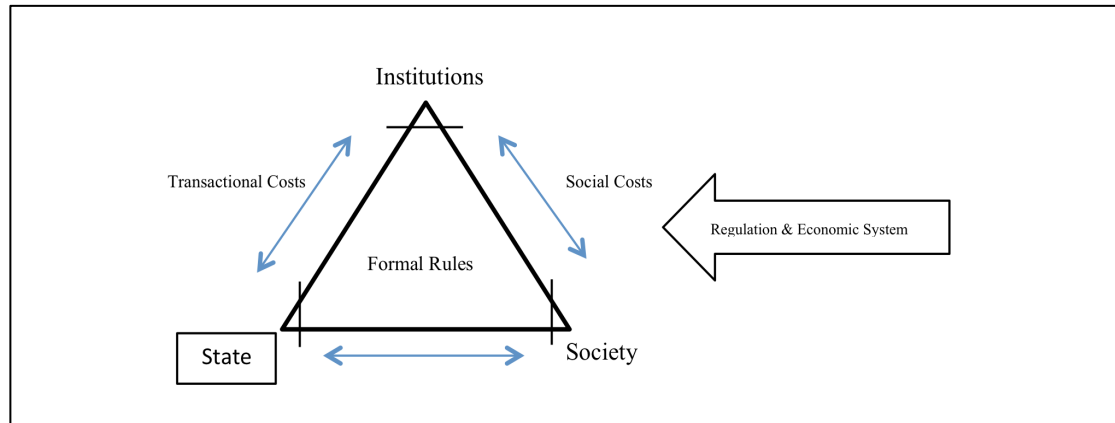
“(…) these studies usually rest on a very limited scrutiny of historical experience”.

In addition, according to Meisel et al. (2007):

*“As populations and markets grow, as the economy becomes more complex and more open, as the opportunities for trade increase, the cost of observing rules under the previous mode increases with each new transaction. **This is because the personal investment required by the predominant regulation system (confidence based on the quality of interpersonal ties) is extraordinarily time-consuming.**”* [Emphasis and italics added]

Following this approach, the formal institutional framework introduces a second theoretical scenario shown in figure 4.

Figure 4: Formal Institutions and the State



In this context, social and economic incentives are introduced by the State through public policies represented by formal mechanisms such as the national law (codes and statutes), and administrative, national, regional and local regulation, and others. Therefore, a set of formal rules is the cheapest system for society (dynamic social fabric) to move from a state of collective depression, social costs and institutional weakening to a better social scenario. Consequently, for some scholars such as Alonso and Garcimartin (2008), a formal institutional framework seems to be the most efficient mechanism to introduce social order, predictability and economic incentives for improving economic planning through public, private and combined initiatives.

However, this research project disagrees with this constrained approach. Following Stigler (1992) it can be stated:

“(...) every durable social institution or practice is efficient, or it would not persist over time. New and experimental institutions or practices will rise to challenge the existing systems. Often the new challenges will prove to be inefficient or even counterproductive, but occasionally they will succeed in replacing the older system. Tested institutions and

practices found wanting will not survive in a world of rational people. To believe the opposite is to assume that the goals are not desirable: who would defend a costly practice that produces nothing?”

In addition, any attend for further empirical studies in this area *-even though recognised by the mainline and mainstream for their relevancy to illustrate a fact-*, have to take into consideration the historical experience of the institutional framework that they aim to analyse. This is necessary to strength their illustrative capabilities and avoid making statements such as follows:

“In developing countries, the shift to the formalisation of regulation systems has not occurred” (Meisel et al., 2007).

Such statements do not consider the “advances” introduced in developing countries (mainly belonging to the Civil law tradition) where the *formalization of regulatory systems* did not necessarily show a positive contribution strengthening institutional coordination and its relevant framework. Likewise, it is essential to contemplate theoretical (fundamental) differences existing between the Rule of Law (where a State shows separation of powers, where citizens are equal before the law and where these laws limit the political power) and Rule of Legality (where the law reflects and protects the political power rather than limits it). In developing countries the *formalization of regulatory systems* has driven their legal system to the second scenario.³⁹

³⁹ In this regard, Voigt (2009) has introduced an interesting analysis stating that: “Hayek (1960, 2006) points out that these basic principles of the rule of law are not laws themselves, but comprise instead a “meta-legal doctrine or a political ideal.” This distinction has important implications for the task of empirically measuring the realized degree of the rule of law, which is no mean feat because informal norms are systematically more difficult to ascertain than formal ones.”

Therefore, going back to the previous point, it is accurate to consider that when there is a lack of institutional coordination only the “cheapest” institutional framework or network will survive. A priori means that the formal institutional framework is not *per se* the most efficient social development. Even though in a scenario where regulation, codes, statutes and common law coming from governmental branches introduce a short, mid or long-term normative equilibrium, human action expressed by its entrepreneurial function and individuals’ “temporary” preferences will occasionally move economic agents to the best institutional framework and network. It means that in the real world, politicians and other policy makers cannot block Smithian’s selfish economic and social behaviour. Consequently, in order to understand how social and individuals preferences works (expressed through alternative modes of production), it is necessary to recognize the process of interaction between informal and formal rules. This is because in the real world economic agents have to face pure entrepreneurial and economic action. As stated before and represented through figure 5, this action must be understood as a process of social exchange, more precisely, as an exchange of property rights developed and guided by a set of interactive formal and informal rules (institutions) and carried out by the entrepreneur in an evolutionary social context.

Figure 5: Social, political and economic organization through normative instruments. Rule of Law and Institutional Coordination

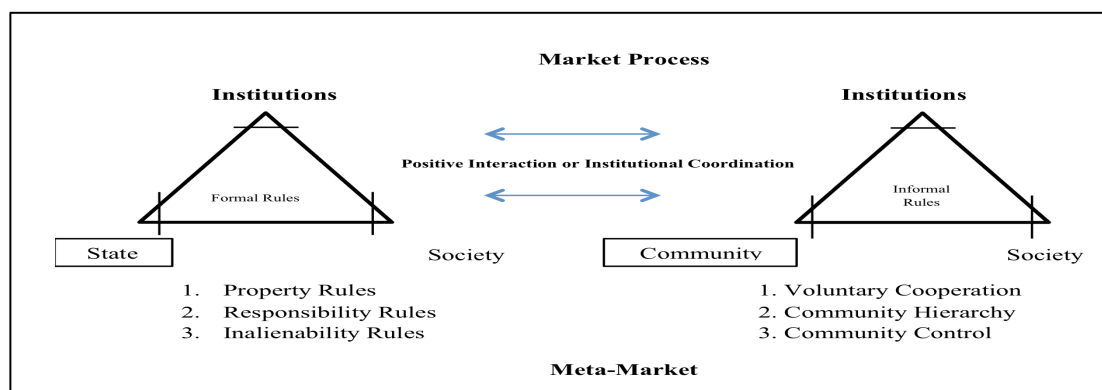
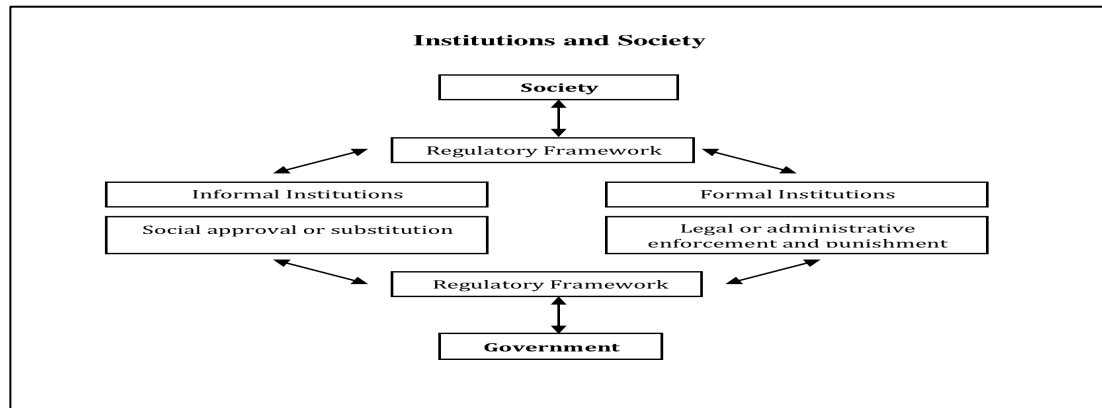


Figure 6 illustrates this interaction or interdependence between formal and informal institutions, their enforcement mechanisms, and the collective agents involved:

Figure 6: Interaction and interdependence between Formal and Informal Institutions



This hypothesis represents a more accurate approach and the level of institutional consumption of individuals will change according to the state of the social process. Individuals living in an accelerated social process will require the most efficient institutional mechanisms to adapt themselves to new social circumstances. This is a subjective valuation difficult to predict by a central planner because of a lack of information and practical knowledge.

This also illustrates the relevance of the coordination problem between formal and informal institutions. Then this problem will persist based on individual perception of cost and benefits. However, this coordination problem can be collectively influenced. Thus, it could be argued that the *coordination problem* occurs in a context of a high degree of institutional weakening. This turns out to be a relevant fact if it is analysed a particular scenario where formal institutions or rules are unable to reflect the precise benefit for individuals (measured in terms of marginal value -MV-) when there is a complex set of rules introduced by the government (measured in terms of marginal cost -MC-). In this complex scenario, a civil society has to face a *social contradiction*:

Individuals perceive a high MV when they do not use the official institutional market. This market is a government monopoly with clear restrictions that allow it to rapidly adapt itself to individuals' expectations and needs. At this point, the MC of producing rules (legislation and regulation) for the government becomes an unorthodox way to understand the coordination and the monopoly issue involved: The government will reach a point where increasing the production of formal rules will not produce a "profit". That is, the production of formal rules has to face a context where the total cost of the formal institutional system increases at a higher rate than the profits, and where the marginal cost of the institutional system for the government will also begin to rise.⁴⁰

This interaction between formal and informal institutions occurs within a context of the market process. From a microeconomic perspective, this institutional interaction is manifested through the exercise of the entrepreneurship function. Moreover, the organization of the market process demonstrates the necessity for rules that cooperate based on the opportunity cost of their provision and consumption. Also, this institutional interaction affects the structural arrangement of the institutional network. In the formal institutions framework these structural arrangements relate to the rules of property, liability and inalienability (Calabresi & Melamed, 1972). Meanwhile, the informal institutions framework relates to voluntary cooperation and communal control. The main feature of this network is to establish "trade-offs" or "compromise solutions" where the absence of governmental coercive power is evidenced. Therefore, these compromise solutions or trade-offs are a response to a scenario where formal institutions, by themselves, cannot

⁴⁰ The marginal cost compliance with the formal institutional framework is defined as the change in their total cost, with one-unit increase in their quantity of rules produced by the government or the cost of producing an additional formal rule. Mathematically this change can be represented as the partial derivative of the total cost divided by the quantity of formal rules introduced in the formal institutional framework.

efficiently reduce transaction costs. Finally, the process of interaction among institutional types occurs within a wider orbit called a *meta-market*. Therefore, this orbit implies the organization of social, political and economic guidelines through “normative instruments or principles” defined as an additional category characterised by a broad descriptive character.

5. Institutional Coordination and the Marginal Rate of Technical Substitution

A consistent analysis of the paradigm of institutional coordination requires considering the prospective combination among formal and informal institutions. These combinations can be arbitrarily represented with a PPF analysis as it can be a useful tool to show, for example, how a society can produce 10 units of Y (formal institutions) and discover 5 units of X (informal institutions); or does not discover more than 10 units of X and allocate most of its resources in order to produce 5 units of Y. However, this assumption needs to take into account a random variable: *Entrepreneurs can productively or unproductively influence available institutional resources*. This conduct can be described as the positive or negative entrepreneurial power. It represents the unique behaviour of individuals, who are permanently looking to satisfy their own interests, and move from a lower satisfaction state to a higher satisfaction state. In the case of a negative manifested behaviour (e.g. rent seeking), a society faces the necessary (but not sufficient) condition of modifying individuals’ social, legal and political environment, in an attempt to control any excessive form of institutional power. This scenario directly refers to the Rule of Law in a democratic system. This represents the best way to limit or control any possible manifestation of negative institutional manipulation and takeover. This is because mainline economic scholars have historically understood manifested individuals’ behaviour as the reason why entrepreneurs can also be considered *institutional planners*.

However, it is important to see that institutional power has not only been allocated to the State as a central agent directing institutional planning, as it has been claimed and defended by legal positivism. In the European Civil Law tradition this perspective was already recognized and explored from a moral and juridical point of view. This discussion has led this legal tradition to examine the evolutionary and complex nature of formal and (in particular) informal institutions and their relation with the so-called legal concept of desuetude or desuetudo (in Latin). As Ghersi (2007) has extensively defended, desuetude refers directly to informal institutions or the so-called *custom contra legem*. Under this theoretical figure and based on qualitative research, this legal scholar claims that in a social scenario categorised as an *unstructured civil society* (Méndez 2014), any kind of legislation and regulation will be unenforceable by the social fabric. Extending this argument to move away from the conventions of positive legal theory, it is rejected the idea that *the Tribunals represent the only agent capable of judging which transgressions are no longer valid or enforceable*. In addition, the extension of the desuetude argument leads us to the lack of positive institutional interaction or institutional coordination as a social issue that has to be more extensively examined from the lack of legitimacy perspective. This is important because it is faced an example where unproductive entrepreneurs can observe a rent seeking opportunity and support their destructive behaviour because formal institutions lack legitimacy. Therefore this is an important variable that cannot be easily excluded from a further and consistent institutional assessment.

Nevertheless, this theoretical exploration has not yet been presented in modern mainstream economic terms. Since institutions are also economic goods it can be stated that institutional manipulation or capture is also limited by time and practical knowledge (Huerta de Soto, 2011). This is important to understand because a society desiring to change its institutional production margins has to face an opportunity cost dilemma. It is not possible for a society to produce more units of X institutions without affecting the number of Y institutions. This

is a preliminary conclusion that will be shown by PPF analysis applied to institutions. The most interesting aspect of institutional transposition is when it is shown by the PPF' slope, since it shows the number of units of Y institutions which must be retired in order to produce or discover additional units of X institutions. That is, it shows the institutional *interaction* or *opportunity cost of an institution*" in terms of another institution. If it is established that the slope is negative, it could mean, for example, that there is an inverse relationship between the volume of production and discovery of each of the Institutions. Equally, if the slope is positive, it could mean that when more X institutions are produced, the greater the amount that could be generated for Y institutions, this is, institutional wealth in quantitative terms would be unlimited. However, this assumption would be very difficult to verify in the real world.

Based on the previous findings, the opportunity cost of institutions can be defined as the exchange value of the second best institutional alternative. Effectively, the prevalence of an institutional framework or type may represent the abrogation of the second best choice because efficient and effective institutions are scarce. Determining the best allocation of social resources corresponds to a complex social process. In this scenario, institutions are clearly created in a competitive way because useful institutions are the result of human cooperation to reach individual targets first and then collective stability and order.

Noticeably, the PPF graph is used to understand institutional coordination and also shows two principal characteristics. The first is the negative slope: If an inverse relation exists between the level of institutional production/discovery of formal and informal institutions, an increase producing one of them will reduce the quantity produced or discovered of the other. The second is concavity: the slope probably will increase according to the growth of the amount of formal institutions and via the reduction of the number of informal institutions.

6. Elasticity's Determinants and Institutional Coordination

The first determinant of institutional elasticity corresponds to the ease with which a "formal institution" can be replaced by an "informal institution" and vice versa. Then the substitution of an institution depends first on its formal or informal "nature" and then from its ability to meet social objectives in terms of individual and collective choice. In this regard, an informal institution in a framework ruled by customs and interpersonal trust would be an example of a good with inelastic demand. Although an informal institution certainly has a potential substitute, such as alternative formal mechanisms supported by the formal institutional framework, none of these would be a strong substitute or a close enough alternative. On the other hand, formal institutions with an inefficient design will represent goods with elastic demand. These would be successfully substituted with informal institutions.

Therefore, the degree to which formal and informal institutions can be substituted or replaced will also depend on the restrictions or breadth of their theoretical definitions. For example, even though an informal institution would not have a close substitute, different sub types of informal institutions could replace each other without difficulty. This can be described as a process of intra-institutional network competition. This assumption is related to the strengths and weakening of formal and informal institutions (Williamson, 2009).

Table 2: Strength of formal and informal institutions

(1) Strong formal Strong informal	(2) Weak formal Strong informal
(3) Strong formal Weak informal	(4) Weak formal Weak informal

Source: C. Williamson (2009)

In addition, the informal institutional framework may differ among regions and even among communities. Thus, it is also important to understand the characteristics of the institutional elasticity, especially if these refer to agents working on the cost-efficient and cost-effective development of public policy. This also means exploring potential negative effects while contemplating a change through *mandatory rules*, including emergency decrees and laws for pro-mercantilist groups (Gherzi, 2009), in the formal institutional framework. In other words, to increase the equilibrium price of the current formal institutional framework. It is worth noting that a change in the price paid for the consumption of an additional formal institution (introduced by a legislator, a Tribunal or administrative agency) often ignores that the prices of other types of institutions may remain constant. Although the formal institutional framework of a country, region or territory has its own characteristics, other institutional types could substitute it and, therefore, potential consumers of this institutional framework can be very sensitive to changes in its relative price.

The second determinant of the elasticity of an institutional framework corresponds to the proportion of income directed to the consumption of an institution. *Ceteri paribus* means that the higher the proportion of income spent on the acquisition or use of an institutional instrument, the higher the elasticity. Therefore, if an agent should only invest a small portion of their income buying an institution, and then the relative price of an institution changes, that change will have little effect on the preferences and budget of an institutional consumer. Moreover, this determinant is observed particularly in a scenario where unproductive entrepreneurship prevails. In this case, the agents performing this kind of entrepreneurship will try to create barriers for those who wish to access the formal institutional framework, affecting the “budget” of those who could be considered potential competitors.

Consequently, a rise in the price of an institution introduced by negative entrepreneurship behaviour will absorb much of the budget of an institutional consumer, regardless of its size. In addition, it will encourage the institutional

consumer to make a reassessment of their spending and actions and, finally, the evaluation of the formal institution's new price will result in new incentives for shifting and substitution in consumption. In other words, an institutional consumer will be in a situation where there is a lack of institutional coordination, which involves the rejection of more expensive institutional framework and in many cases the named repeal of the law (Gherssi, 2010).

In order to appreciate the importance of the proportion of income spent in an institution, it can be considered its own demand elasticity. Thus, doubling the price of formal institutions will have a double effect. First, it will drastically decrease formal institutional consumption and will then introduce incentives that foster informal and illegal or parallel economies. Moreover, doubling the price of informal institutions will affect their consumption. However, more important consequences will arise: the introduction of an incentive to abandon these informal institutions. Their consequent disappearance will be marked by the emergence of other informal institutions and, the formal institutional framework will "finally" succeed. However, there is an important difference. Informal institutions have not only a consumer cost but also a high production cost. This production cost is not assumed directly by government and it is distributed between all layers of society. This cost spread or negative distribution could potentially introduce multiple problems such as negative externalities, adverse selection, free riders, and others. It is true that individuals often report a marked reluctance to take on additional costs because they are permanently looking to improve potential benefits. Nevertheless, there is an equal or even higher rate of refusal to use more expensive institutional frameworks versus less expensive alternatives.

The third determinant of the elasticity of an institutional framework would correspond to the time spent since its relative price has changed. In general, the longer the period, the greater the institutional elasticity of demand will be. The reason for this is related to the possibility of substituting an institution with

another institution. As more time is required, there are more possibilities for a community or the whole social fabric of developing substitutes for the institution (often formal) that represents a high cost of compliance. Therefore, as necessary time has passed a community will have cheaper alternative or substitute institutions.

6. 1 Elasticity of the institutional framework in the short and long term

An analysis of institutional framework supply and demand from the perspective of classical microeconomics requires differentiating between the short run and the long run. In other words, if it is asked how much demand changes an institutional framework in response to a price change, it has to be considered the time frame (also understood as an objective matter) that society allowed before measuring variations in the quantity demanded of a particular institutional type. This period is one in which short-term institutional changes in consumption occur. However, this is more complicated when it comes to long term, where changes in consumption of institutions cannot be determined accurately. This means that the long-term, in the case of such goods, refers to time it takes for consumers and producers to fully adapt to institutional variation in the relative price of formal and informal institutional frameworks. Therefore, if applied to institutions, the demand curves in the short term would also be very different from long-term curves as often happens in the case of other kinds of goods. However, it is understood that institutional demand is more elastic with respect to long-term price than the price set out in the short term. This follows a common sense principle, which states that consumers of institutional assets (like other tangible or intangible goods) require time to change their consumption habits. For example, while the price of informal institutions will increase, the quantity demanded of such institutions would fall only gradually as consumers slowly begin to introduce alternative informal institutional arrangements or the use of formal institutional types that lack design defects and effectively reduce transactional costs.

In addition, it is essential to acknowledge that the discussion of changes in terms of elasticity applied to the study of the institutional framework is not a closed topic. That is, in some cases the opposite could happen: demand for certain informal institutions (within a natural replacement period of time following a change in the social atmosphere) could be more robust in the short term than the long term. Therefore, a small variation on the institutional framework -according to the current interests of consumers- could result in a large percentage change in the level of institutional consumption. However, it is clear that in most cases, “institutional path dependence” can be inserted as a priori that institutions are mostly long-term instruments and cannot be easily replaced, so the amount of institutions available in the short term can be treated, as one factor that remains constant. Therefore, institutional demand will be less elastic in the long run than in the short term.

7. Institutional Coordination and the Problem of the Legitimacy

7.1 The Problem of Legitimacy

For a more traditional legal perspective, individual behaviour is not necessarily relevant to the extent that each *isolated* agent does not always have the capacity to negatively influence the interaction between formal and informal rules. Nonetheless, a more accurate assumption has to assume that the equilibrium or coordination among formal and informal institutional sub types can be affected based on undesirable individual actions. It means that a society always has to face the risk of specific *negative externalities* introduced by agents such as politicians or some public servants and its subsequent inharmonious social cost. In this regard, if it is assumed that if individual behaviour is not compliant with formal institutions and becomes a collectivized scenario, it will introduce a *problem of widespread compliance costs* where the marginal benefit of

compliance with formal rules is lower than the marginal cost of compliance with formal rules. This problem can be formally represented as follows:

$$Bmg_n < Cmg_c$$

Where:

Bmgn = Benefit of compliance with formal rules.

Cmgc= Marginal cost of compliance with formal rules.

In addition, based upon an analysis of elasticity rules, it can be assumed that formal rules, in a scenario governed by institutional weakening, have to be described as **highly elastic**. While in a scenario of institutional strength there is a trend in formal rules of being **less elastic**. Moreover, in a scenario of institutional transition, there might be a higher chance of formal rules being **elastic** in nature. That is, the quantity demanded by individuals of formal rules is gradually reduced. It may be argued that individuals desire the introduction of more formal rules in a period of social crisis in order to solve their *real world issues*. However, our analysis will focus on **actio** and the Hayekian process of trial-error and not on *human will* or normative analysis as law scholars understand this. This means that our assumptions are strictly correlated with a positive economic analysis.

8. The Nature of Informal Rules

Another important point to consider is the nature of informal rules. Informal rules are basically complex and evolutionary idiosyncratic products with a particular character or taste: its potential *legitimacy*. Understanding a further

relation between validity⁴¹ (V) and legitimacy (L) requires departing from a first analytical stage. In this first stage, validity and legitimacy are equal in “terms of result”; this is, when valid rules are considered as legitimate.

$$V = L$$

The first stage reflects an equilibrium state. Nevertheless, this is a temporary, – sometimes- idealistic and perfect stage not consistent with a permanent social reality. The social process is always carried out in a state of permanent disequilibrium. However, this permanent state of disequilibrium does not represent a risk for societies where the internal dynamics of social change help societies to adjust to new circumstances, such as strong variations of the social fabric composition. Furthermore, where there is a lack of institutional coordination, a so-called *legitimacy* gives an advantage to informal rules in the institutional framework. Even though informal rules are in open contradiction to the formally established formal institutional framework with support or enforcement forthcoming from the government. This particular context generates the conflict between validity and legitimacy where the institutional framework cannot meet a social equilibrium. Therefore, validity and legitimacy are not necessarily equivalent under an institutional assessment.⁴²

Conclusions

This first chapter has shown that institutions are not merely a set or network of formal and informal rules. Institutions represent a complex and evolving social process. This is important when considering concepts like *dynamic efficiency*. In addition, based on the strong coordination among formal and informal rules,

⁴¹ In this chapter the concept of *validity* refers to the idea of “legal sufficiency”. In addition, the concept of *legitimacy* refers to a “general social process where the popular acceptance of an institution and authority prevails”.

⁴² These assumptions might require a further stress test. However, the purpose of this section was to introduce a broader analysis.

dynamic efficiency shows “adaptability” and the capacity of this coordinated institutional framework and network to generate: a) Advanced changes to the social fabric; b) Incentives to ease the process of adaptation for entrepreneurs. Consequently, the “efforts” of economic and social agents and the strategic development of markets are part of this “dimension”.

When a society does not have a positive interdependence between formal and informal institutions, social stagnation and institutional weakening prevail. In this social context, individuals cannot adapt to social change and begin to exhibit negative social behaviours. This chapter has proposed that the level of institutional weakening could be used as a social indicator to analyse and classify a society’s social performance.

Without dynamic efficiency, limited political governance and the contribution of functional entrepreneurship, institutional coordination cannot be achieved. Then, as an undesirable consequence, *destructive entrepreneurship* can introduce “*new rules*” through *mercantilist behaviour* that becomes an institutionalized activity. Thus, this *mercantilist behaviour* will negatively affect the effectiveness and strength of institutional coordination and its framework, leading to indirect changes (guiding the social process to a transitional or even an unstructured society scenario). Furthermore, strong institutional coordination contributes to stable social cohesion (a main characteristic of structured societies). Consequently, a society led by a tough social cohesion may have lower transaction costs and may supply models of behaviour contributing to the rational formation of expectations.

Compromise solutions or trade-offs are a response to a scenario where formal institutions, by themselves, cannot efficiently reduce transaction costs. This is important because it determines that the process of interaction among institutional networks occurs within a wider orbit. This orbit involves the

organization of a social, political and economic system through *normative instruments* with a broad *illustrative character*.

Moreover, the chapter determines institutional elasticity by examining the ease with which a formal institution can be replaced by an informal institution and vice versa. Then the substitution of an institution depends first on its formal or informal "nature" and then from its ability to meet social objectives in terms of individual and collective choice. The second determinant of the elasticity of an institutional framework corresponds to the proportion of income spent on the consumption of an institution. *Ceteri paribus* posits that the higher the proportion of income spent on the acquisition or use of an institutional instrument, the higher the elasticity will be. Therefore, if an agent should only invest a small portion of income buying an institution, and then if there is a change in the relative price of an institution, that change will have little effect on the preferences and budget of an institutional consumer. The third determinant of the elasticity of an institutional framework corresponds to the time spent since its relative price has changed. In general, the longer the period, the greater the institutional elasticity of demand will be. The reason for this is related to the possibility of substituting an institution with another institution. As more time is required, there are more possibilities for a community, or the whole social fabric, to develop substitutes for the (often formal) institution that represents a high cost of compliance. Therefore, when necessary time has passed a community will have alternative or less costly institutional substitutes.

For a society, it is not possible to produce more units of X institutions without affecting the number of Y institutions. It shows the *institutional interaction* or *opportunity cost of an institution* in terms of another institution. Based on this argument, the opportunity cost of institutions can be defined as the exchange value of the second best institutional alternative. Effectively, the prevalence of an institutional framework or type may represent the abrogation of the second best choice because efficient and effective institutions are scarce. Determining

the best allocation of social resources is a complex social process where institutions are clearly created in a competitive way because useful institutions are the result of human cooperation to reach firstly individual targets and then collective stability and order.

Chapter III

STRUCTURED, TRANSITIONAL AND UNSTRUCTURED CIVIL SOCIETIES

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Introduction

This chapter seeks to introduce an alternative conceptual taxonomy of civil society as an input to Austrian law and economics and new institutional economics. The conceptual framework of the chapter develops three categories: *unstructured*, *transitional*, and *structured civil societies*. This categorization was, in part, inspired by Parsons' (1966, p. 33) contribution to *functional sociology*:

“Society is an intelligent structure, rationally structured to integrate its complex parts into a coherent whole (...) A social system consists of a plurality of social agents interacting with each other in a situation which has at least a physical or environmental aspect, agents motivated by a tendency towards the ‘optimization of satisfaction’ whose interactions with their own circumstances, are defined and influenced by a culturally shared system of structured symbols.”

However, our proposal does not focus on the *associative system* as a ‘set’ of aggregates (Parsons, 1968).⁴³ In contrast, following a previous academic chapter (Mendez, 2013c), the individuality of the agents is assumed. This differs from Parsons' approach (1978), where agents become secondary receivers in the process of socialization. In addition, it has been assumed in this chapter that the permanent display of individualism (economic subjectivism) in *civil society* occurs through the interaction of associative agents (Garcia-Guadilla et al., 1997). These individuals acting as ‘creative or

⁴³ In Parsons' theory, "associative action" is nothing more than an effort to obey or follow institutions or rules (1968). However, methodological subjectivism and individualism are avoided and clearly criticized. In addition, cultural phenomena (involving associative action) such as ideas, ideals, goals and norms can be considered as *causally* relevant elements in approaches influenced by Parsons' theory. Even though this author never abandoned the idea of individual choice constrained by external forces, he turned away from the focus on *consciousness* and *associative action* presented in his primary contribution “The Structure of Social Action”.

entrepreneurial agents' (Kirzner, 1978a) help to maintain associative cohesion through productive entrepreneurship (Baumol, 1990).

Therefore, our proposal relates to the following idea: *it is individuals who permanently affect the evolution of associative structures and civil society as a whole*. This is important because *civil societies* within this evolutionary process are affected by *complex events* (Hayek, 1978; Zanotti, 1981; Potts, 2000)⁴⁴ and changes that are very difficult to identify from mainstream perspectives in New Institutional economics and Law and Economics (San Emeterio, 2006). Thus, it is essential to selectively use previous approaches to understand civil societies as *functional structures* where the role of the individual is key and therefore cannot be *implicitly assumed* (Polanyi, 1974; Kirzner, 1978a; Huerta de Soto, 2006; Foss et al., 2010).

As this chapter attempts to bring together a large but disparate body of research topics in a more coherent research agenda (Zanotti, 2004; Heyne et al., 2009; Boettke, 2012), it has been organized into three main sections. The first section examines the idea of associative structures, which relate to our alternative conceptual taxonomy of civil society. The second section engages with the idea that a theoretical illustration of civil society 'also' represents an evolutionary process, a perspective 'inspired' by the *Theory of Spontaneous Order* as developed by Hayek (1960) and Barry (1982). The third section discusses the purpose of an alternative taxonomy and conceptual proposal of civil societies and introduces a preliminary attempt to implement a categorization, after which a set of conclusions is submitted.

⁴⁴ Hayek is also considered as one of the fathers of *Complex Systems Theory*. In this regards, complex system theorists very often refer to Hayek's 1978 essay "The Results of Human Action not of Human Design".

1. Associative Structures and Civil Societies

The idea of associative structures and civil societies, despite referring to many different types of collective groups, does not deny the existence of *specific scenarios*. These specific scenarios describe and classify certain moments that reflect the complex evolution of civil societies and associative structures (Krause, 2007). This is so because even civil societies and associative structures, described by Ostrom (1990) as micro and macro communities, regard collectiveness as a dynamic environment that is not self-contained, and whose members need to meet individual requirements before collective ones (Hayek, 1948). This dynamic environment might be described as a *sustainably organized* scenario or the category of *structured civil society*.

Therefore, interest shown in an approach that could be described as *structurally functionalist* lies in assuming the existence of four primary subsystems or associative structures in a civil society (Parsons, 1966). These structures refer to the functions that can be fulfilled within them.

Our theoretical illustration takes from ‘Parsons’ Functionalism’ the idea that there are *functional imperatives*. Functional imperatives are comprised of a complex set of activities, directed towards satisfying one or more functions of the four primary subsystems in a civil society. It is generally assumed that there are four functional imperatives and that, in order to survive, a primary subsystem must perform these four functions:

- 1) *Adaptation*:** Any system must meet any external situational demands. It must adapt to its environment and adapt the environment to its needs;
- 2) *Ability to achieve goals*:** Any system must define and achieve their ultimate goals;

3) **Integration**: Any system must regulate the interaction between its constituent parts. It must also control the ratio between the other three functional requirements;

4) **Latency or pattern maintenance**: Any system must provide, maintain and renew the motivation of individuals (and any cultural patterns that create and maintain this motivation).

Figure 7: Structures in a civil society and its functions

<i>Adaptation</i>		<i>Ability to achieve goals</i>	
	System of trust		Societal/Community Rules
	Economic Aspects		Political Aspects
<i>Integration</i>			<i>Latency</i>

As evident from figure 7, these four structures are related to: a) **Economic aspects**, which play the role of adapting civil society to the associative environment through activities such as work, production and distribution - thus, the economy adapts the environment to the needs of civil society, and helps civil society adapt to these external realities; b) **Political aspects** (or a political system) that perform the function of achieving goals through the pursuit of associative targets and the transfer of individuals and resources to that end; c) **A system of trust** (for example, families), which refers to the transmission of culture (associative norms or values) to other people so that they internalize them; d) **Organizational or societal community rules** (e.g. the law), traditionally used to coordinate and facilitate the interaction between

various components of civil society.⁴⁵

2. Civil Society

A comprehensive analysis of these structures or subsystems is not the aim of this chapter. Instead, this chapter seeks to integrate the Parsonian functional approach in a general, unspecific way, so that we can avoid any potential limitations in understanding civil society, in part, as an ‘evolutionary process’. That is to say, avoiding any arguments that advocate *cultural determinism* or a *historicist analysis* of the evolution of associative groups (Acemoglu et al., 2012).

This *fundamental reason*, where a civil society represents an evolutionary process, follows a perspective inspired by the *Theory of Spontaneous or Self Organization Order* in the same way as that developed by Hayek⁴⁶ (1960, pp. 39-40 and 1978, p. 38):

“(…) If social phenomena showed no order except in so far as they were consciously designed, there would indeed be no room for theoretical sciences of society and there would be, as is often argued, only problems of psychology. It is only in so far as some sort of order arises as a result of individual action but without being designed by any individual that a problem is raised, which demands a theoretical explanation. But although people dominated by the scientific prejudice

⁴⁵ In recent years, it has been argued that there are multiple types of set of interactions among individuals (Ostrom, 1990). These sets of interactions may also describe as "deliberately arranged" (e.g. communal property). Such interactions allow coordination within a framework of private property. This fact introduces social scenarios where individuals freely (contractually) decide to participate or abandon.

⁴⁶ “Catallaxy” as Hayek uses the term refers to spontaneous order in civil society. This chapter seeks to acknowledge the existence of spontaneous order and study it *ex post*. Nevertheless, our taxonomy of civil societies cannot be fully described as a *model of spontaneous order*, despite being influenced by some of its main characteristics. Therefore, our target is less ambitious and consists of the introduction of a theoretical illustration or conceptual model through the use of this theory.

are often inclined to deny the existence of any such order (and thereby the existence of an object for theoretical sciences of society).”

“(…) One effect of our habitually identifying order with a made order or taxis is indeed that we tend to ascribe to all order certain properties which deliberate arrangements regularly, and which respect to some of these properties necessary, possess. Such orders are relatively simple or at least necessarily confined to such moderate degrees of complexity as the maker can still survey; they are usually concrete on the sense just mentioned that their existence can be intuitively perceived by inspection; and, finally, having been made deliberately, they invariably do (or at one time did) serve a purpose of the maker. None of these characteristics necessarily belong to a spontaneous order or kosmos. Its degree of complexity is not limited to what human mind can master. Its existence need not manifest itself to our senses but may be based on purely abstract relations, which we can only mentally reconstruct. And not having been made it cannot legitimately be said to have a particular purpose, although our awareness of its existence may be extremely important for our successful pursuit of a great variety of different purposes.”

See also Norman Barry’s view (1982, p. 9): “(…) it is concerned with those regularities in society, or orders of events, which are neither (1) the product of deliberate human contrivance (such as a statutory code of law or a dirigiste economic plan) nor (2) akin to purely natural phenomena (such as the weather, which exists quite independently of human intervention). While the words conventional and natural refer, respectively, to these two regularities, the 'third realm,' that of social regularities, consists of those institutions and practices which are the result of human action but not the result of some specific human intention.”

Consequently, this taxonomy of civil societies will consider, in part, one of the main aspects of a *spontaneous order*: unintended and unpredictable evolution. This is important because spontaneous order is frequently an unintended consequence of human actions, as it emerges as a result of individuals trying to meet their own ends.⁴⁷ However, to some extent, though not entirely, this approach has to be ‘balanced’. In recent years, authors such as Elinor Ostrom (1990) have successfully argued that civil societies also show a set of interactions among individuals, which can be described as *deliberately arranged* (e.g. communal property). Such interactions allow coordination within a framework of private property. This fact introduces social scenarios - inside civil societies- where individuals freely (contractually) resolve to participate or abandon.

3. The Purpose of the Taxonomy

This chapter introduces the following research question: To what extent can an alternative taxonomy of civil societies enhance the study of institutional coordination and, consequently, the modern economics of rules?

First of all, this is relevant because an alternative taxonomy would work alongside further studies to better the assessment of institutional coordination between both formal and informal rules and a comparative new institutional analysis (Aoki, 2001). Further research for enhancing the assessment of *institutional coordination* is beneficial to advance studies in law and

⁴⁷ Hayek also referred to spontaneous orders as “*complex orders*” or “*kosmos*”. This is an important contrast with what this author called “*simple orders*” or “*taxis*”. This latter category correlates with a modern definition of formal institutions or rules as developed by North (1991). This chapter deals with the categorization of civil societies, which in part relates to the analysis of complex order or kosmos. However, the chapter recognises that “coordinates groups” are not only an example of spontaneous interactions among individuals. In fact, some groups in their “ideal representation” (e.g. private companies) may also represent an example of “deliberate order”. Ronald Coase extensively discussed this finding in his chapter “The nature of the firm” (1942). Since this contribution, private companies may be defined as a “group of contracts”.

economics and new institutional economics (Mendez, 2013c). This is so, since the taxonomy considers that individuals have a propensity to seek associative synchronization or *dynamic equilibriums* (Huerta de Soto, 2010). Furthermore, it is compelled to share links and generate different degrees of *voluntary cooperation* and types of *organization* among civil society members (Ostrom et al., 2003). This process also requires a framework where interaction between formal and informal rules is *functional* (Caceres, 2005). All this can be framed within a cultural and social cohesion. If this process is added to individual and group aspirations, it requires a degree of institutional stability that is achieved to the extent that the functional entrepreneurship and the political and economic environment point to a non-destructive competition context (Mendez, 2011).

Whilst a conceptual contribution, an alternative would represent a discernible point of departure, helping social science researchers to oversee and classify relevant variables affecting the economics of rules (Mendez, 2013a) and, consequently, from an institutional perspective, outcomes such as economic performance. In addition, in order to effectively achieve any of these tasks, core concepts, such as institutional weakening (Helmke & Levitsky, 2004) and institutional coordination, might be considered. From this perspective, further analysis can also be introduced via the integration and assessment of studies based on proxies, such as interpersonal trust, institutional quality, perception of corruption, and the strengthening of property rights.⁴⁸ Also, an understanding of these categorizations will be an important instrument for the aim of classifying civil societies as structure, transitional, and unstructured, according to their level of institutional weakening and institutional coordination.

⁴⁸ The alternative study of institutional quality showed carried out by Prof. Martin Krause, Libertarian Network of Latin America and Libertad y Progreso Foundation (2013) is an example of this aim. This join study was conceived as an Index of Institutional Quality for Latin American countries.

This taxonomical approach might represent a balancing input. This is so, because despite extensive efforts to produce more *analytical* and *empirical* research that focuses on aggregate concepts such as *institutional quality* and the use of proxies (Acemoglu & Johnson, 2005; Axala & Fabro, 2008), scholars interested in mainstream law and economics and new institutional economics but with no formal economic training often have to contend with restrictions on important data, like statistics and econometrics (Alonso, 2008). Together with the issue of *confronting paradigms* (Kuhn, 1962; Zanolini, 1981), the existence of different degrees of rejection and acceptance of *economic imperialism* (Becker, 1962; Swedberg, 1990; Lazear, 2000; Maki, 2008), and the *specific nature* of each social science (Bullard & McLean, 2002), these seem to be consistent reasons for the introduction of a harmonizing taxonomy, that may be useful to address the separation between legal, political, sociological, anthropological, and economic studies in this field.⁴⁹ Moreover, this taxonomical approach, based upon an understanding of law as those fundamental canons of justice upon which all free societies rest (Hayek, 1978), will oppose those scholars seduced by *utilitarian economicism* (Roemer, 1994; Posner, 1998) and therefore missing the exploration of the negative effects and danger of Legal Positivism (Gherzi, 2007). Incompressible, legal positivism is unconsciously used as the main supporter of aggregate concepts (legislation) in the study of institutions (Rojas, 2011).⁵⁰ Consequently, the study of law as a

⁴⁹ The new tendency of providing quantitative training (econometrics and statistics) to lawyers and other social science scientist has not yet become a mainstream teaching approach for Latin American universities. Specifically, public universities in countries like Peru, Ecuador, Bolivia and Paraguay openly reject to deep into a multidisciplinary training perspective.

⁵⁰ There are also positions that still reject the use of quantitative methods for further development in social sciences. These positions involve an active minority, who describe contributions from the study of natural science as “inappropriate” (Rothbard, 1997; Huerta de Soto, 2010). However, as the target is to introduce a conceptual contribution, this chapter does not adopt a methodological or “*methodenstreit*” approach.

spontaneous process is often forgotten and left aside without a strong signal of change by the mainstream law and economics literature (Gherzi, 2002).⁵¹

3.1 Institutions and Civil Society

A civil society can be defined as *a group of interactions among individuals* (Mendez, 2013b).⁵² This means it is a process (a dynamic structure), which is not consciously designed by anyone. It is highly complex, since it comprises a group of people with an infinite range of goals, tastes, values, and practical knowledge, and consists of human interactions (exchanges and dealings that often yield monetary prices and are always carried out according to certain rules, habits, or standards of conduct). All such human interactions are motivated by the force of entrepreneurship, which continually creates, discovers, and transmits information, as it adjusts and coordinates the contradictory plans of the different individuals through competition and enables them to coexist in an increasingly rich and complex environment (Foss et al., 2010; Manne, 2011).

In each category of civil society, these kinds of interactions are regulated through institutions (Hodgson, 2006). Thus, the legitimacy and dominance of these institutions will depend on the level of individual and collective acceptance and their ability to adapt to associative change (Caballero et al., 2005; Alonso et al., 2008). Consequently, the level of individual and collective acceptance may not be the same within each category of civil society. It may vary in relation to the degree of sustainability and organization of each specific kind of associative project. As civil societies are often dynamic categories, it is argued that the level of correlation cannot be accurately determined without

⁵¹ In recent years, contributions from Krause (2013), Rizzo (2011), Manne (2011), Rojas (2010), Gherzi (2009), Epstein (2006), Krecke (1998) and Cachanosky (1997) has represented an important output to start introducing changes to the conventional way to further study law and economics.

⁵² This group of interactions shows a ‘confluence process’ of deliberate and spontaneous orders.

analysing elements such as *associative interaction* and *institutional coordination* (Mendez, 2013a).

Furthermore, it is also essential to establish how strong institutional coordination is, in order to maintain an organized and competitive social fabric. Strong institutional coordination can impact positively on economic growth and performance, but can also have an effect/bearing on associative cohesion, dynamism and proactive ‘individual’ (spontaneous) and ‘collective’ (deliberated) interaction. Civil societies with a harmonious interaction between formal and informal institutions can be categorized as civil structured societies, as stated in previous research (Mendez, 2013c):

“(…) Civil structured societies reflect an associative context where: Individuals can rapidly adapt themselves to their associative context (dynamic efficiency). (…) Civil societies show the interdependence between formal and informal rules that we have called institutional coordination or positive institutional interaction. It is understood as a complex human interaction involving interdependence and rejection after a certain level of institutional confrontation. The possibility of institutional rejection introduced the concept of associative or tacit abrogation and derogation of formal rules (Gherzi, 2007). Alternatively, when a civil society does not have a positive interdependence between formal and informal institutions, there emerges associative stagnation or institutional weakening, which refers to an elevated lack of institutional coordination or negative institutional interaction. In this associative context, individuals cannot adapt to associative change and manifest negative associative behaviour. We propose that the level of institutional weakening can be used as an indicator to describe a civil society’s associative performance.”

The level of institutional weakening can be used to explore a civil society's performance.⁵³ Following Levitsky et al. (2010), institutional weakening must be distinguished from 'normal' institutional change. That is, institutional weakening should be seen as an accelerated institutional change (Pierson, 2000) and therefore as a disruption of institutional coordination. This is so because even though stronger rules evolve, they are vulnerable to being violated by agents who exert political power through 'rent-seeking' behaviour that reflects 'unproductive and destructive entrepreneurship' (Baumol, 1990).

Therefore, an institutional change in the framework of formal rules is not necessarily an indication of instability and institutional weakening (Helmke et al., 2004). Rather, the institutional weakening is shown as a setting or context in which structural problems are present as in: a) *Exogenous shocks* to civil society; b) Changes in political power; c) Changes in the *distribution of preferences*; and d) Other *endogenous changes* in the social fabric (North, 1990). This leads us to argue that institutional coordination can be weakened (as perceived by those on the 'outside') as a consequence of the capture of the foundational framework (constitutional rules), that are supposed to structure the rule of law (Voigt, 2009). For example, Peru and Spain could be mentioned as particular case studies (for an unstructured and transitional civil societies respectively). The former has had sixteen different constitutions and the latter eight since the early nineteenth century.

⁵³ According to Levitsky et al. (2010): "(...) institutional strength can be conceptualized along two dimensions: imposition and stability. Imposition is the degree to which rules are enforced in practice. All relevant agents -in a given territory- routinely complies with rules or face a high risk of punishment, imposition is high. By stability we mean durability; Institutions are stable to the extent that they survive not just the passing of time, but also changes in the conditions -power distributions and underlying preferences- under which they were established".

This is in contrast to Australia (potentially understood as an example of structured civil society).⁵⁴ This country, less exposed to the capture of its foundational institutional framework, has had only one constitution (despite the changes in its governance arrangements, distributions of power, and preferences of the political elite, as stated by Shaw, 1983; Collins, 1985).⁵⁵ Therefore, the framework of formal rules (constitutional or foundational) and institutional coordination in Peru and Spain can be considered less stable and weaker than those that govern Australian civil society.⁵⁶

However, this preliminary exercise (a priori) to delineate some of the facts or conditions of institutional weakening and institutional coordination can also be reproduced by studying the importance of an informal rules framework (O. Williamson, 2009; C. Williamson, 2009; and Mendez, 2013b). In this sense, the taxonomy of civil societies, as proposed in this chapter, could be established as an instrument that would simplify theoretical research and the establishment of primary assumptions. It is hoped that this would encourage further studies (Mendez, 2011). These studies would examine certain aspects

⁵⁴ The selection of Australia (structured civil society), Spain (transitional civil society) and Peru (unstructured civil society) as examples does not refer to a tautological proposal. This selection was introduced, in part, focus on the following aspects: 1) rule of law (arbitrarily represented by the number of constitutions), 2) degree of trust in government, and 3) regulatory quality with data from the World Bank (2014 Worldwide Governance Indicators) and OECD's guiding principles for regulatory quality and performance (2005). For more details please refer to the following sections of the chapter.

⁵⁵ This formal rule was approved in a series of referendums held over 1898-1900. The Commonwealth of Australia Constitution Act 1900 becomes law on 9th July 1900. In the late '80s, the Australia Act 1986 removed the power of the United Kingdom parliament to change the Constitution. Since that, the Constitution can only be changed in accordance with a prescribed referendum procedure.

⁵⁶ According to Williamson & Kerekes (2011), legal and political constraints such as constitutions and electoral rules have to be classified as formal institutions as these rules show depth and durability, "*but policies chosen by a dictator do not*". In this regards, Latin American (Peru, Bolivia, Argentina and others.) and Continental European countries (Spain, Italy, and others.) represent an exception to this statement. From a legal approach it can be argued that Constitutions ruling these countries are actually an example of rules chosen by a dictator and approved through restricted electoral procedures in political scenarios lacking of respect for democratic and individuals rights.

involving coordination processes and institutional weakening, and would try to integrate diverse approaches such as legal, economic, sociological, and/or anthropological ones (Mendez, 2013a). According to Levitsky et al. (2010) this is an important target as:

*“Recent studies on institutions (...) in the developing and post-communist world show that the institutions (...) vary widely along two dimensions: imposition and stability. **This variation has important theoretical implications.** Where agents do not expect institutions (...) to endure or the rules to be enforced, their behaviour will often differ markedly. Existing theories on the design and effects of institutions may well need to be refined if they are to be usefully applied to cases of institutional weakening. Treating institutional strength and/or weakening as a variable, rather than as an assumption that is taken for granted, recent studies have begun to refine institutional theories in ways that increase their usefulness in contexts where strong institutions (...) are the exception, not the rule (such as much of the developing world).”* [Emphasis and italics added]

3.2 Structured, Transitional and Unstructured Societies

Therefore, this chapter introduces a classification based on three new dynamic categories (summarized in table 3):

1) *Structured Civil Society* - characterized by high associative performance.

In this type of civil society, associative interaction is harmonized and structured. Both formal and informal institutions are well coordinated (Mendez, 2013b). Informal institutions (rules) are the key mechanism for associative control to resolve associative conflicts (Domjahn, 2011; Dreyer et al., 2008); they also maximize the economic process and effectively develop the entrepreneurship function (Foss et al., 2010).

- 2) **Transitional Civil Society** - characterized by an associative performance that is becoming either stronger or weaker (Perez, 2001). This civil project lies between the categories of structured and unstructured because it suffers from a middle level of adaptation to associative change (Quian, 2003) and/or associative fragmentation.
- 3) **Unstructured Civil Society** - characterized by a poor associative performance. In this type of associative project, individuals show extremely poor adaptation to associative change; associative fragmentation is a strong impediment to the dynamic associative interaction between individuals. According to Alonso et al. (2008), there is a lack of functionality of the mechanisms for socialization, and institutions as problem-solving mechanisms are ineffective. In addition, if it refers to the primary system functions, it can be argued that this kind of associative project has issues with the following: a) **Adaptation**, whereby the social fabric can neither adapt to its environment nor the environment to its needs; b) **Ability to achieve goals** as a social fabric; c) A lack of **integration** (that is, the system cannot regulate the interaction between its constituent parts nor control the ratio between the other three functional requirements); d) A notable problem with the **latency or pattern maintenance** because the system does not renew the motivation of individuals.

Table 3: General aspects of Structured and Unstructured Civil Societies

Structured Associative System	Unstructured Associative System
Individual is adapted to their environment.	Small or no level of adaptation.
Associative interaction is coordinated and structured. However, individual goals and objectives are not completely determined by the central planner. Informal institutions (rules) are the relevant mechanism for associative control.	Poor coordination, extreme associative pluralism and fragmentation.
Values are spontaneously exchanged/transmitted between individuals due to associative interaction (based upon individual alertness/entrepreneurship function)	The mechanisms of socialization lack functionality
Institutions are well-coordinated mechanisms, effective at resolving conflicts and contribute to the maximization process of individuals.	Problem-solving mechanisms (institutions) are uncoordinated or overwhelmed, unable to be effective.

Source: Own elaboration (2014)

In unstructured civil societies, high levels of corruption among the bureaucracy and political agents help establish interpersonal relations where the illegal sector becomes more powerful. This scenario weakens civil societies' standards of productivity and exchange because the economic environment is not organized as formally as the government has encouraged. Thus, this negative interaction between the formal/legal and the informal/illegal also weakens the associative fabric and is reflected in higher transactional and associative costs.

In addition, the economic environment of an unstructured civil society introduces a set of complex associative scenarios (that is, it lacks dynamic efficiency), which are difficult to accurately describe. Also, the formal institutional framework narrowly regulates a smaller (formal) sector. The consequences of this new scenario are the generation of a more associative exclusion and a 'potential' shortage of strong political governance.

Consequently, in an unstructured civil society, in order to measure welfare and make an efficient analysis, we need to incorporate several associative scenarios due to divisions in civil society. Finding a way out of these 'negative scenarios' is a challenge that can only be undertaken through alternative 'corporate forms' that express the prevalence of functional entrepreneurship. These alternative corporate forms cannot be regulated with a traditional bureaucratic approach; instead, a strategic deregulatory reform becomes the priority in the short-term in order to achieve institutional coordination (Mendez, 2013b).

On one hand, a correlation between the suggested taxonomy of civil societies and the concept of positive institutional interaction or institutional coordination introduces the idea of *community of interest*, or economics as exchange of property rights. In this context, associative issues are not missing the *associative fabric*; rather, they depend upon positive and functional

entrepreneurship and efficient associative interaction (organized by institutional coordination). A priori, it is argued that this can be measured through a basic index of access to welfare represented by *legal stability* or *civic rationality* (Mendez, 2012a; Mendez, 2013b; Mendez 2013c).⁵⁷ Hence, in a context with strong civic rationality, functional entrepreneurship will indirectly induce strong political governance. In some way, and following Weber's approach (1964), the *coordination problems* affecting the social fabric are fixed by auto-generated institutions and other associative mechanisms.⁵⁸

On the other hand, in an unstructured society, institutions representing political governance are weak (Caceres, 2005). Their institutional weakening opens doors to forms of power where clashes between associative groups (domination and associative cost transferences) are always present (Becker, 1983; Gerber, 1999). Therefore, it leads to a situation where political, economic and associative stability is a derivative of the struggle between groups, and so, any instance of associative cohesion is temporary in nature (Boron, 2003).

This conceptual taxonomy and theoretical illustration considers that individuals seek associative cohesion (dynamic equilibriums as described by Alonso et al. 2008), and are compelled to share links and generate different degrees of cooperation among individuals. This process can be illustrated by our proposal, demonstrating that positive interaction functions between formal and informal rules (De Soto et al., 1987). All this can be framed within a cultural and *associative cohesion* (Caceres, 2005). If this process is added to the *individual and group aspirations*, it requires a degree of *institutional stability*, which is achieved to the extent that the functional entrepreneurship

⁵⁷ This chapter defines "legal stability" or "civic rationality" as causally efficient motivation for public-spirited action.

⁵⁸ According to Weber's "Theory of Domination" (1964), it is possible to place the State as the first major concerned (for political and taxation purposes) in the consolidation of legal certainty and resource use in the law.

and the political and economic environment, point to a *non-destructive competition context* (Boettke et al., 2003). Also, in order to fulfil the conceptual illustration and taxonomy requirements, it is necessary to take into account the capabilities of the social fabric presented as a dynamic combination of human resources permanently engaged in cultural change and technological development (Caballero et al., 2005).

In addition, the taxonomy seeks to illustrate that without dynamic efficiency, limited (rational) political governance (Evans et al., 1999) and the contribution of functional entrepreneurship, *institutional coordination* cannot be achieved (Cobin, 2009). In this scenario, there will be a lack of associative cohesion and thus an unstructured civil society. Subsequently, the unproductive entrepreneurship (Baumol, 1996) manifested through mercantilist activities becomes an *institutionalized activity* (Gherzi, 1991). Consequently, this situation affects individual and group aspirations (which in an opposite scenario has to be harmoniously and accessibly organized or materialized by the ‘volk’) and *inhibits* informal institutional arrangements from becoming formal arrangements, understood as stable and predictable associative instruments for organization and control (Mendez, 2013b). In this regard, it can be suggested that coordination among institutional arrangements cannot be seen as a supply or activity carried out only by formal government bodies (Blundell et al., 2000; Byrnes et al., 2001). Even in a traditional political scheme, governments are considered responsible for organizing the dynamics within the associative fabric. Following a similar approach, it can be stated that formal supply of rule of law or ‘Rechtsstaat’ (e.g. a constitutional network, treaty, or code) cannot generate an *institutional framework* introducing a *structured civil society*. Therefore, the supply of formal institutional goods does not create its own demand and depends on an additional mixture of associative elements to reach the *market equilibrium* as it has been described by modern heterodox economic theory (Mendez, 2013b).

3.3 A Preliminary Attempt to Implement a Categorization of Civil Societies

The aim of this study was to introduce a categorization of civil societies. Furthermore, the understanding of those categorizations will be an important instrument for classifying the degree of institutional weakening and coordination in any country in the world. For example, this classification can be used with the following countries: a) ***Australia*** is categorized as a structured civil society due to its relatively strong institutional framework (Kasper, 2003), as indicated by the 2013 World Value Survey, the 2007 Worldwide Governance Indicators, the 2013 Index of Economic Freedom, and the 2013 Index of Institutional Quality; b) ***Spain*** is categorized as a transitional civil society, due to its progressive institutional weakening as discussed by Aixala and Fabro (2008) and derived from the disaggregation of the 2013 Index of Institutional Quality, the 2013 World Economic Forum, and the 2013 Doing Business Index; and c) ***Peru*** is categorized as an unstructured civil society by relevant academic literature (Cavadias, 2001; Cordova, 2004; Caceres, 2007), as illustrated by the 2013 Index of Institutional Quality and the 2013 Latinobarometro Survey.⁵⁹

These countries are categorized as such after taking into consideration: a) ***cultural aspects*** (Mendez, 2013); b) ***consistency between the theoretical trends*** developed by the taxonomy of civil societies and its empirical support; and c) ***other relevant exogenous and endogenous aspects***. With regard to ***cultural aspects***, all three countries are mainly *western influenced*. Therefore, a parallel in associative environment and individual interaction can be assumed. In addition, we need to accurately consider the similarities in cultural and ideological microclimates when addressing the underlying institutional framework (Grief, 1998). Therefore, our proposal differs from other more

⁵⁹ Additional information in regards the selection of these countries was provided in the footnotes 12, 23 and 14.

mainstream economic proposals, as sociological and historical aspects are not usually considered *as part of the framework* discussed in this chapter (Hodgson, 2001). Concerning *consistency between the theoretical trends*, their current overall ranking on the indexes selected by this study is consistent with the sociological categorization introduced above (Mendez, 2011). ***Other relevant exogenous and endogenous aspects:*** the three countries' geographical location and their economic, associative, political, and international importance in their regional areas (Morcillo, 2011).

In addition, a further implementation of the suggested taxonomy will have to enclose other relevant aspects such as: a) ***Economic aspects***; b) ***Political aspects***; and c) Degree of power in the ***system of trust*** (trust in government and interpersonal trust) and the ***organizational or societal community rules***, as these have traditionally been used to coordinate and facilitate the interaction between various components of society.

Conclusions

The categorization of civil societies as structured, transitional, or unstructured, can be a useful, general tool. Also, this study requires the use of more specific instruments, selected *a priori*, to measure the level of institutional weakening, institutional coordination, and other aspects. This taxonomy aims to illustrate that without dynamic efficiency, limited (rational) political governance and the contribution of functional entrepreneurship, *institutional coordination* cannot be achieved. Without these prerequisites, there will be a lack of associative cohesion and thus a civil unstructured society.

Even though interest in the introduction of empirical studies varies among professions (including associative scientists, lawyers, historians, anthropologists, and even sociologists), this alternative taxonomy aims to

create a degree of integration among different *programmes of research* and *methodenstreit approaches*.

Categorizing civil societies as structured, transitional, and unstructured, will make case studies and traditional empirical analysis more accessible. However, in order to effectively achieve any of these tasks, core concepts such as institutional weakening and institutional coordination have to be considered. Further studies can also be introduced via the assessment of matching proxies such as interpersonal trust, institutional quality, perception of corruption, and the strengthening of property rights. Furthermore, an understanding of these categorizations will be an important instrument for classifying the degree of institutional weakening and coordination in any country in the world. An alternative taxonomy would work alongside further empirical studies to enhance the analysis of *institutional coordination* and comparative new institutional analysis. In addition, whilst a conceptual contribution, an alternative taxonomy would represent a *discernible point of departure*, helping researchers to oversee and classify relevant variables affecting the economics of rules (Mendez, 2012) and, consequently, outcomes such as economic performance and growth.

Chapter IV

AN ANALYSIS OF UNEMPLOYMENT INSURANCE AND PENSIONS: A CONTRIBUTION FROM THE INSTITUTIONAL COORDINATION PERSPECTIVE, THE CASE OF PERU

This chapter was submitted as a Conference Proceedings to the II International Economic Conference: analysing Pension Systems, organised by Catholic University of Avila (Spain) under the following title: “An Analysis of Unemployment Insurance (CTS) and its Relation to the Superannuation System: The Peruvian Case”. Proceedings forthcoming for publication as “Actas del II Congreso Internacional de Economía y Libertad: Sostenibilidad del sistema público de pensiones” (Book of the II International Congress of Economics and Liberty: Sustainability of public pension system”), Avila: Catholic University of Avila Publishers, 2015.

Introduction

This chapter focuses on the damage done to institutional coordination through public policies that lack market-oriented economic rationality. As such, this chapter examines the system of unemployment insurance and pension schemes in Peru using the *institutional coordination* approach (Méndez, 2011 and 2013). The chapter begins by assuming continuous and interdependent interaction between the legal and economic fields (*Ius Economics*) (Spiegel (1983). This continuous and interdependent interaction is significant for its impact (costs and benefits) on an *open civil society*—understood as an evolutionary process governed either by *spontaneous order* or artificial governance mechanisms. This chapter conceives of *spontaneous orders* as self-regulated or autogenously systems (Hayek (1964) and Barry (1997).⁶⁰ In contrast, *artificial orders* are conceived of as products of multiple outcomes (positive and negative) introduced by the executive, legislative and judicial powers. Artificial orders are limited by the complexity of the authors' intelligence and characterised by its capacity to generate *institutional weakening* (Levitsky & Murillo, 2010; Méndez, 2013).

The aim of the chapter is to describe some of the constraints that might affect the formal governance mechanisms introduced to improve the interests of workers and retirees. Also, this chapter attempts to answer the following research question: To what extent does a weak proposal to reform the current labour and pension legal framework cause additional distortions and damage to the process of institutional coordination? These distortions and damages

⁶⁰ Spontaneous orders and social spontaneous orders are not ex ante controllable products coming out from the human mind, because despite these orders are arising from the subordination of its elements to certain norms (powered by its reaction to their surroundings social scenario), these spontaneous orders are expressed through no artificial regularities, as it happens with customs, language and money. Therefore, the study of these spontaneous orders requires focusing on certain key elements (social facts), which are escaping the elusive control of collective action coming out from governments.

involve the presence of conflicts in interaction among rules legally known in the *Civil Law System* as conflicts of *normative interaction*:

- a) Formal institutions governing the Peruvian unemployment insurance system (Compensation for Time of Service or CTS) and other pro-worker mechanisms;
- b) Formal institutions that organize the pension schemes;
- c) Formal institutions introduced to regulate an alternative model of unemployment insurance (which might signify the *abrogation* of CTS) and the rules introduced for reforming the pension schemes; and
- d) Informal institutions and security mechanisms (informal unemployment insurance via the underground economy and networks of security and family protection).

In Peru, chronic conflicts of interaction between formal and informal institutions remain an important variable, slowing *institutional change* and a source of *institutional weakening*. The new institutional and Ius Economics literature attributes such weakening to *the failure of institutional transplant* to the political, social, legal and economic scenario dominated by the *State of Legality* (Gherzi, 2010).⁶¹ Hence, there might be a correlation between the creation of a *complex set of formal institutions or rules* (Epstein, 2005) and higher costs in Peru's labour market—affecting its *flexibility* and *competitiveness*. This relationship may also extend to structurally related areas,

⁶¹ The thesis of the *State of Legality* assumes that nominally existing formal institutions are “ruling” social life. However, *these institutions do not restrict the political and legal power, but reflect this power*. Therefore, what has happened in countries like Peru is that the formal institutions reflect the power, rather than limit it. This scenario creates a context in which formal institutions becomes an instrument of oppression rather than one for introducing *fairness* and *justice*.

such as the *pension system*,⁶² creating perverse incentives that affect participant behaviour.

In regards to the methodology, this chapter introduces a combination of *forensic methodology*⁶³ and *axiomatic-deductive analysis*.⁶⁴ These approaches have been selected due to the nature of *Ius Economics* research and the non-existence of reliable and up to date data capable of contributing to a technical analysis (most Peruvian data relates to Metropolitan Lima, which does not allow for an accurate description of the current situation in the rest of the country).⁶⁵

⁶² The parallel model that characterizes the current Peruvian pension system was established in the early 90's as a result of a structural reform wagered by a *parallel system* rather than adopting a *substitution model*. This meant that from 1992, the National Pension System (NPS) operates simultaneously with a Private Pension System (PPS) introduced through firms called AFP's (private superannuation management funds). The reason for adopting of a parallel system rather than a full private one was the lack of experience on how to reform social security through implanting models developed overseas. Under these circumstances, a partial reproduction of the Chilean model was considered as the ideal alternative for a structural pension reform in Peru. The PPS requires from workers to register and thereafter contribute with a fixed percentage of their income during their working lives. Funds are accumulated in individual accounts until workers reach retirement age (65 for men and women). From this point, the accumulated balance remains in the AFP's or can be transferred to an insurance company for a monthly pension based on life expectancy. If the retiree dies, then his / her dependents inherit a share of the pension. The types of retirement benefit are mainly three: a) retreat scheduled administered by the AFP's; b) annuity administered by an insurance company (retired uses the account balance on the AFP's to purchase an annuity in an insurance company); c) joint or mixture of withdrawals and annuity programming.

⁶³ Forensic methodology is a distinctive approach to the legal perspective and prioritizes the need to consider the source and reliability of information. From this approach, you must weigh all the factors in the decision-making and also an initial inspection (deductive) of the facts by the setting of a tailor-made theoretical or conceptual model. Therefore, the fact that the researcher is considered responsible for following appropriate research protocols (soft) is prioritized. That is, the researcher must ensure that the objectives of the research project can be achieved satisfactorily despite the existing material limitations.

⁶⁴ The axiomatic-deductive analysis introduced in this section was inspired by the one proposed by Zanotti (2004, 2011a and 2011b).

⁶⁵ The need for greater quantity and quality of statistical data is a consistent claim in the Peruvian economic literature.

In order to address the proposed topics, the chapter has been divided into four sections. The first section introduces the concept of institutional coordination and its relationship to the Peruvian case. The second section deals with the legal background of this case study while also providing a description of the economic situation. The third section focuses on the arguments regarding the current and alternative unemployment insurance in Peru. This section begins with a description of the technical barriers that restrict the development and implementation of a new formal institutional framework governing unemployment insurance.⁶⁶ The third section concludes by explaining some of the virtues of a policy proposal focused on *the private mechanism*, which attempts to preserve a strong coordinated institutional framework. This discussion is relevant because the Peruvian informal institutional framework shows a remarkable tendency to overrule and diminish formal institutional constraints (Gherzi, 2005). The fourth addresses the pension schemes in Peru. Furthermore, this section describes the new non-contributory scheme (Pension 65 and explains how this scheme affects institutional coordination, emphasising the problem of legitimacy, and the necessity for reform that doesn't damage institutional coordination. Finally the conclusions are presented.

1. Institutional Coordination

The market is a process of competitive rivalry and dynamic entrepreneurial discovery. Also, it attributes special relevance to different types of rules or institutional layers (Huerta de Soto, 2010; Rizzo, 2011; Boettke et al., 2010). Based on this background and contemporary contributions from authors like Ostrom (1990), it might be assumed that modern applied economics requires preserving notions of human action as well as accurate analysis of the

⁶⁶ Then the current institutional design (CTS) is compared with alternative policy scenarios proposed by Peruvian policy experts (Chacaltana, 2000; Jimenez & Cuadros, 2003).

relationship between means and ends, as guided by formal and informal institutions or mechanisms for governance.

These mechanisms for governance can arise from both interpersonal constraints and *deliberate order*. In particular, these interpersonal constraints (characterised as distinctly evolutionary, communal and cultural) are firstly outsourced and then accepted by a group (gaining *legitimacy*)—which is herein referred to as *informal institutions or rules*. However, informal institutions coexist with formal institutions, mechanisms for collective action of deliberate nature, where priority is given to *social planning* and *hierarchy* (Gherzi, 2010).⁶⁷

In line with previous chapters, this interaction between formal and informal institutional layers refers to our concept of institutional coordination. Institutional coordination can be defined as a complex process, showing that institutions interact, compete, overlap and displace through their formal and informal versions. This process requires a framework where coordination between formal and informal layers is functional and can be framed within relatively steady cultural and social cohesion.

Departing from the institutional coordination approach, this chapter examines the development of existing formal rules governing the pension and unemployment systems in Peru. This is important because the design of formal rules that deal with an overcrowded system of private unemployment insurance should also avoid complications in terms of access and transferring information (for example, removing restrictions in knowing how solvent your insurer fund is). This means designing the system as a well-structured institutional *block* and assuming the existence of informal rules, which will enhance its *dynamic*

⁶⁷ Economists identify this characteristic with *predictability*, and jurists from the Civil Law tradition associate it with *Kelsen's Pyramid*.

efficiency, legitimacy and social cohesion in close connection to *productive entrepreneurship* (Méndez, 2013; Alonso et al., 2008).

2. The landscape in the Peruvian economy

The analysis of the Peruvian economy has to examine the situation for labour demand, labour supply,⁶⁸ the institutional framework and the incidence of economic informality (underground economies).

2.1 Labour Demand

Peru has a *moderately free economy*, which has undergone long inflationary processes, only recently showing signs of economic growth. Employment rates have risen, though in modest proportions (IPE, 2011; Gomero, 2013).

Moreover, the cost of hiring workers has been increasing in recent years due to the creation of new *market entry barriers*, such as the higher *cost of wrongful termination* and severe limitations on both *positive law* and *jurisprudence* (Ghersl, 2010).⁶⁹ In addition, employment growth in recent years has been

⁶⁸ The studies of labour supply have focused on urban centres (primarily Metropolitan Lima), with signs of continued growth due to rural-urban migration that has taken place since the 1950s. In recent years, there has been no significant reduction in this migration (Gomero, 2003).

⁶⁹ According to Garcia (2012), Peru has the highest compensation costs for *wrongful termination* in the region. Arguably termination costs derive from labour legislation and under the current design, these costs are a form of tax that formal employers must pay when a worker is terminated. This tax has potential negative effects on employment levels, as a higher expected cost for worker termination reduces hiring in the formal sector (Saavedra & Maruyama, 2000). In addition, compensation payments in Peru are not low, when compared with the average in OECD countries (Pagés, 2010). Moreover, Peru in relation to other countries within the region has the highest additional wage costs.

concentrated in the *tertiary sector*, which has relatively low productivity (Garavito et al., 2012; Jiménez, 2013).⁷⁰

Finally, given the low growth of labour demand, the growth in labour supply and rigidities in the formal labour market,⁷¹ there is a high unemployment rate. There is also high underemployment and unemployment in the informal sector (Diaz & Maruyama, 2000). The increasing presence of a large informal sector also seems to support this assertion. According to Jimenez (2013, p. 14) there is hidden unemployment (high underemployment and informality) and the purchasing power of wages has little importance vis-à-vis economic growth.

2.2 Institutional Framework

Toyama (2004)⁷² and Gherzi (2009) have stated that the Peruvian labour legislation has introduced a higher degree of *rigidity* in the performance of the labour market, showing a remarkably undemocratic and mercantilist nature and representing another example of a contravention to the Rule of Law (as has been presented in Chapters II and III).

In addition, the agencies that oversee the enforcement of labour and pension legislation in Peru have not fulfilled their role in terms of the institutional framework (Caballero, et al. (2004), Garavito and Muñoz (2012) and Garrido (2013), far from the goal of effectively promoting labour demand, labour

⁷⁰ This sector is most commonly advocated as the real engine of the economy, but it requires improvements in competitiveness (Garrido, 2013). This statement has been backed up and reported by the MTPE (2012)

⁷¹ The Ministry of Economics and Finance (2006) has pointed out that formality in the Peruvian economy is reaching only a third of employment in the country. Of the total (formal and informal) workers, only 16% received benefits and a wage, under compliance of current labour legislation.

⁷² This author also that the rules involving labour and superannuation scenarios in Peru reach down deep contradictions and this is verified through the analysis of legal cases. In this sense Toyama calls for drastic legislation reform in accordance with the constitutional principles of *respect for private property* and *private initiative*.

mobility, labour peace and sustainability of the public and private pension schemes. More generally the institutional quality of the country relatively low compared with other countries in the region (Libertad y Progreso Foundation, 2012).

Also there are two basic problems with existing labour and pension legislation. Firstly, the quality aspects including income and pension rates. The second refers to quantity aspects, such as reducing the number of formal job places available and decreasing the number of workers willing to contribute to the pension schemes. (Saavedra et al., 2000). The public policies introduced by consecutive Peruvian governments have not been moving in the right direction Garrido (2013). Arguably, the Peruvian government organizations responsible for proposing and implementing public policies for promoting employment creation and strengthening pension schemes do not perform efficiently. These organisations have overlooked the fact that their proposals focus on protecting a small percentage of the population employed in the formal sector, neglecting those in the informal sector. This asymmetrical impact has restricted the expansion of employment in the formal sector, with those under 30 most affected MTPE (2012).

Since 2002, taxes on the formal sector have increased almost 3.5% to maintain the public social security system (Vega, 2010). The public social security system has been in technical bankruptcy for the last 20 years, requiring contributions from people who are not even its customers (IPE, 2013). In addition, the Peruvian middle class largely prefers the private health and age care systems, rather than the poorly reputed public system (Garrido, 2013; IPE, 2013).

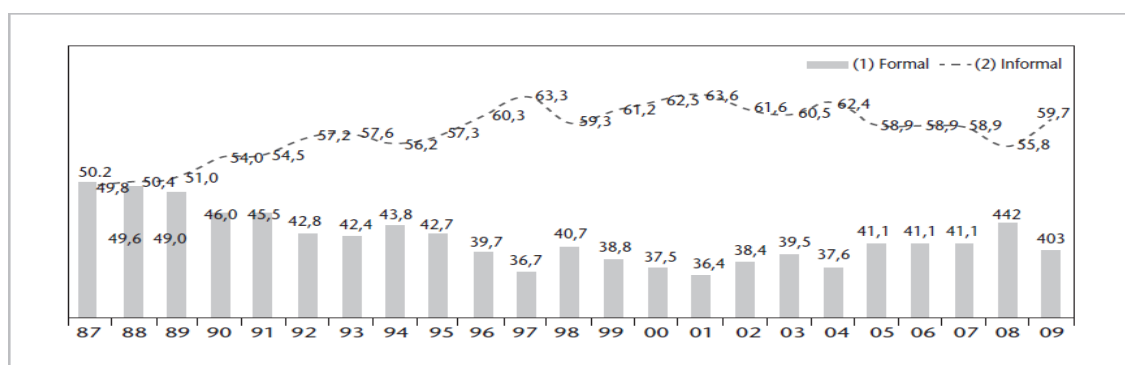
Likewise, the benefits of the current labour market and social security system are still concentrated amongst a group represented by political and mercantilist entrepreneurs. This phenomenon is known as *the problem of concentrated benefits and diffuses costs*. In this situation, additional legislation is unlikely to

be effective or cannot be adopted in practice. Applying this reasoning, it might be observed that the benefit will be concentrated in the legislative sector as Peruvian elected representatives are constantly looking to increase the number of voters without fulfilling the responsibilities for which they were elected (Sardon, 1999). On the other hand, the cost will be diffused amongst retirees, formal employees and micro and small entrepreneurs operating in the formal market. The legislation governing the labour market and social security has gone from excessive regulation to the flexibility of deregulation and then returned again to regulation. This ignores the need for long-term legal rationality in these areas in order to solve structural problems and reduce the resilience of *political patronage*.

2.3 Incidence of Informality

An important feature of the labour market in Peru is the large proportion of the EAP who are employed in the informal sector and the amount of underemployment (Chacaltana, 200; Jimenez, 2013). Under this scenario, informal markets can serve as escape to deal with unemployment and as an incentive to overcome *hidden unemployment*. This is important since the informal sector's current size (see figure 8) is a problem that has not been addressed with structural and institutional reforms (Gherzi, 2005 and Garrido, 2013).

Figure 8: Evolution of the Peruvian Formal and Informal Sectors as percentage of EAP, 1987-2009



Source: MTPE, Monthly Statistical Report (2012)

The Peruvian informal sector includes not only micro and small enterprises not fully integrated into the formal institutional framework that regulates economic activities, but also a large number of self-employed, unskilled workers and independent professionals (MTPE, 2012).⁷³

Unpaid family workers represent a particular case, primarily a rural phenomenon, with 69% located in rural areas of the country (Cespedes, 2013). It is particularly prevalent with farmers who work with their families cultivating mainly for their own consumption (Garavito & Muñoz, 2012). This group also consists of members of indigenous communities engaged in informal mining, artisanal fishing, hunting and other similar activities. This segment has been described as highly vulnerable, excluded from social security and pensions.⁷⁴

In a country where only 12% of workers in the formal sector have access to unemployment insurance and only 10% contribute voluntarily to the pension system, it is correct to infer that the problem of informality affects areas related to unemployment insurance (which also has the problem of its poor structural and institutional design), such as the social security and pension system (Cespedes, 2013).

Systemic informality in Peru is not only related to issues, such as low productivity and competitiveness (micro and small enterprises), but also to the high *cost of legality* (compliance with the administrative and legislative frameworks). There are also the costs incurred by agents attempting to

⁷³According to Cespedes (2013), in 2007, informality in metropolitan Lima was nearly 59% of the working population, with 21% employed in microenterprises (21%), unskilled workers 30%, household workers, trainees, and others (8%). Furthermore, the MTPE (2012) has established that the national informality rate in 2006 was 76% of the EAP.

⁷⁴ Within its members, there is also a feeling of rejection towards these mechanisms, which is stimulated by *idiosyncratic issues* (De Soto et al, 2001). In some cases, these idiosyncratic differences remained latent due to the lack of *institutional legitimacy* attributed to formal rules (Mendez, 2013).

comply with regulations administered by low quality and inefficient government agencies (Gherzi, 2005; 2010).

3. Unemployment Insurance in Peru

Traditional systems of public unemployment insurance have not achieved remarkable results in Europe (Garrido, 2013). Nevertheless, a similar mechanism was proposed by the Bill Draft No. 7182/003 as the best solution for Peru. In this proposal, the public social security system assumed responsibility for its development and administration. This proposal⁷⁵ also created a public fund replacing the current system, which used single accounts.⁷⁶ This is a proposal that has not been enacted because of the delicate situation of Peruvian social security and strong opposition from the MEF (2006). This ministry stated that such reforms should be analysed carefully, because of the adverse effects would reproduce the impact of the *institutional failures* that affected the Peruvian economy in the 1980s and 1990s under the second government period of Belaunde, the first government period of Garcia and the first period of Fujimori.

⁷⁵ The legal foundations of the Bill proposal lied to Sections 10° (the State recognizes the universal and progressive right of everyone to social security for protection against contingencies defined by law and to improve his quality of life), Article 23° (which provides that work in its various forms, is a priority of the state, which provides special protection to the mother, the minor and disabled workers) and Article 24° (which provides that a worker is entitled to a fair and adequate compensation, to ensure, for him and his family, the material and spiritual welfare) of the Political Constitution of Peru, 1993.

⁷⁶ See, DS-TR No. 001-97, Consolidated Text of the Law on Compensation for Time of Service (3/1/97) and DS-TR No. 004-97, Regulations of the Compensation Law Time services (15.04 .97). Initially the CTS was created to constitute an intangible fund (initially 6 salaries). Nevertheless, since its creation, the government allowed different ways to expand the level of consumption and facilitate the payment of debts (real estate and car loans). According to Toyama (2013) the changes affecting the funds' intangibility have damaged the rules of the game originally established. Under the original legislation, the CTS were freely available in a limit of 50%. This limit was subsequently increased to 70% and nowadays a possibility of increasing up to 80% is under analysis.

3.1 Key Issues for Peruvian Unemployment Insurance (CTS)

According to Garcia (2011a), the risk of unemployment is legally covered by the Compensation for Time of Service (CTS). This is a system of *forced savings* and contributions to this fund are mandatory for employers who hire workers, for four (4) or more hours per day and those whose remuneration is not covered by *collective bargaining*. These contributions represent an amount that is slightly higher than a monthly salary per year of service. The CTS can only be released when the employment relationship ends either by termination or migration to a new job (with the new employer responsible for making payments).

This system is currently under legal and economic revision in order to improve levels of coverage and incorporate workers from the underground economy. According to Toyama (2003), these proposals included insurance where benefits decreased over time and a wage tax higher tax when the person eventually gets a job. Most proposals fail to deal effectively with the practical (technical) and political difficulties of implementing an insurance where tax rates depend on the workers' unemployment record (Aguinaga (2005). Furthermore, those with less education would be required to pay a higher premium because they are more likely to be unemployed due to their lower level of adaptability in a market with rapidly changing characteristics (Caballero et al., 2004).

The discussion of a system of unemployment insurance also requires a disquisition on two key issues. Firstly, the workers covered by the insurance, specifically those wrongfully terminated and those terminated as a result of downsizing (Toyama (2003). Secondly, the financing sources for the insurance, including proposals to reform the CTS model involving an alternative co-payment model that would be borne by employers and workers. However, unions and professional syndicates have rejected these proposals

because they require contributions from workers, as well as arguments over which organisation would be responsible for the administration of the unemployment insurance fund (Mattos, 2011).

According to Toyama (2003), the decision on who would manage the fund has to be established according to the Principle of the Subsidiary Role of the Government, as stated in the Constitution of Peru (1993), Article 60:

“(...) Only by special law can the State carry out subsidiary business activity, directly or indirectly, because of high public interest or manifest national interest.”

The existence of this article means that the Peruvian government could assume direct administration of an unemployment insurance fund only if it could meet the following requirements: a) it received the approval of the legislative power; b) private companies were incapable of meeting efficiency standards in the provision of the service or good; and c) there was a significant public interest in intervention, which is to say, an expressed *national interest*.⁷⁷

3.2 Technical Barriers to Implementing and Developing an Alternative Scheme of Unemployment Insurance in Peru

According to Toyama (2003), there are two main characteristics if the implementation of a successful system of unemployment insurance is considered: a) the *characteristics of the labour market*; and 2) the relationship between *compensation and years of service in the case of termination*.

In 2005 46.3% of non-agricultural workers were employed in the informal sector – an increase from 1990, of 42.8% (Ministry of Economics and Finance

⁷⁷ In the last 30 years the Peruvian government has proved to be an inefficient entrepreneur and manager.

(MEF); Diaz & Maruyama, 2000). In the first half of the 1990's, six out of 10 jobs were created in the informal sector (Caballero, et al., 2004). Moreover, employment in the public sector accounts, on average, for around 18% of non-agricultural employment (Garavito & Muñoz, 2012). These circumstances have created significant technical obstacles to the introduction of a public system of unemployment insurance (Superintendency of Banking and Insurance (SBS). These also provide a partial explanation for the declining coverage coverage of the system and its potentially limited effectiveness *for enhancing social protection*. However, it is striking that there are few studies that try to address these issues (Garcia, 2012).

There are also other important interconnecting characteristics of the Peruvian situation that need to be addressed when considered the development of unemployment insurance.

The level and distribution of unemployment among workers needs to be considered in the design. For example there is a barrier to young workers accessing insurance benefits due to the requirement of a minimum number of contributions. Also, public employees have little incentive to participate in an unemployment insurance scheme because of their *job security* (Garcia, 2012). Unemployment insurance is unlikely to cover low-income workers, especially those from the informal sector unable to meet the requirements of previous minimum contributions (Toyama, 2003).

Also, workers -who lose employment in the formal sector- could continue to receive benefits, whilst engaged in informal employment (*parallel employment*). According to Garavito et al. (2012), this scenario was considered as a justification for more government supervision. This type of behaviour is difficult to monitor and would be a significant financial burden on an insurance system. Meanwhile, some authors (Aguinaga, 2005; Briceño, 2011) assumed that only a highly regulated system of unemployment insurance could successfully incorporate formal sector workers.

There are links between the size of compensation and years of service in the case of termination as a protection mechanism. The relationship between these variables can only be verified if the following conditions are clarified:

- *Employee and firm certainty on the amount.* This first condition is rarely met due to a lack of regulatory clarity that complies with systemic

distinctions between *wrongful termination* and *redundancy caused by lack of demand* or other economic needs of the company.⁷⁸

- *A transparent relationship between contributions and payments.* This condition is also rarely met, since workers perceive compensation as an entitlement and firms see it as a tax. Furthermore, the total amount of the cost of termination is made under the liabilities of the company. Because of existing institutional constraints, firms choose not to create a collective fund for that purpose, so when firms' conditions become difficult, a context of problematic decision-making emerges: a low availability of funds set against the necessity to adjust the size of the workforce.
- *Savings for the firms are not necessarily comparable to what the worker would accumulate to protect himself against job loss.* This factor is interesting in the Peruvian case, where unsuitable regulation has been the biggest obstacle to a smooth relationship between what the company saves and what the worker considers to be a satisfactory or fair amount. Peruvian regulations have restrained this relationship, as well as the need for transparency and neutrality in resource allocation. However, this third condition is also infrequently met because, even in cases where reformed unemployment insurance can be implemented, small businesses, again due to institutional constraints, have little opportunity to diversify risk among their few employees. In other words, insurance contributions become quantitatively greater if the aim is to achieve a higher level of protection against the possibility of job loss.

⁷⁸ Another source of uncertainty in Peru is given by the formula for calculating the compensation. Firms made contributions based on their workers current salary, while the workers compensation is calculated as a multiple of the final salary (or based on the average of salary).

3.2.1 Unemployment Insurance and Unemployment Duration

According to Toyama (2003) and Caballero et al. (2004), despite the progress made in the last twenty years, the Peruvian labour market still has a high proportion of people of working age who are not participating in the labour market,⁷⁹ high labour informality and self-employment (Garavito & Munoz, 2012). The Peruvian economic literature indicates that workers quickly retreat into underemployment, the informal sector, and self-employment. These workers are also unable to finance long periods of searching for *suitable employment* (MTPE, 2012).⁸⁰

3.2.2 Estimation and Relevance of Unemployment Duration

In Peru, the duration of unemployment is usually estimated using data from the Permanent Employment Survey (EPE),⁸¹ which is performed only in metropolitan Lima. Although there are no nationwide reports, studies for 1996 suggest that the duration of unemployment in Peru is between 14 and 19 weeks, with the majority unemployed for less than eight weeks, while a small proportion face long-term unemployment (Chacaltana 2000) Diaz and Maruyama 2000). This factor is important when considering the design of an unemployment insurance system. High lengths of unemployment duration are associated with higher unemployment payments and longer periods of insurance coverage, which generate incentives that reduce the search efforts of the unemployed and affect the system's sustainability (Meyer 1990)

⁷⁹ From EIP can be distinguished two main groups: 1) Inactive willing to work (*hidden unemployment*); and 2) Inactive unwilling to work (*inactive agents*).

⁸⁰ MTPE (2006) supports the definition of *suitable employment*. MTPE considers part of this group those workers who are voluntarily working a number of hours less than the length of a normal working day, and do not want to work more or those who work equal or greater number of hours in a normal day but earning an income equal to or greater than legally approved.

⁸¹ EPE features a short-term panel design. A fraction of the sample are reinterviewed each month during a total period equal to a quarter. According to Céspedes (2013) the EPE shows a weakness, it is a survey only carried out in Metropolitan Lima.

However, the design of the unemployment insurance system (CTS) for workers in the formal sector begins with the premise that the average duration of unemployment is six months (Toyama, 2003). This premise has resulted from a mercantilist understanding of the legal protection of workers and without a valid statistical criteria, economic or financial analysis (Garcia, 2011).⁸²

3.2.3 Characteristics of Unemployment Duration

There are also significant differences in the duration of unemployment by population segment (Vieira, 2004). There were no significant differences in the duration of unemployment by gender (0.6 weeks on average). Segmenting by age, older workers take more time to find employment (MTPE, 2012). This statistic might indicate that young people are more willing to accept low quality jobs and low pay, so they have greater ease in entering the labour market. This explanation is consistent with the finding that the duration of unemployment is lower for new entrants (Defensoria del Pueblo, 2005). However, this finding is also due to the *experience factor*: a new person in the labour market has little experience, so demand for him or her might be lower. In general, a downward trend in unemployment duration can be distinguished in all categories. Therefore, the decrease in the duration of unemployment is not a feature of particular groups; rather, it is a feature of the entire unemployed population (Vieira, 2004).

On the one hand, there is an absence of formal systems with high penetration of unemployment insurance that can be used to finance long bouts of unemployment. This situation forces workers to finance unemployment, end inactivity, or seek jobs of lower productivity, such as self-employment and

⁸² According to Vieira (2004), the average duration of unemployment for individuals with legitimate access CTS is 2.7 months.

informality. Nevertheless, the performance of the Peruvian economy has changed.

3.2.4 Duration of Unemployment and Unemployment Insurance

What is the relationship between unemployment duration and the unemployment insurance system (CTS) in Peru? The relationship between the duration of unemployment and any associated insurance, depends on the characteristics of the later (Jimenez and Cuadros 2003). Arguably generous unemployment insurance encourages a longer duration of unemployment. The unemployment insurance system prevailing in developed economies involves payments to the unemployed for the duration of his or her job search. This scheme is based on an incentive mechanism with the purpose of funding reasonable job search episodes for unemployed workers (Holzmann, 1997).

However, in the Peruvian case the CTS excludes those once employed in the informal economy.⁸³ The only variable in the CTS system that relates to the duration of unemployment is the legal limit of six months of wages that the worker can accumulate whilst working (García 2012). As explained above, the design of this indicator has not been rooted in a technical approach, but in compliance with legal principles in the field of labour legislation. However, as noted above, the average duration of unemployment is less than six months.⁸⁴

⁸³ The CTS is part of the annualized salary (like salary bonuses), and its impact on the labour market is considered unimportant; that is, the CTS as a system of unemployment insurance has little relation to the dynamics of unemployment duration (Toyama, 2003).

⁸⁴ According to Li & Olivera (2005), which may indicate the low ratio of the unemployment insurance system with the characteristics of the Peruvian labour market.

3.3 Informality and Unemployment Insurance

A low duration of unemployment is not only due to sustained economic growth but also on the existence of *informal insurance mechanisms*, notably access to the informal sector (Cigno, 2000; Jimenez & Cuadros, 2003). Hence, in the Peruvian case there is a negative relationship between unemployment and informality (described as a temporary security net), which helps to maintain a low level of official unemployment (Riveros, 2004).⁸⁵

However, the current CTS has not received strong support (García, 2012), since its aggressive implementation might (based on a scenario where *institutional weakening* is a chronic phenomenon) impact the formalization of workers in micro and small business. Note that between 60 and 70% of the economically active population (EAP) are informal workers (Céspedes, 2013).⁸⁶

This scenario, where the CTS has not received strong support from workers lacking *legitimacy*, supports the necessity of introducing public policies grounded on an institutional coordination approach (Mendez, 2013c). Particularly, since the goals of deep economic and legal reform is both to formalize the Peruvian economy and to strengthen its institutional framework in a context of high levels of *legitimacy* (Mendez, 2013b). In addition, the

⁸⁵ Few Latin American countries have established a system of unemployment insurance, and where insurance has been adopted the data necessary for proper analysis does not exist (Holzmann, 1997). This fact explains why the Peruvian legal doctrine on labour legislation has focused on introducing the discussion of a context described as *distortion of the CTS* (García, 2011c). This position argues that far from achieving its real objective (García, 2011b), the CTS has replaced the culture of saving with one of consumption. Argentina, Brazil, Chile, Ecuador, Uruguay and Venezuela are the countries that have chosen to formally establish a system of unemployment insurance. However, Venezuela and Argentina use a system of social assistance far from what could be described as unemployment insurance.

⁸⁶ This scenario has been exacerbated by the fact that the CTS coverage reaches only 18.2% of the economically active population (4.5 million people estimated by the MEF in 2006) and the balance in the financial system represents only 1.7% of GDP (Vega, 2010).

current legal design of CTS (under a compulsory saving mechanism) and those presented by the above-mentioned proposals (based on negative tax schemes) only approach unemployment insurance as a public monopoly issue where no space for market mechanisms is allowed.(Garrido, 2013). Such a view diminishes legal protection for workers favouring mercantilist approaches from political entrepreneurs (Gherzi, 2010).

3.4 Unemployment Insurance: Keeping unchanged the current scenario

Despite the previous arguments, the possibility remains to keep the current system of unemployment compensation. This idea seems more appealing considering the structural problems and costs related to alternative systems. Reform of an unemployment insurance model is complex since technical proposals have to deal with adverse selection, perverse incentive and administrative costs (Holzmann et al. (2000) and Toyama (2003). The first risk is what is known as *adverse selection*. This risk is minimized if insurance is mandatory, but this “obligation” threatens the welfare of individuals who do not think they need insurance, and it may impact on perceptions of legitimacy regarding the system itself (Garrido, 2013).

The second risk is represented by the *perverse incentives* created by insurance. Once the beneficiary has insurance, especially when it is compulsory, they might not try to find a new job. A central problem in the design of unemployment insurance is to avoid these disincentives and their behavioural outcomes (Li & Olivera, 2005). But how does the system accomplish this if it cannot efficiently monitor the behaviour of insured individuals?

In an attempt to face these issues, benefits are typically shortened in length, and individuals pay different amounts in terms of contributions. The compensation scheme must create incentives not to prolong the unemployment (Shavell & Weiss, 1989). In this scenario, the terminated worker has an incentive to find a

new job as soon as possible (Meyer, 1990). This is a credit to the CTS and is something that is generally lacking in unemployment insurances schemes in European countries (Garrido, 2013).

3.5 A Proposal of Private Mechanism

This mechanism would be open to employees in the private (no matter if they are self-employed workers or independent professionals) and public sectors, including the informal sector. The idea is that the private sector be given the opportunity to offer unemployment insurance to the general public, so that in the case of a termination, the insured worker would receive a fixed monthly or variable amount (6 or 12 months). Eligible individuals would include admitted workers or public and private contractors (who undertake working activities for a minimum period of one year), as well as employees or freelancers who have a fee income or conduct commercial activity. This information might be confirmed through tax returns, bank deposits or good faith statements (with a possible positive impact toward empowering the system of *interpersonal trust*).

Nevertheless, like any insurance policy, this type of mechanism would require specifying the scenarios where unemployment payments do not apply. Termination must be involuntary termination, which means that benefits would not apply if the employee or worker quits, if he/she promotes the termination or unilaterally and without a reasonable reason chooses to stop providing or performing work activities (Garcia, 2011b). In the case of self-employed workers and independent professionals, their incomes would be confirmed through banking (or other) cash flow, tax returns or other relevant documents that would be submitted and assessed according to the insurance agreement.

Also insurance should not apply in the case of resignation (Aguinaga, 2005); the employee would have to have been fired or terminated in an involuntary way. Also, a predetermined grace period (two or three months) could be

included when agreeing to the insurance. This grace period would help to mitigate *information asymmetry* embedded in contracts. The waiting period could be used as a mechanism for monitoring individuals' working behaviour.

The main virtue of the proposed system is that it would not affect the interaction of labour supply and demand (workers and employers); it would not require the direct administrative involvement of the State (e.g. establishment of subsidies). The goal is that individuals would internalize their costs and benefits. It would also eliminate the false workers protectionism (Toyama, 2003). Finally, the contract and pay coverage for a predetermined period of time (with the option of negotiating a fixed term), would probably yield comparatively better results than when individuals decide to save money in a bank account or through other financial products. This mechanism would have the advantage of generating competition within the system and enhancing the availability of funds for investment (compared to other mechanisms that seek to establish a compensatory income over time). In this regard, the introduction of a private mechanism involves thinking outside the *black box*. It also requires stopping *institutional capture*, removing legal restrictions that inhibit private mechanism efficiency (Garrido, 2013). Otherwise, a private unemployment insurance scheme would be unable to become a sustainable product (cutting down administrative and transactional costs) capable of surviving periods of economic contraction (a characteristic of an emerging market like Peru).

4. Pension Schemes in Peru

4.1 Institutional Coordination and No Contributory Pension

The National Solidarity Program of Assistance, Pension 65, represents an example of government failure affecting institutional coordination. This governmental initiative was not introduced as an extension of the national pension system, but as a non-contributory social program for people 65 and

over.⁸⁷ This program established a financial grant of 250 soles per month for those eligible at an annual cost of 1.89 billion soles (USD 65 billion), equivalent to 0.41% of GDP in 2013 (Jimenez 2013).

Although initially projected as a short-term strategy for temporary relief of poverty and social vulnerability (complementing the pension and social security systems), this program was finally implemented as long run social program: 1) Without considering the informal mechanisms for social protection and its relevance for Peruvian civil society; 2) Idiosyncratic bias and the regulatory informal framework for elders social assistance in the Peruvian scenario; 3) Aiming to establish a demand factor to boost the production and development of the domestic market (IPE, 2013); 3) Without a consistent legal, economic analysis to foreseen the intergenerational regulatory cost of the program; 4) Without a consistent long term financial cost to assess the sustainability of the program; and 5) Without an analysis aiming to introduce a strict eligibility tests to ensure the correct allocation of the financial grants.

Consequently, the design of Pension 65 suffers from unsatisfactory levels of *institutional coordination*, both in terms of the formal rules and the rules governing a social fabric where individuals have historically denoted a preference for (private) informal arrangements to mitigate the *failure of the government* and the dangerous effects of *institutional transplantation* (San Emeterio, 2006).⁸⁸

⁸⁷ Pension 65 was created October 19, 2011 by Supreme Decree No. 081-2011-PCM and is part of the set of social programs implemented by the Ministry of Development and Social Inclusion (MIDIS).

⁸⁸ This defect is attributed to the legacy of the regulatory design based upon the inherited Chilean model and *institutional capture* (Garrido, 2013). This institutional capture is reflected in the Peruvian government's recent decision to force independent professionals and self-employed workers to sign up and contribute to the pension system. Since the government bill did not achieve legitimacy among the targeted individuals, it was finally repealed.

In addition, the survival of Pension 65, since it has a non-contributory design, basically depends on tax reform in a country where "deficiencies" include the existence of a major shadow economy (Cespedes, 2013). This scenario not only affects the collection of direct taxes but also that of indirect taxes (IGV and ISC), which represent the financial source of Pension 65 (Garrido, 2013).⁸⁹

4.3 An Institutional Coordination Approach: Towards Deepening Reform

In Peru, there is a confluence of opinions from the political, academic and business sectors regarding the need to reform the pension system (Jimenez, 2013). Such a system needs to allow greater economic freedom, a better definition of property rights as well as structural improvements to achieve financial sustainability (Jimenez & Cuadros, 2003).

However, the main criticism that can be levelled against Peru is that the systems of public and private pensions, which currently have a parallel design, are not inclined toward deep reform. It is known that the public system, which

⁸⁹ Facing this scenario, a few questions emerge: How can Pension 65 be transformed into a long-term program without entering a scenario that is rejected by the community? How can the government convince the public that this program, represented as spending in the national budget, should be sustained through higher taxes? Why fund those individuals who did not save money, when currently EPAs do so through the compulsory pension system, the traditional financial system, formal and informal property investment or other informal mechanisms, such as communal savings? How does the initiative reach legitimacy and transform a welfare program into a long-term policy instrument, in a country where the failure of such instruments has been continual, as openly reported by the media and reflected in public opinion? An answer to these questions cannot be neglected, considering the political history of Peru, which teaches that welfare programs that reproduce the model and claims of Pension 65 require more than the government's goodwill. That is, the government needs to draw more clear objectives and position the initiative within the existing institutional framework (Cordova, 2004), in a way that avoids creating another temporary experiment, slowing down, as the government does in Peru, after the electoral period. According to Sardon (1999), this situation is embedded in Peruvian political party trends full of *political fracture* where no political movement or party has repeated winning the executive power or congressional majority. This situation makes any long-term social program a dark and uncertain picture.

is a pay as you go system, was virtually bankrupt when the private pension system was introduced. Moreover, according to the Defensoria del Pueblo's report (2005), even with the Private Pension System (PPS) contribution rate of 13%, all members would have to transfer to the SNP and regularly pay their contribution to the public in order to yield a surplus of 431 million soles (reaching a pension paying 32% higher than those currently charged in the National Pension System –NPS-). All of this would be achieved without ensuring the sustainability of the system and maintaining a monopoly always vulnerable to the political interests.

However, under its current institutional design, the PPS has not substantially deepened its coverage level because it depends on formal employment (Garrido, 2013). On the other hand, it suffers from flaws, such as high fees charged despite the introduction of mechanisms like the *default fund auction system* (SBS, 2013).⁹⁰ The PPS has signalled a loss of legitimacy among its contributors who consider high fees charged as the main issue. In addition, benefits from the PPS are comparatively less interesting than fix term deposits, mutual funds or deposit rates offered by savings and credit (IPE, 2013). This situation can be explained by taking into account factors such as the level of investment risk, rates of return in the long term or the existence of regulatory restrictions imposed by the government (which limit the ability of private superannuation management funds –AFP's or "Administradoras de Fondos de Pensiones"- to invest their funds abroad). Nonetheless, a criticism should consider the institutional framework governing the PPS, which has contributed

⁹⁰ Following the Chilean' model, in Peru superannuation contributions of all new members are placed in the same default fund. Default fund management is auctioned on the basis of fees, seeking to create stronger artificial competition between funds for default fund status. According to Garrido (2013), AFP's Habitat was the winner of the first auction of new members to the Private Pension System (PPS). This granted to Habitat the monopoly of the affiliation of contributors to the PPS from 1st February 2013 to January 31, 2015. The Superintendency of Banking and Insurance (SBS) organized this auction under the *system of minimum joint commission*. According to this mechanism, an affiliate pays a percentage of the commission by the flow of contributions and another for the final total balance.

to the AFP's current oligopoly structure and the lack of freedom for contributors (World Bank, 2012; Cruz Saco et al., 2014).⁹¹

Multiple scenarios mark the Peruvian pension system reform, very similar to the CTS landscape. It can be argued that both reforms of the pension system and the CTS require introducing a fully private system to reach its financial sustainability (Garrido, 2013). This line of argument holds that in the medium term, the PPS should aim to eliminate their mandatory contributory component. It should not necessarily point to the institutionalization of a non-contributory pension, represented by Pension 65, to the extent that its existence represents a significant opportunity cost to the treasury; as an PPS hallmark, it should relaunch keeping the individual accounts mechanism which allow the arrival of a larger number of superannuation manager funds and the introduction of alternative long-term savings enabling individuals to freely choose the most beneficial.

Such proposals may converge with the one by the MEF (2006), arguing that the government continue despite facing the dual challenge of ensuring a) improved pensions and b) the sustainability of the pension systems; it should aim to introduce mechanisms to generate synergies promoting the emergence of alternative social protection mechanisms, a position shared by the World Bank in 2012.

4.3.1 Coverage as a Problem of Legitimacy

A pension system based on individual capitalization accounts and managed by professional managers, as is the case of AFP's, has contributed to the development of the Peruvian financial market (Garrido 2013). From a fiscal point of view, it also more sustainable than the SNP managed by the National Pension Office (ONP). However, regulation has created high charges, limited

⁹¹ According to the World Bank (2013), the oligopoly structure of the Peruvian AFP's has contributed to a rate of profit of 59%.

investment in foreign markets⁹² and created an oligopolistic structure (Cruz Saco et al., 2014). The AFP's must still overcome another challenge related to its *legitimacy* or acceptance by the population. Legitimacy refers to a scenario where a public policy introduced by a rule is obeyed without using *legal coercion beyond special conditions* (Gherzi, 2010).⁹³ In this section, the discussion focus on legitimacy. From a civil law perspective, legitimacy refers to the recognition of people (majority support on their merits) accepting a policy and/or regulatory structures created by the government or civil societies (customs). In addition, legitimacy is supposed to be a "conditio sine qua non" to command obedience to legal enforcement. Also from a political science perspective, this section would fit with the "legitimacy of exercise" (the way in which an agent exercises its political power). That is, it connects to the legitimacy of political power largely obeyed without the necessity of the monopoly on violence from the State (Weber, 1984).

A system with higher legitimacy would have a fundamental impact on achieving long-term sustainability and efficiency in the pension system. This lack of legitimacy affects the sustainability of the system, as expressed through membership problems (even under the new auction model) and effective coverage, high administrative costs, the uniformity of the pension fund and the problem of establishing an efficient market to provide adequate retirement pension annuities.

Although 56% of the workforce was enrolled in the private pension system (PPS) in 2003, membership-effective contributions were low with only 24% contributing to the existing AFS (SBS, 2012). The still-low membership rate

⁹² AFP's investments are those in the Peruvian capital or foreign markets. The Superintendency of Banking and Insurance (SBS) supervise the investments and restrict operations in foreign capital markets. This situation limits AFP's' investments to access capital markets with a higher profitability.

⁹³ According to Gherzi (2011)), the law is experienced as "coercive" in two layers: its ability to level coercive sanctions and its ability to coercively enforce its sanctions.

and the gap between the membership and the number of workers who actually make contributions reinforces the hypothesis of low legitimacy and effectiveness of the legal and administrative provisions.

4.3.2 Legitimacy and Social Protection

Few studies in the Peruvian economic literature have attempted to discover the determining factors for achieving an inclusive system of pensions. Most of these studies have focused on other variables (Li & Olivera, 2005; Cox et al., 1998) or the Latin American context in general without an exclusive focus on Peru (Jiménez & Frames, 2003; Cox & Edwards, 2002; Holzmann et al., 2000). In addition, these studies also failed to address the issue of legitimacy.⁹⁴

4.3.34 Legitimacy and Family Agreements: Informal Pension System

According to Li and Olivera (2005), among the most important informal arrangements are in the network system security and family protection (which can even involve the extended family). In the Peruvian case, the family plays an important role and allows intra and intergenerational social protection models beyond intergenerational solidarity as those held by the public systems of social protection transfers. Thus, informal family arrangements are agreements of a private nature that help protect members of the family from the risks and losses of aging. Thus, informal networks, including family protection, act as substitutes for formal social protection systems. This conclusion is in line with the evidence found by Cox et al. (1998) who, in the case of pensions, found that those members of Peruvian families, who hoped to receive family

⁹⁴ As mentioned above, available surveys and data have important limitations that negatively affect researchers performance when developing their work. According to Li and Olivera (2005) ENAHO survey would have to differentiate between 1) those individuals that signed on compulsory or voluntary basis, 2) workers who actually contribute to the system and those who do not. Unfortunately, this survey asks only if the people belong to the pension system.

support in their old age. Through the network system and family protection, parents who were good caretakers for their offspring (assuming education expenses, food, clothing, etc.) expected to receive the same care upon reaching old age.

However, from a technical point of view, it is also argued that this type of protection scheme is inefficient and ends up negatively impacting on institutional sustainability and effectiveness of the formal systems of social protection. The present situation does not benefit older people, who live in poverty (Holzmman et al., 2000).⁹⁵ Therefore, studies regarding the role of informal family protection systems are essential if the goal is to design policies that increase coverage (Kotlikloff & Spivak 1981).

Another consideration is that payment of benefits is legally enforceable under formalized social protection programs. Informal family arrangements are not enforceable and require self-enforcement mechanisms. Cigno (2000) has studied this feature as a set of basic social principles called *family formation*. Moreover, Cox et al. (1998) focuses on the importance of elements like family altruism, loyalty and trust as key to enforcing family arrangements. As a preliminary response to the objections raised by Cigno (2000), it could be argued that family protection functions as a micro community, that is, as a private environment where the delineation of responsibilities are usually very precise and also where the rupture of an agreement or promise of future support could be sanctioned through restrictions on participating in the activities of the family network (extended family) in the future.

⁹⁵ The existence of family nets was not consistent explored to evaluate the introduction of Pension 65. In addition, current studies introducing an analysis of these networks as private demonstrations against the *failure of the state* designing its NPS and limiting the development of the PPS are not yet available.

Conclusions

The field of unemployment and pension regulation is one of the most complex in the introduction of public policies. In this sense, it is an excellent example through which to study the notion of *institutional coordination*. Institutional coordination refers to describing complex processes and institutions and how they interact, compete, overlap and move between formal and informal versions. Therefore, an analysis of the institutional coordination provides an insight into the interactions between institutional hierarchies. It allows for an economic perspective without neglecting the cultural characteristics of a specific social fabric where informal rules and customs remain valid.

The study of unemployment insurance systems and pensions from the perspective of institutional coordination allows us to realize that in a complex legal environment, clear and quick answers and decisions rarely occur (Epstein 2005).

To affect change, the discussion regarding the institutional design of a new system of unemployment insurance and pension reform in Peru must involve a disquisition on two main themes: a) the scope of coverage and b) the source of funding. A system of unemployment insurance is a complex mechanism in terms of institutional design. Therefore, legislature that promotes and technical agencies that assume the task of implementation should avoid focusing on protecting only a minority of the workforce (the formal sector) to the detriment of the majority (the informal sector).

When the discussion is focused on analysing Peru's system of unemployment insurance (CTS) with a view to reform, the fundamentals of the labour market, specifically the duration of unemployment need to be considered and reducing coverage of the CTS system to a value consistent with the average duration of unemployment thus is recommended.

Also, the introduction of compulsory unemployment insurance must be criticised. This critic should depart from *efficiency arguments* related to the administration and sustainability of the system. The Peruvian experience shows that social protection funded and administered by the government or administered by private agents constrained by a regulatory body have failed or been –at least- controversial. This is so because those alternatives keep a system of social protection (or a mixed form where is allowed the co-existence of unemployment insurance with CTS) where property rights and institutional coordination are not considered. Given these drawbacks, the option of establishing private unemployment insurance can be explored -in a scenario distinguished by mercantilist regulations-. It would allow transparency, efficiency and significant savings in terms of establishment and development of a system, which does not require ex-ante direct administrative supervision from the government, or the establishment of subsidies. This alternative could be successful in encouraging individuals to internalize their own costs and benefits. However, the challenge is to ensure that the government takes responsibility for eliminating the false protectionism that favours only stakeholders, which is a major cause of the production of social cost.

Therefore, the public sector needs to continue to undertake and seek the gradual development of a better form of social protection to replace those that are problematic in terms of design and sustainability. That is, it requires action and more efficient public policy to ensure that the new system will provide higher quality care. The introduction of new systems of unemployment insurance (replacing the CTS) and strengthening the social security system (pointing to complementarity between the SNP and PPS) should in any case ensure achievement of universal coverage within a reasonable time. A system of unemployment insurance and pension must be supplemented with other actions that reach most of the population, regardless of their past work (formal or informal); pointing to the synergies and avoiding irrational segregations in the medium term only subtracted from the legitimacy of both systems.

In addition, specific government actions, such as redesigning the regulation of a sector, should be seen as instruments that improve the rule of law and do not preserve the rule of legality that underlays legal and political regimes. This observation is strengthened if we consider the existing correlation between variables and the legitimacy of systems of unemployment insurance and pension coverage. In Peru, the lack of legitimacy has primarily impacted on the expansion of the pension system. The lack of legitimacy has not allowed the deepening of system coverage; restricting an obligation can only be imposed effectively on workers in the formal sector. Consequently, one of the main problems of social protection systems in Peru is the potential lack of legitimacy—not just the technical and legislative shortcomings and the economic and structural constraints.

Finally, it is not just the spaces generated by the informal economy in the case of unemployment insurance that are likely to be described as alternative social protection mechanisms. In the case of pensions, the network system, security protection or family represents a system of informal arrangements that seek to fulfil a similar purpose. Through these informal arrangements, the family plays an important role, facilitating intergenerational solidarity. Thus, it seems that informal family arrangements are agreements of a private nature that help protect family members from the risks and losses of aging.

Chapter V

CONCLUSION

Conclusion

The thesis presents an alternative understanding of *institutional coordination* can improve economic and public policy. The thesis integrated three independent programs of research—Austrian economics, law and economics—and new institutional economics perspectives, instead of only mainstream static economics of perfect competition and Pareto optimality (Boettke et al., 2008). This integration of approaches is an increasingly important topic of research for contemporary *market-oriented* institutional and developmental economics and it represents the core contribution to the economic literature.

The thesis described institutions as rules of the game, which are discovered and produced to facilitate voluntary cooperation and exchange of property rights among individuals (Brooks, Davidson and Faff, 2003). Next, a conceptual model - 'institutional coordination' – was presented. This model represents the theoretical backbone of the thesis. Institutional coordination was defined as *a complex process of interaction between formal and informal rules influenced by human action* (represented by productive and unproductive economic and political entrepreneurship).

The first aim of the thesis was to show that institutional coordination emerges from a *pure hypothetical approach* and is pertinent for *mainline economics* (Boettke, 2012). The second aim was to link the concept of institutional coordination to the real world, through an economic and sociological conceptual taxonomy, represented by the concepts of *structured, transitional and unstructured civil societies* (Méndez, 2013). The third aim focused on the damage done to institutional coordination, because of public policies that lack economic rationality. Then an Ius Economic approach was introduced and linked with the concept of institutional coordination, to examine the function of the Peruvian pension system and unemployment insurance scheme (CTS).

1. Institutions, Entrepreneurship and Institutional Coordination: The Theoretical Background

Chapter II showed that institutions are not merely a set of formal and informal rules, but are a complex and evolving social phenomena. This is important when considering concepts such as institutional coordination as processes of interaction between formal and informal institutions or rules influenced by productive and unproductive economic (Baumol, 1968 and 1990) and political entrepreneurship (Gherzi, 1991). In addition, the chapter posits that due to strong institutional coordination, a social order ruled by *dynamic efficiency* emerges. (Huerta de Soto, 2010) It was argued that when civil societies do not have strong institutional coordination, *social stagnation* and *institutional weakening* prevail (Levitsky and Murillo, 2010). In this context, individuals cannot adapt to social change, and they begin to exhibit *mercantilist* or *antidemocratic* behaviour (Gherzi, 2005 and 2009). Next, the level of *institutional weakening* was proposed as an indicator to assess and classify a civil society's social performance.

Chapter II also argued that without the diminishing of the State of Legality and the contribution of *productive entrepreneurship*, strong institutional coordination cannot be sustained in the long run. As a consequence, unproductive political entrepreneurship might introduce new artificial rules of the games, institutionalising mercantilist behaviour. This will create a situation, where a country's foundational structures are damaged (Ostrom et al., 2003). This mercantilist behaviour will negatively impact on the effectiveness and strength of institutional coordination and its framework, leading to indirect changes and guiding the social process to a transitional or to an unstructured civil society scenario. Furthermore, strong institutional coordination as a main characteristic of structured societies contributes to civil societies' social cohesion, adaptability (empowering the system of trust), economic integration (a stronger system of economic exchange and property rights) and latency

(political governance and legal entitlement). Consequently, a civil society governed by the elements listed above might lower transaction costs and develop models of behaviour that limit rent seeking (Méndez, 2013c).

Chapter II discussed how a civil society lacking institutional coordination would only reach *compromise solutions* or trade-offs, which affect the whole institutional network. This involves the organization and the interaction of the social, political, legal and economic institutions into a functional framework.

Chapter II also explored relevant aspects of institutional coordination, such as *institutional elasticity*. Institutional elasticity was studied by examining the ease with which a formal institution can be replaced by an informal institution and vice versa. It was argued that the substitution of an institution depends on: 1) Its formal or informal nature; 2) The proportion of available budget spent on the acquisition or use of an institution, the higher the elasticity. Therefore, if an economic agent only invests a small portion of its budget in buying an institution, and if there is a change in the relative price of an institution, that change will have little effect on the preferences and budget; and 3) The time, since its relative price change. In general, the longer the period of time the greater the institutional elasticity of demand. This introduces the possibility that one institution will be substituted with another; therefore, it is relevant for the study of strengthening or weakening institutional coordination. Therefore, when the necessary time has passed, civil society's members will have alternative or less costly institutional alternatives.

Chapter II described the relationship between institutional coordination and the problem of legitimacy - the degree of individuals' acceptance (support) and recognition (compliance) of formal and informal institutions. This issue was introduced via a simple conceptual model, where civil societies cannot produce more units of X institutions without affecting the number of accepted and recognised Y institutions.

Chapter II also showed that the nature of informal rules is important. Informal rules were described as evolutionary idiosyncratic products with two particular characteristics: (a) its legitimacy and (b) the prevalence of being *private interpersonal constraints* (C. Williamson, 2009). Also, there is a need to understand the relationship between *legal validity* (conformity of a rule or norm with the rule of law) and legitimacy. To understand this relationship, it is necessary to begin from a first analytical stage where validity and legitimacy are equal in *terms of result*; that is, when valid rules are considered legitimate, which is an equilibrium state. Nevertheless, this is a temporary and idealistic stage, which is not consistent with social reality. The chapter argued that the social process is in a state of permanent disequilibrium. This permanent state of disequilibrium does not represent a risk for societies where the internal dynamics of change assist societies to adjust to new circumstances. Furthermore, where there is a lack of institutional coordination, legitimacy advantages informal rules. However, informal rules are often in conflict with the legally established formal institutional framework (Méndez, 2013b).

2. Structure, Transitional and Unstructured Civil Societies: Taxonomy for Embedding Institutional Coordination

Chapter III presented taxonomy of civil societies, as structured, transitional or unstructured. This alternative taxonomy may stimulate collaboration between different programs of research and *methodenstreit* approaches.

Chapter III begins by categorizing civil societies as structured, transitional and unstructured, to simplify the study of institutional coordination. However, in order to effectively achieve this outcome, core concepts, such as institutional weakening and institutional coordination have to be considered. Also an understanding of this taxonomy will be an important instrument for classifying

the degree of institutional weakening and coordination in any country in the world.

3. Institutional Coordination and Public Policy: The Peruvian Case for Unemployment Insurance and Pension Systems

Chapter IV focused on the damage done to institutional coordination, because of public policies that lack economic rationality. Following an Ius Economics approach and the concept of institutional coordination as a theoretical background, this chapter examined the pension system and unemployment insurance scheme (CTS) in Peru, which has a large underground economy.

The chapter began with a new institutional analysis of the unemployment insurance and pension systems in Peru, addressing the scope of regulation and legislation governing labour, social security and the pension and unemployment schemes. The formal institutional framework governing these areas is highly complex (Epstein, 2005). In this sense, institutional coordination, as it describes the interplay of institutions is a useful framework for the analysis of public policy. An analysis based on institutional coordination addresses the interaction among specific institutional types (formal and informal rules) and subtypes (legislation and regulation on the one side and custom, informal arrangements on the other side). This can be translated into an economic perspective, without neglecting the cultural characteristics (informal rules and customs) of a specific social fabric (Ross, 2007; Ghersi, 2007).

Chapter IV showed that the design of formal institutions to implement labour, social security and pension schemes is restrictive from a legal and economic point of view. These Peruvian formal institutions do not show a simple design. Rather, the complex formal framework that prevails in the Peruvian legal system complicates the process of making *economic decisions* (Becker, 1974).

Chapter IV argued that unemployment insurance and pension systems are both delicate mechanisms in terms of institutional design with important intergenerational costs. Therefore, the legislation and its governing agencies should not focus on protecting the minority employed in formal sector, neglecting the interests of those in the underground sector. Chapter IV also discussed the design of an alternative unemployment insurance scheme and a reformed pension system in Peru, addressing two important issues. The first one was the scope of the coverage of the schemes. The second one was the source of funding, which may require a revision of the system supervised by the government.

Moreover, the implementation of compulsory unemployment insurance and a pension system funded and administered either by the government or a private agent is still a complex alternative. An alternative and compulsory scheme further complicates the current Peruvian scenario. Hence, the compensation for time of service (CTS) should be replaced with a private system of unemployment insurance. This means, the implementation of alternative schemes and it would allow significant savings of administrative resources (in terms of the establishment and development of the enforcement system). This alternative could be successful while individuals internalize their own costs and benefits. However, the challenge is the unproductive political behaviour of the Peruvian government. Decisions as important as who would be responsible for managing or supervising an system would reignite the debate on the subsidiary role of the government as established by Article 60 of the Peruvian Political Constitution of 1993.

The public sector in Peru needs to continue with institutional changes to mitigate the negative impacts on institutional coordination. The damage to institutional coordination has occurred because the Peruvian government has supported *irrational institutional transplant* ignoring the characteristics of the

country's social fabric (Helmke and Levitsky, 2004). This has also affected *institutional embeddedness* (Granovetter, 1985 and C. Williamson, 2009). The rules governing the development of an unemployment insurance and pension system do not consider the informal institutional framework. Therefore, Peruvian collective action has to change if the aim is to ensure that new systems of unemployment insurance and pensions can provide effective assistance. Unemployment insurance and pensions should provide coverage to individuals engaged in both the formal and underground economy.

Conclusion

The thesis explored the concept of institutional coordination as an essential component of public policy analysis. The first hypothesis is that institutional coordination between formal and informal institutions is the key element in the examination of institutions. The second hypothesis is that new institutional analysis is weak when it does not include the interaction between institutions, addressing only the formal institutional framework. A significant flaw in the mainstream new institutional analysis is that it indirectly separates contributions emerging from legal theory and the mainstream economic analysis of rules (Gherzi, 2005). This is predominant in studies that argue for more governmental intervention to strengthen institutional quality by enhancing formal constraints that limit the political and economic freedom of individuals and communities (Krause, 2007). The thesis introduced the concept of civil societies as an evolutionary process governed either by spontaneous orders or by artificial mechanisms of collective governance. This was followed by the introduction of an alternative taxonomy of civil societies aimed at enhancing the study of institutional coordination and, consequently, economic rules. This topic is important for understanding the evolution of social structures and civil societies. The taxonomy also assists the development of the concept of institutional coordination in terms of the rules of the games and comparative new institutional analysis. Finally, the thesis focused on the

damage done to institutional coordination through public policies that lack economic rationality by examining the pension and unemployment insurance schemes in Peru, where there is a large underground economy. Finally, it was argued that alternative systems of unemployment insurance and pension schemes were needed.

Appendix I

1. Presentations associated with the thesis in conference proceedings of the ‘German Law and Economics Association (*Gesellschaft für Recht und Ökonomik e.V.*) - 11th Annual Meeting’; September 13-14th, Bolzano-Italy, Free University of Bolzano (Faculty of Economics), Author was appointed as ‘Chair’ (Institutional Economics Section). Seminar director: Prof. Roland Kirstein. Information available at: <http://www.unibz.it/en/economics/GLEA.html>

Title: “*An Introduction to the Paradigm of Institutional Coordination as an Alternative Mechanism for an Extensive Economic Analysis*”

By Ruben C. B. Méndez Reategui (Economic Department, Macquarie University)

Abstract: This study links the concepts of *functional entrepreneurship* and *institutions*, understood as a set of categories (formal and informal rules), and show a complex, dynamic and interactive character through the formulation of an alternative conceptual model. Additionally it sets out to explore the concept of *institutional coordination* or positive institutional interaction as an essential element for new institutional economics analysis. The hypothesis is that *institutional coordination or positive interaction* among formal and informal institutions is the key element for a theoretically consistent and comprehensive analysis, evaluation and testing of institutions. This assumption seeks to improve the mainstream research strand using concepts taken from *classical legal theory* such as “*desuetude*” and “*contra legem custom*”. Moreover, the paper adopts the “*meta*” concept of society, represented as a process of dynamic collaboration among individuals. Theoretical contributions from previous studies are proposed to highlight notions such as a) Negative institutional interaction is a process where overlapping and displacement between formal and informal rules cannot be left outside the model; b) A discussion in terms of institutional *marginal rate of technical substitution* becomes important for deciding the best possible combination of formal and

informal institutions; c) An exploration of the *determinants for institutional elasticity*, as the author assumes, that determinants of institutional elasticity mainly correspond to the ease with which a "formal institution" can be replaced by an "informal institution" and vice versa; Together the significance of these contributions brings a secondary hypothesis: traditional new institutional analysis is weak, in the sense that it avoids dealing with the real role and relevancy of informal institutions. Instead, it prioritises the formal institutional framework as a tool to reach institutional predictability and a sustainable social order. Therefore, my claim is that one flaw in traditional analysis is that it indirectly supports a separation and confrontation between contributions emerging from the legal theory of the sources of law (Ross, 2007 and Gherzi, 2007) and economic analysis.

JEL: B52, B53, K00, Z13.

2. Presentations associated with the thesis in conference proceedings of the ‘SIDE - ISLE 2013 - 9th Annual Conference’; Dec 12-13th, Lugano - Switzerland, USI - Università della Svizzera Italiana, Editor: Prof. Massimiliano Vatterio.

Presentation published and available upon registration (digital version) at:
<http://www.side-isle.it/ocs2/index.php/SIDE/SIDE2013/paper/view/1204>

Title: “*Structured, Transitional and Unstructured Societies: An alternative conceptual model and taxonomy to improve testing positive institutional interaction and the economics of rules*”

Published as: “*Structured, Transitional and Unstructured Societies: An alternative conceptual model and taxonomy to improve testing positive institutional interaction and the economics of rules*”

By Ruben C. B. Méndez Reategui (Economic Department, Macquarie University)

Abstract: The aim of this paper seeks to introduce an alternative conceptual taxonomy of society as an instrumental contribution to Law and Economics and New Institutional Economics. Following this target, the conceptual

framework of the paper develops three categories named *unstructured, transitional and structured societies*. Even though this categorization was inspired by Parsons (1937) contribution to *functional sociology*, the author steps on the side of the predominant approach in sociology of economics and focuses his research on the particular understanding of society as a *misbalanced and evolutionary process*. This *fundamental reason* follows a perspective influenced by Hayek (1960) and Barry's (1982) approach of the theory of Spontaneous or Self Organization Order. As an instrumental contribution, this paper draft departs from the following research question: To what extents can an alternative taxonomy and conceptual model of societies enhance testing *positive institutional interaction* (institutional coordination) and, consequently, the modern economic of rules? This is relevant as the author understands that an alternative taxonomy seeks to assist further empirical studies to hub on testing” *institutional interaction among and between formal and informal rules* (North, 1994) and a comparative new institutional analysis (Aoki, 2001). In addition, whilst a conceptual contribution, this alternative taxonomy represents an *observable point of departure* supporting researchers to overlook and classify relevant variables affecting the economics of rules (Méndez, 2012) and, consequently -from an institutional perspective-, outcomes such as economic performance and growth.

JEL: A14, B15, B41, B52, B53, K10

3. Presentations associated with the thesis in conference proceedings of the *URJC and IJM - VII Conference in Heterodox and Austrian Economics*; May 22th and 23th 2013, Madrid-Spain. Conference information available at: <http://www.juandemariana.org/evento/5816/vi/congreso/economia/austriaca/>. Presentation published by the Conference Compilation Journal (available at: <http://www.juandemariana.org/estudio/6604/revista/vi/congreso/economia/austriaca/>)

Title: “*Entrepreneurship, Institutions in a changing environment: A new paradigm of institutional coordination*”

Published as: *“An introduction to Institutional Coordination as an alternative model for New Institutional Economic Analysis”*

By Ruben C. B. Méndez Reategui (Economic Department, Macquarie University)

Abstract: In this paper, through the formulation of an alternative conceptual model, the author links the concepts of functional entrepreneurship and institutions, understood as a set of categories -formal and informal rules- showing a complex, dynamic and interactive character. Further- more, the aim of this paper is to introduce an exploration of the concept of institutional coordination or positive institutional interaction as an essential element for new institutional economics analysis. This aim proposes the hypothesis that institutional coordination or positive interaction among formal and informal institutions is the real key element for a theoretically consistent and comprehensive analysis, evaluation and testing of institutions. Moreover, the paper is attached to the “meta” concept of society, represented as a process of dynamic collaboration among individuals. This assumption seeks to suggest an improved theoretical standard through the insertion of concepts taken from classical legal theory such as “desuetude” and “contra legem custom”. This theoretical standard leads the author to introduce a set of contributions to the contemporary heterodox economics literature: a. Negative institutional interaction is a process where overlapping and displacement between formal and informal rules cannot be leaved outside the model; b. A discussion in terms of institutional marginal rate of technical substitution becomes important for deciding the best possible combination of formal and informal institutions; c. An exploration of the determinants for institutional elasticity, as the author assumes, that determinants of institutional elasticity mainly correspond to the ease with which a "formal institution" can be replaced by an "informal institution" and vice versa. Together the significance of these contributions brings a secondary hypothesis: traditional new institutional analysis is weak, in the sense that, it avoids dealing with the real role and relevancy of informal institutions shouldering the prevalence of the formal institutional framework to

reach institutional predictability and a sustainable social order. Therefore, the author claims that the traditional analysis is mistaken as it indirectly supports a separation and confrontation between contributions emerging from the Legal Theory of the Sources of Law (Ross, 2007 and Ghersi, 2007) and economic analysis.

JEL: B41, B52, B53, K00, Z13

4. Presentations associated with the thesis in conference proceedings of the *URJC and IJM - VII Conference in Heterodox and Austrian Economics*; June 11th and 12th 2014, Madrid- Spain. Presentation accepted for publication on the Conference compilation journal (forthcoming and available upon request from IJM)

Presentation accepted for publication by the Conference Compilation Journal (forthcoming)

Title: *“Civil Societies and the economics of rules”*

By Ruben C. B. Méndez Reategui (Economic Department, Macquarie University)

Abstract: The purpose of this paper is to introduce an alternative conceptual taxonomy of civil society as an instrumental contribution to Austrian Law and Economics and New Institutional Economics. In order to achieve this aim, the paper posits three categories of civil societies: unstructured, transitional and structured. Despite the influence of Parsons' (1937 (1968)) contribution to functional sociology in the use of the first category, the author favours the mainstream approach used in the economic sociology and focuses his research in particular on the idea that civil society, as associative group guided by private interests is a misbalanced and evolutionary process. This fundamental reason has its roots in Hayek (1964) and Barry's (1997 [1982]) views regarding the theory of Spontaneous or Self Organization Order. The paper departs from the following research question: To what extent can an alternative taxonomy and conceptual illustration of civil societies enhance the testing of positive

'institutional interaction' (positive and negative institutional coordination) and, consequently, the modern economics of rules? The answer to this question is essential to our understanding of how associative structures evolve. The author believes that this alternative taxonomy would work alongside further qualitative studies to help develop the testing of institutional interaction among and between formal and informal rules (North, 1994) as well as a comparative new institutional analysis (Aoki, 2001). Furthermore, whilst this is a conceptual contribution, this alternative taxonomy aims to represent a discernible point of departure, which would help researchers examine and categorise the relevant variables that affect the economics of rules (Méndez, 2013) and, consequently - from an institutional perspective-, outcomes such as economic performance and growth.

JEL: A14, B15, B41

5. Presentations associated with the thesis in conference proceedings of the *Fifth Annual Conference of the Spanish Association of Law and Economics* (held at Malaga University), June 26th and 27th 2014, Malaga - Spain.

Title: “*An Analysis of Unemployment Insurance in Peru: A contribution from the Institutional Coordination and Austrian Law and Economics Perspectives*”

By Ruben C. B. Méndez Reategui (Economic Department, Macquarie University)

Abstract: The aim of this paper is to examine the implementation of a system of unemployment insurance in Peru and their implications from *institutional coordination* as a theoretical model. Following a cultural approach, this manuscript is implemented through the contributions of the Legal Theory, the New Institutional Economics and the Austrian Law and Economics perspectives. In addition, from the methodological point of view, this manuscript introduces a case study and hypothetical-deductive analysis instead an empirical-experimental exercise.

JEL: B41, B52, B53, K10

Appendix II

1. Paper published in *MARKET PROCESS: European Journal of Political Economy*, Vol. X, N° 2, 2013 p.151-200, Madrid – Spain. This paper links to research undertaken for Chapter II.

Title: “*An Introduction to Institutional Coordination as an Alternative model for New Institutional Economic Analysis*”

By Ruben C. B. Méndez Reategui (Economic Department, Macquarie University)

Abstract: In this paper, through the formulation of an alternative conceptual model, the author links the concepts of functional entrepreneurship and institutions, understood as a set of categories -formal and informal rules- showing a complex, dynamic and interactive character. Furthermore, the aim of this paper is to introduce an exploration of the concept of institutional coordination or positive institutional interaction as an essential element for new institutional economics analysis. This aim proposes the hypothesis that institutional coordination or positive interaction among formal and informal institutions is the real key element for a theoretically consistent and comprehensive analysis, evaluation and testing of institutions. Moreover, the paper is attached to the «meta» concept of society, represented as a process of dynamic collaboration among individuals. This assumption seeks to suggest an improved theoretical standard through the insertion of concepts taken from classical legal theory such as «desuetude» and «contra legem custom». This theoretical standard leads the author to introduce a set of contributions to the contemporary heterodox economics literature: a. Negative institutional interaction is a process where overlapping and displacement between formal and informal rules cannot be leaved outside the model; b. A discussion in terms of institutional marginal rate of technical substitution becomes important for deciding the best possible combination of formal and informal institutions; c. An exploration of the determinants for institutional elasticity, as the author assumes, that determinants of institutional elasticity mainly correspond to the

ease with which a «formal institution» can be replaced by an «informal institution» and vice versa. Together the significance of these contributions brings a secondary hypothesis: traditional new institutional analysis is weak, in the sense that, it avoids dealing with the real role and relevancy of informal institutions shouldering the prevalence of the formal institutional framework to reach institutional predictability and a sustainable social order. Therefore, the author claims that the traditional analysis is mistaken as it indirectly supports a separation and confrontation between contributions emerging from the Legal Theory of the Sources of Law (Ross, 2007 and Ghersi, 2007) and economic analysis.

JEL: B52, K00, Z13

2. Paper published in *Lecturas de Economía (Economics Readings)*, N° 80, 2014, pp. 211-218, Antioquia – Colombia. This paper links to research undertaken for Chapter II.

Title: “*Why Nations Fail. The Origins of Power, Prosperity, and Poverty: A critique*”

By Ruben C. B. Méndez Reategui (Economic Department, Macquarie University)

Abstract: Institutions conceptualized as *rules of the game* (North, 1990) or network of formal (public) and informal (private) political, legal economic and social constraints (Méndez, 2013); represent a key feature for production, allocation and use of property rights and not only of tangible and intangible economic goods and services. This dynamic process involves an evolution of the social fabric as a *complex phenomenon* (Hayek, 1964, 1967). Hereof, weakening the rules of the game means also to disrupt property rights. This is highly risky, as a society cannot afford to avoid identifying the essential features of private and public rules coordinating individuals’ behaviour. Then this becomes dramatically important when a further claim to respect and unblock *functional passive entrepreneurship* (Kirzner, 1978) is introduced. This explain why is important a scenario with low governmental coercion, the

basis of the economic value of rules and the need for respect of variables such as cultural identity (Méndez, 2011). Therefore a strong and consistent understanding of the meaning of culture is essential for new institutional studies. Departing from this brief disquisition, and inspired by Greif (1998), Landes (1999), McCloskey (2006 and 2010) and Mosterin (2009) we will introduce a critique to D. Acemoglu and J.A. Robinson's book entitled *Why Nations Fail. The Origins of Power, Prosperity, and Poverty* (Crown Publisher 2012)

JEL: B52, B53, K10

3. Paper (working paper) published in the *Revista de Derecho UNED (UNED Law Journal)*, N° 14, 2014, pp. 1 – 48, Madrid – Spain. This paper links to research undertaken for Chapter IV.

Title: “*Unemployment Insurance in Peru: A preliminary Analysis through the Legal, New Institutional and Austrian Law and Economics Approaches*”

By Ruben C. B. Méndez Reategui (Economic Department, Macquarie University)

Abstract: The aim of this paper is to examine the implementation of a system of unemployment insurance in Peru and its implications for institutional coordination (Méndez, 2013). This document has been written linking contributions from Legal Theory, New Institutional Economics and the Austrian Law and Economics perspectives. In addition, from a methodological point of view, the paper introduces a case study and hypothetical-deductive analysis.

JEL: A14, B52, B53, K10

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