

Good morning, ladies and gentlemen!

I would like to thank the organizers of this meeting – CIPE and my Ukrainian colleagues. For me, this is an opportunity to share with you some interesting results of the research we have been doing on the lessons and future of reform in a large, three-year project at the INDEM Foundation. The specific purpose of this project was to analyze the transformation of the judicial system, but the concept of the project and the conclusions of our research also apply to other institutions and the problem of reform in general. Our previous studies, including our research on corruption, led us to take on the judicial system. The tipping point was probably this statement, which I love to quote, made by an entrepreneur in an interview for one of our CIPE-funded projects. He said: *“Give us a proper judicial system, and we will solve all of our other problems ourselves.”* We wanted to find out whether this was true. To what extent is the judicial system such a fundamental institution, and most importantly, why are the proper institutional decisions not bringing about the intended results?

I remember what our American and other Western consultants told us: *“Democracy is just a procedure. The most important thing is to enact good laws, and then everything will be fine.”* We believed this, but at the same time we did not believe it. Yet we did it, as others did too. But it did not produce the desired result. This project was based on the following ideas. The problem was that the Western institutions we were trying to copy were not a one-time ‘project’. Douglass North wrote about this, as did Hite and other Nobel Prize winners. These institutions emerged by evolution or by institutional evolution. They arose through natural selection, just as we humans or any other species arises through natural selection. Like us, these institutions did not develop in isolation from their environment. We need food, which we take from other species and plants. We breathe the air that surrounds us. In the same way, institutions do not exist in a void. They interact with other institutions, and the way they function is the result of their history, informal practices, traditions, customs etc. Institutional economists like Douglass North have written about this. That is all great. However, they also wrote: *“We certainly know how effective Western economic institutions function. The only thing we do not know is how they arise, how to create them.”* Likewise, we do not know how to create an artificial person. We reproduce through a natural process. In the functioning of an institution, the first thing we see is the

original institutional design, but we do not see it in context. I have tried to show what this looks like on this chart. An institution is defined by its history, the totality of the formal norms that describe its operation, and also by its administrative procedures, which may be formal or informal, its traditions and background practices, and the disposition of the factors, agents, and clients of the institution. The institution also interacts with its social environment and with other institutions, and this interaction is also defined by both formal and informal norms. The question is this: which is more important to the way an institution functions – the institutional design, or what I call **extra-institutional** factors? I am using the term INSTITUTION here in a narrow sense, to refer to its formal design. What problem arises when we substitute, copy, and transplant institutions? We are essentially removing a formal institution from its social environment, its context, and its traditions and formal practices, and placing it into a different environment, severing it from its context, and ignoring all of the informal aspects. This new environment into which we have transplanted the institution begins to influence it. It is not the other way around. The new formal norms do not supplant the existing informal practices and norms. Exactly the opposite process generally occurs. This distorts the operation of the institution, and the institution begins to do things that are very different from the plan. A simple example in Russia is the institution of bankruptcy. As you know, the purpose of bankruptcy is to reorganize inefficient property owners, but in Russia bankruptcy is used to take property away from efficient owners. That is a clear example.

As part of our research, we conducted a large survey of experts in Russia and the other countries listed here. I will describe one of the results of this research that illustrates my point. We asked experts to complete a large questionnaire, which allowed us to describe the functioning of the judicial system by various criteria. Some of these criteria involved the formal operation of the judicial system, and others were about its informal and extra-institutional functioning in the sense I have described. On the diagram, these sideways columns and the numbers on them indicate the extent to which a particular aspect of the judicial system is a problem for the overall judicial system or its clients. The smaller the number, the less problematic a particular aspect is. If we look toward the top, in the area of the less problematic aspects, we see the formal aspects – justice, quality of laws and regulations, and the formal independence of courts and judges. But if we look down in the area of the more problematic aspects, we see the informal aspects – access

to courts, quality of judicial interpretation of the law, influence by other institutions, the informal aspect of judicial independence, etc. The same pattern is found everywhere, not only in Russia, but in other countries, including thriving Poland, our ally Ukraine, and faraway Chile. The informal extra-institutional aspects are much more important for the proper functioning of the judicial system than the formal aspects and the institutional design. I would like to read a quotation that I like very much. It is from Bruno Leoni's *Freedom and the Law*, an excellent book which I recommend to you: “*Legislation appears today to be a quick, rational, and far-reaching remedy against every kind of evil or inconvenience, as compared with, say, judicial decisions, the settlement of disputes by private arbiters, conventions, customs, and similar kinds of spontaneous adjustments on the part of individuals. A fact that almost always goes unnoticed is that a remedy by way of legislation may be too quick to be efficacious, too unpredictably far-reaching to be wholly beneficial, and too directly connected with the contingent views and interests of a handful of people (the legislators), whoever they may be, to be, in fact, a remedy for all concerned. Even when all this is noticed, the criticism is usually directed against particular statutes rather than against legislation as such, and a new remedy is always looked for in 'better' statutes instead of in something altogether different from legislation.*” I would put it more simply: Which is more important – a particular norm or the willingness to enforce that norm? The answer is obvious. There may be a door, by why pound on it if it will never open? Before my presentation, Dina Krylova was telling me a wonderful story, the point of which was this: The authorities in Russia are willing to accept good legislative proposals from the business community and enact them into law. But as they do this, the authorities know that they will not enforce these laws, or will enforce them as they see fit, selectively, adapting them to their own needs.

I would like to say a few words about the courts and give a bit more detail about how this works so you can understand it better. Here are the data from our analysis of various types of proceedings. This shows the quality of adversarial proceedings. We know that procedural fairness is very important in courts and that adversarial proceedings promote fairness. The lower the column on the graph, the worse the adversarial process functions. From left to right, we have administrative procedure, adjudication of administrative violations, and criminal procedure. As you see, these are about equally bad. Arbitration procedure and civil procedure are somewhat

better, with average scores up to zero. The question arises: how are the first three proceedings different from the other two? In the first three types of proceedings, one of the parties is a government agency. This changes the situation immediately. I hope you will remember this slide, because it will be very important for one of the key conclusions I will discuss later. After we had analyzed our data and reached some important conclusions, we decided to test those using entirely different data. We used data that are published regularly by the World Bank, the Worldwide Governance Indicators, which annually rate nearly every country in the world in six categories:

- Voice and accountability
- Political stability and absence of violence
- Government effectiveness
- Regulatory quality, which refers to the quality of norms regulating the functioning of economic institutions as determined by the World Bank
- Rule of law, a factor that applies directly and primarily to the judicial system
- Control of corruption

Each indicator fluctuates from -2.5 (bad) to +2.5 (good). We wanted to use this barometer to study cause-and-effect relationships. Not correlations, which do not demonstrate causation, but certain other indicators. We developed a technique to assess the extent to which each of these indicators affects or is affected by the other indicators. We made comparisons with four categories of countries: all countries (average), 29 transitional countries, 27 developed democracies, and 22 Asian countries. In other words, we looked at the average for all countries and at three different types of countries. Let's look at the results. In this diagram, the numbers on the vertical axis show how extensively one indicator affects the other indicators and the relationships between them. The higher the number, the more important the indicator is in terms of its influence on the other indicators. A negative number indicates that the indicator is secondary and is affected by the other indicators. Notice that the highest value for all types of countries is the **rule of law**, i.e. the judicial branch. We also see that quality of laws and regulations (third from the right on the diagram, labeled RQ) is significantly lower. The most interesting thing is that developed democracies have the lowest quality of laws and regulations.

These are the countries that have been teaching us that regulations and legal norms are the most important factors. In their own countries the exact opposite is true. I would like to offer an interesting example, which shows that legal norms are incidental in real life. I heard it recently from a colleague in Germany, a member of the Green Party, about my age, who dodged the draft in the 1960s. Under German law at the time, if a young man refused to serve in the army and refused to perform alternative service, he would be sent to prison. According to those laws, after he served his sentence, he could be drafted again. Isn't that crazy? Anomalous legal regulation, right? So the Minister of Defense issued an internal regulation that people who served the prison term would not be drafted. This is a case where other extra-institutional circumstances that are unrelated to the law compensate for the defects in the laws. This is how effective Western institutions operate. A great many extra-institutional factors compensate for the defects in the institutional design. This is the direct result of a process by which institutions develop through evolution rather than by design.

Let us go back a little to talk about two more amusing things. Look at the category of *Stability* (second from the left on the diagram). This is crucial for Russia, because we tend to think that stability is the paramount achievement and the essential precondition for everything else. On the contrary, in all other countries stability is the most insignificant factor, in that it is determined by the other factors rather than influencing them.

Now, the conclusions.

Our first conclusion is that the defects we observed in institutions are caused more by extra-institutional factors than by the institutional design. So if we want to improve the way an institution functions, we must think not only about which legal norms we must change – that fact that we have to change them is not disputed – but we must also change the extra-institutional factors and attempt to influence them. Among Russia's top social thinkers, it is very trendy today to say that we need to grow our own institutions rather than transplanting them from outside. I am not sure exactly what they mean by that, but it may be along these lines. What do our institutions lack? It follows from what I have been talking about. We are not paying attention to the history of institutions and how they developed, and we do not understand how

their history affects them. We do not analyze the ways in which an institution is defined by its relationships with other institutions. Here is one example from our research. Russia's criminal justice system has always been plagued by bias in favor of the prosecution. One reason for this problem is that prosecutors and investigative agencies operate under certain benchmarks of success that create incentives for them to pressure courts to convict defendants. This is a clear example of how related institutions affect each other. We ignore the informal norms and practices when we try to fix the way institutions function, and we do not even try to understand them. However, we know virtually nothing about the mentality of the people who run these institutions or use their services.

Our second conclusion is that the strategies for modernization projects always underestimate the influence of the judicial system. I would point out that in the presentation we heard about Poland's successes, not a word was said about the judicial system. This is the diagnosis we always seem to get. The recommendations we receive usually say, "*You need to create competitive political institutions and new economic institutions. Yes, you should change your judicial system, of course, but that is number ten on the list.*" As a result, when we encounter problems in the functioning of various institutions, we find that everything leads back to the judicial system. This view is supported by the words of the entrepreneur I quoted earlier and by our own conclusion that when we think about future modernization strategies, RE-REFORM strategies to correct our approach, we must pay much more attention to the judicial system.

Our third conclusion answers the question: What is the fundamental distinction between democratic and undemocratic countries and the institutions in these countries? Our conclusion is that in democratic countries horizontal relationships predominate: cooperation, competition, and horizontal trust. Vertical relationships predominate in undemocratic countries: these are relationships based primarily on power. There is also trust, but it is vertical: "*I don't give a damn about my neighbor. I have to trust those above me, but not those below. I must command and control those below me.*" Institutions in these countries operate on this system of relationships. In democratic countries, institutions are supported by horizontal relationships, and in non-democratic countries they are supported by vertical relationships. What happens when we change the institutions? From the perspective of formal institutional design, we are introducing

norms that require support from horizontal relationships, but no one is prepared for that – not the judges, nor the prosecutors, the business community, or the public. Why do businesspeople have trouble coming together to form associations? There is no horizontal trust. Why are they willing to kowtow to the authorities or bribe them to get ahead? Because that integrates them into the system of vertical relationships. If we try to create institutions that based on horizontal relationships without attempting to reorient the vertical relationships into horizontal relationships, our efforts are doomed to fail, because the new institutions will still operate based on vertical relationships. In Russia, our courts provide a classic example. A court is more effective and provides procedural fairness when it is forced to operate in a system of horizontal relationships, i.e. in civil cases. But it does not function properly when one of the parties is a government agency, because the government and the public still exist in a system of vertical relationships. Lon Fuller put it this way in *Morality of Law*: “*The directives of a managerial system regulate primarily the relations between the subordinate and his superior and only collaterally the relations of the subordinate with third persons. The rules of a legal system, on the other hand, normally serve the primary purpose of setting the citizen's relations with other citizens and only in a collateral manner his relations with the seat of authority from which the rules proceed.*” What does this mean? It means that our legal system becomes infected by these vertical relationships that remain in other areas.

In summary, we have failed to distinguish the two means by which institutions emerge: evolution, as in effective democracies, and design, by which we have tried to create institutions in the modernization process. But what happens when an institution is created by design? Take any social environment – the economy, or justice, or law – and imagine suddenly introducing a new system of formal norms into it. For that social environment, these new norms are an outside force, and when an outside force impacts a complex adaptive system, it is not instructive for that system. The outside force does not contain instructions for the system to react. The system reacts, but based on its own internal logic, its internal structure, and its history. It does not react based on the norms imposed from outside. This reaction triggers a process of natural selection of informal practices, norms, and traditions. These norms may or may not adapt to the newly imposed regulatory framework, but not based on the purposes of the new framework. Rather, the social system reacts based on its own purposes, customs, and properties, and this natural

selection leads to new forms of corruption and ineffectiveness and ultimately distorts the institution. The conclusion is very simple: If we want the new norms to function well, we must be able to manipulate that system and that process of selection by creating disincentives for undesirable practices and incentives for desirable ones. Currently we are ignoring this issue and failing to analyze it. However, this is not as important [as understanding it].