

# Informal Institutions and Decentralization of Governance



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In recent years, the Czech Republic experienced significant economic growth. Should this fact be a reason for enthusiasm, or is there a reason to worry? Sound economics should analyze social processes in depth and at their structure rather than rely on aggregate indicators. Together with F. A. Hayek, who famously claimed “nobody can be a great economist who is only an economist – and I am even tempted to add that the economist who is only an economist is likely to become a nuisance if not a positive danger”<sup>1</sup>, we have to maintain that only through a detailed analysis of economic systems with a thorough understanding of underlying political, legal, and institutional processes can we come to more robust conclusions about the nature of its development.

Famous economists (most recently, Thomas Piketty) together with many economic reporters, point out that post-communist countries are rather economies with cheap labor colonized by foreign investors than structurally developed economies with prospects for innovation. Regardless of the positive development of GDP, these countries lack a tendency to converge with its economically stronger neighbors in the European Union (EU). Nevertheless, it is not necessarily caused by the scarcity of physical resources or financial capital, but instead by a conflict of institutions, which are at first glance well-aligned with those of more developed Western democracies, but which are not dovetailing on the margin of individual action.

This article explores a relationship between a feasible degree of decentralization of governance and totalitarian mental models, which prevail in the society. Current political and business leaders in post-communist

<sup>1</sup> Hayek, F.A. (1956) “The Dilemma of Specialization”. [in:] White, L.D. (ed.) *The State of the Social Sciences*. Chicago: University of Chicago Press, p. 463.

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CURRENT POLITICAL AND BUSINESS LEADERS IN POST-COMMUNIST COUNTRIES OFTEN BELONG TO A GENERATION WHICH FORMED MENTAL MODELS THROUGH EDUCATION AND EXPERIENCES DURING THE COMMUNIST ERA

countries often belong to a generation which formed mental models through education and experiences during the communist era. These mental models are on various margins in the conflict with formal institutions of property rights and contractual relationships which were introduced to those countries to mimic the free-market capitalism of the West. The following analysis explores this potential clash, which might cause friction that could further obstruct development of economic systems in post-communist countries.

**IN INSTITUTIONAL ANALYSIS, HISTORY MATTERS: RATIONALITY, PATH-DEPENDENCE, AND INSTITUTIONAL CHANGE**

To understand the interplay between institutions, governance, and (de)centralization, the fact that rationally acting human individ-

uals make choices utilizing specific mental models<sup>23</sup>, which have been formed by their experiences embedded in institutional environment, must be taken into account. Peter Boettke, when praising the Bloomington School of Political Economy, emphasized that: “[Vincent and Elinor Ostrom] did rational choice theory as if the choosers were human and they did institutional analysis as if history matters<sup>24</sup>. His viewpoint thus connects human action to irreversible historical (real) time<sup>5</sup>, in which acting individuals formed their experiences and shaped their mental models.

When historical time enters our analysis, a step sideways from mainstream economics with formalized theory of static equilibrium towards “order defined in the process of its emergence<sup>6</sup> is being made. This side-step may be explained as a realization that the “economy at all levels and at all times is path dependent” and “large and small probabilistic events at particular non-repeatable moments determine [...] the future

<sup>2</sup> Caton, J.L. and E.J. Lopez (2018) *The Cognitive Dimension of Institutions*. SSRN. Available [online]: <https://ssrn.com/abstract=3214278>

<sup>3</sup> “In order to understand decision-making under conditions of strong uncertainty, we must understand the relationship between the mental models that individuals construct to make sense of the world around them, the ideologies that evolve from such constructions, and the institutions that develop in a society to order interpersonal relationships.” Denzau, A.T. and D. North (1994) *Shared Mental Models: Ideologies and Institutions*. *Kyklos*, Vol. 47, Issue 1, pp. 3-31

<sup>4</sup> Boettke, P.J. (2016) *YouTube Interview: Bloomington School of Political Economy I: The Science & Art of Association*. Arlington: Mercatus Center. Available [online]: <https://www.youtube.com/watch?v=MFkdG69J1f8>  
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<sup>5</sup> In contrast to “Newtonian time”. For more details see O’Driscoll, G.P.Jr. and M.J. Rizzo (1996) *The Economics of Time and Ignorance*. London: Routledge, pp. 52-70.

<sup>6</sup> Buchanan, J.M. (1982) “Order Defined in the Process of Its Emergence.” [in:] Reader’s Forum on Norman Barry’s “The Tradition of Spontaneous Order,” The Forum at the Online Library of Liberty, Available [online]: [http://oll.libertyfund.org/?option=com\\_content&task=view&id=163&Itemid=282](http://oll.libertyfund.org/?option=com_content&task=view&id=163&Itemid=282).

path taken<sup>7</sup>. As such, an emphasis shall be placed on a theoretical connection between the Political Economy of Adam Smith and Carl Menger, and the emerging field of Complexity Economics.

Crucial non-repeatable events that structured the institutional environment (and through this environment shaped mental models of respective individuals) may be easily identified in the history of Czechoslovakia. Those events happened in an arguably fast manner, whereas the periods between them were usually shorter than one generation. The periods of free society and totalitarian regimes were changing rapidly in the 20<sup>th</sup> century and tensions between the two systems of governance play an important role in politics and economic performance to the present day.

In *Micromotives and Macrobehavior*, Thomas C. Schelling explains how the motives of individuals and the incentives they face when combined through interactions among these individuals are causing macro behavior<sup>8</sup>. The puzzle, of course, lies in understanding what the circumstances that shape individual action to produce a certain macro outcome are. Rationality of individuals does not exist regardless of a particular institutional environment. On the contrary, it is deeply interconnected to the incentive structure of that environment. This idea is one of the key elements of the complexity economics framework, which studies how “interacting elements in a system create overall patterns, and how these overall patterns in turn cause the interacting elements to change or adapt<sup>9</sup>.”

<sup>7</sup> Arthur W.B. (2014) “Complexity Economics: A Different Framework for Economic Thought”, [in:] *Complexity and the Economy* Oxford: Oxford University Press, p. 28.

<sup>8</sup> Schelling, T.C. (2006) *Micromotives and Macrobehavior*. New York: W. W. Norton Company.

<sup>9</sup> Arthur W.B. (2014) “Complexity Economics: A Different Framework for Economic Thought”, [in:] *Complexity and the Economy*. Oxford: Oxford University Press, p. 3.



## INCENTIVE STRUCTURES AFFECT SOCIETAL STRUCTURES AND MENTAL MODELS OF INDIVIDUALS

Institutions which form an incentive structure in a socialist totalitarian state are radically different from an institutional setting which is required for the functioning of the Smithian invisible hand. Given the same circumstances, a rationally acting individual behaves differently while facing a different incentive structure. Even simple day-to-day interactions between neighbors would differ under different institutional settings. These small, even invisible, differences when taken together produce very visible outcomes on the macro level.

Incentive structures affect societal structures and mental models of individuals. Given the fact that human brain structures are not infinitely elastic, and become even less elastic with age<sup>10</sup>, inertia of mental models can play an important role in institutional change. Historical events which formed the mental models of individuals are therefore important in understanding why there may exist barriers of progress towards cooperation, decentralization, and free society when institutions of coercion, dominance, and obedience are changing into institutions based

<sup>10</sup> “As our mental models become more complex, such major rearrangements become more difficult. Reorganizing an older, more experienced mental model is like reorganizing General Motors, whereas reorganizing a younger, less experienced model is more akin to reorganizing a small startup”. See Beinhocker, E. (2006) *The Origin of Wealth: Evolution, Complexity, and the Radical Remaking of Economics*. Brighton: Harvard Business School Press, p. 360.

on Hume’s principles of “property, contract, and consent<sup>11</sup>. Institutional settings are based on human interaction, and their change is embedded in history and are therefore path dependent.

### EXPERIENCE WITH COMMUNISM IN CZECHOSLOVAKIA: THREE PERIODS OF TOTALITARIAN EVOLUTION AND THE VELVET REVOLUTION

History of the Lands of the Bohemian Crown, Czechoslovakia, and more recently the Czech Republic (together with pretty much every other country in Central Europe) in the 20<sup>th</sup> century and at the beginning of the 21<sup>st</sup> century may be characterized as turbulent and unsettling. The most significant events in contemporary development were the years 1948 and 1989, which marked a change between two very diverse regimes of recent Czech history – communism and a West-ern-style democracy.

Following the events of World War I, the Austrian-Hungarian Empire was divided into separate republics, and in 1918 Czechoslovakia was formed. Its early development had had a liberal vibe and leaders from that time (like Karel Engliš) were celebrated classical liberals, whose influence resonated in the country to the moment of the infamous February of 1948<sup>12</sup>.

<sup>11</sup> “The key point: Smith’s analysis does not turn the behavior postulate of self-interest but instead on the institutional specifications that are in operation. [...] Individuals pursuing their own self-interest within an institutional setting of property, contract, and consent will produce an overall order that, although not of their intention, enhances the public good. Absent that institutional setting, self-interest may very well not produce publicly desirable outcomes and, in fact, may produce the opposite”. See Boettke, P.J. (2012) *Living Economics: Yesterday, Today, and Tomorrow*. Oakland: Independent Institute, p. 7-8.

<sup>12</sup> Sima, J. and T. Nikodym (2015) “Classical Liberalism in the Czech Republic”, [in:] *Econ Journal Watch*, May, pp. 274-292.



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THE PERIOD THAT PRECEDED THE END OF THE PRAGUE SPRING HAD GIVEN HOPE AND PRODUCED LEADERS WHO WERE LATER INSTRUMENTAL IN INTRODUCING THE IDEAS OF FREE SOCIETY AFTER THE FALL OF THE BERLIN WALL AND THE EVENTS OF THE VELVET REVOLUTION

After the Communist Party took power in 1948, socialist totalitarian institutions were put in place in a shockingly fast manner. All citizens learned the lesson of obedience through propaganda and observing brutal kangaroo courts, wherein those who resisted were made to agree with the newly established regime. Those events made a mark on the mental models of everyone who was there to witness such atrocities. Property, trust, and voluntary exchange – traditional liberal institutions – were replaced with theft, deception, and obedience.

The Communist Party and its grasp on power lasted until the year 1989 – with only a brief interlude in the 1960s (following de-Stalinization in the Soviet Union), when Czech society

could for the time being breathe more freely again. Unfortunately, the struggle to gain independence and freedom was destined to fail.

This very unique period of Czech history lasted only five years. The abrupt stop to this development in 1968 – commonly referred to as The Prague Spring – by the invasion of Warsaw Pact armies in August 21, had a significant impact all around the globe as it was a clear manifestation of the horrors of totalitarianism. At the same time, the period that preceded the end of the Prague Spring had given hope and produced leaders who were later instrumental in introducing the ideas of free society after the fall of the Berlin Wall and the events of the Velvet Revolution.

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WHAT FOLLOWED THE PRAGUE SPRING WAS ONE OF THE SADDEST HISTORICAL PERIODS FOR CZECHOSLOVAKIA: NORMALIZATION

What followed the Prague Spring was one of the saddest historical periods for Czechoslovakia: Normalization. The oppression of the regime, now physically supported by the presence of the Soviet army, was less visible – it appeared more on the margins – but, nevertheless, very effective. It can be argued that it was the Normalization period of the 1970s and 1980s that really changed



NORMALIZED CZECHOSLOVAKIA WAS A DARK PLACE, WHERE FELLOWSHIP, TRUST, AND SYMPATHY DISAPPEARED. THIS WAS ABOUT TO CHANGE

institutions and incentive structures into a totalitarian state and left deep scars in the mental models of a whole generation.

The sole purpose of Normalization was to reward conformity and suppress critical thinking. The institutional environment was put in place to form incentive structures that supported the goal. It worked. Individuals accumulated human capital, which was productive only in this particular incentive structure and which consisted of skills to limit own individual thinking and to express agreement with those in power. An unintentional feature of that human capital which individuals developed during Normalization was tacit knowledge of the technology of power – tools and strategies to force other people to conform and suppress their critical thinking. These features may be still found in the mental models of present day citizens.

Normalized Czechoslovakia was a dark place, where fellowship, trust, and sympathy disappeared. This was about to change. The Fall of the Berlin Wall and Gorbachev's decision not to interfere sparked hope in Central Europe and brought about the Velvet Revolution in Czechoslovakia. People demanded

freedom and were enthusiastic about peace and prosperity, which should be guaranteed by institutions of Western-style capitalism and democracy. Leaders of the revolution joined by dissent of communism and self-proclaimed classical liberals<sup>13</sup> became mediators of change and started extensive collaboration with influential intellectuals to give Czechoslovakia (and later the Czech Republic) a democratic structure and free-market institutions. As we know, unfortunately, it is futile to try to design a society in a top-down fashion regardless how celebrated and free-minded the experts involved are.

This concise sketch of historical patterns shows that whole generations of Czechs and Slovaks were influenced by years of life in specific institutional environments. The rules of the game were different in those different environments and individual mental models were changed. Individuals learning how to perceive the world in Normalization formed radically different mental models than those who learned how to perceive the world after the Velvet Revolution.

#### THE MEANING OF THE DECENTRALIZATION OF GOVERNANCE: WHAT IS GOVERNANCE AND WHY DECENTRALIZATION MATTERS

The process of institutional change from communism to capitalism, or from totalitarianism to democracy, requires an understanding of governance and tensions between centralization and decentralization. Governance has a more general meaning and does not simply mean *government*. It has to do with special kinds of relationships which are present in many social artifacts (like states, firms, non-profit organizations,

<sup>13</sup> Sima, J. and D. Stastny (2000) "A Laissez-Faire Fable of the Czech Republic", [in:] *Journal of Libertarian Studies* 14, No. 2, pp. 155–178.



DESIRED DECENTRALIZATION COULD BE DESCRIBED AS COOPERATIVE DECENTRALIZATION WHERE INDIVIDUALS INTERCONNECTED THROUGH COMPLEX NETWORKS OF EXCHANGES INTERACT AND THEIR PLANS ARE COORDINATED

trade associations, educational institutions, among others), and which have a more vertical, rather than horizontal, form.

Even the concept of self-governance relates to a hierarchical relationship which individuals impose on themselves. Indeed, self-governance is a very voluntary process by nature. Government is on the other side of the spectrum from self-governance and refers to the structure of a governing body, selected either democratically or by totalitarian means, which oversees a process of mainly involuntary control over citizens of a particular state or members of a societal group.

Governance with full decentralization would be the situation where the only type of governance is the self-governance of individuals. Governance with total centralization is,

on the other hand, a dystopian government which has absolute control over every individual and dictates every action in such a society. It is a spectrum from free market anarchism of exchanges to totalitarian central planning and control.

This line of thought raises an important question: what kind of decentralization leads to peace and prosperity? One type of decentralization could be autarky, but autarky is not the kind of decentralization economists have in mind when they talk about benefits of decentralization, as it may be peaceful but not very prosperous. Desired decentralization could be described as cooperative decentralization where individuals interconnected through complex networks of exchanges interact and their plans are coordinated. Governmental structures, even in democratic systems, tend to be more centralized than private businesses – still, downsides of centralization negatively affect both private and public ordering<sup>14</sup>.

The dichotomy between decentralization and centralization can be described as coordination over control. Analyzing how a system of hierarchical relationships of social interactions function offers a better idea of the feasibility of decentralization inside governmental structures. It has been widely studied by numerous scholars that under private ordering, the incentive structure is better suited to guide individuals to be beneficial to one another than under the public ordering.

In other words, decentralization tends to be easier to achieve in the market setting because the incentive structure coordinates individual plans towards peace and prosper-

<sup>14</sup> Wagner, R.E. (2017) *Politics as a Peculiar Business: Insights from a Theory of Entangled Political Economy*. Cheltenham: Edward Elgar Publishing, pp. 256.

ity rather than in the governmental setting where the incentive structure tends to favor bureaucracy and centralized control.

If one agrees that decentralization is the right direction and one that enables a further development of an economic system, one might ask where are the possible limits of achieving decentralization and what are the barriers in the system which tend to keep centralization, not only in place, but even increasing its scope? Decentralization of governance is a function of institutions which can allow decentralized decision-making to be efficient and productive. Without the right institutional setting with the proper incentive structure, decentralization would not only be less productive but also impossible to achieve.

#### THERE IS MORE THAN CAN BE LEARNED FROM FORMAL INSTITUTIONS: FROM ACEMOGLU AND ROBINSON TO OSTROMS

In their book *Why Nations Fail*<sup>15</sup> Acemoglu and Robinson show that to answer the essential economic question “why certain countries are wealthy and successful, and others are not” first it is crucial to gain understanding of institutions which play a key role in forming an environment in which individuals interact. The authors put forward a model in which they differentiate between economic and political institutions, where both can be either inclusive or extractive.

**Extractive institutions** in a political realm are limiting access to power, whereas in an economic realm they are redistributing wealth to those politically connected. On the other hand, **inclusive institutions** rely on open access to political power through a democratic process, where wealth is shared based

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THE PATH FROM COMMUNISM TO CAPITALISM, FROM TOTALITARIANISM TO DEMOCRACY, IS ONE FROM EXTRACTIVE TO INCLUSIVE INSTITUTIONS

on merits rather than political connections. The path from communism to capitalism, from totalitarianism to democracy, is one from extractive to inclusive institutions.

In post-communist countries, democratic institutions replaced totalitarian institutions and people once again had the chance to vote in the election process to choose their representatives. Special types of laws, called lustration laws, prohibited former members of the repressive communist apparatus (e.g. the communist-era secret police) to run for designated public offices were proposed and agreed upon by parliaments in many post-communist states. These laws were intended to secure inclusiveness for political institutions. The process of making political institutions more open seemed to happen rather quickly. The pathway to more inclusive economic institutions was paved with struggles as it first focused on “getting the prices right”. Only later was it realized that it is important to focus on “getting the institutions right”<sup>16</sup>.

<sup>16</sup> Boettke, P.J. (2005) “Anarchism as a Progressive Research Program in Political Economy”, [in:] Stringham, E. (ed.) *Anarchy, State and Public Choice*. Cheltenham: Edward Elgar Publishing, pp. 206-219.

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THE SYSTEMS WHICH APPEAR AT FIRST GLANCE AS “TRAGEDY OF COMMONS” ARE NOT NECESSARILY SO TRAGIC WHEN LOOKED AT FROM THE PERSPECTIVE OF HOW THEY ACTUALLY FUNCTION

The approach of Acemoglu and Robinson, which concentrates more on the macro level and analyzes aggregate behavior, may be further developed to broaden their viewpoint and to look into subtle nuances of marginal games. Theorizing about the interplay between political and economic institutions should further consider two important propositions.

First, next to the formal institutions (either political or economic) there exist also informal institutions, which might not be evenly spread across the society. Second, every individual action takes place at the margin rather than in the aggregate. To better understand the real mechanism of institutional dynamics, the level of analysis must be at the margin and at local clusters, where informal institutions are structuring incentives and, through them, individual action. When resorting to formal institutions (e.g. solving conflict through a judicial system) has prohibitive costs, informal institutions are, in fact, those which are more significant for macro-level outcomes.

The distinction between the two types of rules (rules-in-use and rules-in-form), as can be found in the work of Vincent and Elinor Ostrom<sup>17</sup>, may be used to identify features of the system of the post-communist transition, which might work against cooperative decentralization. Their argument shows that in the absence of a very particular set of rules-in-form (e.g. property rights), which are commonly required for economic systems to show self-organizing properties, one has to search for rules-in-use. Rules-in-use, in the Ostroms’ framework, may emerge in the system to play the function of desired institutions to facilitate cooperation. Their point is therefore to show that the systems which appear at first glance as “tragedy of commons” are not necessarily so tragic when looked at from the perspective of how they actually function.

Their argument could be analytically used as a reverse argument, showing that even though free market rules-in-form (which should incentivize agents towards cooperative decentralization) exist in the system, rules-in-use emerge, arising out of totalitarian mental models of individuals, which leads to conflict rather than cooperation.

Formal institutions, which should lead to peace and prosperity through cooperative decentralization, are present in almost all of the post-communist countries – at least at the constitutional level. In the Czech Republic (as well as in all EU member states) free trade and open borders are formally guaranteed. From the very existence of formal institutions, it cannot be concluded that those are, in fact, the institutional environments in which individuals are making their decisions. On the margin, various associations and organizations – especially those with

<sup>17</sup> Ostrom, E. (2007) “Institutional Rational Choice: An Assessment of the Institutional Analysis and Development Framework”, [in:] Sabatier, P.A. (ed.) *Theories of the Policy Process*. Boulder: Westview Press, pp. 21-64.

<sup>15</sup> Acemoglu, D. and J.A. Robinson (2012) *Why Nations Fail: The Origins of Power, Prosperity and Poverty*. New York: Crown.

near monopoly power – could be in a position to establish themselves as a filter mechanism. Such a mechanism may informally put in place institutions, the purpose of which is to bypass formal institutions of free trade and open borders and increase costs to individuals who aim to offer their products or services on the market or engage in international trade.

Let us take the example of a trade association for ski instructors and ski schools (APUL) in the Czech Republic. Since its establishment in 1992, the executive board of the association made numerous decisions which increased the costs for Czech ski instructors to realize gains from international trade. These decisions were, in essence, made in order to keep local wages in the industry at a low level. Measures like limiting the information flow or refusing to facilitate qualification recognition were put in place to impede free international movement of labor. As formal institutions in the form of border walls and barbwire were replaced by open border formal institutions of the European Union, locally established informal institutions within the association functioned as a continuation of impediment of movement of labor outside the country. Although none of these decisions violates legal rules, they have an important impact on creating a filter mechanism to *de facto* bypass formal institutions. Rules-in-use, which ski instructors face, are not the same as rules-in-form, which should be *de jure* institutions of free movement of labor. In contrast, similar trade associations for ski instructors in the USA (PSIA-AASI) or New Zealand (NZSIA) act exactly in an opposite manner and establish procedures to align institutions in the industry with the institutions of free international trade and facilitate the movement of its members.

These are not isolated events, but rather repeating patterns in post-communist countries, where on the margin and through in-

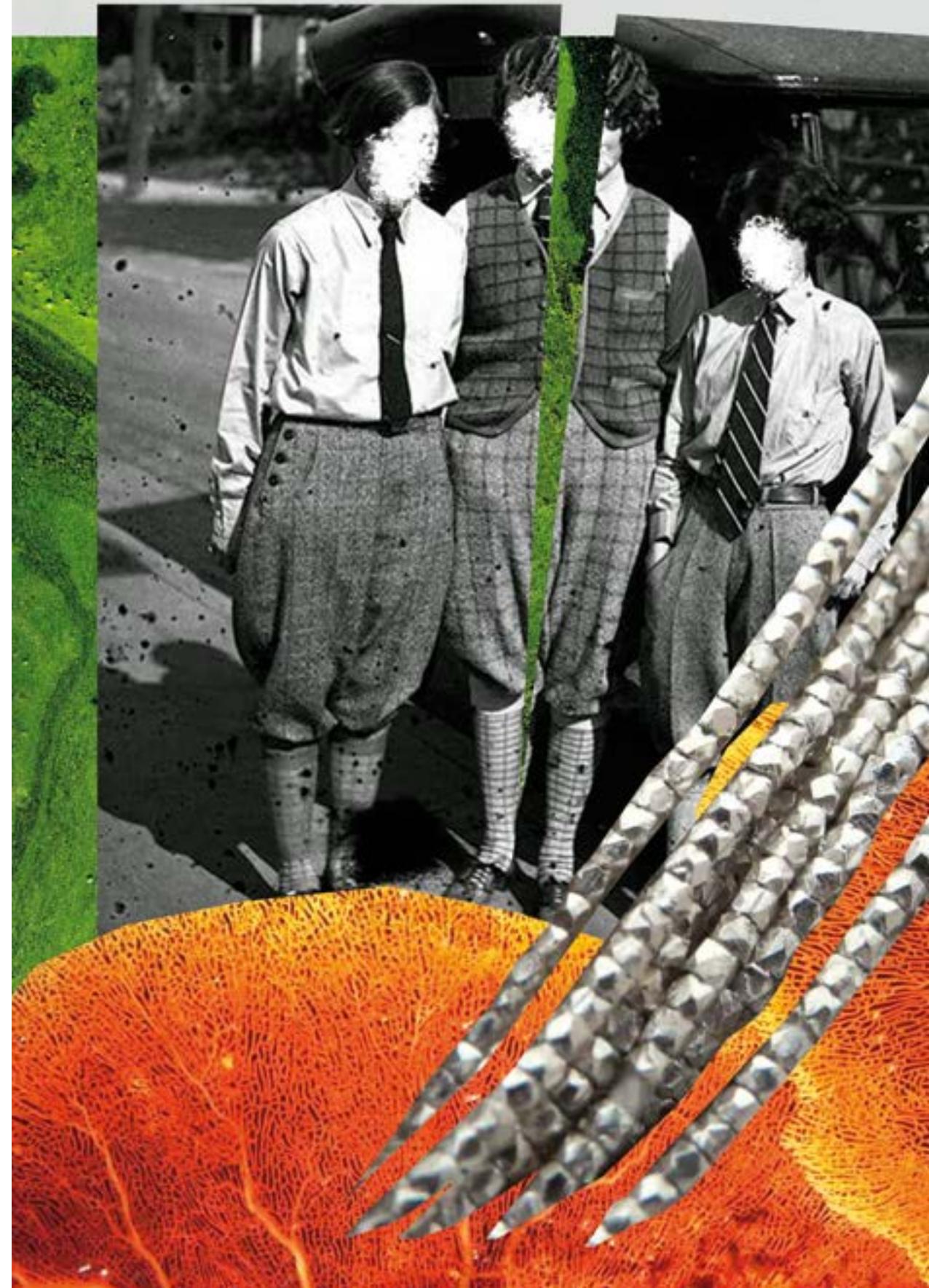
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THE POSSIBILITY OF THE DECENTRALIZATION OF GOVERNANCE, WHICH WOULD LEAD TO PEACEFUL COOPERATION, IS DETERMINED BY ESTABLISHING SHARED CONCEPTS WITHIN INFORMAL INSTITUTIONS IN EVERY SITUATION ON THE MARGIN

formal institutions incentive structures that resemble the Normalization era rather than free society are put in place by individuals with a mental model that is rooted deeply in the past.

**POST-COMMUNIST DEVELOPMENTS:  
THE STORY OF TWO COHABITATING  
SOCIETIES GOVERNED BY DIFFERENT  
INFORMAL INSTITUTIONS**

Almost three decades have passed since 1989. By taking a look at indicators such as GDP, the Czech Republic is a country with steady economic growth. Yet, in general, the overall pattern of convergence to the EU or the West did not match the expectations that had been formed shortly after the Velvet Revolution. When analyzing the structure of the economy and political process, it may be argued that country's development towards institu-





## INSTITUTIONAL ENVIRONMENTS IN ONE PARTICULAR SOCIETY DO NOT HAVE TO BE AS HOMOGENEOUS AS IT MIGHT SEEM WHEN OBSERVING ONLY WRITTEN-DOWN RULES-IN-FORM TYPE OF FORMAL INSTITUTIONS

tions of free-market and democracy either slowed down or ceased to exist completely. This situation might be explained by the existence of reverse tendencies in the system, which resist further decentralization.

As Peter Boettke put it: “economic, political, and legal reforms are not just abstract impositions, but rather a process of growing economic, political and legal institutions [...] culture and imprint of history determine which rules can stick in certain environments”<sup>18</sup>. The possibility of the decentralization of governance, which would lead to peaceful cooperation, is determined by establishing shared concepts within informal institutions in every situation on the margin. Inelasticity and inertia of mental models can function as a barrier to the desired development.

<sup>18</sup> Boettke, P. (1996) “Why Culture Matters: Economics, Politics and the Imprint of History”, [in:] *Nuova Economia e Storia*, No. 3, pp. 189-214. Available [online]: <https://ssrn.com/abstract=1531000>

Everyone in the society shares formal institutions because they are present in the form of a legal and judiciary system. Opposing informal institutions may, however, prevail on various margins within the society. Therefore, institutional environments in one particular society do not have to be as homogeneous as it might seem when observing only written-down rules-in-form type of formal institutions<sup>19</sup>.

The sole fact that all individuals in the society agree with one another that they are and ought to live in democracy, does not mean they live in the same system and relate to one another in the same way. While for some, *democracy* means a process to acquire power and gain from established vertical relationship of superiority and inferiority, for others it might mean the way people relate to one another with respect and how they achieve coordination in a situation of horizontal conflict, which might be costly to solve through market decision-making. Rules of the game in public ordering can have the same names and be very similar in form, but if interpreted through mental models in different or even opposite fashion, such rules cannot efficiently lead to peaceful solutions of the conflict.

“Other, perhaps deeper, conditions for social order include shared beliefs and norms within communities about how they regard one another, what they consider to be fair, how they distinguish right from wrong, and how they see society and nature as wholes coming together to constitute a univer-

<sup>19</sup> Even though citizens are bound to obey formal rules *de jure* it does not follow that individuals are not facing rather opposing *de facto* rules when making decisions, e.g. weak formal laws and strong mafia in contrast to weak property right but rules-in-use to avoid tragedy of commons. In various situations based on where the action is taking place, individuals can be guided by different institutions and therefore institutional environment is not homogeneous, i.e. sometimes it can be like property rights exists and sometimes as if they do not.



## A GENERATION THAT HAS FORMED THEIR IDEAS ON HOW TO UNDERSTAND THE WORLD AND SOCIAL RELATIONSHIPS UNDER A STRICT TOTALITARIAN REGIME UNAVOIDABLY HAVE, BY NECESSITY, FORMED CORRELATED PERCEPTIONS ABOUT THE RULES OF INTERPERSONAL CONDUCT

sal order. If there were no bases for trust, and no shared community of understanding about the meaning of right and wrong, then the terms of trade in exchange relationships, or the patterns of reciprocity in communal and social relationships, would become extraordinarily precarious. Such societies could not develop”<sup>20</sup>.

A generation that has formed their ideas on how to understand the world and social relationships under a strict totalitarian regime unavoidably have, by necessity, formed correlated perceptions about the rules of inter-

<sup>20</sup> Aligica, P. (2003) *Rethinking Institutional Analysis: Interview with Vincent and Elinor Ostrom*. Mercatus Center at George Mason University, p. 5. Available [online]: <https://ssrn.com/abstract=1723393>

personal conduct. Although these rules are well suited to guide action in a totalitarian society, this does not imply that they are also the best guidelines for action in a free society. The Czech Republic (and likely all post-communist countries) is characterized by a complex institutional environment where formal institutions are almost exactly the same for anyone, while individuals at specific clusters of the society are facing conflicting informal institutions at various margins. These discrepancies can promote barriers to cooperative decentralization between individuals with conflicting mental models, and negatively affect coherence of the overall institutional environment. Incomprehensible institutional environment inhibits feasibility of cooperative decentralization.

Many clusters of Czech society can be characterized as having very centralized governance. The function of centralization which functions well is to simulate as if the institutional environment in which individuals are making their decisions resembled the one which was in place during the era of Normalization, where innovation was not present, and stagnation and decay ruled the country. People were afraid of expressing their opinions and fearful to raise their voice against the oppression and unfairness that existed. Even to this day, Czech society resembles on various margins this era, as some clusters are populated by individuals imposing their mental models on the institutional environment.

### CONCLUSIONS

People who invested in human capital advantageous under totalitarian regime usually prefer to operate under rules-in-use, which allow for their human capital to be utilized. They therefore promote these rules to endure on the margins where they have power to influence such an outcome. Horizontal relationships of exchange and cooperation are replaced at various margins by the ver-

tical relationship of power and dominance. This behavior pattern of post-communist democracies leads to increased costs for any potential cooperative decentralization, while promoting processes which lead to centralization, where skills of power and control have more use.

Many commentators<sup>21</sup> are displeased with the current form of the Czech government and criticize the fact that it has been created by votes of the members of the Communist Party. However, it is not the existence of the Communist Party *per se* one should be afraid of, but rather the totalitarian and communist way of thinking in general. This type of a mindset is still deeply ingrained in the mental models of many Czech citizens. When the prime minister claims he wants to “run the state like a business firm”<sup>22</sup> and this idea is supported by the masses, one should worry. We should be even more concerned when we realize what is his, and his generation’s vision for business management – hierarchical centralized channels of control with a powerful omnipotent commander on top.

<sup>21</sup> See Tait, R.: Czech communists return to government as power brokers. [in:] The Guardian 12 Jul 2018 Available [online]: <https://www.theguardian.com/world/2018/jul/12/czech-communists-return-to-government-as-power-brokers>; Muller, R., Lopatka, J.: New Czech government has shaky support, strong anti-migration stance. [in:] Reuters June 27, 2018 Available [online]: <https://www.reuters.com/article/us-czech-government/new-czech-government-has-shaky-support-strong-anti-migration-stance-idUSKBN1JN0R9?il=0>; The Economist: The enduring influence of the Czech Republic’s communists. [in:] The Economist Jul 11th 2018 Available [online]: <https://www.economist.com/the-economist-explains/2018/07/11/the-enduring-influence-of-the-czech-republics-communists>

<sup>22</sup> See Tait, R.: Czechs tipped to join populist surge in Europe by electing billionaire. [in:] The Guardian 19 Oct 2017 Available [online]: <https://www.theguardian.com/world/2017/oct/19/czech-republic-andrej-babis-billionaire-agrofert-populism>; Bendová, J.: Řídit stát jako firmu? Naposledy to zkoušel Lenin, říká ekonom Zelený. [in:] INFO.CZ 29. září 2017 Available [online]: <https://www.info.cz/cesko/ridit-stat-jako-firmu-naposledy-to-zkoušel-lenin-rika-ekonom-zeleny-16776.html>

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THE CZECH REPUBLIC (AND LIKELY ALL POST-COMMUNIST COUNTRIES) IS CHARACTERIZED BY A COMPLEX INSTITUTIONAL ENVIRONMENT WHERE FORMAL INSTITUTIONS ARE ALMOST EXACTLY THE SAME FOR ANYONE, WHILE INDIVIDUALS AT SPECIFIC CLUSTERS OF THE SOCIETY ARE FACING CONFLICTING INFORMAL INSTITUTIONS AT VARIOUS MARGINS

Not only should we oppose the idea that a state is the same as a business, as we know very well from Hayek that this type of thinking constitutes a road to serfdom, but we should also oppose extremely hierarchical and centralized management in general. Relying solely on hierarchical management structures is ill suited for more complex organizations, in both private and public ordering, and causes management costs to skyrocket while suppressing potential innovation.

Google, Spotify, as well as Aspen Skiing Co. employ decentralization and horizontal relationships to promote the autonomy of their employees. An extreme example of this approach is Valve Corporation (an innovative video-gaming and digital distribution company), with virtually no horizontal structure at all. These companies and their approach to decentralization should serve as an example for the development of business management and public administration in post-communist countries.

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INCOMPREHENSIBLE INSTITUTIONAL ENVIRONMENT INHIBITS FEASIBILITY OF COOPERATIVE DECENTRALIZATION

There are still some unexplored and unused potential benefits of cooperative decentralization in the Czech Republic. By aligning informal institutions with formal ones, the incentives for cooperation among generations would lead to beneficial innovations. In contrast, by enforcing rules-in-use, which resembles a totalitarian state, and establishing barriers for younger generation (which does not have the skills necessary to efficiently navigate such an institutional environment), there are two possible outcomes: the youth will either leave the country or will stay but instead will become frustrated and apathetic. In both cases the drive and potential for innovation will be massively impaired.

It is not only in physical capital and foreign financial capital where a developing post-communist country could find resources to grow and converge with the EU and the West, but also in allowing unused human capital to be implemented through cooperation between generations. The key problem may lie in the necessity of disinvestment in human capital acquired during life in a totalitarian socialist state. It is only in the hands of the generation with mental models from the past to make a conscious decision to leave such a mindset behind and move forward to make the country successful in the future. •



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