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## **De jure and de facto institutions – disentangling the interrelationships**

*incomplete – work in progress*

### **Abstract**

In this paper we contribute to the debate on the nature of institutions and their economic effects by extending the focus to the *de jure – de facto* institutional distinction. Firstly, we define and conceptualize *de facto* institutions and elaborate on their place in the broad institutional system. We also propose an approach for identification of these institutions. Then we investigate the possible interrelationships between *de facto* and *de jure* institutions. Finally, we make a link between these interrelationships and economic outcomes. In this way the paper fills an underexploited niche in institutional research, which is a major background for law & economics.

### **Keywords**

new institutional economics, *de jure* institutions, *de facto* institutions,  
formal institutions, informal institutions, institutional interrelationships

### **JEL Classification**

B40, B52, K19, P21

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## 1 Introduction

In new institutional economics and related fields there exists a broad body of literature on formal and informal institutions, their role for economic growth and development, as well as their interrelationships (e.g. the interaction thesis – Pejovich, Colombatto 2008; Pejovich 2012). However, recent works in law and economics increasingly emphasize the distinction between *de jure* and *de facto* institutions, e.g. in relation to constitutional rights and freedoms (including property rights), judicial independence, central bank independence or the independence of media regulators (e.g. Law, Versteeg 2013; Melton, Ginsburg 2014; Voigt et al. 2015). Similarly, political economy studies use the *de jure* – *de facto* distinction in reference to political power and its role for economic growth and development (e.g. Acemoglu, Robinson 2006). Analysis of the interrelationships between *de facto* and *de jure* institutions, beyond studies confined to individual rules, still constitutes an underexploited niche.

In this paper we aim to fill this lacuna and provide a systematic analysis of the relationships between *de facto* and *de jure* institutions from an economic perspective. In doing so we draw on the theoretical and empirical literature in new institutional economics, law and economics, political economy, constitutional economics and other related fields. Firstly, we conceptualize and define *de facto* institutions, differentiating them from the well-known concept of informal institutions. We also provide the background for identification of *de facto* institutions (using the theoretical apparatus and empirically, based on data pertaining to a given institutional setting). We then analyze the possible interrelations between *de facto* and *de jure* institutions. In particular, we ask the question when these two types of institutions boost and when they inhibit each other. We also investigate the possible crowding-out effect between *de facto* and *de jure* institutions and verify whether it is solely determined by the degree of law enforcement or also linked to other factors such as e.g. the so-called institutional genes. Finally, we reflect on how the interrelationships between *de jure* and *de facto* institutions shape their economic effects.

## 2 Conceptualizing *de facto* institutions

Numerous definitions of institutions have been proposed in the social sciences, also in the works of institutional economists themselves. Most generally, institutions are perceived by this literature as systems of established social rules that structure social interactions (Hodgson 2006). They are certain “rules of the game”, encompassing both formal and informal systems (North 1990). Institutions are introduced to life by organizations or people (Leftwich, Sen 2010). They provide for a (relatively) predictable structure for economic, social and political life by shaping people’s incentives and decisions, but, institutions do not always have to determine social behavior, e.g. because of exogenous factors (Leftwich, Sen 2010). It is important when one talks about institutions to emphasize that institutions are a dynamic concept – they change over time as a result of being reformed through people’s actions (Giddens 1984), which may be organized top-down (constructivism) or bottom-up (spontaneous action). Additionally, it usually takes time for social actors to adapt to a new institutional environment (Williamson 2000). For economists it is crucial that institutions cause positive or negative economic effects, in particular with regard to economic development, and the nature of these outcomes depends on the type of behavior that institutions enable to execute, as well as on the allocation of resources in society that they cause (Leftwich, Sen 2010).

Several classifications of institutions have been proposed by the economic literature, the most popular one distinguishing between formal and informal institutions. Formal institutions are laws (including constitutions), policies, regulations, rights etc. that are enforced by official authorities. On the opposite, informal institutions are social norms, traditions and customs that may also shape social behavior, but are not enforced by any official authority (Berman 2013). While part of the research on institutions and their economic effects tends to prioritize formal institutions and presents informal ones as a separate concept that may be detrimental to development (Unsworth 2010), many other studies provide theoretical grounds and empirical evidence of a particularly

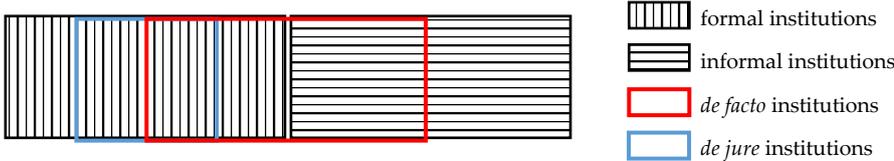
strong (and not necessarily negative) impact of informal institutions on the economy (e.g. Raiser 1997; Williamson 2009; Farrell, Héritier 2003; Greif 1998).

In this paper the focus is on *de jure* and *de facto* institutions. *De jure* stands for a state of affairs, that is in accordance with the law and is officially sanctioned. *De jure* institutions are, therefore, formal institutions. However, as e.g. formal policies may exist, which are not rooted in the legal system, *de jure* institutions are a subclass of formal institutions.

The definition and conceptualization of *de facto* institutions is, however, more sophisticated. *De facto* institutions are those observed in reality, in the market and in social practice. *De facto* means a state of affairs that is true in fact, but does not have to be officially sanctioned. While fulfilling the condition of being factually executed, *de facto* institutions may be of varying nature – formal or informal. There is also literature on quasi-formal and semi-formal institutions (e.g. Aslanian 2006), which indicates that they may also be classified as *de facto* institutions under certain circumstances.

*De jure* and *de facto* institutions are therefore not antonyms. Figure 1 presents the relationships between the sets of formal, informal, *de jure*, and *de facto* institutions. The sets of formal and informal institutions are disjoint from each other and together they form the complete set of existing institutions. As argued earlier, *de jure* institutions constitute a subclass of formal institutions. *De facto* institutions, in turn, may be either formal (*de jure*) or informal, provided that they are valid. A subclass of *de jure* institutions that are perfectly enforced will simultaneously constitute *de facto* institutions. *De jure* institutions, which are not observed and enforced, will not be classified as *de facto* ones. A question remains whether a particular informal institution that is invalid may still be regarded as an institution (this resembles a controversy in social norms literature regarding the role of normative beliefs and actions – see e.g. Bicchieri, Muldoon 2014).

Figure 1. Sets of formal, informal, *de jure* and *de facto* institutions



Source: own elaboration.

Table 1 presents examples of institutions that fall within the different sets outlined in Figure 1. Interestingly, while the formal/informal distinction produces two disjoint sets of institutions composing together the complete set of existing institutions, the *de jure* / *de facto* distinction produces sets with an overlap which do not cover the entire spectrum of institutions, i.e. there exist both formal and informal institutions which are neither *de jure* nor *de facto*, such as e.g. unenforced policies based on documents which are not law (formal) or normative beliefs when conceived as social norms (informal).

Table 1. Classification of institutions – examples

	formal	informal
<i>de jure</i>	laws, regulations	-
	perfectly enforced laws and regulations	
<i>de facto</i>	factually executed policies based on documents which are not law	social norms (actions)
neither	unenforced policies based on documents which are not law	social norms (normative beliefs which are not followed by actions)

Source: own elaboration.

Based on the presented classification, some additional remarks are in order pertaining, in particular, to the conceptualization of *de facto* institutions. Formal institutions may be classified as *de facto* institutions, when they are observed (complied with) and executed (enforced). The same regards informal institutions. In fact, when we deal with a valid institution, it is relatively easy to determine whether it is a formal or an informal one. However, the same is certainly not true with regard to the reverse, i.e. when we analyze a formal or informal institution it is not trivial to classify it as a valid or invalid one.

Resolving whether a given institution is factually executed poses a methodological challenge. Firstly, this has to be based on actual and precise data. Secondly, even if such data is available, one should keep in mind that some institutions can only be executed integrally, while others also partially, *per analogiam* to Dworkin's legal standards and rules (Dworkin, 1977). In fact, only with respect to a very confined set of institutions, which are characterized by a binary nature of enforcement, one may find that they are observed integrally. Usually institutions are complex and socially valid just to some (limited) extent. And this is where another problem linked with *de facto* institutions reveals itself, namely: how does one detect and identify a *de facto* institution?

With regard to the question posed above, first we have to determine whether we actually analyze an institution and only then, whether this institution is valid and factual. With regard to the necessary first step, i.e. distinguishing *de facto* institutions from some behavior that does not in itself constitute an institution, one approach could involve using theoretical apparatus but this way of analysis will usually be imprecise as theoretical models describe merely selected aspects of reality. Empirical data-based research, on the other hand, does not provide for a complex tool, which would allow to assess whether a particular institution is a *de facto* institution. All in all, this judgment will necessarily be discretionary.

A similar conclusion regards the second step, i.e. determining whether an institution is valid and factual. We may use theoretical apparatus to classify a particular institution as valid or invalid, or construct a dedicated weighted index (in particular, when the institution is a complex one). Such indices usually state for an approximation (which involves some degree of discretion) of real and observed behavior. As a result, again, the decision in this second step is also discretionary. *[In the final version of the paper, we will discuss these approaches more precisely. Additionally, we will elaborate on the economic significance of the arbitrariness of this institutional classification, especially with reference to valid and invalid institutions.]*

### **3 De jure – de facto institutional interrelationships** *[preliminary, will be extended in particular by adding more references to the relevant literature]*

Having discussed the problems with conceptualization of *de facto* institutions as well as the demarcation of the key types of institutions, in this section we turn to the main focus of the paper, i.e. disentangling the interrelations between *de jure* and *de facto* institutions. In the subsequent section we place them further in the economic effects perspective.

We begin, as previously, by relating to formal and informal institutions. As institutional theory develops, it becomes clear that formal and informal institutions usually do not exist in separation from each other. While the distinction between formal and informal institutions is unambiguous, in real world settings when we focus on certain areas of human interactions these two types of institutions interplay with each other and this in very different ways. Formal and informal institutions may be complements, substitutes (when they compete with each other) or overlapping (Jütting et al. 2007). The character of those interrelationships depends on the particular context, these institutions' strength and their nature – inclusive or discriminatory (Unsworth 2010). As a result, there are cases when informal institutions tend to undermine formal

ones, while in others the first ones substitute for the second in a smooth way or even boost their importance (Jütting et al. 2007). Many researchers agree that informal institutions often shape the construction and implementation mechanisms of formal institutions (Migdal 2001). As the literature regarding institutions shows, not only formal and informal institutions may affect the economy in significant ways, but also their interactions are crucial from the economic perspective (Pejovich 1999).

An important strand of literature regards the relationships between social norms and the law, i.e. between informal institutions and the *de jure* subset of formal institutions. Among these works some authors argue that social norms may arise without formal *de jure* institutions as efficient alternatives allowing to internalize negative externalities and providing costless or low-cost signaling mechanisms (e.g. Ellickson 1991; Bernstein 1992; Posner 2002). Acemoglu (1995), Glaeser et al. (1996) and Ferrer (2010) show how law-breaking behavior can become profitable when others also engage in such behavior, while Posner (1997, 2002), Cooter (1998), and more recently Benabou and Tirole (2011) analyze what has been called the expressive role of law and its relation to the signaling role of social norms. Yet another work by Acemoglu and Jackson (2014) considers the two-way interactions between social norms and the enforcement of laws showing, inter alia, in a dynamic setting that laws which are in strong conflict with prevailing social norms may backfire, while gradual tightening of laws can be more effective by way of changing social norms.

In order to study the interrelationships between *de jure* and *de facto* institutions it is helpful to begin with observing the relative position of these two sets of institutions. Figure 1 suggests that some institutions will have both a *de jure* and a *de facto* dimension (i.e. the two sets overlap), however there also exist *de jure* institutions, which do not have an identical *de facto* equivalent, as well as *de facto* institutions with no identical *de jure* equivalent. The first group are formal institutions which are simply parchment or dead letter provisions, i.e. are not factually enforced. The second group is more complex. Firstly, it contains *de facto* institutions functioning in areas of *de jure*

regulation where the *de jure* institutions are not enforced and, as a result, *de jure* and *de facto* institutions diverge (i.e. these *de facto* institutions have a *de jure* equivalent, however not an identical one). Secondly, it contains *de facto* institutions functioning in areas that are not *de jure* regulated (formal or informal in nature), i.e. with no *de jure* equivalent.

Depending on whether the concern is of *de jure* and *de facto* institutions functioning in the same area of human interaction, narrowly construed, or from different areas, we will encounter various possible structures of interaction between them. In the case of institutions functioning in different areas, one obvious possibility is no interaction (a neutral relationship). However, one can also imagine a situation, when a *de jure* institution and a *de facto* institution exist in different spheres of social interaction but both of them encourage social actors to a commonly desired behavior, so these institutions will mutually boost each other, even though they are not overlapping.

In the situation when *de jure* and *de facto* institutions function in the same area of human interaction, however, *de facto* and *de jure* institutions are in line, or not in line, with each other and a neutral relationship cannot occur. This signifies that when *de jure* and *de facto* institutions refer to the same area, they inevitably interact. The situation when *de jure* institutions boost *de facto* ones is natural in this setting. When a *de jure* institution is imposed and executed in a society, social actors comply, i.e. start to behave in line with it. When such institution is perfectly executed, the *de jure* institution becomes a *de facto* one. As a result, *de jure* and *de facto* institutions overlap giving ground for the boosting effect.

The boosting effect, however, can also run in the inverse direction: from *de facto* to *de jure* institutions in the same area. We argue that boosting of *de jure* institutions by *de facto* ones is a matter of law enforcement. Formal rules are enforced because of three key elements of their character and position within an institutional system: 1/ sanctions, 2/ probability of executing imposed sanctions, and 3/ social attitude with respect to (perception of) *de jure* institutions (Alston et al. 1996; Knight 1998). A

situation of enforcing legal rules thanks to overlapping *de facto* institutions (representing social practice) is, therefore, an example of institutional interaction that results in boosting *de jure* institutions.

When *de jure* institutions are not factually executed, *de facto* institutions functioning in the same area of human interactions deviate from them. There may be different sources of this divergence. Firstly, when a new *de jure* institution is imposed, it may be not in line with the existing social attitude and/or preferences in a given sphere of interactions. This may result from the fact that legislative proposals and adopted legal acts are a product of the political process, which, as much of the public choice literature emphasizes, may give rise to outcomes that diverge from the general preferences of the society (see e.g. the classical works of Black (1948) and Downs (1957)). Secondly, another source of the incongruity between *de jure* and *de facto* institutions at the moment when the former are enacted, may be the “import” or “transplant” of institutions (e.g. La Porta et al. 1997, 1998; La Porta et al. 2008; Berkowitz et al. 2003). Thirdly, even if *de facto* institutions match the formal ones at a given point in time, this must not be an infinitely stable situation (see e.g. North 1998). Due to endogenous social changes and the operation of exogenous factors, even previously coherent institutions may become contradictory. Thus, we can assess interrelationships between *de jure* and *de facto* institutions over a given limited period of time only. Fourthly, weak law enforcement mechanisms may also contribute to the development of a gap between *de jure* and *de facto* institutions (for results of recent empirical studies confirming this inference with regard to constitutional rights and freedoms see e.g. Law, Versteeg 2013; Melton 2013; Metelska-Szaniawska 2016).

*De facto* institutions diverging from *de jure* ones in the same area may be connected with the crowding out effect, which occurs when these institutions inhibit each other. It may be that *de facto* institutions crowd out *de jure* ones. This situation exists when *de jure* institutions are not executed properly or/and are not socially accepted. Formal institutions may also crowd out inconsistent *de facto* institutions from the institutional

system of a given society or social group. However, this ousting of *de facto* institutions may in some cases be only temporarily or sham because of the so-called institutional genes. Institutional genes are factors that constitute long-term *de facto* institutions (which do not have to be in line with actual *de jure* institutions). They are characterized by e.g. time durability of institutions and social positions of actors that enforce them (Xu 2012). [In the final version of the paper, we intend to extend the elaboration of various aspects of interrelationships between *de jure* and *de facto* institutions. In particular, we will argue that the boosting of *de jure* institutions by *de facto* ones is strongly related to the issue of law enforcement and characterize the crowding-out effect mentioned earlier in a more precise way.]

#### **4 Economic effects of *de jure* – *de facto* institutional interrelations** [largely incomplete section, will be significantly extended in the final version of the paper]

Last but not least, we focus on economic effects of interrelationships between *de jure* and *de facto* institutions. In this section the following aspects will be elaborated on: possible interrelationships of boosting or inhibiting *de jure* institutions by *de facto* institutions and *vice versa*, the significance of these interrelationships from an economic point of view, as well as their impact on transaction costs of legislation. When *de facto* institutions inhibit the *de jure* ones, transaction costs of implementing and enforcing the *de jure* institutions increase and may even become prohibitive. As long as some of the *de jure* institutions may cause negative economic effects, *de facto* institutions inconsistent with them may reduce the consequences of such suboptimal legislation. Economic effects of boosting *de jure* institutions by *de facto* ones also result in affecting the level of transaction costs of legislation (may limit them). Analogous effects occur with reference to *de jure* institutions' impact on *de facto* institutions.

This paper brings value added to institutional economics and related approaches by conceptualizing and organizing the possible interactions between *de jure* and *de facto*

institutions, with special reference to their economic relevance. We highlight that not only *de jure* and *de facto* institutions are significant from an economic perspective, but also interrelationships between them are well worth analyzing. To some extent such analysis can draw on findings relating to formal and informal institutions and their interactions. In this way an additional link to transaction costs of legislation can also be established.

### **Conclusions** [*very preliminary*]

Summarizing, *de facto* institutions may be either formal or informal. *De facto* and *de jure* institutions are, therefore, not antonyms, they may overlap. Identifying *de facto* institutions is a methodological challenge and is (at least to a certain extent) discretionary. *De jure* and *de facto* institutions may boost or inhibit each other. Institutions boost each other, when they lead to a commonly desired behavior. On the contrary, institutions inhibit each other, when they limit their enforcement. Economic effects of the interrelationships between *de jure* and *de facto* institutions result, depending on their nature, in decreasing or increasing the level of transaction costs connected with implementing and enforcing legislation.

The arguments and discussions presented in this paper contribute to a better understanding of the nature of *de facto* institutions, as well as their relationships with *de jure* institutions, and, in this way, may provide a common ground for future studies of the *de jure* – *de facto* distinction in relation to particular rules and institutional settings.

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