A THEORY OF INSTITUTIONAL RESILIENCE

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Abstract
Institutions matter: they affect individual action, influence cooperation, and are crucial in making the difference between wealth and poverty, growth and stagnation. Yet, the explanatory power of modern institutional theorizing has not been exceedingly satisfactory.

In contrast with the consequentialist perspective cherished by most of the economics profession, this paper suggests a theory of institutional dynamics based on the notions of justice, liberty and tolerance. In particular, we put forward a stylized model of society, which includes two groups of individuals: the socialists and the libertarians. We discuss under which conditions these groups are likely to cooperate, when instability emerges, and when demand for institutional change builds up. We conclude that today’s democracies are inherently stable, and that this stability is explained by the socialist notion of liberty that characterizes the vast majority of the population of a typical modern society.

Keywords: Legitimacy, tolerance, justice, institutions.

JEL Classification: A12, A13, A14, B52, D02
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1 An introduction to the analysis of institutions

Institutional analysis has always played a key role in political science and sociology. On the one hand, the historical school of political science has depicted institutions as “procedures, routines, norms and conventions embedded in the organizational structure of the polity”, the purpose of which is to define authority and contain conflicts (Hall and Taylor, 1996: 938). In their view, institutional resilience and path-dependence are explained by the actions of the coalitions in power, which rationally try to preserve their prerogatives by making change difficult through ordinary law-making; and also by the presence of cultural elements, as a consequence of which institutions are shaped by the individuals’ visions of the world, visions that are in turn affected by the context within which individuals operate and develop their cultural traits (Steinmo, 1992). On the other hand, sociologists maintain that institutions are ultimately the expression of the community’s shared beliefs (Berger and Luckmann, 1966). Thus, sociological institutionalism lays considerable emphasis on people’s perception of the existing system of laws, government agencies and procedures, and analyzes the possible tensions between the moral standards of a society and the formal and informal structures in place within that society.

Despite their numerous points of contact, however, the historical and the sociological views have originated two different research agendas. Historical scholars have been trying to assess what kind of shocks interrupt a path-dependent process and how the actors involved react to shocks. By contrast, the sociological context has been discussing the notion of legitimacy, which ensures that the individual recognizes an institution as the source of authority and is ready to comply.

The economics profession has also been aware of the importance of the institutional dimension. As Adam Smith pointed out over two centuries ago, institutions affect individual action, influence cooperation and are crucial in making the difference
between wealth and poverty, growth and stagnation.\footnote{Adam Smith underscored the role of institutions both in The Theory of Moral Sentiments (e.g. in Part III) and in the Wealth of Nations (e.g. in Book V). See also Buchanan (1976) and Elsner (1989) on the Smithian insights into institutional analysis.} Not surprisingly, therefore, speculation about the role and purpose of the “humanly devised constraints that shape human interaction” (North 1990: 3) has generated a substantial literature.\footnote{See for instance the surveys and references suggested in Hodgson (1989, 2004) and Sen (2009: Introduction). See also Hodgson (2000), who emphasizes the vantage point of the old-institutional scholars (from Veblen to Hamilton and Galbraith).} For example, scores of influential authors have pointed out the differences among various categories of rules (Crawford and Ostrom 1995) and have called attention to property rights, path dependence, repeated interaction and collective action. In general, the economics approach proceeds in three steps. First, it puts at the centre of the stage the definition of “good institutions”. Second, good institutions are analyzed in order to assess whether they emerge more or less spontaneously. Third, the analyst makes proposals with a view to steering institutional dynamics in desirable directions. A typical example is provided by the Posnerian approach to law and economics, characterized by the quest for the legal order that generates the greatest amount of material wealth. Yet, this perspective presents a critical weakness, in that it takes for granted previous choices about which ends (good institutions), and neglects that the institutional challenge is not about identifying and selecting the ideal set of laws and rules, but rather – and consistent with the political science and the sociological traditions – about analyzing how the existing laws and rules are perceived and evolve. Put differently, the real challenge is not about searching, designing, and maintaining the best institutions, but about explaining why individuals tolerate and possibly support the institutions they have, even when those institutions have failed to deliver the expected results – say in terms of material wealth or income growth.

Yet, the contributions of economics should not be discarded altogether: despite methodological shortcomings to this approach, it is undeniably true that neither historical accident, nor ethics can aspire to be the only variable that explains the institutional environment of a society. For example, the ability to enhance material prosperity does matter. Thus, we believe that an interdisciplinary approach can shed a clearer light on the grand issues with which the various disciplines have been grappling.
in isolation, and with only mixed results: Are economic performance, civic virtue, or military success the appropriate benchmarks with respect to which one should evaluate the quality of institutions? Why do people often accept and sometimes advocate inefficient institutions, even when they know that such institutions benefit only selected interest groups? And what moves them to look for substantial institutional change? In this paper, we focus on the last two questions – institutional tolerance and institutional tensions -- by framing an interdisciplinary approach that draws from the political-science, the sociological and the economics traditions.3

1.1 Grand principles and ordinary law-making

We begin our investigation by distinguishing between ‘grand principles’ and ‘ordinary law-making’ (Hayek 1960, Ménard 1995). Grand principles correspond to shared beliefs about ‘fundamental rights’ (‘justice’ and ‘fairness’ – these terms will be used interchangeably) that may or may not be detailed in formal documents. For example, most individuals within a given community would agree that all the members of the community should be free from need. This principle is often mentioned in official documents (constitutions) as a generic social commitment to fairness and solidarity, a principle to which few citizens would object. Yet, grand principles need to be made operational. To this purpose, ordinary laws are created to fill in the details and transform principles into actions. Following our example, ordinary law-making gives substance to the generic notion of poverty and enforces redistribution, by imposing suitable taxation, and by establishing and funding agencies responsible for managing poverty-relief programmes, including the distribution of merit goods and outright transfers of money.

3 A similar methodological approach has been suggested by Thelen (2003), which has been used by Gilley (2008) in order to identify three different traditions – economic institutionalism, sociopolitical institutionalism and historical institutionalism – and to put forward a “legitimacy-based approach”. However, Gilley’s notion of legitimacy is narrower than ours.
1.2 Tolerance

Conformity to grand principles defines the effectiveness and legitimacy of ordinary law-making. Of course, in an ideal world, all ordinary institutions are seamlessly consistent with one’s sense of justice and thus perfectly legitimate. Yet, reality is never perfect, and individuals are aware that the quest for perfection is vain and understand that tolerance is an ingredient of peaceful cohabitation. For the purpose of this paper, we suggest that tolerance depends on three variables. The first is the individual’s perception of the social covenant (social legitimacy), i.e. of the moral standards that one believes are shared by most members of the community. In particular, he respects ordinary laws consistent with the implicit, recognizable covenant characterizing the community, even when these shared standards do not totally coincide with his own. The second variable relates to conformity with the rule of law (procedural legitimacy), i.e. to the policymakers’ compliance with the prescribed, agreed-upon procedures, independent of the substantive desirability of the law (Mueller and Landsman 2004). This is frequently the case in mature democracies, in which majority or super-majority decision-making procedures prevail and are accepted as legitimate even when consistency with the grand principles appears doubtful. Under these circumstances, the greater the role of procedural legitimacy, the greater the importance of the electorate as judge of the policy-makers’ right to legislate. The third variable is civility, which refers to instinct, education and experience, and which implies consistency with the behaviour that one expects from the other members of his community. Put differently, civility characterizes the individual’s perceptions of the interactions among the various members of the community, which can meet the standards of honesty, charity and mutual trust, or which can come closer to the Hobbesian perspective on human nature (hostility, possibly accompanied by violence). A community lacking civility is a community the members of which hardly respect each other, are prone to cheating, are inclined to take advantage of people’s weaknesses or carelessness, and frequently decline to offer disinterested help. Clearly, lack of civility is different than breaking ordinary laws and thus might not involve sanctions, but loss of reputation. And the lower the degree of civility in a

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4 The political-science literature has coined the concepts of “affective support” and “diffuse support” in order to characterize people’s attitude towards current institutional contexts. Thus, legitimacy is “defined as a person’s conviction that the system conforms to his/her moral or ethical principles about what is right in the political sphere” (Muller et al., 1982: 241).
society, the fewer the possibilities for fruitful interaction (not only in material terms) and the more individuals feel uncomfortable about the prevailing institutional context.

2 Liberties, tolerance and institutional stability

Following from our emphasis on the role of legitimacy, therefore, in this section we study how humans perceive the institutional context; while we devote sections 3 and 4 to exploring the dynamics of institutions and the mechanics of institutional interaction. Section 5 concludes by taking stock and reassessing the agenda for future research in the realm of institutions.

2.1 Absolute and civil liberties

As mentioned earlier, we argue that the beliefs about justice play a significant role in the development of the individual’s social preferences and his assessment of the rules of the game. In particular, we posit that each person elaborates his own notion of justice by following two different criteria. The first criterion is defined by the range of rights that he feels are innate to human nature, that belong to him from birth and upon which nobody should encroach. Blackstone called these rights the individual’s set of “absolute liberties”. Of course, different individuals may have different opinions about the content of these absolute rights. For example, some people might think that they have no rights other than those produced and assigned by the state. By contrast, others might believe that each individual has a right to physical integrity, freedom of movement and unfettered private property, no matter what ordinary law-making prescribes.

Yet, there is no guarantee that one’s absolute liberties are respected. For example, although most people would agree that cheating and mugging are a violation of someone’s absolute right, they are still vulnerable to criminal misbehaviour. Put differently, when we enter a community – or assess our role within the society in which we happen to be born – we pursue two different goals. We aspire to enjoy the absolute

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5 See Blackstone (1753/1893: vol. 1, chapter 1) and also Humboldt (1852/1993: 6), who referred to “the freedom of private life”. 
liberties to which we believe we have a right; but we also realize that our absolute liberties cannot be fully enjoyed unless they are properly protected (Locke, 1689a/1764: 148 and 1689b/2010: 12). Moreover, we are eager to develop our nature and our potential as human beings; but we are aware that our flourishing needs interaction with the other members of the community (Humboldt 1852/1993: 10-11 and 27; Granovetter 1985). In a word, we are ready to accept cooperative agreements to ensure protection and enhance our human potential, even if this might require compromising some of our beliefs. That explains why most people are willing to join a community, follow its rules, and give up some of their absolute rights.

The second criterion an individual uses in developing his own notion of justice is “civil liberty, which [...] is no other than natural liberty so far restrained by human laws (and no farther) as is necessary and expedient for the general advantage of the public” (Blackstone, 1753/1893: vol. 1, chapter 1). In accordance with Blackstone, therefore, we call civil liberty the bundle of rights left to the individual once he becomes part of a society, rights that are in fact strengthened (i.e. enforced more effectively) as a consequence of government intervention. In this context, we assume that the state is the main producer and enforcer of those human laws that end up restraining Blackstone’s natural liberties. Clearly, the smaller is the set of civil liberties, i.e. the natural liberties the individual can enjoy after the introduction of laws, the greater the role of government.

To complete our line of reasoning, we suggest that desirable state intervention is not only instrumental in guaranteeing one’s absolute liberties and defining the extent of one’s civil liberties. The nature and quality of government intervention also affects economic performance – for example by encouraging or discouraging rent-seeking practices. Put differently, legitimacy requires that government intervention focuses on the areas deemed legitimate by the population: for example, extensive government intervention might be appreciated when it enhances the production of public or merit goods, less so when it engages in arbitrary redistribution or bad projects (e.g., white elephants), or when it distorts incentives through unjustified subsidies and barriers to competition. When economic performance worsens, tensions might emerge, since
individuals believe that the cost of government encroachment is too high and that the institutional context must be reconsidered.

An illustration of our argument is presented in graphs 1A and 1B below, in which we describe the behaviour of two hypothetical individuals, A and B, each of them enjoying or hoping to enjoy a given degree of liberty, as measured on the horizontal axis. In particular, points N identify one’s ideal notions of liberty in a world in which social interaction plays no role. Points M correspond to the most desirable amount of liberty, given the fact that we want to or must cooperate in a social context and secure our rights from aggression. As a consequence, the distance between N and M reflects the diminution of liberty as a result of government intervention, which is necessary for securing rights and cooperation in a social context. In graph 1A, individual A features a libertarian notion of absolute rights, which can be encapsulated in the “freedom-from-coercion” principle, i.e. Blackstone’s list of absolute liberties. Thus, point NA identifies an anarcho-capitalist context and is positioned at the far end of the horizontal axis.

Following from what we have argued thus far, however, in our example, individual A believes that his welfare requires a political community. If the institutional environment is favourable to growth (rent-seeking is moderate), therefore, he is willing to accept
restrictions on his absolute liberties up to point $M_{1A}$, where he believes that his satisfaction would be maximized (see schedule $A_1$). The breach of absolute justice is significant, as witnessed by the distance between $N_A$ and $M_{1A}$. Yet, in our example individual A is willing to bear the cost of diminished absolute liberties because the civil liberties he enjoys by joining the community create more opportunities to be happy – and are more secure -- than the liberties he would enjoy in isolation.

To complete the picture, schedule $A_2$ describes a society in which the quality of government intervention is poor: encroachment by the government generates abuse, rent-seeking is substantial, economic performance trails off, and people feel that the sacrifices they incur in terms of absolute liberty yield modest rewards. As a result, the benefits of government intrusion are rapidly exhausted: poor economic performance reduces happiness, and the demand for civil liberties is greater than under $A_1$ ($M_{2A} > M_{1A}$).

Graph 1B is similar to Graph 1A, except that individual B has a different perception of human development than A, and a socialist view of absolute liberty: in his opinion, an ideal society should offer a relatively wide range of remedies to compensate for the presence of alleged market failures. From this perspective, therefore, although individual B ends up with a relatively low degree of civil liberties ($M_B < M_{1A}$), he does not find that society deviates very much from his ideal of justice, since his ideal already implies substantial government intervention ($N_B - M_B < N_A - M_{1A}$). Of course, an environment in which legislators take advantage of their prerogatives and encourage wastages by engaging in extensive rent-seeking would be problematic, since poor performance would be frustrating and therefore cause unease. This is why the $B_2$ schedule lies below the $B_1$ curve. Yet, this outcome would not raise major doubts about

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6 Clearly, the underlying assumption is that individuals believe that more income/wealth provides favourable opportunities to develop their potential and be happy. We admit that this assumption is convenient for eventual empirical work, since it makes flourishing measurable. Yet, it is also plausible, since material affluence is certainly a significant aspect of what people consider a good or successful life, though of course it is not the only part.

7 Our libertarian/socialist dichotomy echoes Humboldt (1852/1993: chapter 1), who distinguished between the minimal state, which aims at securing individual freedom from coercion and possibly contract enforcement; and the modern state, which acts on behalf of the individual citizen and provides for his welfare.
the role and size of government, but merely elicit reform, so as to make the current rules more effective. In other words, individuals belonging to the B group would simply attribute failure to procedural imperfections, rather than to substantial institutional flaws. Hence, reform would focus on closing loopholes, and effective enforcement of existing rules, rather than changing the rules or the goals of the regime. As a result, both schedules B₁ and B₂ would point at roughly the same level of M_B, which defines the desirable rules of the game and is hardly affected by how those rules perform.

Thus, it is apparent that if a community includes only two stylized categories of individuals – A and B, as illustrated earlier on – civil liberties are going to be between M₁A and M_B, if the quality of government intervention is satisfactory and rent-seeking is moderate (satisfactory economic performance); or between M₂A and M_B, if government abuse and rent-seeking are significant (disappointing economic performance). If a society starts from high-quality government intervention and later performance deteriorates, social learning encourages the A group to press for institutional change (more liberty), whereas the B group insists on institutional stability and merely presses for procedural change.

2.2 Liberty gaps, tolerance and economic performance

Let us now turn to individuals’ attitudes towards the prevailing institutional context. We have observed that the schedules depicted in graph 1 determine the desired intensity of government intrusion and – correspondingly – how much civil liberty one wishes to enjoy. Yet, the members of a community do not always have the same preferences about the civil liberties one should enjoy. For example, some might believe that for a given Mᵢ, rights are not secure enough and that more government intervention is required. By contrast, others might be persuaded that government intervention greater than at Mᵢ does little to enhance one’s rights and in fact involves too heavy restrictions. Thus, except in highly homogenous communities, the civil liberties that characterize a society are necessarily the result of a compromise, so that the liberty Mᵢ actually enjoyed by each member of the community probably differs from his ideal (previously indicated as M₁A or M_B in graphs 1). We shall henceforth identify the difference between the actual and desired civil liberties as the ‘liberty gap’ which, given the actual
civil liberties defined by \( M_i \) depends on one’s notion of absolute liberty and on economic performance.

Tolerance is what makes the liberty gap acceptable and contributes to making a society stable by reducing pressure for institutional change. When tolerance is great enough, individuals are satisfied with their condition: they believe that they are living within a shared social covenant and the government is not abusing its powers (rent-seeking is not excessive and, as a result, economic performance is adequate). In other words, tolerance is embedded in the assumptions that originate political life and for which the social covenant is instituted: it draws both on the Hobbesian view according to which the liberty gap is the cost the individual must bear in order to secure greater advantage; and on the Lockean claim that men are also driven by their feelings of a moral commitment towards other men, despite their differences.\(^8\)

3 The libertarian and the socialist reactions to tensions

Let us now explore some implications of the analysis suggested in the previous section. It is clear from our reasoning that tolerance is crucial. In particular, its absence might generate cumulative phenomena, since individual A’s tolerance also depends on his perception of the others’ attitude: if everybody cheats, one might be less inclined to be honest, abide by the rules and hold the institutions in high esteem. In section 1.2 we pointed out that tolerance depends on social and procedural legitimacy of government action, as well as on one’s perception that most of the other members of the community are civil. In other words, when people observe that they are living in a community characterized by legitimate institutions and civility (\( T>T^{**} \) in graph 3, below), they feel encouraged not to betray trust (no cheating, no free riding, limited rent-seeking) and they also feel it is their duty to monitor and expose in public wrong behaviour. As a...

\(^8\) See Gauthier (1977), who draws attention to Locke’s vision, according to which morality means consistency with the divine law, expressed in the law of nature; and Locke’s *Second Treatise of Government*, in which he argues that “the first and fundamental natural law […] is the preservation of the society, and (as far as will consist with the public good) of every person in it” (chapter XI, §134) and “A man, as has been proved, […] having in the state of nature no arbitrary power over the life, liberty or possession of another, but only so much as the law of nature gave him for the preservation of himself and the rest of mankind” (chapter XI, §135).
result, tolerance increases further (dT/dt >0) and becomes a self-reinforcing mechanism. By contrast, if wrong behaviour is widespread and the institutional context is discredited, trust is eroded and the cost of flouting the rules drops. Once the tipping point T* is reached, the fall becomes cumulative: why should one be honest and run the risk of being tricked or deceived while everybody else – including government authorities -- is misbehaving? This situation is illustrated in the phase diagram below, where T stands for tolerance and the interval T*-T** denotes a situation in which individuals do not feel like changing their attitude (the cumulative process does not operate).

Put differently, if a society operates to the right of T**, its institutional legitimacy deepens with the passing of time, and tolerance becomes large enough to absorb increasingly considerable liberty gaps. By contrast, if society operates to the left of T*, it is intrinsically unstable, and the weakness provoked by a relatively modest imbalance

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9 This point had already been noted in Adam Smith’s Wealth of Nations (Book V.ii.f and k). More recently, Zak and Knack (2001: 317) show that “cheating is more likely (and trust is therefore lower) when the social distance between agents is larger, formal institutions are weaker, social sanctions against cheating are ineffective”.

Graph 2
(e.g. bad ordinary law-making) might turn into a cumulative process, unless remedies are applied promptly enough. The slower the reaction, the greater the effort required to recover.

What are the implications when tensions emerge? Let us distinguish between the reactions typical of the libertarian camp from those of the socialist camp.

3.1 The libertarian reaction

Following from the line of thinking articulated in the earlier sections, tensions emerge if an ideological shock and/or poor performance broaden the liberty gap. In particular, instability arises if the shocks occur when tolerance is close to the critical value $T^*$ (see graph 2 above). When this happens, tolerance is likely to fall further, rent-seeking pressures intensify, economic performance suffers, and the liberty gap widens further (movement from $M_{1A}$ to $M_{2A}$ in graph 1A). An ideological change in a balanced institutional situation in which tolerance is close to $T^*$ induces people to believe that the institutional context is choking their human nature and their individual rights (absolute liberties), that radical change is required, and that compliance with the current rules of the game is no longer a moral duty. As a consequence, ordinary laws tend to be flouted, the quest for privileges (rent-seeking) intensifies, and economic performance worsens. This worsening leads to a further widening of the liberty gap. As mentioned above, speed matters and less than radical responses might not be enough to redress the situation. In the end, if enough people really believe that radical change is required, radical change does take place.

The linchpin of the transmission mechanism remains the liberty gap even when tensions originate from poor economic performance. True, if economic outcomes are only

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10 We remind the reader that the liberty gap is a function of the difference between desirable and civil liberties, as well as of the difference between actual and expected economic performance (see section 2.2).

11 The example suggested here refers to an ideological change following which individuals resent government intrusion to larger extent. Mutatis mutandis, a similar mechanism applies when the ideological shock goes in the opposite direction and drives individuals towards socialist preferences (the $A_1/A_2$ schedules in graph 2 move to the left). This situation will be discussed further in section 4, devoted to the analysis of the interaction between the two categories of individuals A and B.
occasionally disappointing (cyclical crisis), the liberty gap is not going to be affected, insofar as agents consider they are still positioned on the $A_1$ schedule and/or if agents operate within the $T^*--T^{**}$ interval (tolerance absorbs the shock). Thus, the libertarian members of the society are unlikely to advocate radical institutional changes. When crisis presents structural features, however, the liberty gap that individual $A$ is willing to tolerate shrinks. If it is not absorbed by enough procedural legitimacy or civility, pressure for change occurs. Similar to the previous case, if the attempts to reduce rent-seeking are timely enough and successful, equilibrium is restored. Otherwise, demand for institutional change builds up, and the social environment rapidly deteriorates.

The above situations are illustrated in graph 3, in which the origin identifies the initial equilibrium situation and the arrows show how a society characterized by free-market principles could lose legitimacy and, if tolerance no longer succeeds in bridging the gap, spiral into an institutional crisis after having been hit by an ideological or a performance
shock. The essence of the mechanism is straightforward: a change in the liberty gap puts a strain on tolerance. If tolerance is deficient, rent-seeking pressures emerge, the existing liberty gap widens, and demand for radical institutional change intensifies.

Thus, Quadrant I describes the minimum degree of tolerance necessary in order to accommodate different liberty gaps and to avoid a possible institutional crisis. In our example, in order to absorb a liberty gap $D_1$, the community needs tolerance equal to $T_1$. The difference between required and actual tolerance is illustrated in quadrant II, where the schedule has a 45° slope and measures how much tolerance is missing. Of course, there will be one schedule for each degree of actual tolerance. In our example, the schedule refers to a level of actual tolerance equal to $T_1$ and, therefore, the difference between required and actual tolerance (missing tolerance) is zero. By contrast, if $D$ increases to $D_2$ and individuals’ tolerance remains constant ($= T_1$), then tolerance is deficient and the horizontal axis in Quadrant II shows the (positive) gap. Quadrant III describes the causal relation between missing tolerance and rent-seeking. The temptation to engage in rent-seeking is certainly always there. We all like privileges and guarantees. Nonetheless, it is plausible to assume that the incentive to seek privileges increases when cooperation looks less promising (civility weakens), when the future is discounted at a higher rate (tensions emerge) and when politicians react to an increasing liberty gap by distributing privileges in order to obtain consensus – especially when economic performance is still relatively strong and the cost of rent-seeking more difficult to perceive. As tolerance is inadequate, the social fabric weakens and its members more aggressively pursue privileges (rent-seeking). Finally, quadrant IV shows the causal relationship between rent-seeking and the tolerable liberty gap. Rent-seeking puts a brake on economic performance, which, in turn, affects individuals’ happiness and thus increases intolerance with regard to the liberty gap (the tolerable liberty gap is reduced). Eventually, tensions become more acute and the perceived legitimacy of the institutional environment degenerates.
In the example portrayed in the graph above, the initial liberty gap is \( D_1 \) and actual tolerance equals \( T_1 \). This is clearly a satisfactory situation, since missing tolerance is zero (quadrant II). We have also assumed that rent-seeking is modest (=RS*), so that the liberty gap stabilizes. As shown in quadrant IV, \( D_1 \) is indeed tolerable, given \( RS=RS* \). However, a significant ideological shock that increases \( D \) to – say – \( D_2 \) originates a lack of tolerance (see quadrant II), which in turn leads to rent-seeking (quadrant III) and thus to a cut in the liberty gap that the community members can sustain (quadrant IV). The difference between the actual and the tolerable gaps \( (D_1 - D_0) \) provokes the institutional crisis.

The dynamic is not very different if the shock comes from poor structural performance. In this case, however, individuals believe they have moved from schedule \( A_1 \) to schedule \( A_2 \): this movement causes a larger liberty gap and sparks the mechanism outlined earlier.

3.2 On socialist behaviour

In the previous paragraphs, we have argued that liberal societies are stable when they rely on a significant stock of tolerance, which cushions cyclical changes in economic conditions and relatively small alterations in the ideological climate. Can one make the same claim for the members of a socialist community? Does the vision of a just and prosperous society typical of group B (see the shape of the curves in graph 1B) lead to different conclusions than those we have reached for group A?

As pointed out in section 2.1, for our purposes liberals and socialists diverge in two respects. First, their notion of absolute liberty differs \((N_B < N_A)\), so that the size and – most importantly – the direction of their liberty gap is not the same: while for the libertarians the institutional environment might be delegitimized by excessive government intervention and insufficient liberties, the opposite holds true for the socialists, who believe that justice is enhanced by government intervention and by curtailing some individuals’ liberties in the name of equality. Furthermore, when economic performance slows down, the liberals react by advocating de-regulation and more liberties in order to reduce the greater liberty gap. By contrast, the socialists react
by advocating improved policy-making, a more effective bureaucracy, and more rigorous monitoring. In other words, according to the socialist vision, stagnation or recession do not undermine the legitimacy of the institutional framework. From his vantage point, therefore, tensions emerge because of disappointment with performance, not because the institutions are “bad” or perceived differently than before.

From the socialist perspective, therefore, institutional stability can only be threatened by ideological change, as a result of which the agents come closer to the libertarian view or advocate a greater role for government intervention, depending on the direction of the change. Certainly, when the shared ideology changes, the current institutional context can seem inadequate. For example, if people require greater income equality and stricter regulation, the liberty gap widens and the search for rents and guarantees intensifies, to the detriment of economic performance. Contrary to the libertarian case, however, the liberty gap does not widen further. In other words, an increase in rent-seeking and a decline in performance do not affect the rules of the game, which prove resilient (stable). People might be unhappy about the state of the economy and believe that their flourishing is choked. Yet, unless further ideological change occurs, pressure for institutional change is going to be weak. Pressure will be for the government to do more to remedy perceived problems in the guarantees of civil liberty and economic growth, but there will be no demands to change the vision of what the government does.

4 Interaction and change

The upshot of the previous two sections is straightforward. In most societies, the rules of the game to which individuals voluntarily subscribe necessarily feature a mix of civil liberties positioned between the ideal coveted by the libertarians (M_A) and that desired by the socialists (M_B). Compromise and institutional stability are guaranteed if the liberty gap is bridged by tolerance, i.e. if the social contract is clear enough and most of the population plays according to the agreed-upon principles of social and procedural justice. When these requirements are met, people recognize the legitimacy of the institutional context, peacefully cooperate, and pursue their own visions of happiness. Tensions might surface from time to time, but they tend to play a minor role, since most
members of the community sincerely believe that they should content themselves with what they have and that institutional change would be unlikely to better their condition.

In partial accordance with the historical literature, therefore, one could indeed argue that a society that is initially stable is bound to remain stable unless hit by a shock that delegitimizes the institutional context because the grand principles have changed. Thus, such a society does follow a path-dependent process (inertia), in that institutional activity consists in accommodating to the last shock and developing suitable conventions, until something new occurs (Young, 1996). Certainly, the legislators might introduce adjustments in the realm of ordinary law making, sometimes in response to technological innovation or cyclical fluctuation, other times as a result of the political quest for consensus. If the society’s grand principles and the notion of liberty are constant, and if law-making adjustments do not affect the civil liberties enjoyed by the population, institutional stability is likely to strengthen the underlying element of tolerance and thus make the social structure more resilient to shocks. By contrast, if policymakers do get carried away and interfere with civil liberties, and if tolerance is thin, then tensions come to the surface, with possible cumulative effects.

Thus, absent serious ideological crises, which are the core of the sociological approach, in our perspective the critical element leading to the emergence of possibly serious institutional unrest is the presence of a large enough group of libertarians, who are more sensitive to the link between economic performance and institutional legitimacy and therefore more inclined to ask for institutional change even when majority (i.e. compromise) concerning the notion of justice stays constant. The implication is that when the libertarian component is weak, society is stable even in the presence of economic crises: it requires disaster or virtual disaster before the institutional context is questioned.12

Our analysis also suggests a few additional conclusions: First, ideological minorities do not pose major social problems for communities characterized by a clearly identifiable

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12 This possibility had already been conceived by Tocqueville (1835-1840/2010: 1261). See also Berggren et al. (2011) on the relation between stability and growth.
social covenant with which the population complies spontaneously. Put differently, as long as the social contract is clear, rent-seeking is contained, and everybody plays according to the rules of the game.

Second, stagnation or recession is certainly likely to provoke widespread resentment, but it brings about institutional crisis only when the libertarian component is substantial and tolerance dwindles. Under such circumstances, the libertarians would advocate structural change, while the socialists would press for better regulation and monitoring in order to attain existing goals.

Third, finding an institutional solution to unrest becomes critical when the liberty gap is large and tolerance -- legitimacy and/or civility -- is not sufficient to bridge the gap. This becomes even more problematic when society is fragmented into many groups and loyalty to the group is more important than overall community cohesion. Then, the fragility of the social covenant becomes apparent, and respect for its clauses is necessarily flimsy. At that point, two outcomes can emerge. Some groups may end up hoping to exploit the system to acquire privileges (slick conformists); or rent-seeking becomes such a drain on the economy that the socialist group eventually gives in and accepts free-market reforms to revive economic performance.

All in all, we admit that the dynamics of ideological change – and thus legitimacy – remain hard to define. As we have argued elsewhere, however, we believe that shared beliefs are almost exogenous. Although people are indeed influenced by what they see around and what they have inherited from the past, genuine ideological change is a very rare event and requires momentous shocks that radically affect the way people perceive the role of the individual in a social context. Typical examples were the Gregorian Revolution in the late eleventh century and the Thirty Year War in the seventeenth century: the first sparked the debate on the source and legitimacy of the political authority, whereas the latter undermined the foundations of the divine order on earth.\textsuperscript{13}

\textsuperscript{13} It might be observed that the term “shock” is in fact rather misleading, since it conveys the idea that change takes place rather rapidly, in a few days or weeks. In fact, ideological shocks may take decade or even centuries to unfold. For instance, the full consequences of secularization became visible only in the nineteenth century.
Although generalizations are often deceptive, we suggest that Western societies are presently under the influence of the ideological change sparked by the Great War, as a result of which for most people the notion of absolute liberty has come relatively close to the socialist ideal. As witnessed by the increase in government expenditure and regulation that has characterized the past decades, it appears that the vast majority of the population in much of the Western world is fairly happy with a limited version of absolute liberty. In other words, most of us are close to the socialist end of the spectrum and not inclined to question the current view on social justice, no matter how disappointing economic performance might be. As result, today’s modern societies feature a rather limited liberty gap and, thus, the willingness to change the role of government is fairly small. Government intervention therefore turns into a matter of fine tuning, but its scope and nature are not really doubted. In this light, investigating the drivers of institutional change in a society by looking at grand principles does not pay.

Rather, the challenge faced by the social scientist is to assess what kind of shocks can break inertia and how to articulate the mechanics of unwarranted change. To repeat our earlier point, tensions do not necessarily provoke institutional change, although they might create opportunities for populism and rent-seeking. The institutional literature remains rather vague on both points. We have tried to make some progress by suggesting that there exists a tipping point beyond which the shock could lead to institutional crisis, that the position of this tipping point is defined by the width of the tolerable liberty gap, and that this gap is defined by legitimacy and civility. Put differently, unhappiness might reach a point in which it brings about tensions and discontent and the implicit social bonds that constitute the essence of social cooperation might be shaken. Yet, discontent about one’s own situation does not necessarily imply that one elaborates or imagines a new institutional architecture inspired by a consistent vision of liberty and individual responsibility. In fact, a second tipping point must be reached, so that the institutional transition costs (broadly understood) are overcome. Moving from one set of institutions to another is not easy, since obsolete legislation must be scrapped, a new consensus must be found, new laws passed, and one is never sure about the outcome, which might easily differ from expectations. In the end, unless the liberty gap reaches a critical threshold, and unless uncertainties and inertias are
overcome, the outcome is conformism, grumbling and rent-seeking, while existing institutions adjust at the margins, with no substantial change.

5 What do we make of institutional economics?

This article is inspired by the belief that individuals’ attitudes and willingness to interact, exchange and cooperate are not entirely the outcome of a common evolutionary story. Our very nature as human beings presumes our ability to choose whether to give in to our instincts and emotional drives, or rather engage in rational sets of actions, possibly restrained by value judgments (morals).

A similar line of reasoning holds true for the institutional context: institutions do not emerge spontaneously, nor are they accepted independently of what they mean and imply. Value judgments and rational compromise feature prominently in the emergence and acceptance of legislation and we suggest that all stable, complex institutional arrangements are characterized by ideological components. Following from this, we have argued that the political science, the sociological and the economics literatures have much to say, but none of them taken in isolation can articulate a fully satisfactory explanation of what we observe. For example, Chen et al. (1997) developed an index of legitimacy for China, and concluded that although the Chinese were not particularly happy about the economic performance of their country, they thought that the institutional context was satisfactory – a result also confirmed by Gilley (2008), with some qualifications. Hence, the authors conclude that the institutional system is stable. Yet, from the standpoint suggested in the present paper, this information is incomplete and the conclusion unwarranted. In particular, the crucial question is not whether the Chinese institutional environment is stable, but how performing the economy must be in order to avoid tensions, whether the Chinese society can really be considered ideologically homogeneous (as the authors assume), what drives institutional change

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14 Of course, institutions might be the unintended result of the agents’ actions. But this does not mean that they emerge spontaneously. For example, informal rules are the product of repeated intentional actions, while formal rules are often the result of a conscious decision by the law-giver.
and in which direction. From a different angle, the literature has been investigating the connection between economic performance and regime change – say democratic breakdowns as a result of economic crisis (Gasiorowski, 1995). The results obtained are ostensibly inconclusive: we suggest that economic performance alone says very little, if it is not analyzed in terms institutional tolerance/legitimacy.

In particular, in this paper we have tried to analyze the nature of institutional tensions and the consequences these tensions might generate. We have pointed out that, when unrest comes to the surface, policy-makers can react by following different patterns. They can operate at the margin by adjusting ordinary law-making and keeping the liberty gap within tolerable limits, in order to diffuse pressures. Or they could acknowledge the existence of a new context of grand principles and engage in deep change. Generally, however, populism, expediency and marginal adjustments prevail in fragmented societies, and the grand principles are very rarely questioned. Individuals might feel frustrated in their efforts to improve their condition, and they might be aware that the current body of laws is responsible for the lack of opportunities and disappointing economic conditions. Yet, lack of convergence on a new, widely shared ideological structure prevents a new notion of social justice from emerging and overhauling the institutional context. This is particularly true when the cost of transition remains uncertain; it is magnified in societies with a socialist tradition, in which the sense of individual responsibility is modest, solutions usually follow a top-down process, and bureaucrats or technocrats, who are usually confronted with circumscribed, operational problems, are asked to come up with new visions of the world; and can be further aggravated when the population is quickly aging, since elderly people would surely suffer from the bumps involved in transition, while the benefits would be relatively short-term. To repeat, unease and tensions do not necessarily lead to crises. When tolerance is deeply rooted, institutions can still be accepted despite their social legitimacy having dwindled. On the other hand, when discontent is significant, the extent to which it degenerates and society becomes vulnerable to rent-seeking pressures marks the difference between relatively rich economies (in which rent-seeking

15 Of course, the new-institutionalist economist would say that the driver is economic performance. See however Przeworski (2004) for a word of caution.
is limited or highly inclusive)\(^{16}\), and communities featuring large pockets of wasteful privileges, in which cooperation is biased towards personal relationships and the opportunities offered by impersonal exchange are overlooked.

Moreover, our view has emphasized that the debate on the role of tolerance should always be framed in the light of the existing liberty gap and, therefore, in terms of ideological perspectives, legitimacy and civility. True, today’s prevailing emphasis on the pragmatic role of institutions\(^ {17}\) seems to strengthen a view according to which legitimacy is indeed a question of material outcomes, rather than of compliance with moral standards. Advocates of the so-called “Veneer Theory”, for example, hold that morality is just a hypocritical layer covering up men’s purely rational, self-interested core (Wright, 1994). We do acknowledge that for most people morality might be a puzzling notion and that for a substantial number of individuals fundamental principles boil down to the (absolute) right to physical integrity and a generic right to solidarity, the rest being subject to debate and negotiation. But we also agree with De Waal (2006), who maintains that individuals do have a more or less sophisticated sense of morality. It originates from an evolutionary process that combines passions, emotions and instincts; and it gives substance to the Smithian “impartial spectator”, who allows us to make value judgments about potential goals and behaviours, and to transform subjective judgments into general rules also applicable outside the community to which we belong.

In this vein, the economists’ traditional view about how to analyze the evolution of institutions might need to be reassessed. True, the dynamics of ordinary institutions is powered by the interaction between concerns for efficiency and pressures from different interest groups; and is also influenced by significant institutional costs (inertia). Still, the kind of game and the playing ground that determine the range of actions and

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\(^{16}\) In accordance with Olson (1965), inclusive rent-seeking refers to large coalitions, whose activities are likely to produce only limited externalities.

\(^{17}\) Neglect of the transcendental vantage point is consistent with mainstream (neoclassical) economics, as well as with the position held by influential thinkers. For example, in the early 1940s Frank Knight advocated the discovery of morality through discussion (van Horn and Emmett 2011). In a similar vein, although from different quarters, Amartya Sen held that justice should be defined by rationally debating its content, starting from a broad enough definition and keeping only those elements that do not solicit substantial objections. It might be worth pointing out that common to these lines of thought is that morality is ultimately to be defined by intellectuals.
reactions are to be defined at a higher level. Neglect for this component runs the risk of transforming institutional analyses either into empirical exercises in *ex-post* determinism, or into generic models according to which everything depends on everything.
References


