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 elaborate on 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 regulatory agencies (e.g. Law, Versteeg 2013; Melton, Ginsburg 2014; Voigt et al. 2015; Hanretty, Koop 2013). 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. 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 enforceable 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. Although this classification of institutions becomes increasingly popular in economics and other social sciences (e.g. in philosophy, Gracia 1999), there is no commonly recognizable definition of de jure and de facto institutions in this literature. The de jure and de facto approach as such may be presented intuitively, however only if it is related to some well-conceptualized occurrence, like independence (e.g. Cukierman 2007; Hayo, Voigt 2007). When it comes to institutions, the precise meaning of de jure and de facto has to be defined. Still, in the literature those types of institutions are just introduced without further description (e.g. with reference to property rights, Alston, Harris, Mueller 2009). Therefore, our first goal in this paper is to fill this lacuna, with particular emphasis on 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 actual human interactions – in the market and 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 actually operative (effective), 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. We, however, do not develop this topic further in the paper as quasi-formal and semi-formal institutions are relatively scarce in economic literature.
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 operative. 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. It remains a question whether a particular informal institution that is inoperative 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

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<thead>
<tr>
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<th>formal</th>
<th>informal</th>
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<tr>
<td><strong>de jure</strong></td>
<td>laws, regulations</td>
<td>-</td>
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<td></td>
<td>perfectly enforced</td>
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<td></td>
<td>laws and regulations</td>
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<td><strong>de facto</strong></td>
<td>factually operative policies based on</td>
<td>social norms (actions)</td>
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<td>documents which are not law</td>
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<tr>
<td><strong>neither</strong></td>
<td>unenforced policies based on documents which are not law</td>
<td>social norms (normative beliefs which are not followed by actions)</td>
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</table>

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 (enforced and complied with). The same regards informal institutions (without official enforcement though). In fact, when we deal with an effective 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 operative or inoperative.

Resolving whether a given institution is actually operative poses a methodological challenge. Firstly, this has to be based on precise and reliable data. Secondly, even if such data is available, one should keep in mind that some institutions can only be observed 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
effective 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 operative (effective). 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 operative (effective) . We may use conceptual apparatus to classify a particular institution as operative or inoperative, or construct a dedicated index based on the factual state of affairs (in particular, when the institution is a complex one). Some examples of such *de facto* indices are indicators pertaining to the protection of various rights and freedoms (e.g. Freedom House 2016, Cingranelli et al. 2014). Such indices usually state for an approximation (which involves some degree of discretion) of real observed behavior. Moreover, only some fraction of institutions can be analyzed via the expenditures-effect perspective. 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.]
Having discussed the problems with conceptualization of \textit{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 \textit{de jure} and \textit{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 function 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 this literature regards the relationships between social norms and the law, i.e. between informal institutions and the \textit{de jure} subset of formal institutions. Posner (1997) indicates that it is not possible to understand the functioning of the law without reference to social norms, which interact with the legal system. This literature indicates the following possible relations: (1) formal and informal rules as
complements (e.g. Baker et al. 1994; Lazzarini et al. 2004); (2) formal rules as substitutes for social norms and it is possible for societies to function based on informal rules, without the need to establish costly *de jure* rules (Macaulay 1963; Ellickson 1991; Huang, Wu 1994); (3) formal rules as substitutes for informal rules and introduction of the former undermines or even destroys the functioning of social norms (e.g. Frey, Oberholzer-Gee 1997; Fehr, Gachter 2001); (4) depending on the particular context and conditions, formal and informal rules as complements or substitutes (e.g. Posner 2000, Zasu 2007). Some authors, in particular relating to (2), 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. More recent 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*
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 as above, 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 visualize the 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 (e.g. regulations contained in civil and penal codes may both incentivize to safer and more careful driving). The opposite may also take place, when de jure and de facto institutions existing in different areas are mutually conflicting from the point of view of incentives for human behavior that they produce (e.g. hiring employees on civil and labor contracts, primarily designed for different purposes).

In the situation when de jure and de facto institutions function in the same area of human interaction, de facto and de jure institutions are in line or not in line with each other and in this sense they inevitably interact; a neutral relationship cannot occur. While the ultimate relationship between such de jure and de facto institutions will be assessed – as a mutually boosting or inhibiting one – at a given point in time (static analysis), any existing institutional setup is a result of one or several dynamic processes and the latter should also be considered to provide the complete picture. The situation when de jure institutions boost de facto ones is natural in this setting. This is the case when a de jure institution is imposed and implemented in a society and social actors comply, i.e. behave in line with it. When the implemented de jure institution differs at the outset from the existing de facto institution in that given sphere of human
interaction, compliance may involve a change in behavior, i.e. de jure and de facto institutions converge. When such de jure institution is perfectly enforced, it becomes a de facto one. As a result, de jure and de facto institutions overlap giving ground for the boosting effect.

The boosting effect 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. It should be emphasized that there is also a link between the mentioned social attitude and de facto institutions, as people tend to perceive de jure institutions based on their observation of the functioning de facto equivalents of these institutions. Moreover, as a component of law enforcement this social attitude reflects various kinds of behavior towards de jure institutions across different institutional systems.

Based on the discussion so far it is noticeable that relations between de jure and de facto institutions are mutual in nature. De jure institutions, which boost de facto ones, are usually being boosted by the same de facto institutions, and vice versa. This mutual interrelationship is particularly evident when de jure and de facto institutions are in line with each other. In such case newly imposed de jure institutions simply legitimate the actually operative de facto ones and this legitimization may be regarded as a form of the boosting effect. In addition, these de facto institutions facilitate the implementation of de jure ones, mostly thanks to inherent social attitude.

When de jure institutions are not actually operative, 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).

The divergence of de facto institutions from de jure ones in the same area naturally leads to these institutions inhibiting each other and may even result in a crowding out effect. It may be that de facto institutions crowd out de jure ones. This situation occurs when de jure institutions are not properly enforced 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. Again, the relationship between divergent de jure and de facto institutions, is mutual in nature. De jure institutions, which are not in line with operative de facto ones, inhibit them. At the same time, inhibited de facto institutions disturb the implementation of the corresponding de jure institutions. [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. By these costs we mean all costs connected with law-making except for those evolving strictly from producing new legal regulations. Thus, the following categories of costs can be, inter alia, classified as transaction costs of legislation: costs of announcing new laws, costs of adjustments incurred as a result of introducing new laws by public and private entities, costs of regulatory instability, as well as costs of law enforcement. As transaction costs of legislation increase, they make the mechanism of the state less effective (Rothstein, Teorell 2008).

When de facto institutions inhibit the de jure ones, transaction costs of implementing and enforcing 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.

Additionally, since, as discussed so far, interrelationships between de jure and de facto institutions matter for the levels of transaction costs, they also affect the primary goal
undertaken by the legislator when imposing new regulations. Due to the fact that *de jure* and *de facto* institutions may interact, interrelationships between them may impact on the real outcome of legislation and this is obviously significant from an economic point of view.

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 each other when they lead to a commonly desired behavior, or inhibit each other when this is not the case. We have discussed various possible structures of interaction between them, including potential convergence and divergence, as well as the crowding-out effect. 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.

With this paper we aimed to contribute to a better understanding of the nature of *de facto* institutions, as well as their relationships with *de jure* institutions, in the context of economic analysis. Given the gaps and inconsonance in the existing literature, we
believe that applying the proposed de jure – de facto classification of institutions, which also includes reference to their formal-informal nature, in future studies of institutions and their factual execution will lead to more consistency and less confusion in the terminology used by theoretical and empirical researchers in the field. The systematic account of the possible interrelationships between de jure and de facto institutions that we proposed may also provide theoretical ground for future empirical studies of the de jure – de facto distinction in relation to specific rules and institutional settings. This refers, in particular, to research in Law and Economics, as problems of enforcement and compliance are crucial in the study of the functioning of legal rules and their economic relevance.

References


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