

Comments on<sup>1</sup>:

**Agent's Response to Inefficient Judiciary: Social Norms and the Law in Transition**

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This paper, like much of other contemporary work, is based on an understandable presumption that in corporate governance, and in other economic domains, what the higher income countries do is superior to the practices of the lower income countries. From here, it is only a small jump to the presumption that adaptation, adoption, or imitation of the socio-economic-political institutions of the high income countries may help the lower income countries raise their own incomes. In the movie *Fiddler on the Roof*, Tevye dreams in his song "If I were a rich man:"

*The most important men in town would come to fawn on me!*

*They would ask me to advise them,*

*Like a Solomon the Wise.*

*"If you please, Reb Tevye..."*

*"Pardon me, Reb Tevye..."*

*Posing problems that would cross a rabbi's eyes!*

*And it won't make one bit of difference if I answer right or wrong.*

*When you're rich, they think you really know!*

Yet, the evidence in support for the general superiority of the institutions of societies that enjoy higher incomes today and the gains from transplanting them to others is shaky at best (except by definition). Attempts to establish the proposition raise pesky questions about the role of history, political and military power and contingency in determining the wealth of nations. The rapid economic recovery of China during the past three decades has been accompanied by radically different forms of corporate governance, while the events of the past eight days or past eight years hardly inspire confidence that such superiority of the US and west European systems is not transient.

There is an alternative perspective on human societies as an ecological system in which a large number of variables evolve through complex interactions into values and forms which are unique and hard to predict. Thus finches living in each valley of the Galapagos Islands, isolated by mountain ridges, evolved into unique species through mere accident of chance and adaptation to variations in local conditions. Which of these finches is better is an unanswerable question. Whether finches in all valleys should be replaced by one "superior" variety is irrelevant.

In contrast, Cartesian perspective is based on the assumption that we possess enough conscious understanding to design better social systems top-down, and disseminate them advantageously without the benefit of bottom-up evolution through trial-and-error process of natural selection. In current discourse on corporate governance (as well as financial reporting), this design perspective dominates the Darwinian/Hayekian emergence perspective. I am aware of little evidence that supports such beliefs.

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Ecological systems are driven by mutual fit among a large number of variables. Architecture is another example of mutual fit where it is difficult if not impossible to identify a single design to be optimal. Given the large number of variables, and far larger number of interactions among them, it is difficult to use either econometrics or experiments to identify the marginal effect of a single variable on the performance of the system as a whole. Whether a corporate governance regime, finely tuned to the legal-economic-social-political environment of the OECD countries, will improve the efficiency in other economies remains to be addressed in a serious and convincing manner.

Although the focus of the present paper is on “transition” economies of Eastern Europe, the issues addressed in the paper—the role of social norms and law—are common to all societies. To my mind, social norms of a group of people consist of the set of shared expectations for one another’s behavior in various circumstances. Technically, norms are “common knowledge” expectations in the sense that not only does everybody have these expectations but everybody knows that everybody else does, and so on, *ad infinitum*. Under this perspective, good corporate governance can be seen simply as a match between the self-interest of each participant, and expectations of him by the others in the organization. Once the self-interest and expectations match, we have a balance that could be defined as good governance. There is little reason to believe that the pair of incentives and expectations that can achieve such a balance is unique.

Links between social norms and law present knotty problems and have been the subject of much analysis. To the extent laws coincide with social norms, they are largely self-enforcing. To the extent laws go beyond the social norms, their enforcement becomes increasingly difficult. If this is so, why do we enact laws and not simply let social norms carry the burden of coordination in society?

When they correspond to social norms, laws help communicate the norms to members of society because they are codified. This is especially valuable to socialize the newcomers and reduce the time interval needed for their orientation.

But laws are not confined to social norms and often extend beyond. Such laws may represent an attempt by the legislature to nudge the norms in a particular direction. Abolition of slavery is an example of this leadership function of legislation. As laws against alcohol and prostitution suggest, it is difficult to predict whether such attempts would succeed in changing the norms. In some cases, such laws may be passed as legislative grandstanding, posturing, to serve a well-organized interest group, or simply to save face. It is questionable if the passage of the Federal Corrupt Practices Act (FCPA) of 1977 by the US Congress led to any significant decrease in bribes given abroad to win

The experiment in this report offers the participants no incentives to report truthfully. There are well known issues associated with surveys consisting entirely of hypothetical questions. This raises the possibility of moralizing responses from the subjects, especially when they are students supervised by the authority figure of their own teacher. Anonymizing the responses in a believable fashion becomes difficult in this environment. For this reason, the chances of getting a neutral response from subjects who have no relationship to the experimenter might be better.

The two part experiment gave the subjects a partial scenario for assessment, followed by additional information in a third paragraph. With this additional information, would the subjects wonder what else is being held back from them? Just because the

experimenter does not say something does not mean that they form no expectations about the left unsaid part; they could “fill-in” the missing details in their own individually diverse, uncontrollable, and unknown ways.

The experiment uses “reputation” of a firm as a generalized positive attribute of ambiguous import. What is high reputation of a firm? The field of corporate governance is concerned with the conflict among various participants in the firm, especially the smaller shareholders, senior managers and the members of the board of directors. Does cutting corners on income taxes improve the reputation of the firm if it results in less money for government and more for the shareholders? Does appointment of the former CEO lower the reputation of the firm if he brings wise counsel and guidance to the supervisory board but violates the law? It would be helpful to the reader if the paper makes the reference group for reputation clearer.

There are some statistically significant differences reported across Slovenia, Croatia and Montenegro. It would be useful to get the authors’ analysis of the possible reasons for these differences. These differences also raise a question about the scale of comparison at which differences could be significant and stable. One can conceive of conducting a study of such differences at many different levels of aggregation varying from individuals to the whole world.

Finally, in comparing the corporate governance or other institutions across societies one cannot help wondering about the question: Why is a dog not like a cat, why is an apple not like an orange? Which is more efficient or desirable? If dog is regarded as superior, can and should cat be reengineered to be a dog? The present study is not designed to address this question but the larger literature of comparative analysis of systems of corporate governance would have to engage with it.