Economic Freedom and Development

— Completely revised edition —

by
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Acknowledgments

An essay such as this could not have been put together without drawing on the wisdom of many, only some of whom are explicitly cited in the references and further readings. I am probably not even aware of many of their contributions. This essay has benefited enormously from the joint undertaking of writing a book on institutional economics with Professor Manfred Streit, the Director of the *Max-Planck-Institute for Research into Economic Systems* at Jena, Germany (W. Kasper-M.E. Streit, ***Institutional Economics — Social Order and Public Policy***, published in 1998 by Edward Elgar, Cheltenham, UK in the *John Locke series*, and in 2000 by Commercial Press of China, Beijing, in a Chinese translation).

I gladly acknowledge the helpful, critical feedback I received from my students and participants in the "Liberty and Society" seminars of the Centre for Independent Studies in Sydney, on whom I tested some of the ideas in this volume. *The Centre for Independent Studies* (CIS), which published the original version of this booklet under the title ***Property Rights and Competition*** in 1998 (www.cis.org.au), was generous in allowing us to reproduce the bulk of that manuscript, in revised form, except for Chapter 1, which is newly written.

Last, but not least I am greatly indebted to Mrs. Linda Whetstone for her cheerful drive and boundless enthusiasm. Without her the original CIS publication would not have been dispersed to think tanks and other readers around the Third World, and would not have been revised and added to for the present publication.

Numerous readers and commentators helped me to sharpen the argument and to avoid blunders. However, the usual exclusive responsibility for judgements and errors must remain with the author, who – in some instances – insisted on being obstinate.

WK

By Way of an Introduction:

A Personal Perspective

Two decades ago, when I was looking for an introductory economics text to support a post-graduate course on economic development for a general audience, I looked through about thirty bestselling textbooks from the US and Britain. With one laudable exception, these texts did not offer realistic, useful definitions of concepts like "entrepreneur", "competition", "innovation", "profit", "private property" or "rule of law"[1]. Rather, they were all based on the wholly unrealistic neoclassical assumption of "perfect knowledge".

My own life experiences — as an academic teacher, researcher, government advisor, international civil servant and industry consultant — had led me to believe that these concepts were integral to successful development and that "perfect knowledge" was a non-sense. I had spent my formative years in post-war West Germany, where a defeated people had resurrected its broken economy and created full employment, including for millions of returning soldiers, all within a dozen years. The neoclassical growth models, which were the fashion at the time and which – at best – treated knowledge was a "dummy variable", had not helped me to understand these experiences. Then, I read a lecture by Friedrich Hayek at the Kiel Institute of World Economics, where I had been a student. He spoke about discovery being the essence of economic life (Hayek, 1978) — *Eureka*! It was the finding and testing of useful knowledge by confident, enterprising people in competitive markets that made the essential difference between development and stagnation.

This insight made a lot of sense when I observed what was happening in Spain during the 1960s. Liberalisation generated the fastest industrial growth anywhere in OECD other than Japan. Later, I worked as an advisor to the Malaysian Treasury and could observe the same liberating forces at work in those countries of East Asia, where economic development was taking off (and observed poor growth, where they were stifled by heavy-handed regulation, import substitution and nationalisation). In Australia and New Zealand in the late 1970s and early 1980s, I was, in a modest way, able to contribute to the public debate and subsequent economic reforms, which turned stagnant economies and insecure populations into societies full of robust confidence about their future. As one of the first Western economists invited to the Chinese province of Sichuan in the early 1980s, I observed how repression and food riots were, in few short years, overcome by the biggest *de facto* privatisation in the history of mankind. 'Household units' and the workers in factories were given back reasonably trustworthy property rights. Food production rose steeply and cheer-inspiring markets appeared everywhere (Kasper, 1981). The economic rise of China, accompanied by an infectious optimism, had begun!

My dissatisfaction with the economic literature induced me to write a textbook with a long-time friend and colleague, Manfred Streit, on *Institutional Economics* (Kasper-Streit, 1998) and to publish a small book for an Australian lay audience, in which I focused on the institutions, the rules of the economic game. This latter publication by the Centre of Independent Studies (CIS), a free-market think tank in Sydney, Australia (Kasper, 1998) forms the bulk of what follows. It is supplemented by Chapter 1, in which I deal with long-

1 The exception was A. Alchian–W.R. Allen, *Exchange and Production*, Wadsworth Publishing, 1977. Fortunately, at the time of writing, a new edition of A. Alchian, W. Allen, and A. Hoel, *University Economics* (Oxford-New York: Oxford Univedrsity Press, 2005) can be expected on the market.

term economic development in the Third World. The CIS publication has been reprinted and translated by think tanks in many countries from India to Turkey to Nigeria, and I am pleased to contribute an updated version to the *Eureka Project*.

It is my hope that the reader will find out that free people, who can be reasonably sure of the rules (institutions) under which they cooperate, are likely to make millions of small and big discoveries that add up to what we call economic growth. More importantly still, readers might learn that economic freedom is a most critical precondition for the attainment of human dignity for all and for what the American Constitution so aptly calls the 'pursuit of happiness'.

Wolfgang Kasper

Sydney, August 2005

CHAPTER ONE

ECONOMIC GROWTH AND INSTITUTIONS

"I believe that free societies have arisen and persisted only because economic freedom is so much more productive economically than other methods of controlling economic activity."

M. Friedman, in Gwartney, Lawson, Block (1996), p. vii

"Across the countries of the world, annual income per capita varies by a factor of almost 100… We find surprisingly good news; approximately 85% of the international variation in income per capita can be explained by.. [man-made differences in]…. property rights,… black market activity, ….regulation…, inflation, …. civil liberties…., political rights…., press freedom …, government expenditures … and trade barriers."

Conclusion from a major study of differences in national incomes levels, Roll – Talbott (2001)

In recent times, most nations around the world have managed to achieve an amazingly fast pace of economic growth. Humanity's average living standards have more than doubled since the end of the second world war. To be more precise, the volume of goods and services per inhabitant of the globe has been raised by no less than 2.1% p.a. On top of this, the number of people on earth has multiplied 2.5 times. Consequently, humankind is now producing some five times as much as it did at the end of the second world war. This achievement is unprecedented in human history.

Many places, such as Singapore, Hong Kong, Taiwan and Shanghai, have managed much faster economic growth than the world average and have followed Japan out of the Third into the First World. There, one can observe a high level of pragmatic cooperation and general can-do optimism among the people. Skill levels in technical and organisational jobs are being built up at a rapid clip. Trade and investments flow freely between these rapid-growth economies and the affluent countries of North America and Western Europe. It is evident that most people in those "catch-up economies" eagerly welcome the amenities and challenges of the modern age.

The exception from this generally cheerful picture are a number of places that have lagged behind or have even experienced declining living standards, for example in Africa, West Asia and parts of the former Soviet empire. Industrial development there seems stunted and normally directed to substituting imports with second-grade products, which could not be sold in global markets. City infrastructures in large parts of the capitals of these laggard economies are in visible decay. Unemployment is high and rising, and many of the young are despondent, pessimistic and disoriented. The West and modernity are often perceived as the enemies.

Even without going to the normative question of whether material advancement is a good or bad thing, the observer will feel compelled to ask: Is the difference in economic performance due to systematic factors? And if so, what are they?

In the remainder of this chapter, we will make the case that it is plausible that differences in wealth and growth have a lot to do with the quality of institutions, rules of coordination for human activity. We will then outline the broad pattern of global economic growth and population, and add more to the question of institutions and prosperity. Finally, because all choices of institutions are normative – in other words require discussions of what is good or bad –, we will discuss the pros and cons of economic growth for all.

Economic Growth and Institutions – A First Glance

Economic growth – the sustained rise of productivity and hence real per-capita incomes throughout the community – is a relatively new human experience[2]. The widespread experience of sustained material improvement has spread since the industrial revolution in England a little over 200 years ago and has now become the norm around the world, except in those socialist and dictatorial countries of the Third World that are ravaged by war, despotism and corruption. Growth in the First and the Third Worlds has been accompanied by big reductions in absolute poverty, malnourishment and child mortality, as well as by massive improvements in health, longevity, job satisfaction, life opportunities and human dignity — not only for small elites, but for the population at large. Even the poorest in the United States of America live better, longer and healthier lives than the middle classes of traditional, but stagnant societies (Simon, 1995). Since the onset of the Green Revolution some forty years ago, the share of malnourished people on earth has dropped from 35% of the world population in 1960 to 18% now (Lomborg, 2001). It keeps falling. For most people, the quality of nutrition has also greatly improved; and education levels have risen. A hundred years ago, 75% of humankind was illiterate, now all but 20% of us can read and write. Most would therefore agree that economic growth is desirable, both for economic and non-economic reasons (for more of the normative discussion, see the final section of this chapter).

The worldwide growth record, and the limited number of cases of continuing stagnation, suggests the questions which will be at the core of this monograph, namely:

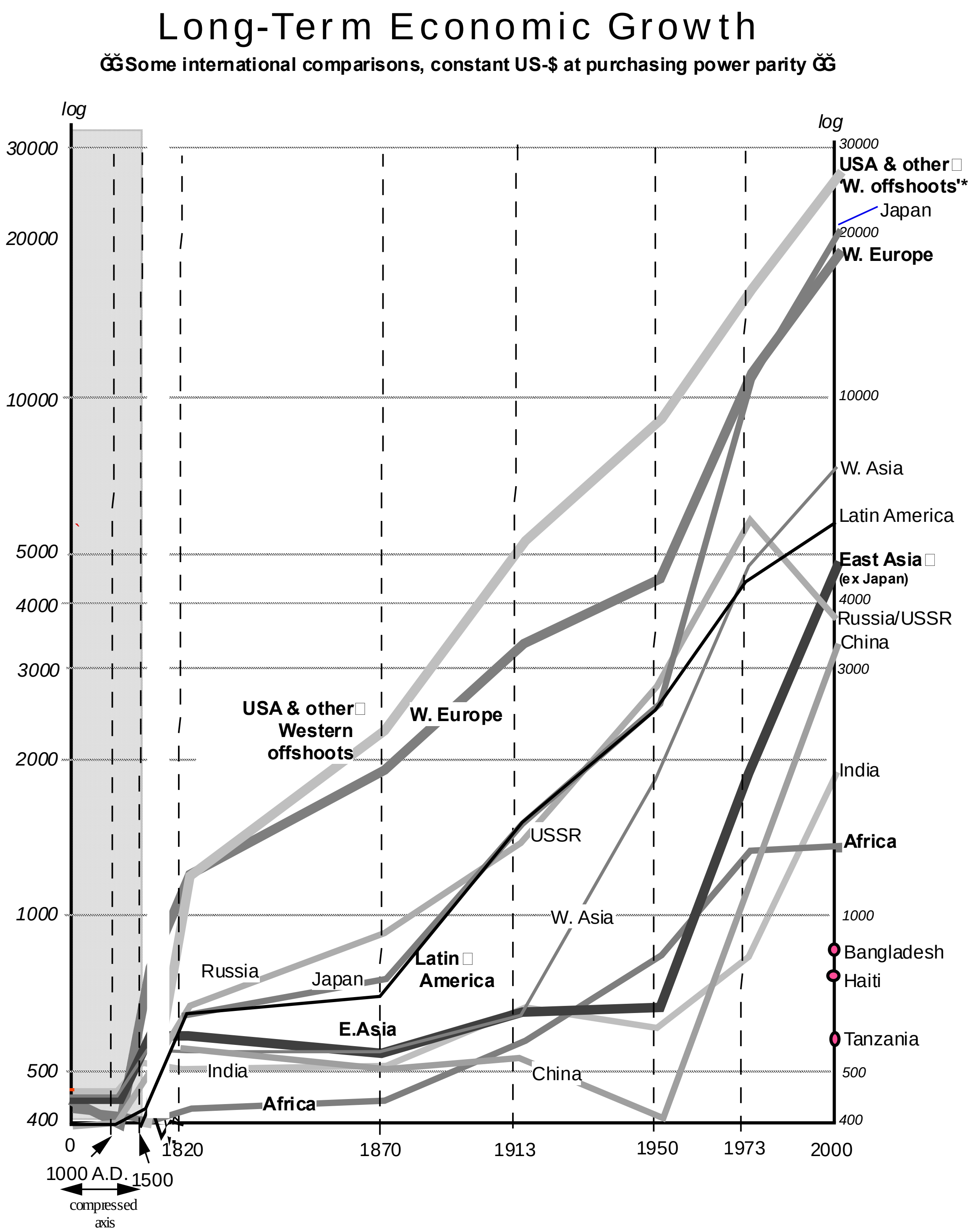
- What explains the take-off into sustained economic growth, first in western Europe and north America, then in Japan, east Asia, and parts of Latin America?
- Why has economic growth not taken off in the – partly energy-rich – Middle East and still lags badly in Africa?
- Can one derive general lessons from this experience for specific countries, which have in recent years been unsettled by declines in living standards? Or are there specific factors, such as geography, culture or religion, that make sustained economic growth and modernisation impossible in certain places?
- What changes in institutional and public policy are needed to facilitate a catch-up of living standards with those of affluent countries of the West?

It is the main purpose of this essay to highlight the importance of simple, stable and universal ground rules (institutions) in establishing trust and coordinating human conduct in the economy[3]. We will argue that certain simple rules of an overriding, constitutional quality serve to constrain theft and corruption by powerful individuals, and self-seeking political groups and their allies. Appropriate rules open life opportunities for all by creating better predictability and security. Enterprising people can then concentrate on their own aspirations and capabilities without having to glance all the time over their shoulders to see whether their venture is imperiled by the next confiscation, the next arbitrary act of a

2 See ‘Glossary’ at the end of this monograph for a definition of economic growth.

3 See "Institution" in the Glossary at the end of this monograph. A number of terms have to be given specific and precise definitions, if we want to analyse policy issues. To assist the reader, the most important such definitions have been collected in the ‘Glossary’ at the end of this book.
In the social-science literature, the term "institution" carries many and conflicting meanings, to the extent that it becomes meaningless. Moreover, everyday English often refers to banks, universities and insane asylums as institutions; but in reality these are organisations, durable combinations of production factors to pursue specific purposes. In line with a rapidly growing academic literature on Institutional Economics, the word "institution" will be used here exclusively as synonymous with "rules that carry sanctions".

Graph 1



* 'Western offshoots' = common-law immigration countries, USA, Canada, Australia, New Zealand

Source: Maddison, 2001

corrupt official, the next subsidy scheme, a new, prescriptive regulation, or a lawless act of someone powerful. Sustained economic growth requires that basic economic institutions are universal and credibly enforced equally for everyone, in order to inspire confidence and to reduce the costs of transacting business. As well, proper institutions tend to de-emotionalise political life and constrain social and inter-ethnic conflict. It is simply not constructive to have matters of daily life — such as working, buying, selling and investing — constantly embroiled in legal and political conflicts or subjected to the undue exercise of private power and the vagaries of an arbitrary or corrupt public administration.

World Economic Growth – A Broad-Brush Overview

Graph 1 depicts the very long-term growth experience in the world at large, taking the latest and most solidly researched set of data available as a basis (Maddison, 2001). On the vertical axis, we show the logarithms of real per-capita incomes (inflation corrected and measured in US-$ at purchase power equivalents). This means that accelerated growth is depicted by an upward bend of the curve, and decelerations by a less steep angle. Absolute decreases in living standards – for example the decline over the past quarter-century in the former Soviet Union – are shown by a downward slope. The horizontal axis is compressed at the beginning to show some (necessarily crude) income estimates for the years 0, 1000 AD and 1500. The graph also shows the broad development of real per-capita incomes since 1820, as far as such data are available, as well as indicating some of the poorest countries in 2000.

The graph draws attention to a number of important facts:

- In the first millennium AD, most people were poor (except the few powerful members of elites). Material living standards were on average even lower than is now the case in the poorest Third-World countries, as for example in Ethiopia, Bangladesh or Vietnam. Increased production was regularly outstripped by rises in the number of mouths to be fed[4]. Disease, dirt, discomfort, periodic starvation, high child and maternal mortality and a short, insecure life were the norm. And no one believed that such human misery could ever be overcome.
- With the Renaissance in Western Europe (ca. 1500), something revolutionary happened: General living standards began to rise. Later, some 'new-world offshoots' of west European civilisation (North America, Australia, New Zealand) rapidly achieved unprecedented living standards, and then relentlessly kept up the economic growth experience. The growth process began amidst intense inter-State rivalry in Europe (wars of religion) and with the emergence of individualism, the rise of critical, sceptical thinking, the emancipation of peasants and women, relatively secure private property rights, a market economy and gradual improvements in the rule of law (see below).
- After 1820, Eastern Europe, Russia, and Latin America took off into sustained growth. In the 19th century and first half of the 20th, south and East Asia showed little growth in per-capita incomes. Added production was largely matched by accelerated population growth (extensive growth). Since 1950, per-capita incomes have begun to rise there, too, though much less than in the open, export-oriented East Asian countries. With progressive liberalisation, south Asian incomes rose faster towards the

4 This was the so-called 'Malthusian trap', named after a dour British economist, who in 1798 stipulated that the number of hungry mouths would always outstrip the resources to feed them. Oddly, he published his theory just when the beginnings of the industrial revolution created conditions under which his assertions were no longer true (Kasper, 2005b).

end of the millennium, albeit still with less vigour than in the open, more lightly governed and more developed East Asian nations. Growth also spread to parts of Middle East (west Asia and north Africa) from the early 20th century, when the initial modernisation of government and oil launched some countries there on a growth path. However, Mideastern modernisation did not lead to a significant rise in female education, consequently reducing birth rates as it had done almost anywhere else. Indeed, west Asian countries continue to the present to have among the highest population growth in the world and growth rates of per-capita incomes are very low (Kasper 2005a).

- A real breakthrough came in the second half of the 20th century. Growth accelerated and carried the affluent western countries to unprecedented heights of wealth creation, as world markets were opened and more knowledge and technology were applied and utilised. The most spectacular change occurred in East Asia, however. There, revolution, war, corruption and civil turmoil had previously inflicted untold misery. Now, one autocratic regime at the edge of communist China after the other launched economic and political reforms to achieve fast economic growth, typically by industrialising and exporting to the rich countries. Since 1980, even the Peoples Republic of China embarked on a rapid catch-up with the West by instituting waves of *de facto* privatisation, decontrolling economic activity, promoting self-responsibility and opening the economy to the world market forces[5]. More recently still, south Asian countries have managed a take off into growth, though remaining below the average income of East Asians. As a consequence, the numbers of people on earth who live in abject poverty have declined in absolute terms.
- Over recent decades, only the African economy south of the Sahara as a whole has remained almost stagnant, despite rich natural resources. Some African countries even managed a substantial decline in living standards since 1973. Similarly, people became poorer in some of the former communist states of the USSR, where the old system collapsed and a reliable, new order has yet to emerge, as well as in Iran and Iraq where a lack of economic freedom and wars have combined to bring about a tragic, long-term decline in living standards. Elsewhere in the Middle East and North Africa, many have also been left behind in the global economic take-off.
- On the affluent end of the spectrum, the Anglo-Saxons countries outside Europe and the western Europeans are now producing annual average incomes between US-$ 20-30 000 per inhabitant, i.e. some ten to fifteen times what, for example, the average south Asian manages to produce and enjoy.

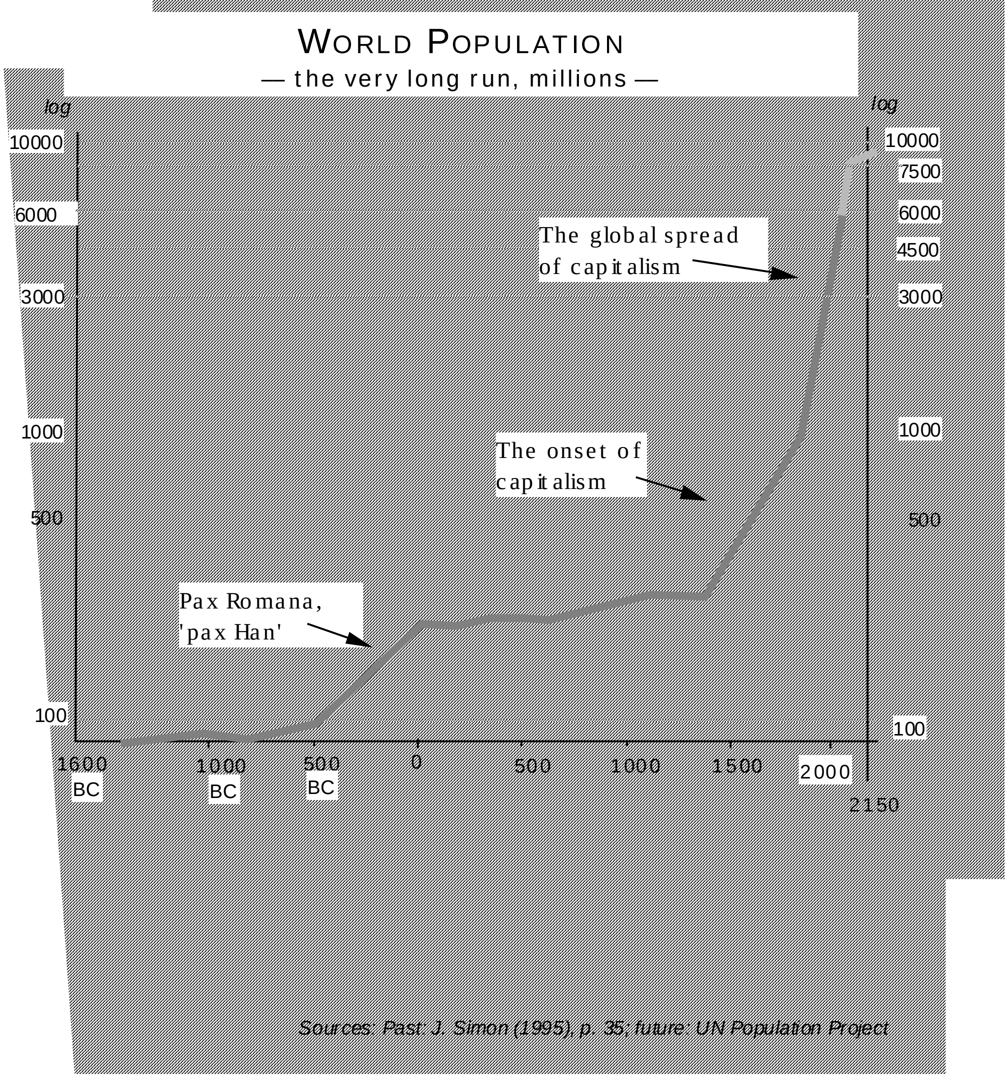
The big picture of the world economy since the year 1500 is that the rise in productivity and living standards has spread progressively to more and more communities. The take-off into economic growth was at first usually accompanied by an accelerated rise in population, until rising affluence and better education led to falling birth rates. This demographic transition was repeated with the spread of economic growth beyond the original industrial countries and progressive globalisation during the second half of the 20th century. Take-off went again along initially with an accelerated population increase (Graph 2). Greater productivity allowed more people to survive and enjoy a longer live expectancy, living more productive lives. More people generated bigger markets and more productive knowledge, facilitating the continued spread of economic growth. With a time lag, population growth slowed due to a falling birth rate. The relatively early response of

5 This statement holds true even if we accept that economic growth rates of China have been greatly exaggerated in Chinese national and many of the international statistics.

death rates to rising living standards and the delayed drop in birth rates make for a temporary phase of fast population growth. That subsides with time; indeed populations in the very affluent countries is often negative, a factor that has lately contributed to major and growing global migrations from poor to rich countries.

The distribution of the world population is thus shifting considerably, with the share of Europeans and Russians declining dramatically. They were the focal point of the big historic conflicts of the 20th century, but their share in the world population is now shrinking. By 2020, they are estimated to make up only 12% of the world population. By then, most people will be living in east and south Asia (nearly 30% and 26%, respectively). 13% [illegible] Africa. The [illegible] nomic vigou[illegible] t even more [illegible]

Graph 2



Why Do Some Economies Grow, but Not Others?

Economists have investigated this broad-brush picture of the world economy over the past 200 years. Some have stressed that growth requires the sacrifice of current consumption for saving and capital formation, others the better exploitation of natural resources, technical innovation, or the learning of new skills by education and training (Kasper-Streit, 1998, pp. 13-21). There is little doubt that these factors have been important, but the analysis immediately raises the question: Why did the Europeans invest more in the 18^{th}, 19^{th} and early 20^{th} centuries, develop their natural resources better, have more innovative entrepreneurs, and engage more in learning than, for example, the Chinese or the Indians?

Clearly, the answer cannot lie in genetic traits. If this were so, one would find it hard to explain why so many south Asians prosper in Britain, but not in Pakistan or Bangladesh, or why Mexicans, once they cross the Rio Grande, often become high economic achievers. Nor could one explain why a generation of “miracle growth”-producing Germans have been followed in more recent decades by a generation of economic sclerotics. And why should so many East Asians, who used to live in abject misery up to the 1960s, have suddenly joined in the economic growth experience with a vengeance? Indeed, some – such as the inhabitants of Singapore and Hong Kong – now even outperform many in the West.

The Importance of Institutions

The answer lies in certain cultural traits, social traditions and habits. A very large share of the difference between the poorest and the richest countries can be explained by the quality of the shared rules of a particular society, the ‘institutions’ that coordinate individuals. Some communities adhere to rules, which engender trust, self-reliance and incentives to perform; others have rule systems that deprive many of the fruit of their risk taking and their effort. In societies, where life, limb and property are poorly protected and corruption looms large and where the powerful can exploit the weak, economic growth cannot be sustained over the longer term. The evidence is strong that rule-guided economies, in which the citizens enjoy economic freedom, tend to be prosperous, whereas societies with pervasive and unequal restraints on economic freedom remain poor (Bauer, 1972; Berger, 1987; Scully, 1991; Kasper-Streit, 1998, chapter 14.2; Bethell, 1998; Roll-Talbott, 2001; Gwartney-Lawson, 2004; O’Driscoll, Holmes, O’Grady [Heritage Foundation], 2005).

What is the essence of the institutions that matter? Good institutions protect individual autonomy to make free decisions. They allow people to act as they see fit, unless they harm others; what constitutes harm is reasonably clearly defined by transparent and evenly enforced rules. These rules can be considered as the software of economic development, so to speak. They enable the hardware – the infrastructures, labour, skills, knowledge, natural resources, and capital – to be productive and to be enhanced.

Whenever individuals interact with others, they have to trust that their counterparts will behave in predictable ways, fulfilling promises made. This fact is so fundamental that we frequently lose sight of it. Yet, when you hand a sum of money to a bank teller to pay an account, you trust that the teller will not steal the money and the bank will remit the funds to its intended destination. When you sign an employment contract, you trust that many matters, which cannot be spelt out in the contract, will be handled reasonably and without your boss exerting undue arbitrary power over you. When you order a book from an overseas supplier over the internet and pay with your credit card, you rely on a large number of people, whom you have never met and never will. When foreign-exchange dealers conclude telephone contracts worth billions of dollars every day, they deal with complete strangers in far-away countries, whom they have to trust blindly.

Only by trusting each other, can we properly exploit the division of labour and draw on the specialised knowledge and know-how that is held in the minds of many diverse people.

Only then can we produce all the many goods and services that allow us to enjoy high living standards[6]. High living standards, indeed mankind's very survival, thus depend on a gossamer web of rules that establish trust and coordinate our manifold, diverse activities with those of others. In good societies, the rules work most of the time, despite the well-known fact that people are opportunistic, forgetful and unreliable. Rule breakers are threatened with sanctions. In corrupt societies, the rules do frequently not apply to the powerful. Then, people who strike deals cannot be sure that promises will be fulfilled. Therefore, they often abstain from even attempting certain transactions. The consequence is a poor division of labour and little experimenting with promising, innovative ideas. Consequently, economic growth remains elusive.

Without the incredibly complex, ever-changing division of labour of the modern world, all of us, if we could survive at all, would be miserable. Just imagine what your living standard would be if you were put down, all on your own, in the most favourable spot of your country, but had to fend completely for yourself, without the help of others and the tools and provisions supplied by others! Seen in this light, the modern division of labour and the use of so much dispersed human knowledge appear almost incomprehensible. Yet, all this is made possible because people's efforts are coordinated by effective institutions.

Institutions of course matter also in non-economic ways. They provide the necessary basis for all social interaction. They form, figuratively speaking, the cement that holds communities together and allows us to conduct ourselves as members of society. Indeed, shared institutions define our culture and our society. They are central to how people define themselves. If you are asked who you are, you are likely, for example to respond: “I am a Pakistani …. a Muslim”, which means that you want to be known as someone playing by Pakistani or Muslim rules of behaviour. Institutions matter so much, because people are not isolationist individuals. They rely on the company of others to bring out the best in them and to be creative, secure and confident. However, they can interact with others satisfactorily only if human behaviour is, by and large, predictable thanks to shared and respected institutions.

People, who obey appropriate institutions, will find that they are not lonely. To a large extent, loneliness — the involuntary lack of personal contact with others — seems the consequence of lacking or disobeying effective rules of social conduct. Modern cities or shantytowns are full of recent immigrants who may be yearning for the simple certainties and direct contacts of their traditional villages. In the modern mass society, much human coordination has been shifted from the interpersonal to the collective level, from civil society and voluntary associations to formalised, administrative coordination, partly by coercive, top-down rules. Many rightly regret this. In many respects, the informal rules, which served people well in traditional villages, have to be adapted to modern mass society. We have to learn new rules, which is not always an easy task. Imposed institutional arrangements are all too often tailored for "the masses" and breed unnecessary uniformity. It is therefore important that government-made institutions do not crowd out civil institutions that evolve within society, which often allow greater diversity and that are more effective in coordinating human interaction. Modern communications often help with anonymous interactions and the evolution of institutions, which centralised rule makers in governments cannot shape appropriately (see below).

To sum up the argument so far, human wellbeing in general and material productivity in particular depend crucially on the right kind of institutional system.

Rule Enforcement and Corruption

6 The almost unimaginable interdependence of people with specialised knowledge and skills to produce even the most simple product is driven home by one of my favorite readings in economics: “I, Pencil” by Leonard E. Read. It is reproduced on the *Eureka* disc.

A society's institutional foundation sometimes consists partly of formal laws, enforced by courts and the legitimated use of force by certain government agents. More often than not, however, social interactions are based on informal institutions that evolve and are spontaneously enforced within the community. Examples are ethical norms, customs, conventions, work or trading practices, and professional standards. These rules are enforced in informal, but powerful ways, such as peer pressure or the fear of losing one’s good reputation. People who continually break conventions and customs will be shunned and become isolated and lonely. Those who disregard professional standards lose their reputations, and soon their business. Dishonest traders in the bazaar will soon lack suppliers and customers, as their bad reputation becomes known. These informal institutions explain why markets often function smoothly and often with surprisingly small cost and trading losses. Moreover, the society-internal institutions are anchored in fundamental values that most of us share, such as high preferences for freedom, justice, security and equity, or a shared belief in God. Where such shared moral foundations are missing, institutional structures stand on uncertain ground and people often feel insecure.

It is now widely known and communicated internationally, which national communities adhere to the rules and which fail to do so. This is made transparent by international comparisons of economic freedom (Gwartney-Lawson, 2004; O'Driscoll *et al.,* 2005). In addition, survey data are collected by private agencies, which regularly reports on corruption, i.e. the quality of national rule systems and the reliability with which they are enforced (for example, see www.transparency.org). The corruption of the basic rules reduces the nation’s benefits from economic opportunities and globalisation. Indeed, the costs of corruption grow when the economy is opened up to international competition for trade and investment, as then the owners of mobile production factors, such as capital and high skills, migrate to more promising locations elsewhere.

Yet, despite their central importance to prosperity, a country’s institutions and shared fundamental values are normally overlooked or taken for granted. Traditionally trained economists, for example, frequently do not even mention the underlying ground rules, when they explain productive activity and exchange, or when they investigate why some countries manage fast economic growth whereas others fail[7]. They tacitly assume a country’s institutions to be given. However, if not cultivated with care and defended against the assaults of opportunistic operators, a society's institutional infrastructure will remain stunted or will even decay. In that case, the best resource endowment, the best technological knowledge and the hard work of individuals will yield relatively little economic growth. This becomes evident when one looks at countries where the institutions have been corrupted in dramatic ways, for example in present-day Russia, Vietnam, Cuba, Iraq, Bangladesh and North Korea. Observers then often blame freak weather or foreign boycotts for economic failure, rather than a lack of effort-inspiring institutions and shared values.

By contrast, the international observer, who is aware of the crucial role of institutions, cannot help but conclude that, in countries with poor economic freedom and widespread corruption, ordinary people have to work extremely hard, yet are able to earn relatively little material reward and that poverty is caused by the deficiency of the key economic institutions. It is the consequence of insecure property rights, over-regulated markets, and a system of governance and law that favours the privileged.

Competition-supporting economic rules and the rule of law are likely to emerge and be adhered to more consistently in electoral democracies, which is a system of competition for (temporary) control over political and certain general rule-making powers. But in many developing countries, intellectuals have often considered democracy as a way to rule much

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7 Thus, the World Bank, in its annual *World Development Reports*, took a long time to even mention the importance of institutions and still often displays a preference for the intervention of the ‘visible hand’ of the state to obtain specific outcomes, rather than the cultivation of rules that discipline market-driven evolution.

detail in society and the economy (*dirigisme*), rather than a method of controlling and constraining ruling elites.

Institutions and Value Judgments

At this point in our discussion, an explicit word seems required about a fundamental methodological point. No discussion of institutions can be value-free. This is therefore an exercise in normative economics. The arguments are influenced by the author's personal preference for a free, prosperous, secure and peaceful society. Some readers may be more comfortable with purely positive economics, what is, rather than what ought to be. They may, for example, want to confine the analysis to the choice between *known* alternatives of how to meet *known* human wants with *known* resources. But this is not very useful for understanding economic development and guiding public policy in a developing country where many wants and many resources are unknown. It is therefore inevitable to be judgmental and normative, judging what is good and bad, if for example, one decides to suppress thievery to promote wealth creation by everyone (Olson, 1996).

The choice, and the reform, of institutions require a subjective preference for wealth creation in the hands of the broad majority of citizens. The intellectual luxury of value-free analysis is therefore not available to those who discuss institutions and constitutions. These rules invariably affect fundamental human values, such as freedom, prosperity, security and peace in the community, which are dear to most people of all cultural backgrounds. It is of course not easy to evaluate alternative institutions against such abstract criteria. But a good starting point in sorting good from bad institutions would, in my opinion, be to ask two questions:

(a) Does a specific rule enhance people's freedom of choice?

(b) How does a specific rule affect the life opportunities of the poorest 20% of the population in the long run?

The answer to the first question will give pointers to the quality of liberty, which is central to the attainment of so many other fundamental qualities. The answer to the second would shed a light on the degree of equity between rich and poor.

In the following chapters, I hope to show that the competitive efforts of the many in discovering and testing what serves them best (the market) normally offer outcomes superior to the centralised top-down approach (government control and provision). The main reason for this is that government agents often simply do not know enough. They act instead on a dangerous pretence of knowledge — to cite the title of Friedrich Hayek's famous lecture, when he received the Nobel Prize in economics (Hayek, 1974/84). Moreover, political leaders are all too often driven to activism by their own political and material interests. They care little what uncertainty, disadvantages, compulsion and conflict their decisions impose on ordinary citizens.

It seems therefore appropriate to explicitly acknowledge the basic fact that we are discussing normative value judgments, when we foster a system of rules, which empower all citizens to freely pursue their own purposes.

Economic Growth: Is It Worth Having?

Before we can leave this opening chapter, it seems useful to discuss explicitly whether economic growth – the sustained increase in average real per-capita incomes – is at all desirable. The desirability of higher living standards is not an issue for the majority of citizens in most poor countries. But many people in the affluent West, who take high living standards for granted, as well as religious leaders and power brokers in poor countries sometimes express fundamental doubts about the desirability of economic growth.

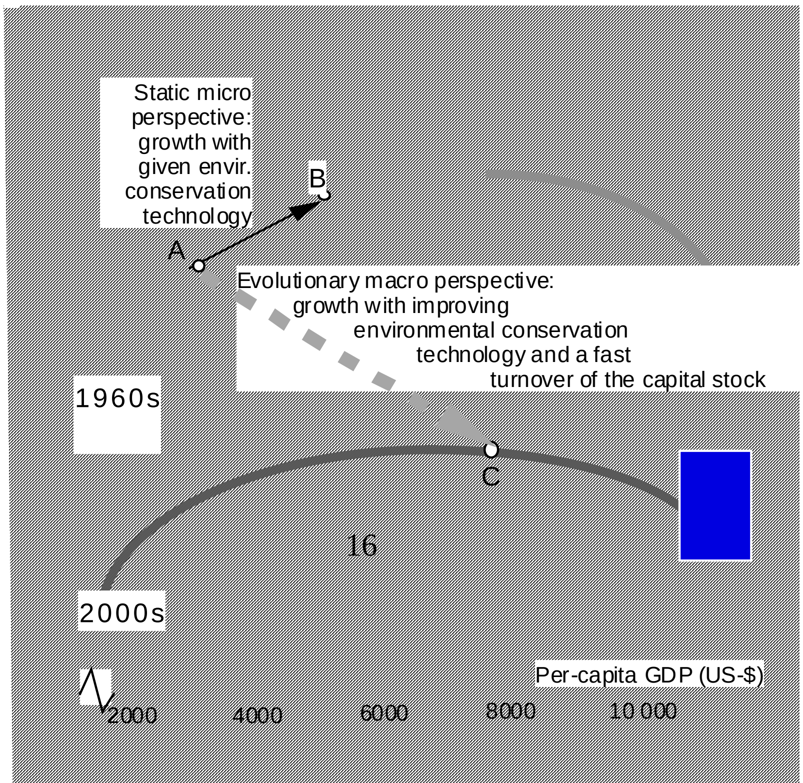
Economic growth inflicts costs: First, the present generation has to sacrifice instant satisfaction and consumption to put some product aside for capital formation and learning, so that subsequent generations are better able to produce more. Our distant ancestors, who gave up leisure time and consumption to search for more resources in order to shape digging sticks (a capital good) incurred that ‘savings sacrifice’. Now, parents are forgoing consumption to send their children to costly education (investing in human capital) or business people channel profits into improving their businesses (investing in physical capital).

A second cost of economic growth is that it demands manifold structural changes. Economies, like trees or other living organisms, inevitably change their structural composition as they grow. Thus, the income share (and the political influence) of agriculture tends to shrink as economies grow at the less-developed country income level; secondary industry is the growth leader, increasing disproportionately fast. This development was evident in the industrial revolution of the 19th century in Europe and North America. It went along with rapid urbanisation, deficient infrastructures and services, the growth of urban slums and other phenomena of early industrialisation, which are only too familiar to contemporary citizens of Third World cities. Structural economic changes bring about changes in power structures. Rural feudal elites may loose out to rising industrial groups, or – later in the development process – new service industries gain political clout over established industrial interest groups.

Many observers focus critically on a third problem with economic growth, environmental exploitation and pollution. Experience in the old industrial countries – and more recently in the new industrial countries of the Third World – has shown that this is indeed often a problem. But it can be made a transient one. Continuing growth to higher levels of affluence goes typically along with improvements in environmental conditions (Kasper, 2005b). As incomes keep rising, manufacturing ceases to be the growth engine, and the service sector – the knowledge industries – take over, generating high incomes, but relatively little pollution.

To understand this, one has to guard against a comparative-static micro perspective and look at the evolutionary-dynamic ‘macro picture’ of economic development. By observing development only from the ‘micro perspective’ of an individual developing region of a given production technology, one can easily fall prey to the common fallacy of equating economic growth with worsening pollution. If, for example, one only looks at the development of a heavy-industry area, one can easily make an association between economic growth and environmental degradation. Yet, countries with high levels of economic activity, such as Switzerland or the USA, have used their wealth in part to clean up the environment. In addition, there is a powerful effect at work, namely the improvement of production technologies over time. By the year 2000, people at every level of income tend to produce lower levels of pollution per unit of output than was the case 30 years earlier (see Graph 3). Indeed, progress in environmental improvement has been fastest in the fast-growing economies, because polluting old technologies were replaced relatively fast.

Graph 3 illustrates this oft-repeated point in conceptual on terms. At any one point in



time, production technology comes with a given trade-off between different levels of output (per capita) and environmental damage. Output growth thus goes along with rising levels of environmental damage in a given place and over the short run (we move along a *given* production function). However, over longer periods, technologies improve, so that a given per-capita income can be generated with less pollution per unit of output than before. In other words, the production function shifts, as economists would say. From short-run observations and a comparative-static viewpoint, one will observe a move from point A to B and may then extrapolate into the future, predicting dire outcomes (static micro-perspective). But as all of industry evolves over time with reinvestments and innovation, the trade-off curve shifts downward (in Graph 3, a shift of the curve from its 1960s to 2000s position). Consequently, income growth amounts to a move from point A to C. Long-term economic growth is therefore rarely accompanied by cumulative environmental degradation. In reality, the opposite normally holds true and a dynamic-evolutionary macro perspective is the appropriate view to take. As societies grow richer, they enjoy cleaner environments, too, as innovators respond to environmental problems, developing cleaner technologies. Observed environmental problems in developing countries are indeed often the result of deficient economic growth (Norberg, 2001)[8].

Graph 3

Similar evolutionary improvements can, incidentally, also be demonstrated for many other alleged drawbacks of economic growth. The lesson is to look at the problems over the long term and with the assumption that human intelligence is able to tackle evolving problems in constructive ways (Kasper, 2005b).

At the same time, it needs to be acknowledged that economic growth confers massive benefits. It is worth listing the following:

- Economic growth raises living standards. It does not merely generate more unwanted junk, as some allege. Markets respond, after all, to what people appreciate. If people are prepared to use their growing incomes to pay for better entertair ultural goods, education of their children, health care and better nutrition, supp ll cater to that demand. Growing economies also allow people to overcome na lamities more easily, for example by the distribution of emergency aid after a bac t.
- Economic growth has been closely associated with the reduction of absolute poverty. During the 1990s, for example, there was a telling association between the growth of per-capita incomes and the reduction of the population share of those who have to survive at or below the World Bank's poverty measure of US-$ 1 a day. Where economic growth was high, the material benefits also trickled down to the very poor, as the following comparative World Bank figures for the 1990s show:

Region	Real income growth (% p.a.)	Change in poverty (%)
— East Asia/Pacific	+ 7.1	– 12.9
— South Asia	+ 3.9	– 4.0

8 The logic underlying Graph 3 can be drawn upon to make the point that Karl Marx was fundamentally wrong: In *Das Kapital,* he had stipulated that increasing capital accumulation would lead to an ever-decreasing output contribution by each additional unit of capital input. From some point, the added output would not pay a sufficient return to the capitalists. The whole system would collapse. This prediction has repeatedly proven to be premature, because the production function (relation between capital inputs and outputs of product) is ceaselessly being shifted by innovators. New ideas raise capital productivity, and old capital sometimes is superseded and has to be written off. Marx' static view of production misled him (and still misleads many Marxists), whereas in reality the entrepreneurs and the engineers keep the capitalist system dynamic and thereby save it!

— Mideast/N. Africa	+ 0.6	– 0.3
— Latin America	+ 1.8	– 4.7
— Sub-Saharan Africa	+ 0.4	+ 0.1

- Growth goes along with falls in child mortality and rises in human life spans. People live healthier lives. They remain self-reliant into their high 80s. By contrast, the average life expectancy in poor, traditional societies was often a mere 40 years.
- One of the benefits of rising living standards is that communities can afford better education, which in turn facilitates future economic growth. Rising literacy tends to be accompanied by an improved social status of women and more effective birth control. This again helps to raise productivity growth.
- As societies become more affluent and educated, people become more assertive of their inalienable human rights and more skeptical of autocratic political control. Thus, the 1960s generation in the East Asian growth economies concentrated on economic opportunity, and often tolerated autocratic rule. Their children had the education and material means to demand more democracy — and did successfully (Kasper, 1994b). Similar trends are now showing up in south Asia. This may of course lead to conflicts between modernisers and reactionaries, as it did after the take-off into modern economic development in Europe, the US and Russia. When these challenges of modernisation, individualism and secularisation are not resolved by institutional adjustments, conflicts and backlashes may hold up economic growth.
- If there is a political preference for economic growth, politicians will promote freer international trade and investment as a major driving force of economic progress. A resulting greater material stake in neighbouring countries, in turn, is normally a force for peace — as the great 19th century French liberal Frédéric Bastiat put it: “If goods do not cross borders, soldiers will”.
- Different from what Marxists have predicted, inequality among people in growing, free economies diminishes. Admittedly, the short-term micro perspective at the early stages of economic growth may suggest otherwise: In the take-off phase, the growth process benefits only some, who become wealthier, but not yet others. Indeed, the take-off into economic growth tends to offer the poor and uneducated rather some small material improvements. More of them are able to survive, albeit as poor slum dwellers. So, we observe more poor people. Before take-off, their forebears had simply died; now, they swell the ranks of the poor, which gives the impression of a deterioration. However, over the longer term, higher incomes trickle down and “democratise” rising living standards. It is one of the most challenging tasks of the leaders in any poor country to ensure that the economic opportunities of the growth economy spread quickly and evenly. Free markets and the fight against political corruption are the most effective means to this important end (Norberg, 2001, 77-83).
- Many less developed countries have benefited from prosperity in rich, free economies. The capital-rich sooner or later share their abundant capital by investing in less developed countries, at least those which offer secure property rights and stability. To be sure, investors from affluent countries select those jurisdictions that offer them economic freedom and secure property rights. Attractive locations in the Third World (such as Singapore, Taiwan or Thailand) have seen the development of modern industries within one generation, accompanied by most of the blessings of economic growth, as discussed here.

Different from what the social activists in the "fear industry" commonly assert, the increase in human numbers has not led to worldwide environmental catastrophes. Rather, we experience frequent improvements — some atrocious localised disasters notwithstanding (as a recent survey of more than 50 leading experts documented, Simon, 1995). Nor will the process of economic growth come to an end because of limitations of available physical resources, as many physical scientists surmise. After all, economic growth occurs in an open system. Higher living standards reflect not just a growing use of (ultimately limited) natural resources, but the higher valuations of the molecules that humankind takes from nature! Thus, we register economic growth because we take a mere grain of sand — an abundant resource — and add enormous value by applying knowledge to make valuable silicon chips from it. Modern economic growth owes little to the exploitation of nature and much to wealth creation and exchange among knowledgeable people (Kasper 2005b).

All this does not mean that economic growth can be taken for granted. Local catastrophes and episodes of economic decline (such as the decay of the Roman empire into the Dark Ages, the Chinese economic decline in the modern era, the disintegration of the world trading system in the 1930s, or the economic collapse of the Soviet empire) are stark reminders that economic growth has to be nurtured carefully. Economists are agreed that growth is a complex process in which numerous, interacting conditions have to be met. The main source of economic growth is human knowledge, not only the wisdom, knowledge, know-how and aptitudes that reside in the individual, but equally importantly the shared human capital embodied in institutions. They allow individuals to make the best of their assets and to explore improvements.

Ultimately, it is of course up to each citizen to weigh the pros and cons of economic growth and to decide whether to welcome economic progress. Those who are opposed to growth have, it would seem, a major task in convincing others that growth should not be pursued as a goal of public policy. What seems morally unacceptable, however, is that affluent elites in rich countries try to enforce rules which deprive the citizens of poor countries of the freedom to make their own decisions whether they want economic growth or not. Those, for example, who argue for protecting nature, the earth or agricultural producers in rich countries by coercive political means at the expense of the development opportunities of the poorer segments of the world population, commit a gross injustice.

Let everyone on earth choose their material life opportunities and pursue them within free and just institutions.

CHAPTER TWO

THE ECONOMIC PROBLEM: COORDINATION, KNOWLEDGE AND MOTIVATION

"It is the great multiplication of the productions of all the different arts, in consequence of the division of labour which occasions, in a well-governed society, that universal opulence which extends itself to the lowest ranks of the people".

Adam Smith (1776/1970-71), p. 10

"... rational action is possible only in a fairly orderly world. Therefore it makes sense to try to produce conditions under which the chances for any individual ... to achieve his ends as effectively as possible will be very high .... [P]rotection of private initiatives and enterprise can only ever be achieved through the institution of private property and the whole aggregate of libertarian institutions of law."

F.A. Hayek (1978), pp. 183-190.

To understand the importance of institutions in economic life, one has, first, to understand what an economy is. It is an extremely complex, evolving system — not an organisation where top-down commands can be relied on to produce all wanted outcomes. It is a living organism with an unimaginable multiplicity of complex interactions that evolve over time, often in the light of experience. We face the economic problem of scarcity because we do not know where to find sufficient resources and how to match them with our diverse and changing wants. If we had perfect knowledge of all our resources and wants, the problem would be much less intractable than it is in reality.

In the venture of matching changing wants and changing resources, which is at the core of economics, the knowledge problem is pervasive and compounded by a frequent problem of motivation. We have only limited solidarity with complete strangers, on whom we frequently depend. People often fail to make sufficient efforts to satisfy our wants. We need to be specifically motivated, either by love, by compulsion or by appeals to our self-interest.

As we shall see later, institutions are devices that economise on what people have to know to be effective. They also assist with people’s motivation to contribute to the satisfaction of the wants of others, when love does not come into play and coercive force is unacceptable (see "Institution" in the Glossary). Therefore, institutions are central to every adult's economic pursuits.

The Economic Problem: Scarcity

Every beginner's text on economics starts by making the point that the essence of economics is scarcity — human wants having the tendency to exceed the resources needed to satisfy them. The human ability to discover more wants than resources to meet those wants has been an eternal obstacle to human contentment. The Biblical description of the Garden of Eden can be interpreted as the reflection of a yearning for a world without scarcity. In the Judaeo-Christian and the Islamic traditions, the economic problem has been tied to the concept of original sin and economic pursuits are frequently associated with avarice and greed. Other civilisations, such as the Chinese, have adopted a more cheerful and pragmatic stance to all matters material.

Scarcity forces people to make choices between alternatives. The choice of one use of resources means that other opportunities have to be foregone, for example your purchase of a new car may mean that you cannot afford an overseas holiday (or as economists might say: “The opportunity cost of your new car is this year’s overseas holiday.”). It is clear that everyone's opportunity costs vary subjectively. For you, the opportunity costs for reading this chapter may be that you cannot attend a rock concert, for someone else that she cannot flirt with her boyfriend.

As we live in an age of dynamic changes, we have to conceive the economic problem as a dynamic one. The human imagination continually discovers new wants, and a major part of the human pursuit is to search for and develop new resources and new methods to use them effectively. Opportunity costs change constantly. Economics may seem a dismal science when seen in a static setting — the attempt of rationing scarcity. But it becomes a cheerful subject when one studies how people have incessantly searched for and found ways to satisfy their diverse and growing wants and to attain their changing purposes. As we saw in Chapter 1, the past 200 years have seen an enormous rise in living standards, beginning in Holland and Britain. Now, the economic growth experience has spread to an ever-wider circle of communities around the world, so that the traditional economic conditions of hunger, filth, epidemics, ill health, boredom and early death has been overcome in more and more societies, even though, stagnation and acute human misery still exist for a decreasing part of humankind.

The Economy as an Evolving, Complex System

Since we satisfy our diverse wants in the pursuit of changing and self-set purposes by using increasingly diverse inputs, we have to draw on the productive contributions of more and more people. As a consequence, the modern economic system has become incredibly inter-dependent and complex. It never stands still or simply reproduces what was done before. Much of economic life is about new wants, innovative resource uses, new technologies, better ways of organising factories, commerce and service delivery, and testing new goods and services. In that sense, the economic system is open-ended (O'Driscoll, 1977). It evolves in unknown and unpredictable ways — who could have predicted how computers and the internet have been changing our lives!

We need to pause here and define carefully what is meant by "system", "complex" and "evolving". An understanding of these definitions is essential to understanding the contemporary economic problem.

We speak of a "system" when various elements interact in a fairly regular pattern. My watch is a system, as is my university department. The global telephone system, the Internet, world trade, and international currency markets are other examples of such constellations of systematically interacting elements. A system is simple if the parts interact only with regard to one characteristic. Thus, the battery in my watch drives the handles. We speak of complexity when elements interact with regard to more than one characteristic. Thus, my university department is a web of complex social interdependencies and feedbacks. So are world currency markets, where numerous hard-to-comprehend interactions take place among millions of decision makers, who never meet personally.

Some systems are static, repeating the same interactions in each period (for example, my watch until the battery is flat). The economy is an example of an evolving system: We learn new knowledge and apply it. Others may select or reject the results, so that some concepts and elements gain critical mass and become widely accepted, others vanish. Economic evolution follows a path influenced by old structures, as well as memories of the past. Future directions are in our diverse imaginations. They can therefore not be precisely known to any one mind. With hindsight, the evolution of the system is evident. But its direction and detail cannot be easily predicted, as no-one knows beforehand what selections the many individuals will make when faced with changed circumstances (see "Evolution" in the Glossary at the end of this volume).

We speak of an evolving system if successive states of the system follow a path of change. However, when too many elements change at once, we cannot decipher what happens and feel confused. Take, for example, a television picture. If only a limited number of pixels change, we can follow what happens. However, when all, or a great many, pixels change at random all the time, cognition breaks down and we can make no sense of what we see. Similarly, overwhelming changes in economic life lead to massive mal-coordination because people get confused. This was, for example, the case after the Soviet revolution when markets and private property were abolished. Economic chaos resulted, so that Lenin had to backtrack by re-introducing markets in some areas. Likewise, there are indications that many citizens have been overwhelmed by the many changes in recent decades, when overdue economic reforms were instituted. People have lacked guiding institutions that would have made their cognition task more manageable. It is therefore normally in people's interest that systems change gradually and with a certain pattern that can be understood.

In relatively simple systems, someone in command can establish order, because he can understand all interactions, what is needed and what consequences will follow from certain actions. But the cognitive capacity of those who wish to impose order are sorely overtaxed when the system at hand is complex, let alone when it evolves over time, as is the case, for example, in an ecological system or a national economy. Even when complex systems in line with a broadly predictable pattern, specific outcomes may not be predictable and cannot be easily achieved. If a visible "ordering hand" intervenes in such complex, evolving systems, this is likely to produce unforeseen and often detrimental consequences (Hayek, for example 1974/1984 and 1988; Parker-Stacey, 1995).

In recent decades, complex, evolving systems have come to be better understood by scientists (Anderson *et al.*, 1988; Parker-Stacey, 1995). We have, for example, learnt that ecological systems are complex and evolve, so that human interventions often lead to unexpected, deleterious side effects. Ecologists admonish us rightly to be cautious when tangling with nature. Likewise, medical research has shown us what a complex evolving system the human body is. Some cures turn out to be worse than the ailment. Likewise, with regard to an economy, we do often not know enough to intervene. Here, too, it is always wise to tread carefully when tangling with the systems.

Alas, many policy makers (and many ecologists, who demand economic interventions) disregard this fundamental lesson when they deal with the web of economic life. In a national economy, after all, millions of individuals interact in complex ways as producers and suppliers or buyers of goods and services, or as owners and users of assets. What happens in a distant part of the global economy may have untold effects in a factory or a field near you. For example, when oil supplies were curbed in the early 1970s and then again in the early 1980s or when China stepped up oil demand in the early 2000s, this affected virtually everyone on all five continents. The price rises sent a coded signal to millions of people to drive less, to buy energy-saving cars, to save energy in home heating, industry and transport, to replace petroleum products by other sources of energy, to build new nuclear power plants, to search for oil in new areas, to crack petroleum differently in refineries, to redesign technology and factories, and so on. Many of these changes had follow-on consequences for other producers, sometimes reinforcing, sometimes mitigating the original petroleum-price effect. When such challenges occur, some observers tend to go as far as predicting the end of modern civilisation. Yet, numerous decentralised, spontaneous, flexible, creative adjustments always have overcome such crises. Admittedly, this costs effort and sacrifices, but humankind has always gone on prospering. Where an ordering hand intervenes in this complex system, for example by fixing gas prices, queues, hold-ups, political disputation, chaos and unforeseen complications have often been the result.

Is it not paradoxical that people, who preach caution when intervening in complex eco systems, are still often advocating interventions in equally complex and evolving economic life? They pretend such interventions are feasible and their effects can be fully predicted and controlled. Indeed, they often demand such interventions in economic processes on the assumption that one can intervene without any unforeseen, hurtful side effects. Many policy commentators and academics still have a fundamental belief in the visible, coordinating hand of government — as if governance was as simple as pushing a few policy buttons! Disappointments with simple-minded interventions in the past do not seem to teach most of us that such a style of push-button policy is not feasible. Numerous academic and media commentators persist with a preference for what has long been castigated as "social engineering" based on an unrealistic "pretence of knowledge" (Hayek, 1988). Policy advisors and academics typically operate with econometric models, which are closed off to future evolution, assuming that interactions will continue as in the past[9]. The more realistic evolutionary — so to say "ecological" — view of economic life has not yet been widely absorbed into the popular culture of most nations.

Ignorance, Discovery and Knowledge

In complex, evolving systems, knowledge becomes a central focus. Who can master what knowledge? How can various people's limited knowledge be coordinated? How do people discover new information and absorb into cohesive bodies of knowledge? How is knowledge tested and rejected in the course of evolutionary change? What are the best condition devices for discovering and testing knowledge that other people may find useful? These are some of the questions that are explored by philosophers under the rubric of "epistemology" (from Greek *episteme* = knowledge, Kasper, 1998a).

When discussing knowledge, one has to begin with a fundamental insight: Everyone has cognitive limitations. Our five senses do not allow us to read the complex world around us completely, and different people recognise different aspects. In addition, we have only a limited mental capacity to reflect and assimilate the new information that our senses pick up into a body of useful, cohesive knowledge. We therefore easily suffer from information overload and then cannot make sense of unfamiliar environments.

Because of this pervasive knowledge problem, it makes no sense at all to build models of human action and public policy assuming that people, or committees of policy makers, have 'perfect knowledge'! One cannot legitimately assume the vexatious knowledge problem away and still hope to explicate economic issues. The knowledge problem is *constitutional* to the economic problem. Were we all knowing, scarcity would not exist! As Hayek has pointed out, models that begin by assuming perfect knowledge "for simplicity's sake" lead to nonsensical answers (Hayek, 1948, p. 94; also see O'Driscoll-Rizzo, 1985, ch. 6; Kasper, 1998a).

We can illustrate this fundamental point with a non-economic example: It makes no sense to start analysing ballistics on the assumption that gravity does not exist. Gravity is a first-order (or constitutional) element of the subject at hand. One may of course begin by assuming second-order elements away, such as humidity, air temperature, and wind, when analysing ballistic trajectories. Likewise, economists who assume perfect knowledge have unwittingly assumed the essential economic problem away — how to find and use evolving, complex knowledge! They have reduced economics to the petty issues of

9 Econometric models cannot be solved easily if there are too many unknowns. This, is why model builders have to make assumptions of no change in the future or operate with ill-justified “dummy variables” for what they cannot measure. Such modeling often creates a false sense of certainty where, in reality, extreme caution would have been justified. For example, numerous financial models of financial markets in Asian countries notwithstanding, the “Asian financial crisis” of 1998 surprised most economists. Had they focused on the institutions of well-functioning financial markets, and their corruption, they could have anticipated and averted some of what happened.

allocation of *given*, *known* resources to *given* wants with the aid of *known* technologies (the reader may wish to refer to the "Postscript" on neoclassical economics at the end of this chapter). In such a closed, anaemic world, there is no need for profit, entrepreneurs, and business management. Where everything is known, there is no need for business law and risk analyses. Businessmen, lawyers, risk managers and other practitioners — rightly –– switch off when economists make the assumption that all relevant knowledge is available. They know that this is simply not so.

Knowledge is best understood if we consider it an open-ended, evolving stock of abstract ideas — information and concepts, which are held, dispersed in millions of human minds. They cannot possibly be concentrated in any one place or human mind. All the time, completely new facts are discovered. New ideas emerge. By targeted search or chance discovery, complementary information is found and then tested. As circumstances change, ideas that were once useful may lose their usefulness to some or many people, and new ideas are selected and accepted. In ways similar to biological evolution, the body of human knowledge thus evolves under the influence of millions of decentralised human choices[10]. Economic development thus is the result of millions of little knowledge revolutions.

We have to distinguish in this context between genuine discoveries and new supplementary information (Kirzner, 1997). We should speak of a discovery when something becomes known of which a person or a community were previously totally ignorant. With hindsight, discovered facts will often be obvious. For example, we speak of the discovery of America, as Europeans were unaware of the existence of that continent, and of Matthew Flinders' discovery that Tasmania was not part of the Australian mainland. A second-order type of ignorance exists where the big, general outlines of human knowledge are vaguely known, but the details have to be filled in by supplementary information. Here, we speak of "information search". Thus, the explorers who traced the coastline, the engineers who got nuclear power to work in power stations, the software developer who tests serial combinations to get new computer programs, and the market researcher who establishes where sales outlets should be placed — they are all engaged in a mere search for information. They are not after breakthrough discoveries. When we deal with information search, we probably know enough to judge what is a more or less efficient way of getting results. By contrast, it would be nonsensical to speak of efficiency in making discoveries because the object is totally unknown. Thus, Christopher Columbus cannot be called an "efficient discoverer", because he chanced upon America. All we can say is that he had attributes of curiosity and tenacity that made him more likely than others to discover some genuinely new knowledge and that he was prepared to marshal resources for exploration (Readers confused by the study of neoclassical economics, who have been indoctrinated by the assumption of perfect knowledge, should refer to the 'Postscript' at the end of this chapter).

The knowledge problem in economics is further increased by the fact that everyone has different knowledge and that diverse people pursue their own, differing, subjective purposes. Everyone values available options subjectively, in his personal manner. People will not necessarily chose what others have chosen. Since one's own opportunity costs depend on one's subjective and changing preferences, these costs cannot be readily known to others. This of course adds to the knowledge problem in economic life. It also means that collective choices affect everyone's well being in different ways. "One size fits all" may suit you, but be hopelessly inadequate for me. Summary collective purposes can therefore not be imposed on entire communities without great losses to individual satisfaction. This is at the heart of what has been called "subjectivism", a conception that

10 In one important respect, the evolution of human knowledge differs from Darwinian, biological evolution. Biological variations are random and selection does not depend on intelligent, willful decisions, whereas human knowledge is often varied and tested by human will.

has profound implications for one's world view and for how one wants public policy to be run (see Insert).

Insert

On Subjectivism

Since we cannot know fully what our fellow human beings feel, know and want and since we must accept that they will want to pursue their own self-set purposes, we must respect differences in subjective valuations. This is the maxim of "subjectivism".

It is often disregarded when individuals hide behind collectives or when it is assumed that, somehow, collectives act and pursue goals, which are separate from (or superior to) the goals of the diverse individuals who form a community. Individuals always make valuations and decisions. Sometimes, they consult with others and act out of altruism. But often they pursue only their own ends, all the while pretending they decide for the common good. It is part of the art of politics to disguise decisions as “in the public interest”, when in reality they promote their careers or the party’s political fortunes.

In the ultimate analysis, only individuals know and decide. One therefore has to focus first on individual pursuits to understand social interactions. This is a central tenet of "Austrian economics", indeed of all individualist conceptions of society. This insight drives one to be wary of collectives as pseudo actors. It forces one to focus always on the real actors. Once presumed collective motivations are brushed aside (example: "the government wants to maintain tariffs in the national interest"), one comes to a much better understanding of public policy. One might then say, for example: "The industry minister upholds tariffs that discriminate against consumers and benefit companies A, B and C, who are prepared to share the windfall with the minister and his political party!"

Readers are invited to be on the lookout for statements that imply phoney collective actors (such as "the world community", "African opinion", "the national will", “it is commonly believed”) and to translate these statements into subjective, individual terms. Consider such exercises as truth-finding devices!

Three Kinds of Rationality

When they act in complex, evolving environments, individuals typically adjust their aspirations in the light of achievements and failures (*adaptive or bounded rationality*). But sometimes, they all of a sudden tackle long-tolerated constraints head-on, trying to overcome them (*creative, entrepreneurial rationality*). Only in simple and repetitive circumstances do people uphold fixed objectives, which they maximise with known, available resources (*end-means rationality*).

When faced with incomplete knowledge, decision makers do not go on indefinitely chasing additional knowledge, until it is “perfect”. After all, knowledge acquisition costs resources, time and effort — it causes what economists call "transaction costs". And the world changes anyway. Instead, experience tells decision makers when they should probably end the information search and make a decision based on what they have been able to learn so far. Men of action will not allow themselves to remain moored in "paralysis by analysis". When past experience shows them that they consistently under- (or over-) fulfilled their aspirations, they will adjust their aspirations downward (or upward) (Simon, 1982; Streit-Wegner, 1992).

Such pragmatic behaviour is a far cry from the end-means rationality that underlies most contemporary economic analysis. *Homo oeconomicus* is assumed to know all the ends and all the means and will then maximise his utility. Standard textbook economics is accordingly based on the assumption that people set themselves fixed goals (such as a profit or material satisfaction) and then maximise them on the basis of perfect information about all relevant alternatives. Yet, it is only possible to maximise the achievement of given ends when the situation is simple, and hence can be fairly fully known. Thus, a self-contained household in Antiquity could, after the harvest, plan survival to the spring by "economising" (this effort of rationing scarce resources was called "*oikos*" by the ancient Greeks). Thus, engineers may "maximise" the performance of a given machine. Thus, we may aspire to maximise the distance we can jog within 30 minutes. However, in more complex constellations, we do normally not know enough and cannot control what is going on to engage in such a "rational" pursuit of a given end. Then, narrow, end-means rationality has to give way to bounded rationality. This important point can probably be best understood by discussing an every-day example: I can make a rational choice as to which of my shirts best matches the colour of my suit today, but I cannot make a rational choice as to where on earth I will optimally live for the remainder of my life! The narrow rationality of neoclassical economics would be totally inappropriate for such a locational choice. End-means rationality is an inappropriate guide to analysing evolving complex constellations, such as what is typically the object of economic policy, let alone of long-term economic development.

People do not always adapt their aspirations to what they believe to be feasible. At times, they decide to tackle existing and hitherto tolerated constraints head-on: They take a "creative leap" and act entrepreneurially. Thus, someone may try to overcome resource, technical, social, or institutional constraints by launching into an innovative venture. Such action is risky, but it promises gain. It is wholly rational, too (see Insert below).

Creative, entrepreneurial rationality is typified by two things: an alertness to opportunity and a preparedness to incur the necessary search costs (Schumpeter, 1961; Kirzner, 1997; Kasper-Streit, 1998). Entrepreneurial behaviour is fairly prevalent when people have confidence and feel in control, even if they can never be absolutely sure of the results. Where people are free to use their assets and talents, without asking anyone’s permission, many will be enterprising in searching for new ends (satisfactions of wants) and means (resources). Entrepreneurship and dynamic development are at variance with the end-means rationality of *homo oeconomicus*. As we shall see, discovery and the use of knowledge, which are so important to economic development, prosperity and job creation, depend greatly on the prevalence of the entrepreneurial spirit to break away both from end-means and adaptive kinds of rational behaviour.

When one allows for adaptive and creative behaviour — rather than just the maximisation of given ends by known means — one begins to appreciate the importance of devices that economise on the need to know, namely institutions that create confidence. Economists who approach what is an open, ongoing process of economic life on the familiar assumption of *ceteris paribus* (all other things being known and remaining the same) and who operate with the artificial construct of *homo oeconomicus* are blind to these different kinds of rationality in the real world. They fall into the trap of an unrealistically narrow kind of "economic rationalism" and they deserve the criticism that this concept has been subjected to in recent public debate (see the following Insert and the 'Postscript' at the end of this chapter).

Insert

About Economic Rationalism

The term "economic rationalism" has been given many and contradictory meanings in recent times, so that it has become meaningless other than being an all-purpose invective against those who advocate less collectivist-statist economic policies and the reprivatisation of responsibilities for personal economic welfare. Those who argued this line of policy in the 1980s never shared a common methodological base. Some, including this author, came from classical liberal philosophy and Austrian-institutional economics, i.e. held economic life to be an open-ended complex and evolutionary phenomenon. Others — in particular international organisations, pro-market government agencies and model builders — worked with models that had been closed to unforeseeable future events, in line with the assumptions of neoclassical economics. Because of these methodological inconsistencies, the advocacy of less government and more market lacked cohesion in many countries. Reforms have suffered from the setback of a "retro fashion" in economic policy making, namely again extending tariffs and other privileges, picking winners to receive government subsidies, and obstructing the liberalisation of markets. Consequently, economic reforms in many countries have followed a political zigzag course, often confusing investors, consumers, and young people about the long-term institutions and making the reforms unnecessarily costly to ordinary citizens.

What Motivates Us?

Another fundamental consideration in discussing the economic problem is motivation. Individuals are sometimes motivated by love (altruism) and coercion, but — in the modern mass society where millions interact — people are normally motivated by self-interest (Boulding, 1956/1977).

Most of us have experienced motivation first on the plane of altruism, solidarity, and love in the small setting of our family. There, we knew each other fairly intimately and could influence their reactions. Altruism is a highly effective way of cooperation in such small communities (Hayek, 1976, pp. 133-152; Boulding, *op. cit.*; Giersch, 1996). Yet, even in small communities — though kind souls may regret this — love and solidarity have frequently to be backed by authority and coercion. The parents — or tribal elders — have at times to threaten and coerce others in the group. This tends to be tempered by empathy and intimate knowledge of the others. In modern macro societies, we interact with millions of strangers and depend on their motivation to fulfil their promises to us. We cannot depend on love alone because we do not even know many of those people with whom we interact. Solidarity and benevolence decline quite naturally with social distance. Therefore, other motivating mechanisms are needed, either compulsion and fear, or self-interest.

The latter is the main motive that drives human cooperation in the capitalist market economy. People pursue their own ends, generating by-products which are welcomed by others. Shocking as it may appear to some readers, the baker who provides you with your daily bread, the doctor who makes a house call in the middle of the night and the employer who provides you with a job, do so because they are after an income. Your bread, health care, and jobs are mere by-products of their selfishness! Whether such a system works well, depends — as writers from David Hume and Adam Smith to Friedrich Hayek (1989, pp. 6-47) have pointed out — on the institutional system, an extended order which co-ordinates spontaneous human actions as if by an invisible hand.

Those who reject self-interest as a valid motivation — for example Fabian socialists and idealistic religious leaders — have to demonstrate how else millions of people will provide for each other without coercion. This requires that the leaders know (i) what the people want and are able to achieve, (ii) what their agents are doing, and (iii) that they can induce discovery procedures by coercion. These conditions are rarely fulfilled, as we know. They were certainly not fulfilled in the Soviet economy or under Mao's repressive regime. Under these alternatives to market motivation, quality standards and choice were appalling; innovation was so poor that the system was near collapse.

As already observed, the voluntary coordination of self-interested people and organisations requires shared, respected rules. People can only interact effectively, given their cognitive limitations, if recognisable, predictable patterns of behaviour exist. They depend on an "order of human conduct", which normally requires that arbitrary and opportunistic behaviour incurs punishments (sanctions). In other words, the division of labour comes into existence only if the institutions are conducive to the sustainable interaction between free, self-motivated individuals. The rules will be more effective in stabilising behaviour if they themselves are stable or evolve along predictable paths. This holds true *a fortiori* for communities where there is a tradition of small-scale coordination, say at village level, and where all of a sudden a new generation moves to cities and produces in industries that operate in world markets. Stability and coordination cannot be derived from extrapolating the past. In these circumstances, the coordination by simple and stable rules is doubly important for material progress and social harmony (see Chapter 4 below).

Human interaction in modern macro societies, such as a national economy, can therefore – on the whole – be coordinated only by relying on spontaneous actions that respond to individual incentives through voluntary cooperation (contracts). Individual actions then are ordered by shared, enforced rules of conduct (institutions). This is normally preferable to a coercive, collective, top-down approach to the economy, because the leaders, too, suffer from limited cognition and motivation. Besides, the coercive approach imposes high costs of supervision, monitoring and enforcement, if it is to work at all. When slavery was abolished in America, for example, it was found that slavery had been very inefficient and costly, slaves not being motivated by a reward, but only by coercion. Free, paid workers had much higher productivity and needed less monitoring.

Principal-Agent Problems

What has been said about knowledge and motivation is at the root of another pervasive problem of human interaction, which has become known as the "principal-agent problem" (see Glossary). Whenever someone (the principal) draws on the services of someone else (an agent), there is a possibility that the agent will be better informed than the principal about the task at hand, about what can be achieved and whether the best is made of opportunities. But the agent will frequently be motivated to pursue his own purposes, not necessarily those of the (ignorant) principal. This principal-agent problem came to prominence in the economic literature in the 1930s when it was said that modern share companies were owned by often poorly informed principals, but run by well informed, self-interested agent-managers. These were inclined to shirk risks, prefer high on-the-job consumption, and pay themselves excessive salaries at the expense of the principals' profit (Berle-Means, 1932). In the meantime, it has been found that share companies outperform other types of business organisations — such as mutual societies and family firms — because competitive markets, which surround the share company, produce information for the share-owning principals. Competitive markets exert control of agent opportunism because the principals, once informed, can act to assert their interests. The competitive discipline that matters here derives not only from the market for the products of those companies, but from agile, competitive share markets, take-overs (reflecting a market for corporate control), and markets for managerial skills (Jensen-Meckling, 1976; Jensen, 1983; Jensen-Ruback, 1983).

The principal-agent problem has proved to be a much more serious handicap to motivating agents in areas not subject to competition. Serious motivational deficiencies could be observed in centrally planned economies, where most resources are socialised. This can go to the point where lacking motivation leads to widespread starvation, as was the case in Marxist-era China, Ethiopia, Khmer Rouge Cambodia, and 1990s North Korea.

The principal-agent problem is prevalent in all government organisations around the world: The appointed political and bureaucratic agents of the citizen-principals are normally better informed about the task at hand. They often have a degree of tenure on their jobs and exploit this in their self-interest. Even in effective democracies, the citizens face high information costs, so that the agents — the parliamentarians, bureaucrats and judges — are indeed often able to run government to suit their own purposes, even when this is at the expense of the citizens. In dictatorships, these problems tend to be much worse, and economic progress suffers accordingly.

Conclusions So Far

To sum up the argument so far: The economic problem has to be seen in an open-ended, dynamic context. Growing human knowledge can help to satisfy existing human wants, but people have an even greater capacity to discover new aspirations and new wants, so that scarcity persists. Because the knowledge necessary to tackle the economic problem evolves and is dispersed, complex coordination is necessary to satisfy human wants. This coordination can be motivated by empathy and love in small, intimate communities. But in complex modern mass societies, this does not suffice. Then, either compulsion and fear or self-interest channelled by institutions has to be relied upon. Experience has shown that — in large communities — voluntary, rule-bound interaction through markets and motivated by appropriation of returns is the far superior system to deal with the constitutional problem of human ignorance and inertia.

To understand what is necessary for a healthy economy and the discovery of better ways to satisfy human wants, we therefore now need to explore institutions that facilitate human interaction and the discovery of what people value most.

A Postscript for Those Whose Perceptions Have Been Deformed by "Economics 1.01"

The Knowledge Problem, Austrian *versus* Neoclassical Economics, and Some Commonsense Consequences

Cognitive limitations are a constitutional part of the human condition. This is why one cannot simply assume "perfect knowledge", as conventional economics textbooks habitually do. Most economic activities are in reality tied to the search for knowledge, the peering into the "fogs of ignorance". This is an essential and constitutional condition from which one cannot abstract without getting nonsense answers.

If one takes the knowledge problem seriously, as Austrian economists have done (Hayek, 1945, Boettke, 1994, Kasper 1998a), this has a number of important consequences. Certain widely accepted assertions, which have trickled down from neoclassical "know-all economics" into popular policy and culture, can in reality not be upheld; for example:

(a) The pursuit of "efficiency" requires perfect knowledge of the outputs, the inputs and the processes to generate outputs. In simple contexts, this is a realistic assumption. One can say that "A runs more efficiently from city to surf than B", or "washing powder C washes whiter than D". But in more complex, evolving situations, where different people may value given inputs and outputs differently, it is not readily clear what is most efficient. If you were asked, "what is the best book", you would hesitate and seek to find the criteria on which your choice should be based. In complex, evolving situations, typical of national economic policies, it is therefore not valid to speak of efficiency maximisation or to assume that policy makers can make rational choices — they simply do not know enough. Nor can one assume that their valuations are yours or mine! The simplistic end-means rationality of *homo oeconomicus*, which often dominates the policy debate, is only applicable where the means and the ends are known.

(b) In complex situations, rational choice is typically not of a maximum or minimum (which cannot be known), but is based on the limited information at hand. Utopian assumptions about what they know easily mislead economists to pass critical judgments about an assumed maximum which markets should achieve, but have failed to achieve. "Nirvana judgments" of "market failure" frequently lead to policy interventions, which in turn end up in "administrative failure". Perfectly informed people might be able to achieve perfect outcomes when interacting in the market place, but — in reality — these outcomes are not achievable because we deal with normal, ignorant people. They will seek information and judge when to act on limited information. To say that the outcomes of such rational behaviour are "market failures" only betrays the arrogance of assuming perfect knowledge.

(c) Another consequence of human ignorance is that all human interaction requires, often costly and risky, information search. Markets do not function without cost. They require buyers and sellers to incur what economists call "transaction costs", most of which are information search costs or costs to cope with the risks of imperfect knowledge (contracting, supervision, enforcement). Much real-world economic activity deals with this problem. Over half of all costs of producing and distributing the national product in modern economies are transaction costs (Kasper-Streit, 1998, pp. 125-27). Indeed, the fastest-growing part of our economy is the transactions-and-communications services sector: communications, advice giving, accounting, finance, business services and the like. Traditional mainstream economics has little to say about the service sector because it assumes that all is known, and that market transactions are cost-free.

If one assumes the knowledge problem away and closes the model of what in reality is an open-ended evolutionary process, then one can derive convincing and precise policy solutions. However, it has been learnt time and again that precise solutions and predictions are often precisely wrong, because many complications and consequences have been assumed away.

On a more philosophical plane, one can draw parallels between the open-ended evolutionary model of classical liberalism and Austrian economics and the Darwinian probabilistic world view on the one hand, and the closed-off neoclassical model of 20th century modelers and econometricians with a Cartesian, deterministic world view on the other. The two approaches are mutually exclusive and may lead to policy conclusions that differ diametrically.

No amount of mathematical or econometric escapism can disguise that the neoclassical assumption of perfect knowledge limits the usefulness of what economists and econometricians have to contribute. Economic models are therefore now less in demand and economists now have less credibility. The public and policy makers are increasingly aware of the evolutionary, unpredictable nature of economic life. Instead, attention turns to studying how people can improve the knowledge, which neoclassical economists so glibly assume as given.

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A related term that needs to be clarified is “**neoclassical** (or neoliberal) **economics**”. It became a fashion in 19th and 20th century Anglo-Saxon economics to make assumptions that facilitated model building. *Ceteris paribus* (all other things remaining the same) allowed mental experiments by which variations of one variable could be related to changes in others. Such model analysis was greatly facilitated if one could assume that economic agents already had all necessary knowledge. This allowed economics to become more rigorous, more easily teachable, and “scientific”, full of mathematical equations — but often also less relevant to human reality. This was the starting point for the development of a body of economic knowledge that became known as “neoclassical economics”, both in micro- and in macroeconomic analysis. It was focused on short-term decisions and consequences and had its uses in well-developed economies whose structures and institutions varied little over time. The analysis lent itself to collective policy intervention and was therefore popular with expanding bureaucracies, international organisations and control-happy politicians.

However, the neoclassical approach had always been criticised by other economists. Thus, the scholars of the "**Austrian school**", who built on subjectivist foundations, were always critical of *ceteris paribus* assumptions and looked beyond the first-round impact effects. Adopted a more evolutionary approach also, because they realised that economics could not be properly treated on the unrealistic assumption of perfect knowledge. To the contrary, they made this the very essence of economics. They also realised that economic life and evolution were critically shaped by the evolving rule system. This is why the Austrian school is sometimes also labeled "**institutional (or constitutional) economics**" or "**evolutionary economics**". While these disciplines may stress slightly different aspects, they are at fundamental variance from neoclassical economics.

For a long time during the 20th century, Austrian economics was overshadowed in academic teaching and research, as well as in the public policy debate by neoclassical ways of thinking, including the Keynesian concept that government interventions could and should try to stabilise aggregate demand and employment. Only a few countries, such as post-war West Germany, were run by a style of economic policy that owed much to the Austrian approach. The results were interpreted by neoclassical economists and poorly informed journalists as "an economic miracle" — something one did not have to explain. So, little was learnt from that experience and neoclassical economics remained triumphant.

However, the persistence of Austrian critics and the emerging contradictions and failures of neoclassical policy led to a revival of Austrian economics from the 1970s onwards. They had, admittedly, not much influence of the teaching of mainstream economics and academic research. However, policy advisors of an Austrian bent, and with a commitment to greater economic freedom of the individual, gained the ears of political entrepreneurs. Ideas about systematic institutional change (economic reform) were on the agenda. Deregulation, the liberalisation of trade and capital flows and privatisation of government-owned industries became the policy fashion, often to the bewilderment of the academic mainstream, that found the new approach incompatible with the neoclassical paradigm, which indeed it was. Austrian-institutional ways of thinking were accepted in a number of developing countries, where it was realised that modernisation also required the adaptation of formal institutions, in particular the opening up of the economy to international traded and payments. Economic success was imitated, more or less, with the consequence that economic freedom, and the institutions underpinning it, spread, often to the bewilderment of formally trained economic advisors. Important transmitters of Austrian-institutional concepts into policy making were independent think tanks. Operators, who were concerned about the progressive erosion of individual freedom and private property in developed and developing countries alike, began to set up organisations that embraced the Austrian way of thinking and tackled real-life issues with the apparatus of institutional and evolutionary economics.

Another circumstance that is now promoting the wider acceptance of Austrian-evolutionary and institutional concepts derives from the relative growth of the service sector. Neoclassical concepts, such as a given production function or a Phillips curve, matter little in an economy in which services occupy 2/3 or 3/4 of all production, in which there is ceaseless, dynamic change (think of computer software!) and in which much output is tailor-made. In the knowledge economy of the 21st century, concepts such as property rights, competition, product differentiation and control of corruption matter infinitely more than the steady input-output trade-offs that were once derived from agricultural reality (and are often still taught in those terms).

The terms "neoliberal" or "neoclassical" are nowadays often wrongly applied to those Austrian-inspired economists and advisors who had disproportionate influence over the successful reform policies of governments such as Reagan's or Thatcher's. Indeed, they were methodologically opposed to the dominant neoclassical paradigm and argued from much more realistic assumptions. Nonetheless, neoclassical economics still rules much of academia, the journals and the press in the developed countries, despite efforts by some to incorporate lessons about institutional reform, corruption or economic freedom in the existing models. After all, so much intellectual capital as is the neoclassical paradigm is never easily depreciated and discarded.

Where Austrian-evolutionary economics is making headway is in those teaching programs, where the assumption of “perfect knowledge” has led to disappointing practical men, courses on management, engineering or the law now seem increasingly drawn to the Austrian paradigm. The same can probably by now be asserted about the teaching of development economics in many countries.

CHAPTER THREE

INSTITUTIONS AND ORDER

"Intelligent beings may have laws of their own making; but they have also some which they have never made."

Charles de Montesquieu, 1689-1755

"As every individual endeavours ... as much as he can both to employ his capital in support of domestic industry, and so to direct industry that its produce may be of greatest value; every individual necessarily labours to render the annual revenue of the society as great as he can.... he intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which has no part of his intention. Nor is it always the worse for the society that it was no part of it."

Adam Smith, *The Wealth of Nations* (1776/1971, vol. 1, p. 400)

Order and the Knowledge Problem

Since the knowledge problem is constitutional, it is essential for the effective coordination of people that they economise on the information which they need to recognise and digest. Where appropriate, they must be able to extrapolate from certain bits of information. Simple signals, which people can quickly recognise, will often convey complex patterns of information. And people must be in a position of trust that their predicted patterns will not normally be overturned in arbitrary ways.

Predictable patterns and the elimination of arbitrary disturbances create order, as opposed to chaos (see Glossary). Order means that elements in a system remain in a recognisable and predictable interrelationship, though not necessarily a totally static one. When the system changes, change should follow some general, recognisable pattern, so that total surprises, disorientation and cognitive overload are avoided. Order is essential to the effectiveness of our actions — just think of how hard it is to go down a staircase with steps of varying height and width and how easily you can skip down regular stairs.

The question therefore arises: How can order be created and safeguarded? In essence there are two ways in which human conduct is coordinated and actions are ordered (Hayek, 1973, pp. 35-54):

- Order can be designed and imposed. A pattern that someone has designed in her or his mind can be implemented. Thus, architects design orderly steps. Or to give you another example, I order the books on my shelves in a certain way so that I can readily find them. After I moved office, chaos reigned and life was hell, because I had not yet imposed order and could not find much-needed reference books and files. I suffered from cognitive overload and a poor use of my resources.
  It is often effective to coordinate people by a plan and by top-down command, for example in a firm or work team, where leaders lay down an action plan and exercise a degree of control over collaborators. Order of course depends on the visible, ordering hand of someone in the know and in control.
- Order can also arise spontaneously: The flocks of birds that mill around the evening sky, do so in a recognisable, orderly pattern and do not crash into each other, without a “top bird” in command. The cars in the city move in predictable patterns, obeying traffic rules and signalling devices; disorder (accidents) is rare. The Scottish philosopher Adam Smith wrote in 1776 that human beings produce, sell and buy what others want as if ordered by an "invisible hand" (see quote at the top of this chapter).

> Recognisable patterns emerge in these instances because all participants obey shared rules. Then, participants find it easy to interact constructively with others because they can rely on those patterns.

The spontaneous order depends on clear rules, which have evolved from experience and tradition. It is not dependent on human design and control. When people are guided by such rules, they are able to share knowledge and cooperate confidently even in complex and changing circumstances.

We therefore must now turn to take a closer look at rules or institutions — their precise definition, the various types of institutions, the properties which make for an effective, spontaneous order, and the benefits of appropriate institutions.

Institutions Defined

Institutions are rules of human conduct whose violations carry sanctions. They serve to make repetitive actions and reactions more predictable. Rules without sanctions have little normative influence, in the sense of making the behaviour of others more predictable. They are therefore useless. Effective institutions confine the range of the outcomes one can normally expect, but without making specific outcomes certain. And often it is sufficient for us to depend on broad patterns of behaviour, which save us knowledge-search and other transaction costs. Without institutions, the transaction costs would, in many cases, be so high that production and exchange are made very difficult and no innovation comes about.

Institutions have a pervasive influence over economic and social life. Their quality is central to our well-being. People identify with communities, which share institutions, because they can function within them without costly information-search efforts. We feel relaxed when transaction costs are low, and order and mutual trust are safeguarded. Nevertheless, we are frequently totally unaware of the institutions that order our behaviour and that of our partners. This is amazing because different institutional set-ups can profoundly affect our prosperity and the extent to which we achieve our own purposes. The importance of institutions often becomes evident only when they disappear. Thus, people who migrate from the familiar village lawless shantytowns or people who all of a sudden have to work in a different culture, begin to appreciate the importance of trust-inspiring rules. When Karl Marx observed what the immigrants in the new factory towns of industrial-revolution England experienced, he spoke of alienation and found much resonance. With experience, newly formed groups of people find or develop new rules. A more people move between communities and as we can make more international comparisons, observers now increasingly recognise the importance of reliable laws and rules of civil conduct. Thus, economists used to take given rule sets for granted in their analyses or ignored them, because they focussed on the short-term analysis of what happened in affluent, mature societies. As more attention is focused on international comparisons and operators shift capital and enterprises between different cultures, institutional differences and changes have to be taken account of explicitly.

In a similar vein, the spread of the welfare state during the second half of the 20th century has gradually debased time-tested attitudes and institutions that underpinned Western economic growth. This has gradually under has detracted from economic performance, identity with the community and hence the stability of social life. Social harmony and civility have suffered. To correct some of this, many Western governments engaged in microeconomic reforms from the 1980s onwards in an attempt to redefine the basic rules of economic conduct. Easy welfare provision was tightened and self-reliance stressed again. The widespread reforms of recent decades cannot be understood without an explicit analysis of the role of institutions in social and economic coordination.

Institutions are not to be confused with organisations (as is frequently the case in everyday usage). Organisations are more or less permanent combinations of production factors, which are marshalled by someone in pursuit of certain purposes. Thus, a firm is an organisation that pools capital, technology, knowledge about markets and that is led to pursue certain goals, such as a profit. Banks, universities and insane asylums are not institutions (as defined here), but organisations (see Glossary).

Institutions are, however, often given backing and substance by organisations. Thus, the share market depends on certain specific rules to operate effectively, and some of these rules are maintained within the organisation of the stock exchange. Many rules of economic interaction could not survive outside organisations, such as firms of auditors, accountancy firms, land registers and the legal profession. Many institutions are indeed implicit (or embodied) in organisations, but others are disembodied and require no formal organisational back-up, as we shall see below.

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One can classify institutions according to various criteria:
- whether rule compliance is voluntary or coercive;
- whether the rules have arisen by spontaneous social interaction (internal institutions) or are designed and imposed by political agents (external institutions); and
- whether the sanctions are applied spontaneously by social feedback, such as exclusion of rule violators from one's circle of friends (informal institutions), or are applied by an appointed group, such as a law court (formal institutions, see Graph 4).

When we speak of "the law", we refer not only to formal legislation and regulations, which emanate from parliaments, administrations and court rulings, but also the body of norms that are the result of tradition and the internal evolution of society. In the common law tradition of Britain, the US and Australia, evolved rules have had a relatively high status. Internal rules and unwritten laws form an important part of the system of institutions under which we live. Indeed, the natural law, a body of internal institutions, has a very high status in many countries and may even override constitutional and statute law.

Graph 4

A Classification of Institutions

			Genesis	
			spontaneous, decentralised evolution within society	design and imposition by outside (political) authority
			Internal Institutions	**External Institutions**
Enforcement	spontaneous decentralised feedback	**Informnal Institutions**	*Examples: Customs and good manners which are enforced by social feedback, tit for tat, or exclusion*	*Examples are rare. Sometimes breaches of top-down rules are penalised by moral suasion or public criticism (such as enforcement of "political correctness")*
	formally organised procedures of sanctioning	**Formal Institutions**	*Examples: A professional code of conduct that is administered by a professional body; rules of a club*	*Example: A legal code which is enforced by court and police procedures*

Internal Institutions Evolve in the Community

One can distinguish institutions according to their genesis and the method by which sanctions for rule violations are applied (Graph 4). Most rules that shape individual behaviour have emerged within a community (internal institutions) and are enforced in spontaneous, informal ways. Compliance with these institutions is voluntary, but violations have repercussions. Experience has, for example, shown that lying is harmful to effective social interaction, so that the institution "thou shalt not lie" gained community-wide and voluntary acceptance. Violators attract spontaneous sanctions, such as shunning or loss of reputation.

Examples of internal rules are

- rules that we follow in our own self-interest (example: I do not write this essay in German, because I want to be widely understood widely in the world);
- rules that we have internalised by education, acculturation, and practice (examples: ethical behaviour, civic virtues such as punctuality and honesty);
- customs and manners that are obeyed and enforced by spontaneous reactions to facilitate smooth interaction (examples: in polite society, we listen to opponents; traders offer reliable service so they do not lose their good reputation; workers in teams follow certain work practices, if they do not they are shunned by their fellows); and
- rules that have proven useful to group interaction and are sanctioned formally, i.e. in organised ways, by selected senior members of the group (example: professional standards, whose violations are sanctioned by appointed professional bodies).

The first three categories of internal rules are informal in the sense that violations incur sanctions in the form of decentralised, spontaneous, and self-enforcing responses. Thus, we control our whims often out of self-interest, as we would be isolated if we did not. When we write by hand we try to form the letters according to certain agreed rules, simply because otherwise people will not take note of what we have to say. Violations of ethical rules often lead to the quasi-automatic sanctions of a bad conscience. In decent societies, informal, spontaneous enforcement works in most cases. In this way, the internal institutions are the cement that holds civil society together.

Self-enforcing mechanisms can be extremely effective. People with poor manners are lonely. And the damage to an opportunistic firm's reputation may cost it much business. A stunning example that shows to what extent self-enforcement works can be found in global currency markets. Foreign-exchange traders, who daily transact billions of dollars, conclude deals very fast, may live in different cultures and jurisdictions, and cannot rely readily on the judiciary of one country to sort out conflicts over contract fulfilment. Yet, they deliver on contracts, even when this means a loss to them. The reason for this is that they would otherwise have to fear for their reputation. Opportunistic currency traders, who lose their reputation in the trade, will not find contract partners and will soon be out of business.

Most human conduct is guided by such internal (or evolved) rules that are enforced informally. These rules incorporate the wisdom of past generations. Initially, internal rules may have been tried out by chance or on the initiative of a few. When the rule was considered a help, others imitated it, and the rule gained wider acceptance and sufficient critical mass to become a community institution. At times, established internal rules are rejected by people whose circumstances they no longer fit. Some may begin to accept the sanctions for rule violations or hope that they can explain why sanctions should not apply to them in their particular circumstances. Such variations may be found to be successful and may gain critical mass to become a new institution, or people may reject them. The body of internal rules is thus the result of mutation, selection and evolutionary adaptation over which no one in particular has control. The rules are the result of the interplay of numerous people. Their origins or rationale are often not even understood (Hayek, 1967a and 1979).

In immigrant societies, such as more and more affluent countries are becoming, the internal rule system is subject to particular challenges from new arrivals. Immigrants may appreciate the results of ordered, secure community life, but nevertheless challenge specific rules, either intentionally or out of ignorance about the prevailing rules. This raises the costs of coordination and creates irritation among the incumbents, who have relied automatically on the familiar institutions. But newcomers may also trigger innovative changes of the shared rules. They may cause adaptation costs, but changes may also be welcomed by sufficient numbers of incumbent residents. Thus, a poor "payments morale" (lack of reliability in paying debts) and low honesty standards of certain immigrants may force everyone to incur higher monitoring and enforcement costs. On the other hand, the work practices of certain immigrants may be seen to yield better productivity and income results than traditional ways of running the workplace. This may eventually induce more and more people in an immigrant society to adopt a different work ethic.

As noted above, some internal, evolved institutions carry formal sanctions. Thus, a community of legal, journalistic or medical professionals may have organised formal mechanisms to deal with professional misconduct, for example by reprimanding or expelling violators from their community. They do so either to facilitate the expedient interaction within the profession or to ensure that the profession’s reputation does not suffer from the opportunistic behaviour of a few. The profession chooses members of the group to apply the internal rules to deal with alleged rule violations. These arbitrators bring their specialist knowledge to bear and tend to be inspired by the wish to get on with the business. They clamp down on breaches where this harms their collective reputation. There are costs in such self-regulation, but they tend to be moderate, as long as the adjudicators are not driven by self-interest in extracting high adjudication costs.

External Institutions Require Political Action

The second major category of institutions is external (Graph 4). These rules are designed, imposed and administered by authorities who have been given political authority and are above and outside the community. External institutions thus always require some collective action, a political process to appoint agents, who may have interests of their own. The designers of external rules, as well as the administrators, are political agents, whether legitimised by the grace of God, spontaneous acclaim, usurpation of power, or democratic election. Examples of external institutions are legislation, regulations and administrative practices. All external institutions are formal in the sense of carrying explicit sanctions, which are applied in organised ways by outside authorities (e.g. the judiciary, the police, administrators).

The agents in charge of external institutions incur agency costs (costs of governance). These have to be financed, normally by taxation. The costs of implementing external institutions include not only the agency costs, but also compliance costs that have to be borne by the citizen. Citizens are, for example, obliged to keep and submit records (for example for taxation) or to conduct themselves in specific ways (not to undertake certain actions). External institutions are normally much more costly to implement than internal ones. This is so because the agents of government frequently do not know of infractions! Legal enforcement thus often inflicts high information costs, in particular if the legislation runs counter to the informal institutions of society. On the other hand, agents may act in their own interest. After all, specialist agents normally derive their livelihood from designing and implementing external institutions. Thus, there is an understandable bureaucratic self-interest in having complex and costly-to-administer external rule system (just think of the Byzantine income tax rules of most developed countries!). This provides jobs, income and influence to the agents. It is a case of the principal-agent problem as mentioned above. A well-run community therefore requires strong checks on the costs of operating external institutions and on the behaviour of the agents of government.

External institutions are, nevertheless, often necessary to obtain order. In modern mass societies, the rules are often better known when codified and formally decreed, and are more uniformly obeyed when formally enforced. Given the monitoring and enforcement costs of external institutions, they should, however, only serve as a back-up to internal institutions. The attempt by socialist revolutionaries earlier this century to replace all traditional, grown institutions of societies by "scientifically designed" rules has been a resounding failure. The new, decreed rule systems imposed very high monitoring and enforcement costs and led to alienation and a cynical withdrawal form social life. Frequently, the rules could not even be known and implemented, after the spontaneous incentives and the traditional internal rules had been suppressed. Thus, newly collectivised farmers in China after 1950 and in southern Vietnam after 1975, who were told to follow commands from above, failed to produce food sufficient to feed the population, whereas they had grown surpluses before. Indeed, socialist plans and draconian coercion could not even stop newly "liberated" peasants from destroying rice, which they did not want to yield to expropriating government agents. Only when the rule set was changed again with the economic reforms of the 1980s, did China and Vietnam end the food problem. Vietnam again became a surplus producer and major exporter of rice! This experience is replicated by numerous other cases where "scientifically designed" and enforced institutions have led to major famines, which were then invariably blamed on the weather (for example, in the Soviet Union in the 1920s, in Ethiopia under Colonel Mengistu; in North Korea since the 1990s — as if South Korean farmers did not face the same climate!).

The conclusion from the experiences with external, enforced institutions versus spontaneously obeyed internal institutions must be that the external rules should be used sparingly and, wherever possible, in harmony with the internal rule sets. Those ignore the transaction costs of alternatives, undermine the prosperity, the security and the harmony of society.

The methods by which to co-ordinate modern mass society, and in particular economic life, have arguably been the most fought-over social issue in the last century. The imposition of a top-down socialist order in the communist countries has cost over 100 million lives during the 20th century, among them some 20 million to enforce the new order in the Soviet Union, 65 million in the Peoples' Republic of China, 2 million each in North Korea and Cambodia, and one million in Vietnam (Courtois *et al.*, 1999). The attempts by the Mugabe regime in Zimbabwe are a more recent African example of the futility and costs of replacing all traditional farming wisdom of self-interested farmers by a central regime of top-down directives.

The Qualities of Effective Institutions

Not all institutions are equally effective in creating order. One therefore has to ask what essential criteria of — both external and internal — institutions are effective in ordering human conduct and fostering confidence, justice, prosperity and peace.

Given the limitations of human cognition, one important quality of rules to be effective in ordering human actions is that they should be universal. The great Italian legal philosopher Bruno Leoni (1913-1967) defined universality as comprising three characteristics (Leoni, 1991/1961; also see Hayek, 1973 and Walker, 1988):

- Universal rules should be *general and abstract*, rather than case-specific. To put it in the words of Friedrich Hayek, abstract rules are "applicable to an unknown and indeterminable number of persons and circumstances" (Hayek, 1973, p. 50). This criterion is not fulfilled, for example, when the nation’s president rules that his son's car assembly plant has preferential access to the local market, or when governments hand out tariff preferments to the specific crony industries. Rules, which discriminate between citizens, fail the test of universality.
- Universal rules are also *certain*: This means that everyone should have a reasonable chance of being able to know and understand the rule and the sanctions for

infringements. This criterion is violated, for example, in present-day Russia where a voluminous and inconsistent stream of decrees is promulgated, when different mullahs give binding, but conflicting interpretations of Islamic law, or when parliamentarians continually rejig the tax rules. In the course of this century, the volume of legislation and regulations in all mature economies has swollen to a level where no one is able to know and obey all these imposed institutions. Proliferating, detailed rules, which are often made on the run rather than by an orderly process, violate the maxim of certainty.

Certainty also extends to the sanctions for rule violations, which must be part and parcel of any effective institution. The rules must be enforced equally on all, without fear or favour. When the rules and the sanctions for violations are negotiable, coordination breaks down. Just imagine how the traffic would move if every give-way sign were subject to bargaining, arbitration and doubts and violations would attract negotiated sanctions! When the law loses clarity and its teeth, the community's capacity to generate order and spontaneous growth wanes and justice suffers.

- Universal institutions should also be *open*, so as to allow actors to respond spontaneously to new circumstances by their actions. In other words, the rules must be designed in ways that guide people in new experiments. The criterion of openness is absent when legislation is prescriptive and case-specific, so that decision makers are bound to particular outcomes even when circumstances change. The criterion of universality is met when the rules offer guidance in new experiments. Thus, universal property rights and existing tort law offer guidance when people wish to market their services on the internet. By contrast, intricate and specific rules offer little such normative guidance. Thus, the legalisation of heroin in some circumstances, the toleration in others and the persecution in yet others is institutionally deficient and will not have an influence in preventing heroin abuse.

Universality can be safeguarded relatively easily when the institutions are prohibitive, i.e. when they rule out classes of actions that are widely seen as harmful. Moses promulgated prohibitive rules, such as "thou shalt not steal or lie". This left everyone great scope for their own initiatives as long as they obeyed these rules. Likewise, the rule that no one is above the law is a good example of an easy-to-understand universal rule. By contrast, prescriptive rules, which aim at attaining specific outcomes, are much less likely to offer certainty and openness. As already noted, the promotion of specific industrial activities by government decrees and subsidies violates the maxim of universality. Therefore, it is so often fairly ineffectual. Once prescriptive institutions proliferate, the whole rule system becomes ineffective, because people suffer from cognitive overload and enforcers are overtaxed due to their lack of knowledge and resources. This is why a rule system to be effective cannot prescribe all that many specific outcomes.

Whilst rules order human action, there should also be order amongst the rules themselves. Institutions to be effective should remain reasonably stable over time, because rule changes impose adjustment costs on citizens, who always bear the risks of mal-coordination. The conservative dictum that "old rules are good rules" has much to recommend itself in the face of our cognitive limitations. But from this does not follow that the conservation of all existing rules is always desirable. After all, circumstances do change and social systems evolve, so that rule systems must evolve, too, if people are to make the best of the new circumstances. Hayek made the point in his famous essay "Why I am not a Conservative" (1960/1992) that we always have to ask what serves our purposes best and that new rules have the potential to improve matters.

The change of rules is made more predictable (less order-disrupting),

- when the institutional system consists of a hierarchy of rules, ranging from more specific institutions that are changed within a stable framework of more general, overriding rules, and

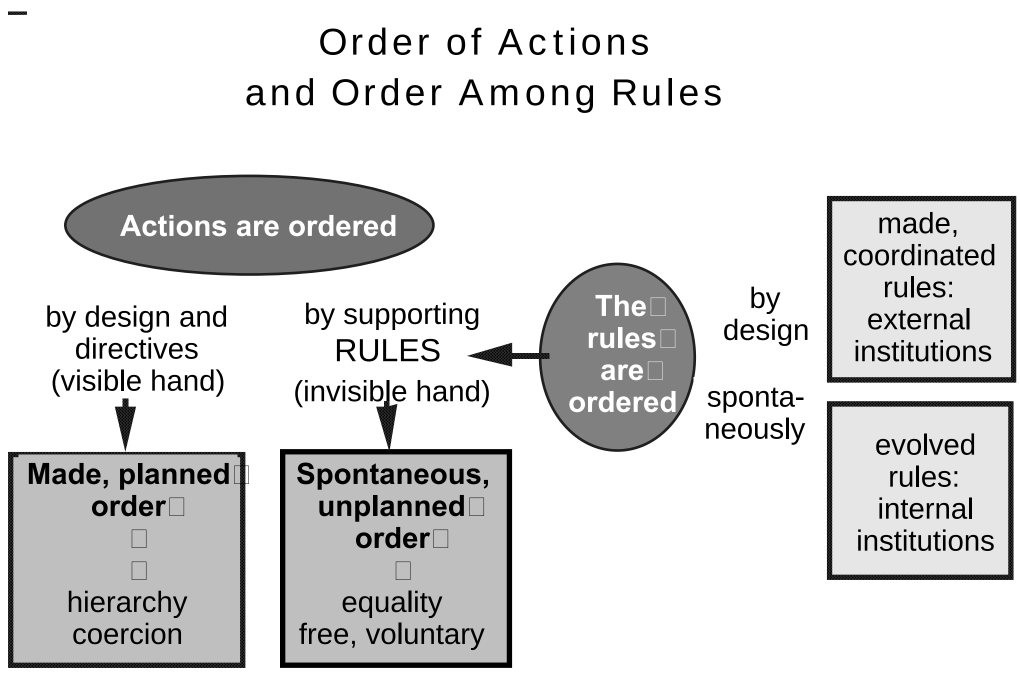
- when there are so-called *meta* rules that lay down predictable methods of rule change, for example the Constitutional rule that new legislation must be passed by a majority in parliament, or that only elected parliaments are entitled to change legislation, but not a country's high court or individual ministers.

These higher-level rules are often formally enshrined in written Constitutions. Effective Constitutions give cohesion and predictability to the rule system.

Order Among the Rules

An additional aspect of universality is that there should be no contradictions among the various institutions. Thus, it is for example ineffective to have liberal rules that govern capital and product markets, but a heavily regulated set of rules for the labour market. The same applies to the compatibility or otherwise of the economic and the political rule set. It is true that a liberal economic order set can coexist with a repressive, dictatorial political regime, as is to a considerable extent the case in contemporary China. However, long run historic and international experience suggests that individual rights in economic life are more fully developed and better protected when individual citizens also enjoy individual political rights. Compatible sub-orders tend to reinforce each other and create more effective, more confidence-inspiring overall regimes.

Graph 5



A cohesive order within the entire rule system can be brought about in two different ways (Graph 5): Individual rules may be ordered by the spontaneous acceptance or rejection of certain rules (which is common in internal rule systems), or they may be made compatible in designed ways by formal mechanisms, such as a Constitution or accepted procedures of judicial review. New legislation, for example, has to be compatible with the Constitution. If necessary, this can be tested before the country's highest court. Legislative and judicial activism is likely to destroy the stable order of rules and introduce inconsistencies among the various rules and over time. People then resent the chaos of rules and lose confidence. This seems increasingly to creep into the public life of mature democracies, for example when simple property rights get increasingly modified by cumulative government regulations. It can then be said that burgeoning legislation destroys the law, namely the fundamental rule set that people have adopted. People also resent incompatibilities between the made rules and their internal institutions — legislation is widely resented when it clashes with the grown standards of the community. Certain regulations and formal laws, which are on the statute books, are widely disregarded or even completely forgotten. In a society where the citizens are the ultimate arbiters of institutions, laws should be abandoned if a critical mass of rule violations occurs and it becomes obvious that "the rule-making Emperor has no clothes".

The tendency of opportunistic political parties and activist judges to create specific, outcome-specific rules, maybe to please vocal single-issue groups and organised lobbies, leads gradually to chaos in the rule system. The consequences are disorder, a loss of confidence, growing cynicism about governance, and systemic weaknesses in the community's institutional infrastructure. One poor rule then often generates unforeseen side effects, which need to be corrected by further, specific rulings. This triggers a slide into a disorder of rules. The evolution of socialised welfare in many mature democracies offers numerous examples for such incompatibilities and the resulting system-wide ineffectiveness of the institutions (Chapter 7).

Order among institutions is also furthered by adherence to certain unwritten procedural *meta* rules. Most people obey in their daily lives certain informal *meta* rules. For example, we let common sense prevail, and we attach a high value to a degree of tolerance of the ideas and aspirations of others, to a sense of humour, frank debate and letting opponents have their say. In Western society, people who violate these procedural *meta* rules will soon find themselves sidelined or reprimanded. Tolerance is a procedural *meta* rule that normally promotes internal peace and freedom. But it is not a goal in itself, such as freedom or justice.

The Benefits of Effective Institutions

Institutions that are universal and form an orderly system have major advantages for those who share them:

(a) As already noted, respected institutions economise on the need for knowledge search, so that people can interact with confidence and ease. Good institutions expedite business and facilitate social interactions. They allow us to reap the benefits of a wide division of labour and of specialised knowledge, which is the most critical cause of widespread prosperity and growth.

Human interaction always causes transaction costs, and universal institutions help to economise on these costs. Particular problems arise when people want to try out new ideas and search for new knowledge. Because the matter at hand is yet unknown, they simply cannot make rational choices as to the extent to which they should incur search costs. Clearly, they can never know and evaluate the results of the search, before the search process has yielded the necessary knowledge (information paradox)! Given the risks and costs of knowledge search and its importance to a prosperous, free society, it is essential to foster institutions which encourage the widespread search and testing of knowledge. Proper institutions can make it cheaper to find out what people value most highly, whereas non-universal, complex, changing rule systems impede knowledge search and innovation.

Saving transaction costs is an extremely important consideration for modern societies, which unavoidably rely on a complex division of labour and ongoing innovation. It may surprise that over half the costs of generating and distributing the national product of advanced countries, such as the United States, have been estimated to consist of the expenses of coordinating people, rather than outright physical production (Kasper-Streit, 1998, p. 126). In recent decades, transaction-supporting services have outgrown most other sectors in the advanced economies, as is reflected by the growing share of the service sector in the gross national product (business advice, communications, planning, finance, trade, logistics, research, development, information exchange etc.). In an international context, a nation’s cost-saving institutions constitute an important source of international competitiveness.

(b) Good institutions also are of non-material benefit, in that they create a sense of security and facilitate social contact. After all, people are not isolationist individuals. They strive and function best in the company of others. The pursuit of happiness is typically a group experience. Appropriate institutions enable us to build bridges to our fellows and are therefore essential to what we call "social".

(c) A major function of effective institutions is to protect individual spheres of freedom. Appropriate rules constrain the opportunistic use of power by some at the expense of others. Good institutions rule out undue coercion and delineate how far the autonomous pursuit of one’s own subjective purposes can go without infringing the freedom of others. Without appropriate institutional constraints, liberty would be license and freedom would collapse, as the Roman orator and jurist Cicero (106-43 BC) made clear when he said: "We are servants of the law, so that we can be free!" Freedom is essential for the motivation to be enterprising and creative. This in turn contributes to material progress.

(d) Effective institutions also serve peace and harmony within society. They help to avoid conflicts. Where different people with different aspirations and resources pursue their own, self-set purposes, it is inevitable that occasional conflicts arise. Thus, it is the purpose of road rules to prevent hold-ups and accidents.

Yet, even with the best of institutions, conflicts cannot be avoided altogether. Where conflicts might occur, institutions tell us beforehand how they will be sorted out. For example, traffic accidents are settled by known procedures and by material compensation from those at fault under the rules. Physical violence, and other fierce and often futile forms of conflict resolution, are thus avoided. Indeed, "road rage" meets with strong popular rejection — a spontaneous, informal sanction to preserve social peace and harmony that most consider to be fundamental values. By avoiding conflicts and creating predictable processes of conflict resolution, institutions reduce transaction costs. This, too, is conducive to economic growth, apart from the gain of security, which is a fundamental value of its own.

(e) Last not least, appropriate institutions can serve to encourage people to conserve scarce resources. When institutions give owners secure tenure of an asset (based, for example, on the institutions that ensure private property rights), it is likely that they will marshal their assets with a view to their future well-being. People often think not only of their own future, but that of their heirs and descendants. When institutional protection is insecure, people with control of assets are much more likely to run down their assets. Good institutions make for good stewardship. In a similar vein, only when stable, predictable institutions provide long-term certainty, will people accumulate human and physical capital and trust that they will, in due course, reap the returns. Deficient institutional systems are, by contrast, characterised by short-termism, the quick gain, ripping out the resources and little commitment to long-term skill and capital formation (Gwartney, 1991; Anderson-Leal, 1997).

This is not to say that universal, stable, consistent institutions are a panacea for all human problems. They are only an instrument that can help or hinder productive, peaceful interaction and the sense of satisfaction most of us derive from it. In the rapidly changing, globalised setting in which more and more people now inevitably operate, appropriate institutions — as well as the order they help to create — can serve as an important source of confidence. A growing lack of confidence suggests that the search for more effective institutions and better underlying political and economic constitutions should be a priority, so that the community can return to the experience of trust and confidence which were the hallmarks of an earlier age.

Shared Values Underpin the Ordering of Rules and Conduct

The cohesion and effectiveness of a community's rule system are underpinned by shared fundamental values, i.e. very high priorities that inform the daily actions of individuals, such as freedom, justice, security, equity and prosperity[11].

Shared fundamental values tend to be abstract. Yet, they are seen as desirable by the vast majority of the community, even if there is disagreement on the methods how to attain them. They are the normative anchoring points of a rule system; normative stopping points when we discuss what is good or bad, should be done or not. In invisible, but powerful ways, they inform our daily actions in fundamental and pervasive ways, similar to the DNA information shaping biological characteristics and processes. However, different from its biological analogue, fundamental values are shaped by intelligent and wilful human efforts.

One consequence of a shared value system in a community is that it facilitates the order of rules and the order of actions. Moral value relativism and a post-modernist denial of absolute standards of good and evil can easily make a community's rule system inoperative. This is demonstrated by anarchic, chaotic, cynical and dysfunctional societies, for example in post-socialist Russia and segments of post-modernist Europe. The fundamental values, as well as the institutions, therefore constitute a worthwhile and valuable possession of a community, even more important than its physical infrastructure. They are part of a community’s precious possessions, its capital!

The anchoring of institutions in fundamental values drives home an important point about institutions: They are not value free! We can objectively analyse what the effects of certain rules and rule systems are, but when we apply the insights to shape concrete rules, we cannot — and should not! — avoid value judgements (normative institutional economics). To dismiss a preference, for example, for freedom as "unscientific" would mean the suppression of an important element of economic and social analysis. What scientific analysts should, however do when they make normative judgements, is to make it explicit where their own preferences lie and to acknowledge that others may rate the various fundamental values quite differently[12].

Some Consequences for Public Policy

Parliamentarians, politicians, unionists and industry representatives tend to rely on case-specific interventions to obtain predetermined economic outcomes, ordering matters from above to suit their particular purposes. Many seem to assume that the national economy is simply an organisation, like a business firm, where simple commands produce the desired results. But societies are not organisations, and the managerial ‘push button style” of policy making produces numerous deleterious side effects. Even modern business organisations have adopted management styles that rely on "participative management", i.e. spontaneous cooperation in teams that obey shared rules. Less and less, business

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11 When we use the word "justice" here, we intend this to mean formal or procedural justice, namely the application of the same rules to all equals. Security here is the inter-temporal dimension of freedom; it refers to the future freedom to make un-coerced choices.
Security and justice when combined with the adjective "social" have, however, often been given totally different meanings, namely referring to outcomes being equal, irrespective of effort or luck. As we shall elaborate later, these concepts of justice and security tend to undermine freedom, peace and security as defined here (Hayek, 1988, pp. 112-119).

12 For a more extensive and varied coverage of these issues, the reader is referred to Radnitzky-Bouillon (1995-97).

organisations are run on the command-and-control approach so typical of an earlier, simpler and less dynamic industrial era (Parker-Stacey, 1995)[13].

Once one understands the fundamental traits of human nature and the complexity of a system of national and international economic and social relationships (Chapter 2), one is amazed that so many members still wish to rely on specific, instrumentalist designs that order economic life from above and by coercion. Few observers ask, when confronted with clever new government schemes in developed and developing countries — to save this industry or that, and to subsidise one industry location or another: "How do politicians and their advisers know? Indeed, do they have any relevant knowledge about these matters at all?" Little wonder that so many well-laid political schemes are mugged by reality and disappoint!

We now possess ample evidence from around the world that "know-all interventionism" often overtaxes human knowledge and the capacity to control social processes by political and administrative means. In microeconomic policy, we have learnt that intervention in markets invariably leads to unforeseen, deleterious side effects, as circumstances keep changing. For example, the scheme to shore up the rubber price in the 1970s by stockpiling natural rubber in Malaysia, not only cost considerable resources, but also led eventually to a replacement of natural by synthetic rubber and a protracted depression of the rubber price. We know that schemes to control housing in the interest of the poor invariably serve in the longer term to restrict the supply of dwellings and make housing less available to low-income earners. Minimum wages hinder those less well-equipped with labour skills from getting their foot on the “training-and-income ladder”. Indeed, persistent unemployment is a consequence of collective choices based on assumptions that are not true. Industry ministers may argue for the simple-minded means of tariff protection or bounties to favour certain producers, but they cannot control international developments, price and cost changes, exchange rate fluctuations and numerous other variables. Consequently, such specific industry-policy interventions fail. Prime ministers may promote specific development ventures with great fanfare and at great expense to the budget. But we hear little about subsequent failures. Thus, many a developing country "bought itself" an industrial venture by subsidies. These were harvested, and later these ventures were closed down again. There is a rumour that the same sewing machine was employed in start-up ventures to make garments in Thailand, China, Mauritius and Bangladesh to reap government handouts, and was then moved on. A cable-making factory was placed on a ship in Malaysia to “harvest” available subsidies; when government authorities tried to extract a return for the preferment, the ship sailed on. Despite numerous such experiences, politicians are habitually promising specific outcomes, and — in the end — still seem surprised when their action disappoints. They may think short term and hope that the side effects become evident after they have left office. Ultimately, however, they of course earn themselves cynical disinterest.

Instead of coordinating economic activity by such "visible hand" interventions, governments should desist from interventions and protect the market order, by enforcing universal rules, such as protected, private property and the enforcement of contracts. Governments should primarily protect the intentions that promote spontaneous order (Kasper-Streit, 1993; 1998, pp. 155-162), and that often requires abstinence in matters of outcome-specific social engineering.

13 Although we do not deal here with business management, we should note in passing that top-down ordering by the managers is appropriate to mass production and when technical change is slow. The steel factory and car assembly in the 1930s fitted that organisational approach, sometimes labeled "Taylorism". But much contemporary business consists of tailor-made services and production with rapid technical change. The essence of modern economic life is a great diversity and variation in the goods and services on offer. These conditions are better handled by an organisational model that leaves much scope for decentralised information search, initiative and control. It has to rely on rules. Modern organisations therefore are coordinated less and less by prescriptive controls and more by rule-guided behaviour (Kasper-Streit, 1998, ch. 9).

Economists have done little to draw attention to the pervasive knowledge problem in policy making because their classroom models are based on the assumption of "perfect knowledge" and *ceteris paribus*. Their pretence of knowledge has given them great, but undue influence (Boettke, 1997). Everyone knows that other things never remain equal. At least in macroeconomics, the belief has now been largely abandoned that government can stabilise aggregate demand and restore full-employment by discretionary, fine-tuned policies (Keynesianism). By the mid-1970s, when mass unemployment again reappeared in OECD countries and governments tackled the problem by simply managing demand through fiscal and monetary policies, it was discovered that — alas — this led to unexpectedly high inflation, budget deficits and instability. Unemployment went up despite the expansion of aggregate demand. In the 1990s, Japan engaged in the biggest spending-and-stimulation policy anywhere ever, but attained little by way of a lasting economic turnaround. At least in this respect, most policy makers have learnt to be more cautious about the feasibility of outcome-targeted policy.

A similar caution about relying on the visible, ordering hand of government is still rare in microeconomic and social policies. The naive belief in the feasibility of ordering the economy from above is still rampant both in affluent and poor countries. It should have been dealt a massive blow by the collapse of central planning in the former Soviet orbit. There, "scientific central planning" had been introduced to do away with the "chaos of markets", i.e. the spontaneous co-ordination by buyers and sellers. The socialist governments' visible hand of command and control predictably led to mal-coordination and waste of resources on a massive scale. Discoveries and new uses of knowledge were rare and often misguided. Living standards, health, education, old-age care, and the environment suffered as a consequence. Mortality rose, so that the population of Russia is now plummeting by 3/4 million people a year. A similar trend can be diagnosed in the socialist-democratic welfare states of "old Europe", where governments have virtually given up on upholding private property rights, economic freedom and self-responsibility. The result is widespread despondency amongst the citizens, and economic stagnation and persistent unemployment. Obviously, the made order delivered inferior results. This truism has been realised by the leaders of the Peoples' Republic of China, who have gradually scaled back the sphere of central planning since the late 1970s. Now about 60% of China's national product is subject to the decisions of private producers and buyers. As the residual, planned state sector is mired in a deep and costly crisis, its share continues to contract.

The experience of the former command economies has underlined another crucial point. The spontaneous coordination by market processes does not easily take place in a vacuum. One cannot assume that markets function effectively before a reasonably universal fundamental rule system has emerged. The collapse of the ham-fisted old order in the Soviet Union and the failure of reliable, trustworthy rules of human coordination to emerge quickly have led to considerable drops in Russian living standards. The old order lingers, as former bureaucrats pursue their own narrow interests with coercive means, more or less like members of criminal gangs. Only gradually are new rules of economic conduct emerging, or are imposed. A minimum of institutional infrastructure is now in place in some east European countries, such as Poland, the Czech Republic, Hungary and Estonia, and long-suppressed internal institutions of society are re-emerging. Consequently, these economies are now showing visible improvement, although the process of institutional reform is far from complete (Kasper-Streit, 1998; ch. 14).

How long can political and interest-group leaders go on pretending arrogantly in the face of the evidence that they have the knowledge for firm- or industry-specific interventions? When will it be widely realised that they pursue group egotism at the expense of the common good?

A simple, reliable order of rules, which foster the confidence that one can invest in physical and human capital, cannot emerge as long as arbitrary and industry- or product-specific interventions proliferate, triggering impossible-to-predict and often unsettling side effects. In Western countries, where the inherited, time-tested rules have long been implicitly taken for granted, little attention is still being paid to the need of cultivating the underlying institutional system as a matter of priority in policy. The notion that order is a precious possession, which requires nurturing, is not widely accepted, nor is the understanding of what institutional qualities are needed to facilitate order.

CHAPTER FOUR

ON INSTITUTIONAL EVOLUTION

πάντα ρει [panta rei — all is in flux]
Greek proverb

From Tribal to Capitalist Society

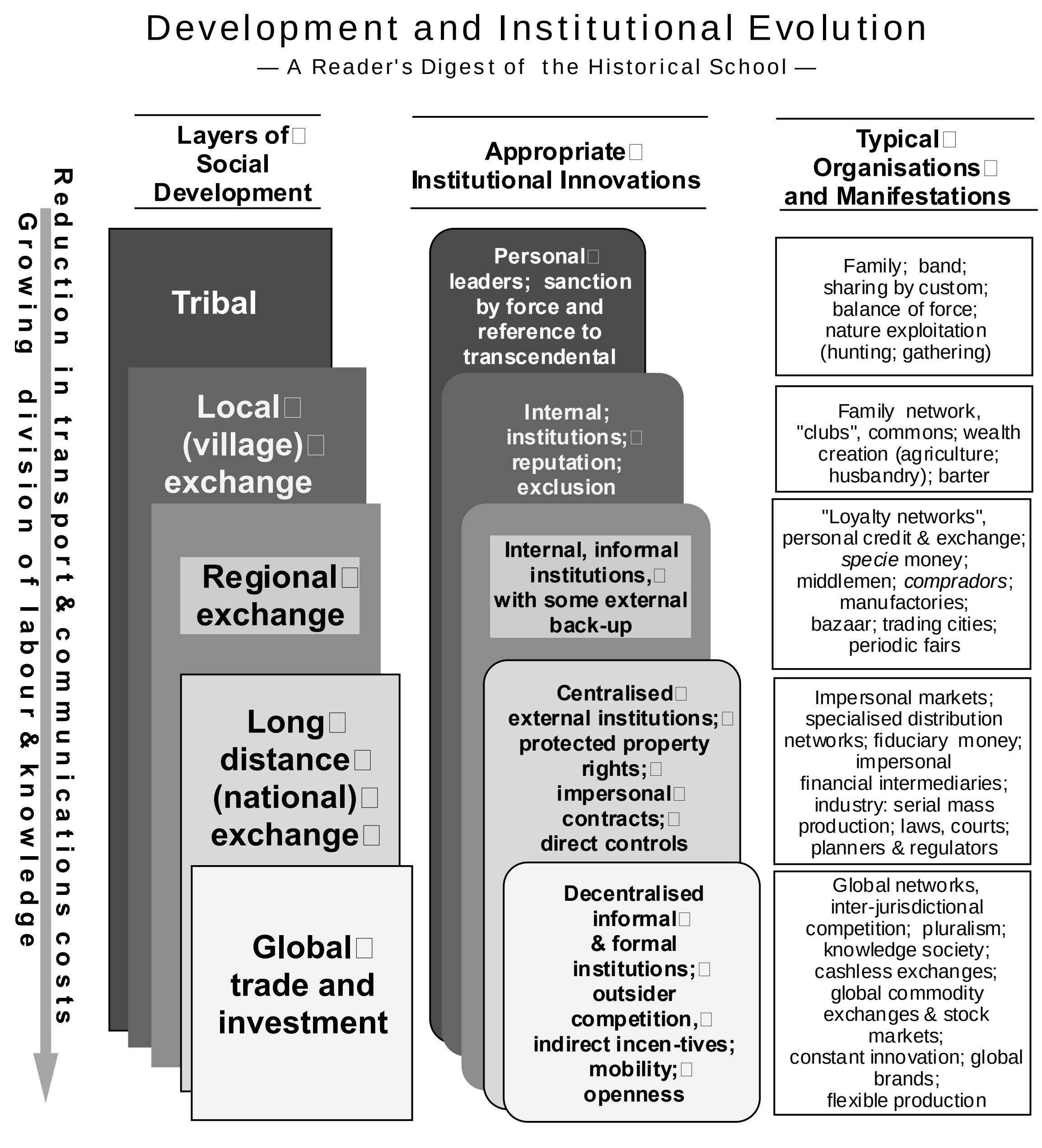
While they need a certain stability over time, institutions can – fortunately – be learnt and adapted. Yet, changing the "software of economic interaction" is often harder than changing the "hardware" of development, for example adopting new crops or new technologies. The reason is that the institutions, which shape our social interactions, are deeply entrenched. We normally consider them a part of our very identity. Moreover, relearning or adding to the institutions also affects existing power structures. Some at the top get challenged; established power and wealth may be exposed to new competitors. Of course, this inflicts uncertainties on the rich and powerful, who will often resist change and denigrate reforms as "ideology driven". Moreover, the wider public will often support a conservative stance. It is after all not easy to expose familiar hierarchies and communities to new competition and the challenging, confusing dynamics of the open, changing society.

Nonetheless, different "traffic rules" are needed for different types of traffic and different circumstances. The foot traffic in a village may need very simple and informal rules; the traffic on the inter-state highway requires more detailed institutional arrangements and organisational back-up, etc. The same can be said for different types of society. As societies develop from small tribal bands, such as hunting tribes, to local agricultural or herder economies with some-inter-regional exchange, such as those of central Asia, to national economies, and now the open global economy, the rule systems have to be supplemented with new layers of rules. Each step in political and economic evolutions requires that we learn additional rule sets and reconcile the new with the old institutions. Thus, we may interact in the global market economy, following one set of rules, but when we return to our home, we may happily return to familiar tribal habits of interacting in a small group, perpetuating rules that our paleolithic ancestors developed long ago.

Graph 6 refers to various stages of economic development and the layers of additional institutions necessary to cope. We know from history that refusal to adopt new rule systems can frustrate or even stop economic development. Indeed, institutional rigidity can pave the way for persistent poverty. Thus, the statist planning system of the USSR proved to be acceptable only for the rapid development of crude, basic industries at the expense of everything else. But such regimes were incapable of coordinating broad-based innovation and the modern 'knowledge economies', on which the affluence of the West and of East Asia is now based. Consequently, the Soviet system collapsed under the weight of its own failures. Similar gross deficiencies in the rule system have caused the economic and political difficulties in the Middle East.

Small bands of hunters and gatherers who exploit nature, but hardly create wealth, are typically coordinated by personal leaders, who may use force to attain their will. Their rule tends to be tempered by personal empathy and bonds of kinship (Graph 6). Whilst paleolithic hunter-gatherers have close ties to the land, they have rarely developed fully defined property rights in defined areas. Once a society moves from the paleolithic economy of mere nature exploitation to the neolithic economy of wealth creation by agriculture and animal husbandry, societies become bigger, and the rules have to be refined. In particular, largely respected, enforced private or group property rights have to be developed, so that sown crops can be harvested and herds kept without excessive exclusion costs. In societies of thieves, no one sows, no one harvests, and no one raises a herd[14]. With the new rules, come forms of governance that are more anonymous. The new rules permit networking by barter and joint ownership in an exchange economy.

Graph 6



Source: W. Kasper in N. Berggren et al. (eds.) (2002), p. 221

14 Anthropologists have pointed to certain societies that have failed to make the transition from nature exploitation to wealth creation (often described as the "neolithic revolution") and have been puzzled why such societies did not imitate neolithic neighbours. Sometimes, there may have been no need for a change and hunting may have been considered more fun, but failure to learn the rules of the agricultural society are often a more convincing explanation. Similarly, cultural and economic decline is frequently preceded by a decay of the institutional system.

Once societies and economies develop regional exchanges around market towns, political leaders tend to emerge who codify, refine and enforce the traditional rules of ownership and exchange (Bernholz *et al.*, 1998). An example for the rule system that made agriculture and trade possible in the neolithic age was the Codex of Hammurabi, which codified many useful rules in Mesopotamia. It is probably the oldest know collection of written laws. When the exchange networks grow beyond regions, governments arise that develop more centralised, external institutions. For example, princes, kings and finally emperors emerged in historic China who made economic exchanges over wider spaces possible. As long as they enforced institutions that facilitated prosperity, the rulers were deemed to enjoy the "Mandate of Heaven". Likewise, the Roman empire grew on the basis of Roman law, in particular property law, and princes, sultans, court administrations and *kadis* cultivated sophisticated commercial law in west Asia and North Africa after the advent of Islam. This facilitated trade and lifted the level of development. Nevertheless, rulers with absolute powers also tended to claim considerable privileges. This was, for example, the case in medieval Araby, India and Feudal Europe[15].

The Emergence of the Institutions of Capitalism

In early modern Europe, institutional structures were developed further. Under the influence of inter-State rivalry, some rulers constrained their powers and opportunism by offering controls (such as letting parliaments review royal tax proposals) and guaranteeing the citizens certain inviolate rights (for example, of freedom, religion or trade). The rulers did not do this out of deep philosophical insight or philanthropy. Rather, they tried to attract merchants and manufacturers, as well as skilled people, in order to promote the economy. This in turn strengthened their tax base and capacity to wage war.

What evolved in Western Europe from the Renaissance onwards were the institutions of capitalism – secure private property rights, freedom of contract, and the rule of law – and with them modern economic growth could take off. The institutional evolution preceded the industrial revolution, and ushered in the extraordinary, sustained rise of living standards and its spread to a growing numbers of people. Early 20th century, the famous German sociologist-economist Max Weber drew attention to the institutions that permitted capital accumulation, innovation and industrial enterprise in post-Medieval Europe (Weber 1927/1995). More recently, American, Australian and European economic historians have again highlighted the processes how appropriate institutions and enforcement mechanisms were established before confident, enterprising and innovative capital owners could start the industrial revolution. Resistance to such institutional change, for example in Spain, China and the Arab countries in the 19th and early centuries, hampered industrial modernisation there (North-Thomas, 1973; Berger, 1987; North, 1990; Jones, 2003/1982; Rosenberg-Birdzell, 1986; Weede, 1996; Bethell, 1998).

Before the industrial revolution took place in Western Europe, an observer would probably have predicted industrialisation first to occur in China. The technical preconditions for an industrial revolution had certainly been excellent in Tang and Sung dynasty China between the 7th and 12th centuries AD. Sustained growth might therefore have been predicted to take off in China or on the Indian subcontinent, where artisans and thinkers had long had skills and knowledge far superior to those of the Europeans. Why did the industrial revolution nonetheless occur in Western Europe?

The explanation points to the central role of institutions. European and Asian rulers were probably equally arbitrary and opportunistic, with little interest in the material welfare of their ordinary subjects. Different from the large Asian empires, however, many of the European fiefdoms were small and open. Enterprising bankers, merchants and artisans were thus able to "vote with their feet", if they felt poorly treated by a particular

15 On the evolution and contents of private property rights in the Muslim world, read T. Bethel (1998, chapter 15 ('Property in Araby').

ruler. Some rulers — initially in Venice, Florence, Genoa and Barcelona, then in Amsterdam, and later still in England and Prussia — saw mileage in constraining their own power by binding themselves to general rules. They promulgated and enforced laws that protected private property and individual autonomy to make contracts, as well as religious and other liberties. European city governments operated on the principle that "city air makes you free". They protected the freedom of refugees from the feudal countryside and thus attracted the bright and the enterprising who then contributed to the prosperity of the cities.

In the Middle Ages, Feudal law had given each class of citizen specific privileges and obligations. In some Third-World societies, such as Hindu India, long-standing social divisions were even imbued with religious belief. The caste system made social mobility and competition near impossible. However, merchants who traded between different jurisdictions found a system with rigidly defined, more or less privileged classes too uncertain and cumbersome. Corrupt, arbitrary rulers and judges, who applied group-specific laws, were simply bad for the business. So, European merchants avoided the rule of men and government-run courts. Instead, they agreed to operate on the principle of equality before the law and began to enforce their own rules. In Medieval Europe, this became known as the *lex mercatoria* (Merchant Law). Certain princes supported these simple and reliable rules. In many parts of Europe, rulers began to guarantee economic, religious and civil liberties and to separate religion and state. Laws and independent courts were set up to protect the fundamental rules that eventually became the institutions of capitalism -- secure private property and a high degree of private autonomy in using those property rights under the rule of law. Fraud and the arbitrary use of violence were controlled, and citizens were no longer treated like immature dependents. The rule of men was being turned into the rule of law.

Those princes who effectively protected private property and the freedoms to use it prospered. At the end of a long evolution, this gave rise to constitutional government and formal controls over the powers of the rulers, for example with the Glorious Revolution (1688), which entrenched the rule of law in Britain (Walker, 1988, ch. 3). Only thereafter could private capital accumulation and entrepreneurial risk-taking proceed with confidence, triggering what was to become the industrial revolution. The creation of a citizen- and enterprise-friendly system of institutions was thus the by-product of the rivalry among the small, open states of Europe.

By contrast, all Chinese lived "under the same Heaven". The rulers of China were not much exposed to competition with other rulers. Dissident citizens could normally not move elsewhere. From the 18th century onward, when Europe opened up and underwent an industrial revolution, China turned inward and sank into economic decline. China's inward turn under the Ming emperors is amazing since there had been expansion of China's international trade in the preceding century (along with a population explosion). But there was no competition among differing power groups in the Ming and Manchu empires, thus no competitive control on the central power, and hence little innovation in institutional and administrative practice. The same was true of other large empires in Asia, such as Mughal India and the Persian and Ottoman empires (Jones, 2003/1982). The authorities were able to treat merchants and producers arbitrarily. Bureaucrats were able to discriminate with impunity and extract massive bribes. Court cases could be run without due process or obeisance to notions of procedural justice. Private fortunes were confiscated almost anytime by opportunistic officials, and people who fell into political disfavour, often lost their fortunes. Hence, there was much less incentive to accumulate and use wealth in productive and visible ways. Much useful knowledge was never exploited commercially in Asia despite its historic scientific and technical lead over Europe.

The difference between the petty states of Europe and the closed empires of Asia is highlighted further by the fates of two great explorers. In the 15th century, the Chinese eunuch admiral Cheng Ho had sailed as far as Java, India and East Africa and brought home wondrous tales and goods, even a giraffe. But one word from a new Ming Emperor sufficed to stop further exploration. By contrast, Christopher Columbus, whose plans for a voyage westward across the Atlantic were rejected by several potential backers, was able to shop around among the rulers of western Europe till he obtained the material support of the Spanish kings — the rest is history.

From Early Capitalism to the Global Economy

Over centuries, the European institutions of governance moved gradually and piecemeal in the direction of non-discriminatory enforcement. Individual rights were gradually enforced in better ways. All the while, the various warring rulers competed with each other to attract mobile producers and merchants, and successful regimes were imitated. Elsewhere, for example in British India, incoming colonial rulers imposed their own institutions and combined them with local law, which allowed some economic development, but often also imposed limits on sustained long-term development.

During the 19th century, as big nation states emerged, more stress was laid on public policy by national governments and national institutions that favoured impersonal contracts between strangers in the market. Government invented more formal controls to enforce the rules. In many parts of the Third World, this process began under European colonial influence and was subsequently taken much further by the newly independent governments, despite the fact that they lacked the administrative capabilities to give effect to the rules, which they decreed. In other segments of economic life in the Third World, traditional reliance on personal rule and personal relations was never moderated sufficiently by the rule of the impersonal law. Personal structures of governance were then often combined with central planning, import substitution and massive industry regulation, as in India, Pakistan and Latin American countries from the 1950s onwards. Such centralisation destroyed economic freedom and wasted many growth opportunities. Many talented people lost their motivation; and economic growth remained poor.

Now, as more exchange is on a global level, as investors shop for the most promising locations around the world, and as the knowledge economy grows thanks to exchanges over the internet, new rule sets are yet again needed. Many ineffectual, rigid government-run institutions now have to be replaced by more decentralised, less formal institutions. Those who cling to the closed-economy mentality and retain corrupt organisations are the losers in the globalising economy. Openness to outside competition is productive, even if it demands some “creative destruction” of old habits and rules. Global markets benefit those societies that have simple and reliable institutions, which facilitate rapid adjustment to new opportunities. People and groups, who are not rule-bound and cannot be trusted, are by contrast losing out very quickly, as their poor reputations become known around the world and no one invests there or trades with them. Marxists tell us that, under globalisation, ‘the rich are getting richer and the poor poorer’, but in reality it is those who adapt and can be trusted who are getting richer; and those who are corruptly governed are getting poorer.

The priority task for communities and public policy around the world is now to acquire new rules suitable for global exchange and harmonise them with the old, inherited rule systems. Sometimes, traditional rules become counter-productive and have to be jettisoned. Thus, large-scale public ownership and heavy-handed regulation is now being abandoned under the pressures of global competition in many countries, from the US to China, from Russia to South America. Old power structures, which have a vested interest in old rules, often fight against such reforms. The powerful, who make corrupt use of old rule systems, resent the disciplines imposed by global markets and the quick response of internationally mobile investors to corrupt or opportunistic political behaviour. Yet, when reforms begin, people learn that a good reputation, reliability, punctuality, good will, flexibility and other civic virtues constitute valuable capital assets. Such institutions are worth cultivating in the interest of prosperity, freedom and justice for all.

East Asia's Ascendancy Was No Miracle

From the 1950s onwards, the beneficial European experience with open and competing jurisdictions was replicated in East Asia. Over the past fifty years, openness has led to the evolution of – albeit imperfect – institutions that now constrain political power and empower the private citizens. In the first instance, the Japanese economy was opened up by American intervention after the mid-19th century. This triggered internal constitutional and institutional changes, the Meiji revolution. Many of the institutions that facilitated modern economic growth probably pre-existed in Japan, but were adapted to support modern technical and economic development (Powelson, 1994, pp. 25-39; Kasper, 1994a, b).

After the second world war, the dominant centre of the East Asian world, China, went into hostile seclusion when it became the People's Republic. As a consequence, several small jurisdictions in east Asia had to cope during the 1950s and 1960s with the experience of insecurity and external exposure — Hong Kong, Taiwan, South Korea, Singapore, Malaysia and others. Political innovators, such a Lee Kuan Yew in Singapore, a new generation of leaders in Taiwan, General Park in South Korea and British administrators in Hong Kong, created institutions that supported private enterprise and facilitated foreign investment and access to world markets. They went against the prevailing fashion (for example in the United Nations) of pursuing import substitution and protectionist interventionism, which were the style of policy by the newly independent rulers of Africa, India, Pakistan and Latin America. Of course, the likes of Nkrumah, Nehru, Pakistani military chiefs, the Bhutto and Bandaranaike governments, Sukarno and Perón and their advisers had no idea what industries to select for preferential development and how to do it — other than what their self-seeking cronies told them and what served the short-term interests of their political supporters. The result was enormous waste and industrial backwardness.

The reformist political entrepreneurs who laid the foundations of East Asian development did of course not act out of deep insights or the kindness of their hearts. They developed good institutions as a means to pursue power and tax revenue. At the same time, the populations of those countries adjusted their traditional internal institutions to master their precarious circumstances. Though it had long been considered a handicap to development, Confucian ethics soon evolved from a hierarchical-static to a forward-looking set of effective institutions. Confucianism proved a much more adaptable set of institutions than, for example, Islam. Without these institutional and cultural changes in East Asia, the Far-Eastern industrial revolution of the 1960s to 1990s would not have been possible. The monetary and banking crisis in 1997 reminded many East Asians again of the importance of an open, non-discriminatory rule system (Kasper, 1997). Some are now again trying to enhance the rules. As the economies are maturing and the cost of land and labour is rising, institutional evolution and reform are indeed becoming crucial for continuing fast growth and social harmony. And those political leaders who corrupt the rules in order to retain or exploit power (crony capitalism) are discovering that capital flight; currency depreciation and slower growth are a price, which the population has to pay.

Creating Institutional (or Social) Capital

Around the world, it has in recent decades been increasingly realised that appropriate institutions are a central condition of freedom, security, prosperity and economic growth (Gwartney-Lawson, 2004). A universal rule system allows local labour and governments to enhance their productivity and incomes in ways similar to the acquisition of good new tools and other capital goods (Olson, 1996). To underline this, some authors have spoken of "institutional capital"; others have used the term "social capital" (Coleman, 1990; Weeded, 1996).

In many parts of the world, there is now a renewed awareness of the need for effective institutions and much systematic research to find out how to shape institutions that facilitate superior outcomes in terms of freedom, security, justice, peace and prosperity. In some countries, the pursuit of piecemeal microeconomic reform has given way to discussions of the overall design of entire economic and legal constitutions. Do they serve to constrain corruption, political whim, discrimination and power abuses, or not? New Zealand, for example, has engaged in a comprehensive venture to recast the rules of coordination to simplify them and advance justice, although that effort is incomplete.

It is therefore appropriate to go beyond thinking only in terms of a country's given constitutional and general rule system, and to explore the costs and benefits of alternative constitutional and institutional designs. Would a systematic effort to cultivate the shared institutional capital of the nation allow us to "pick up big bills from the sidewalk" — as Mancur Olson put it to signal that big gains can be made by enhancing the entire rule system (Olson, 1996)?

One standard conservative response to such a comprehensive and ambitious attempt is that changes are not feasible under the existing Constitution. In a rapidly changing world, this conservative attitude may, however, need to give way to a more systematic approach to the underlying rule system. Such reform efforts should be based on the insight that enormous gains can indeed be made by a streamlined, universal framework of the underlying rules. They have been taken for granted, or even allowed to decay, for too long. Potential gains of comprehensive reform promise to exceed marginal improvements that can be had from piecemeal microeconomic reforms.

CHAPTER FIVE

PRIVATE PROPERTY RIGHTS

"What is common to many is taken least care of, for all men have greater regard for what is their own than what they possess in common with others".

Aristotle (384-322 BC) [cited after Gwartney, 1991, p. 67]

"Property is surely the right of mankind as real as liberty.... The moment the idea is admitted into society that property is not as sacred as the laws of God, and that there is not a force of law and public justice to protect it, anarchy and tyranny commence".

D. Hume (1786/1965), Book II: 2, para. 2.

The institutional system which has, to date, most effectively addressed the fundamental traits of human nature (as outlined in Chapter 2), has generated the most sustained rise in material living standards and human numbers, and has facilitated the most advanced — although far from perfect — degree of individual freedom, is capitalism. Capitalism, in its pure form, is a rule system, which assigns most scarce resources to specific owners –- persons or private organisations, such as clubs or firms — and which fosters the autonomous self-responsible use of private property (freedom of contract). It functions well only without discrimination, i.e. when it is based on the rule of law.

On Private Property Rights

Private property is a right, which means that rightful owners can exercise it without specific approval of others, as long as they do not harm others. If you have to ask someone’s permission or seek a license to make use of what is yours, you do not have a genuine property right. When you exercise one of your property rights, others may of course object and claim harm. In a free economic system, there are a number of known rules that can be examined whether the objection is valid or not (Kasper, 2004). It is important for the confidence in the system and for the expediency of its use that the institutional system is simple, stable and open, in other words universal.

Private property conveys an open-ended bundle of rights to possess, to use, to benefit from and to dispose of valuable and scarce assets, either in parts or as a whole. These rights must not be confused with the physical assets themselves. The rights are attached to the assets, not only to physical assets — such as land, buildings and equipment — but also to one's own body, knowledge and labour. When people are denied autonomy over the use of their body and labour, they are slaves. In addition, property rights may be attached to one's intellectual creations (intellectual property rights).

Property rights establish protected, widely respected rights of ownership. They allow, in the first instance, "passive use", namely the right to exclude others from access to and possession of the assets, unless one consents to grant others such access. Secondly, they encompass rights of autonomous "active use" — to combine the asset with the property rights of others in pursuit of expected gains (returns) and to appropriate to gains that accrue. This is done through voluntary private contracts that are normally concluded only when both parties expect mutual benefit from the transaction. In an insecure world, not all expected gains materialise. Expected profits may indeed turn out to be losses that lessen the value of the property. Private autonomy therefore includes the responsibility to bear the losses from property use, should they occur. It precludes the devolution of losses on others or the community at large. Finally, private property rights include the right to dispose of assets, either by an outright sale contract, or by ceding some specific rights from the "property-rights bundle" to others more or less temporarily under a voluntary contract. Thus, we may loan an asset to others for a certain time or allow someone a specific property use, such as the right of way across one's land.

The passive holding of property, mere possession, is not cost-free. Even with the best institutional safeguards, passive property use is likely to inflict exclusion costs. Fences, locks, security alarm systems and computer encoding are examples of devices that help to exclude illegitimate property uses. The better the internal and external institutional protections of property in a community, the lower are the exclusion costs and, consequently, the higher is the value of property. Property owners therefore have a direct interest in effective institutions. One might turn the old saying around and say that "law-abiding neighbours make for low fences". When respect for private property is low, the private exclusion costs can be considerable. It then makes sense for property owners to pay some collective agent to help with excluding unwanted property uses. This may be a private protection agency, or a government organisation that sets up formal, external rules and enforces them, for example the police, the judiciary, prisons and similar forms of legitimated force. In most countries, property owners rely on both, with private security services typically employing several times the number of people that the police do.

The active uses of property cause further costs. The owners of physical and intellectual property have to be coordinated. Firstly, they need to search for potential contract partners, with who they can make good use of what is theirs. They have to find out their characteristics; they may have to engage in research and development so as to identify new, but needed intellectual property or resources. They have to negotiate and execute contracts, and to monitor and enforce contract fulfilment. We call these coordination costs "transaction costs" when property is used through market contracts. They are called "organisation costs" when property is used within an organisation, such as a firm. The level of these coordination costs depends greatly on the internal institutions of society — such as spontaneous honesty and disapproval of rule violations — as well as on the external institutions, namely the universal quality of the law, the reliability of the judiciary and the quality of regulations. Effective institutions, therefore, do not only determine the value of property in a society, but also the ease or otherwise of its active use. In today's open economies, property owners often go to where the rule system is most conducive to their using private property and where the exclusion and coordination costs are low. Fuzzy, complex rule systems thus lead to poor competitiveness and the flight (exit) of financial, physical and intellectual property[16].

Historically, government has had an important role in protecting private property. Indeed, government probably came about soon after the emergence of property rights in the full, modern sense of the word during the "neolithic revolution" some 10,000 years ago. Humans then engaged in agriculture and the domestication of animals. This revolution occurred in a number of different locations, such as the Middle East, northern Thailand, Papua New Guinea and the Americas. Agricultural production is not imaginable without a degree of respect for property rights. Who would dig the soil and sow, capture and care for animals, if ownership and use are constantly threatened and the fruit of one’s efforts cannot be appropriated? The exclusion costs can be so high without a respected property rights system that agricultural production does not take place.

In this context, it should be noted that the mere possession of a useful asset, for example by a dog or a chimpanzee, does not constitute property. What matters is the social recognition of property rights. Property can be compared with a social truce, a multilateral agreement that people will not steal or trespass, because all can then be better off than in an anarchic "war of all against all". When modern property rights were invented, community leaders with a reputation for impartiality became elders, judges and kings who offered external adjudication in conflicts over property. They promulgated and enforced

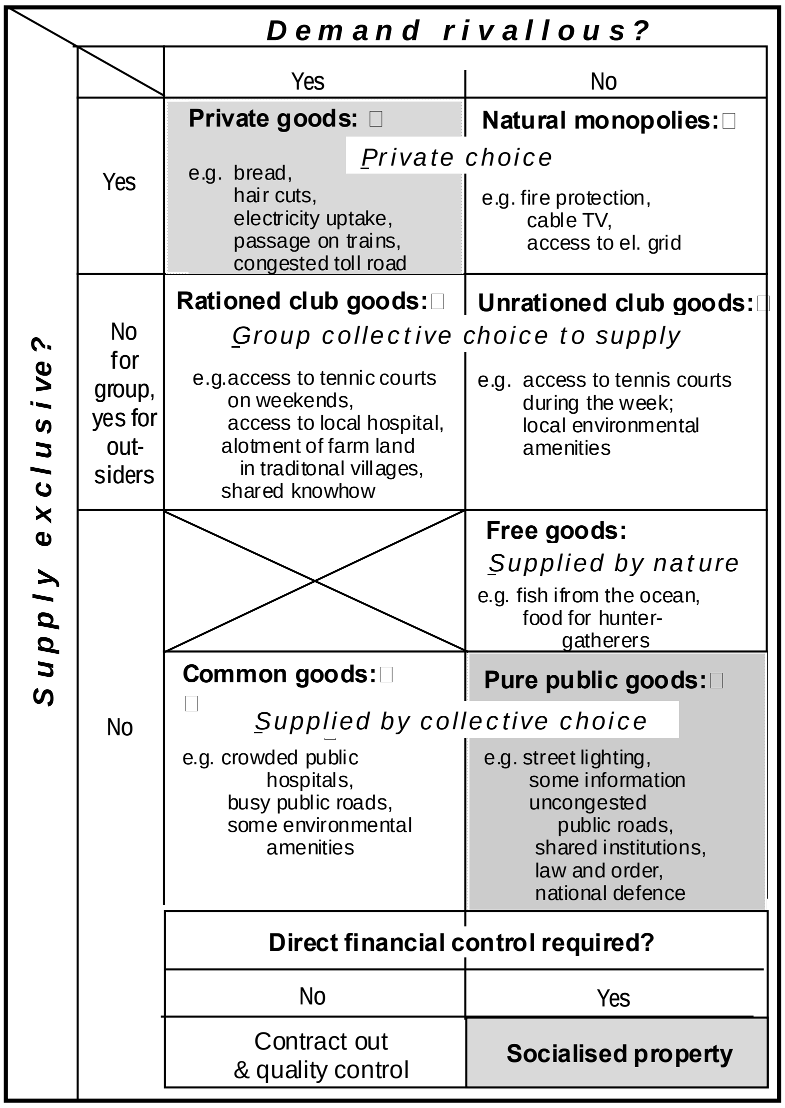
16 We shall return to the transaction costs of using property through markets in the following chapter.

rules on property ownership. Since this activity cost resources (agency costs), the rulers and judges had to collect fees or impose taxes (Benson, 1997).

The invention of private property had an important consequence for human progress. As long as the prevalent form of economic activity was the mere exploitation of nature (hunting, fishing, gathering), assets were not combined in a major way with human skills and knowledge to create valued goods and services and to supply them to others. Only when the tribal exploitative mentality gives way to cooperative, creative efforts, are a great variety of goods and services created for the enjoyment of others. Only then does xenophobia give way to exchange and curiosity about what outsiders have to offer (Jacobs, 1992). Although most of our forebears have lived with private property and creative enterprise for many generations, we are nonetheless sometimes still prone to fall back instinctually into the atavistic, tribal mentality of the palaeolithic age (Hayek, 1988, pp. 11-28; 48-65).

Graph 7

Private, Club and Common Property



To sum up the argument so far, the defining characteristic of private property rights is excludability, namely that the benefits from and the costs of a particular asset are specifically assigned to one person or organisation, and that all others are excluded. When private property is used actively, all the benefits and costs should ideally impact on the owner (or should be "internalised", as economists would say). Only then will private people make the choices, which lead to the best-possible attainment of prosperity. Only then will profits and losses be a good guide to finding and using resources. Where it is not possible to attach private property rights to assets (i.e. where externalities exist), complicated political interventions have to be contemplated (see Glossary on "Externalities").

The decision to supply private goods is based on private, voluntary choices (Graph 7).

The Taking of Private Property

Private property must be secure from being taken by government authorities. The only valid exception is when the use of a private property right harms others. Another theory is that eminent public purposes justify takings of property rights (eminent domain); but this latter theory is controversial, since multiplying claims of eminent public purposes can thrust the door wide open to frequent, arbitrary expropriation. Thus, public authorities in some US States claim commercial interest in developing local commerce as sufficient grounds for taking just about any private property.

Nowadays, it is relatively rare that private property is taken holus bolus, as was the case in the expropriations after Communist takeovers or the nationalisation of whole branches of European industry in the 1930s, 1940s and 1950s, or later still in some underdeveloped countries. The abysmal failure of communism and the poor performance of nationalised industries in developed and underdeveloped countries alike has put paid to wholesale collectivisation in most places. What is now much more common is the taking of individual property rights by regulations. Thus, a traditional right to harvest rain or trees from one's land is being taken away by legislation in many affluent countries with Green policies. Such takings of individual rights have material consequences in that they reduce the value of the land one owns. Owners of farms that are designated wetlands in parts of Australia, who are told that they can no longer farm those most valuable parts of their properties, doctors in Germany who are told by regulators that the diagnostic equipment they bought can from now on only be used in public hospitals, and landowners in the United States, who, as of 2005, face expropriation because local councils consider commercial development as a valid "eminent domain cause" have one thing in common: They are subject to regulatory takings, and typically are not being compensated for the loss of long-standing property rights. Both European housewives and Argentinean cattle breeders are the victims of takings by Brussels bureaucrats that either impose high tariffs or total import prohibitions on beef exports to the European Union. Such expropriation is also common in developing countries, for example when imports are subjected to license, when joint ventures require approval (and probably bribes) or when certain trades are reserved to cronies. In many places, the exercise of skilled activities is being more and more tightly regulated, so that the owners of many forms of valuable human capital are being partially expropriated. When legislators deprive them of their property rights and requires licenses for certain property uses, the burden of proof for previously free property uses is placed on them. Property owners lose their autonomy and their freedom. Property rights become less secure, and owners are discouraged from exploring new uses of what they own. Gradually, sclerosis sets in and development suffers. As Ludwig von Mises showed long ago, the economic effects differ little from the complete expropriation by socialists who shouted, "Property is theft!"

In countries with a tradition of secure property rights, government authorities, which want to seize property rights, have to prove harm (or tightly defined eminent domain purposes) in a court of law. The burden of proof always rests with them, if they want to abridge or take an existing property right. The practice by many contemporary legislators to reverse the burden of proof by simply prohibiting the exercise of certain property rights or making them subject to government approval, destroys private property, and with it individual freedom.

When a private property use is contested, this should be done under long-established rules of evidence, due process and scientific proof. Mere suspicion, allegations or hearsay that harm might occur in the future is not sufficient cause for interventions (precautionary principle). Harm must first normally have occurred to be proven (Kasper, 2004).

Experience with regulatory takings suggests that three conditions must be fulfilled if policy makers are justified in taking property rights away:

(i) There must be a reasonable prospect that the regulation attains a recognised policy objective. Mere political convenience or career ambition on the part of the regulator is not sufficient grounds for a taking.

(ii) An objective assessment of the costs and the benefits of the regulatory taking must show a net benefit. Mere allegation of such benefits, or benefits to particular groups, rather than the entire community, at the expense of the general community does not justify a regulatory taking.

(iii) Private owners must be fully and justly compensated for the loss of their right or rights. This means that the reduction in market value of the property before the regulation was contemplated and after the taking must be compensated by a payment. It will not do that the authorities threaten a taking, and then use the reduced property value as a basis for estimating the amount of compensation (Kasper, 2004).

These precautions are not only needed for reasons of justice and equity, but also to impose some discipline on zealous authorities. The fundamental principle of equality before the law demands that specific property owners must not be singled out for regulatory expropriation. Equally importantly, the maxim of just compensation imposes a budget discipline on eager authorities. They must make measured choices about where to regulate, and to regulate only as far as budget funds permit. It has become a fashion in many countries for parliaments, which are confronted with taxpayer resistance and budget constraints, to pursue policies not through spending, but through regulation. In so far as such regulations disadvantage certain property owners, regulatory policy disadvantages some to the benefit of policy makers and the general public. It behoves a justly run polity that regulations, which benefit the public, should also be financed through funds raised by taxes on the public. For example, if an area at the outskirts of a city is to be reserved as a "green lung" for the general public, it is only just that a landowner in the "green lung area" be fully compensated for the loss of development potential out of general taxes. Political entrepreneurs can then compete by offering to the electorate alternative regulation-tax packages. The electorate may then vote for tax increases and more acquisition of green, open spaces, or they may not.

These time-honoured principles of property right protection are now endangered in many countries, because of a proliferation of "Green" policies that diminish traditional private property rights without due process, proof of actual harm and without proper compensation. Only a few short years after the collapse and manifest failure of old socialism, the new-age neo-socialism of Green regulation is taking over in many places. Instead of old-style expropriation, property rights are being taken by salami tactics, often by activists, who have marched into government organisations with a mission and who still believe that "property is theft" and that propertied people deserve to be treated unevenly. They, and a tolerant public, fail to see that an essential pillar of our civilisation is being undermined, no less!

Free Goods, Club Goods

When early humans roamed in nature, property rights were not needed. Hunters and gatherers found free goods, i.e. goods that were not scarce because the few humans hardly rivalled with each other for resources. In the Garden of Eden, there was no need for private property, as all goods were supplied by nature. The spread of the human species across the globe was no doubt driven to a considerable extent by the search for new free goods. But as the number of humans increased, demand for certain assets became rivallous. Humanity came to be confronted with scarcity — or was expelled from Paradise, as the Bible put it. Groups and tribes began to defend their patch against outsiders, but allowed insiders unconstrained use. This created what economists call "the commons" or "club goods", goods whose supply is decided by small groups for small groups or clubs. Where scarcities arose within such clubs, more or less elaborate informal and formal rationing devices were invented (Graph 7).

Small groups that possess such a "commons", ration individual uses by internal, informal institutions, for example by mutual supervision or taboos against overuse. When people know each other and meet frequently, such informal institutional means work cheaply and effectively. The anthropological literature on different civilisations shows that informal policing of commonly owned resources such as fields, forests, fishing grounds and tennis courts works reasonably well in groups not exceeding five or six dozen participants. Once the group exceeds this limit, the informal institutional mechanisms break down and lead to over-exploitation and internal conflicts. Therefore, when the group grows, internal institutions have to be enforced more formally. Probably, they have to be backed up by external institutions — a king or chief allocates land uses or hunting rights; and this is formally enforced. Thus, members of a country club may be allowed to collect flowers and mushrooms, but the amounts are limited under the by-laws.

Where such rationing mechanisms are not invented and enforced, the "commons" deteriorates, as each member appropriates "common wealth" without constraint. Everett Hardin has cited a telling case of such "tragedy of the commons" (Hardin, 1993). When the first satellite images were made of the Sahel region in Africa during a major, catastrophic drought, patches of well-grassed land were discovered amid overgrazed, durably damaged land. Ground investigation revealed the consequences of good and bad institutions. The grassed areas belonged to small groups of private owners who had fenced their land and conserved their own resources during the drought, whereas the commonly owned land was overgrazed by herdsmen, who were only able to appropriate benefits from the land by intensive grazing. The institutions that secured private and club property thus limited the damage of the drought — a telling instance to illustrate the fundamental effect of universal institutions for resource conservation and good stewardship (Hardin, 1993). With the increasing numbers of people on earth, property rights can often be used to encourage careful stewardship of natural resources.

When common property uses cannot be policed adequately, one way to secure the most highly valued uses of the scarce assets is to introduce the rules that establish exclusive private property title to specific parts of the commons. These can then be exchanged in markets on the basis of voluntary, bilateral contracts (Graph 7). This happened in post-Medieval England when village commons were fenced off, and in many parts of the world, when free goods or commonly held club goods were assigned to specific private owners. This privatisation process still goes on, not only in the Third World, but also in developed countries, for example, when local councils introduce parking fees in the CBD or when previously free commercial fishing access is auctioned off to holders of exclusive fishing licenses. These are steps towards a more effective, less conflict-ridden way of allocating and using scarce goods.

The observed problems with the tragedy of common ownership and the political conflicts which arise within large groups of joint owners and users, can be expected to loom large in those "ownership clubs" that have been established for indigenous people, for example in the US, Canada and Australia. If human experience is anything to go by, common ownership by large, anonymous groups, whose members rarely meet, inevitably leads either to excessive use or to the diversion of benefits to influential insiders and agents who are in *de facto* control of the asset. The institutional arrangements necessary to police large "club properties" may well be more complicated and require more administrative control than the alternative of assigning smaller properties to private ownership by individuals, families or clans. Private property of land in the hands of families and clans has the advantage of inducing some individual owners to seek more creative uses of their land. This would give families the chance to test alternative ideas how to make use of newly reconfirmed property titles to their own best advantage.

In many instances, the move from free goods and traditional, informal club ownership to private property is often inevitable in the modern world.

Those Troublesome Externalities

In practice, it is not always feasible to exclude non-owners from enjoying some of the benefits or bearing some of the costs of certain asset uses. Certain property uses create effects, which cannot be measured or clearly attributed to the owner. Economists speak of "externalities" when property uses create costs and benefits that cannot be confined to the owner and that impact on society at large (see Glossary).

We speak of "external costs" when others than the owners have to bear some of the costs of certain property uses. For example, the emission of noise or pollution from an industrial activity impacts on the community at large. We speak of "external benefits", when others than the owners gain benefits from certain property uses, for which they do not or cannot compensate the owners. For example, when I create a beautiful front garden or light the street, my neighbours enjoy the amenity (free riding). Such externalities are due to the fact that not all costs and benefits from property usage can be assigned, because they cannot be measured or the assignation would create inordinately high costs. I simply cannot collect a penny from everyone who passes my house at night and is glad of my streetlight. Advances in measurement and information technology (computers) have, however, often permitted the internalisation of what were previously considered externalities. Thus, we can now often determine who pollutes the air and who suffers. Then, we can make sure that the polluter pays, compensating the sufferer. This is, for example, being done with noise pollution around major airports. Residents receive compensation out of airport-user charges. For a long time, street use by cars could not be easily measured, so that streets had to be provided out of taxation by governments. Recent advances in transponder and computer technology now make it possible for private businesses to build public-access roads and to charge for measured road usage.

In instances where measurement is not possible or economical, the private production of goods and services may not be privately rewarding to individuals. As long as positive externalities impact in close proximity, neighbours can form an association to internalise all the benefits. Local government areas often capture such neighbourhood effects. Recent private land developments in the United States and Australia, which offer owners shared amenities such as sporting facilities or a high degree of security, are based on reaping external benefits within self-administering associations. A similar case occurs in clubs when one individual cannot capture the full benefits of a sports field, swimming pool or a social club, but an association of individuals can. Then, members have to decide how to distribute the costs and the benefits amongst themselves. Often, so-called "club goods" can be rationed at low transaction costs because the information on usage and controls of over-usage can be monitored informally and relatively easily among a small community. Outsiders are of course excluded from access to such "club goods". The rules that ration use and the costs of provision are shaped by the fact that disaffected club members can exit from such open, voluntary associations. The decisions over the supply of and demand for club goods are then a mixture between collective and private choices (Graph 7).

When externalities cannot be internalised because they are widely scattered or when the measurement or compensation costs escalate, then reliance on private property will fail to induce owners to make the allocational decisions to yield what is most highly valued in the community. Activities where private owners are able to shirk bearing a part of the total costs, which they cause, will be over-expanded. These activities appear to private property owners more profitable than they are of utility to the community. And property uses, where not all the benefits can be captured and appropriated by the owners, will be under-supplied, because the incentives to do so are weakened. In other words, externalities cause the profit-loss motive to be a poor guide on what goods and services are most highly valued and should be supplied or demanded. A case can then be made for public policy interventions, although — as we shall see in Chapter 6 — this raises complications as compared to private property uses.

While many externalities of property uses impact on neighbours, there are externalities that even transcend the reach of national jurisdictions. For example, if an up-river country, such as Turkey, uses irrigation water, it may cause external costs to down-river countries, such as Syria and Iraq. Likewise, greenhouse emissions by high-energy users may affect the global climate, imposing external costs (and, possibly, benefits) on people in distant places. Since there is no supra-national authority, which might police the pollution of the "global commons" and enforce appropriate rules internationally, this poses difficult problems for international politics. In the case of greenhouse emissions, the trend — if a trend it is — tends towards uniform, centrally planned and hard-to-enforce targets for the reduction of emissions. This is the approach of the United Nations under the "Kyoto Treaty". The alternative to this "one size fits all!" approach is to take a page from institutional economics and to think of globally tradeable rights. Such rights can be transferred from the importers of energy-intensive products, such as aluminium, to the exporters who, after all, alleviate the importers' pollution burden. Such an arrangement would allow those who make the most valued use of tolerable levels of CO_2 emissions and would create a price incentive to ration such emissions. This will ensure that the cleanest producers reap a benefit, creating a material incentive to economise on activities that burden the atmosphere.

Public Goods

There are some cases where exclusion by the device of private property rights is not necessary because private users do not rival with each other. An example would be street lighting or picking up radio waves. My enjoyment of a brightly lit street or of a radio transmission does not diminish access to these amenities for others. Economists call these "pure public goods" (see Glossary). Demand is similar to free goods, but — different from free goods, which are provided by nature — the supply costs resources and effort. Provision therefore has to be decided and made by collective choice (Graph 7). In the case of street lighting, it would not be practicable to collect fees from the passing traffic to compensate the provider for incurring the cost of the street lights. The collection and monitoring costs would in practice simply be too high. Instead, government will fund street lighting from taxes. More important cases of pure public goods are the provision of defence against external aggressors and of internal protection from thuggery by providing and enforcing agreed institutions (law and order).

It makes practical sense for government to finance general access to these public goods and to raise the funds through a politically determined impost. Government may also get involved in providing widely useful information, for which individual citizens would incur disproportionately high costs. Thus, the preparation of maps, the provision of weather or health information, the conduct of geological surveys and legislation against fraud and deception fall into the category of public goods. It also seems appropriate for government agencies to provide reliable information on the effects of pharmaceuticals or the minimum capabilities of surgeons, because individuals who are suddenly confronted with a need for medication or surgery would find it extremely difficult to obtain reliable information on such vital matters. A similar argument can be made for the public provision of money.

Government money reduces the information costs of the public as compared to a payments system based on diverse private moneys.

Technical change can remove the argument for treating certain goods as pure public goods. As mentioned before, electronic monitoring and accounting are now making it possible to treat roads as private goods, for which users are billed through transponders.

When the conditions that make for pure public goods are not given, governments nevertheless often engage in providing goods and services. In this case, supply is determined by collective choice, and there is rivalry between users. Some collective decision has therefore to be made about rationing the demand — by charging a fee or a price, by queuing, by political favouritism, or by lottery? Different from the case of clubs which people are free to join or leave, membership is compulsory. All residents have to fund the provision of these common goods, and all are subject to the collectively determined forms of rationing. Disaffected members have no exit option, only an option to raise their "voice" by voting, demonstrating, lobbying etc., (Hirschman, 1980).

The Private Production of Public Goods

The terms "public good" and "common good" do not necessarily imply that the means of production of such goods should be publicly owned, nor that the production process has to be managed by government administrators (Demsetz, 1970). What matters is access — providing these goods and services in the public domain (Graph 7). Thus, a good case can be made for financing street lighting and roads from taxation, but to have these services produced by private and preferably competing producers. Many common goods, such as electric power, rail services, telephone connections or school education, can be made accessible to everyone without having to be produced by state-owned enterprises. Private trains can run on publicly-owned tracks. Telephone companies can be broken up and privatised. Access to private schools can be made possible by tax-financed vouchers. With competing providers, the community is better protected from monopoly abuses. The rivalry of contending producers is likely to empower the citizen, promote the better use of knowledge (innovation) and offer a richer variety of goods and services to chose from. These considerations have played a major role in making privatisation a worldwide phenomenon.

Government has two roles in the competitive, private provision of common or public-domain goods. One is to ensure that quality standards are upheld. Another is that less affluent citizens have access, e.g. through vouchers. Thus, poor kids in Puerto Rico were recently given the option to access private schools through government-endowed school vouchers. Similar voucher experiments in many countries now empower relatively poor people to access health and education services and other basic necessities that are deemed by the political majority to be essential for all.

The case for direct public ownership of certain assets rests on a completely different consideration. Sometimes, there is a need for the complete control of asset uses, because competition might be too costly for the citizens or because producers cannot be trusted to do the citizens' bidding. Thus, military forces, police officers and other "violence professionals" come normally under the direct political control of government. Control of the purse strings by direct ownership is part of an arrangement whereby they are controlled by non-violent means. The alternative might be private competition in the use of force, with unacceptable collateral damage to the population. The competition between mobs of mercenaries and competitive police protection rackets would indeed be fairly unattractive forms of competition! In a similar vein, most law courts are nowadays run by the government because private judges might be too exposed to temptations of influence peddling and bribery.

The case for political control through the collective ownership of the means of production is, however, not always clear-cut. The administrative agents of government may exploit the knowledge problem of elected political supervisors and citizens, acting opportunistically. Police corruption and judges who favour interest groups or who seek public acclaim for being "ahead of their time" come to mind as examples of the failure of political controls. A case can therefore be made in certain cases for private policing and competing private jurisdictions.

In modern economies, there are massively more publicly owned ventures than is justified by externalities or the need for direct collective control. Governments have expanded socialised ownership as an easy way to raise revenues, to redistribute incomes, to expand political influence, and to respond to ideological criticisms of private property. Public ownership is even more attractive to parliamentarians and bureaucrats, when publicly owned firms can be turned into a monopoly. Then, monopoly rents accrue to the government and those who work in it. However, economic theory teaches us that monopolies sell at a higher price, offer less quantity and poorer quality and innovate less than competing privately owned producers. The state's gain is therefore typically the private citizens' loss and an impediment to long-term innovation. That this is not mere ideology – as protagonists of public ownership in unions and governments often maintain – has been demonstrated in numerous privatisation exercises around the world. Costs to consumers have come down, and the quality of service and innovation has typically risen.

Dividing Property Rights and Discovering New Ones Promotes Economic Development

The private property rights system hinges on excludability. But two other important features of private property rights are needed to make them fully productive: divisibility and tradability.

The property rights, which are attached to a specific asset, do not form a monolithic bloc. They are a potentially open-ended bundle of specific rights. The value of an asset can therefore often be greatly enhanced by making institutional provision for the separation of the various rights. Thus, a land-owner may lease the land to someone for farming, to someone else for cutting timber or mining, to yet another for fishing the stream through the property, and yet others for recreational uses or various rights of way. Such divisibility of the property rights bundle means that different people with different knowledge and motivations can make use of the same asset, deriving much more highly valued outputs from it than a single owner-user ever could. Divisibility is based on institutions. The Romans, for example, refined existing property laws to allow mortgages and partial uses of assets, giving people who could not afford outright property ownership access to those parts of properties that they valued highly. Roman law secured contracts, reduced uncertainties, and the transaction costs of divisibility. It was an important foundation of the rise of the Roman empire (Bethel, 1998, pp. 61-74).

We called property an “open-ended bundle” of rights, because owners do frequently not know all the rights that can be attached to private property. Thus, a landowner may one day discover that his property gives him the right to rent out the street front to shop owners. Someone else may discover that he can harvest the rain and use it for irrigation, thus greatly enhancing the value of the land. In the development process, the millions of private property owners are constantly on the lookout for new uses of what they own. They discover new rights, and these rights add up to what we call economic growth. This is at least the case, where the institutions that underpin private property are secure and justly enforced. Alas, in many underdeveloped countries, property titles are ill defined, and the rights that derive from it fuzzy (de Soto, 2001). Thus, shantytown dwellers do not have clear title to their land and shacks, and street stall operators may face eviction anytime. Then, they cannot use their only assets as collateral to borrow funds to improve their lot, nor will they have much incentive to develop higher skills that would enable them to use their property in more effective and rewarding ways. How important the security of private property is could be observed in China, where the reforms after the late 1970s bestowed fuzzy sorts of property rights on “household units” (families, frequently the same families that had owned the land prior to the Communist take-over). The farmers tried to discover by experiment, whether their land could be sub-divided, built on, sold, inherited etc. As word spread that these property rights were indeed acceptable, people began to use their assets more intensively and creatively. Similar (re-)discoveries of property rights were made by the owners of industrial shares. All this contributed greatly to the economic ascendancy of China.

Trading Property Rights

A related, valuable characteristic of property rights is their tradability. If property rights cannot be traded (in other words, the property is inalienable), they can only be used by whoever happens to own them. Other people with more enterprise and possibly better knowledge about what to do with a specific asset, cannot acquire the asset, or specific rights devolving form it, in exchange for money or other assets. When, by contrast, rights can be traded, their potential value is greatly enhanced, and discovery of new knowledge (innovation) is encouraged.

If a property is inalienable, for example by an inheritance clause or by custom, it has little value, which is then often resented. We observe, for example, a tendency to assign a growing share of Canada’s and Australia's land surface inalienably to national parks for purposes of nature conservation and to collective Aboriginal ownership. In an inevitably evolving world, new ideas and opportunities will arise how to conserve endangered species and how to open ways for indigenous people to advance themselves materially. The non-tradability of land rights, however, blocks many of these opportunities. Maybe, one area of a national park would, if sold or exchanged for another, contribute more to the conservation of an endangered species. Maybe, the (voluntary) sale of some land or the selling of a right to mine or make other specific uses of the land would greatly enhance the indigenous owners’ life opportunities. It is cruel to deprive these poverty-stricken groups of the right to make the best of their assets.

CHAPTER SIX

MARKETS: THE RIGHT AND THE RESPONSIBILITY TO COMPETE

"The market is the best garden".

George Herbert, *Outlandish Proverbs*, 1640.

".. .... competition is important as a process of exploration in which prospectors search for unused opportunities that, when discovered, can also be used by others...."

F.A. Hayek (1968), p. 188.

"The modern business economy has as its basis human freedom exercised in the economic field.... We acknowledge the legitimate role of a profit, this means that the productive factors have been properly employed and corresponding human needs have been duly satisfied."

Pope John Paul II, *Centesimus annus*, 1991

Owners normally use their private property rights in combination with the property rights of others. Property rights can be combined (a) within an organisation, i.e. in a more or less durable arrangement to pursue a shared purpose under some form of leadership and direction, and (b) through markets. The purpose of this chapter is to outline how individual markets, as well as entire, interdependent market systems work[17].

The Market Process

A market is a meeting place. Intending buyers and sellers, each with limited knowledge of their own, seek and find information about what property uses might be mutually advantageous. Intending buyers (on the demand side) and sellers (on the supply side) are engaged in ongoing, open-ended processes of knowledge search and exchange, in which new wants are discovered and explored, new resources and resource uses are uncovered and tested, and unwanted resource uses, which are signalled by low profits or even losses, are discontinued. What happens in markets is therefore at the heart of the economic problem: discovering and satisfying changing wants with scarce resources and discovering new resources, in a process that has been called "catallaxy"[18] (Hayek, 1948, 1978; Mises, 1949, also see Catallaxy in the "Glossary"). The market is a dynamic phenomenon — a "discovery procedure", as Hayek used to call it (Hayek, 1978). Markets fulfil their function in tackling the economic problem well if they

17 How property in capital, one's labour and knowledge is used within organisations, such as business firms, is the subject of organisation science. Although this is beyond the framework of this essay, we should note in passing that coordination by market and by organisation are often interchangeable ways of combining production factors. For example, some firms produce an input in-house and others subcontract the same input in the market, and your mother may have done the cooking in-house whereas you subcontract it to fast-food outlets. Information technology has, in recent decades, shifted the relative costs of organisation versus transaction in markets and thus enabled more sub-contracting to take place (for more detail, Kasper-Streit, 1998, chapter 9).

18 The term derives from the Greek word *katallatein*, "to exchange and thereby to turn strangers into friends". One can almost visualise merchants landing in a port, talking, trucking and bartering to obtain useful market information...... The term was first applied to the science of exchange by the Rev. Richard Whately in his 1831 "Lectures on Political Economy".

- facilitate entrepreneurial exploration and discovery,
- spread useful knowledge around, and
- bring about the spontaneous correction of errors.

All three effects are essential for to sustained economic development.

How effective market competition is in advancing in knowledge and living standards depends on the specific rules that guide the behaviour of market participants. Some rule sets do this obviously better than others. What matters here is not only what happens in one specific market, such as the potato market in London, but the entire system of interdependent markets, the incredibly complex, evolving network of interrelated processes which constitute the web of global economic life.

The Costs of Transacting Business

How is useful knowledge discovered and tested in markets? To answer this question we have to acknowledge first that this is not a cost-free process. Indeed, market transactions –– searching for new products and business partners, negotiating deals and monitoring them — absorb considerable resources. We have already noted that, in a modern economy with an intricate division of labour and specialist knowledge, about half of the economic effort is used to find knowledge and cope with other costs, of coordinating business and production This fact may amaze the reader. Much work effort in firms is dedicated to organising resources and coordinating the activities of collaborators and outside contract partners (workers, lenders, borrowers, customers, suppliers of inputs, R&D and other such activities). Entire service industries have sprung up to expedite such coordination (trade, communications, finance, advisory services, etc.). In mature economies, these transaction services are growing faster than most other parts of the economy. The share of transaction services in the GDP of OECD countries has probably doubled since the start of the 20th century. It is an inevitable consequence of the ever-more sophisticated division of labour and knowledge and a natural concomitant of the process of economic growth.

The coordination costs in markets (which we call "transaction costs") fall into the following categories:

- *Exploration and information costs*: finding out what one wants and is able to aspire to, what sources of supply there are, as well as where, at what prices and qualities goods and services may be available, whether potential contract partners are reliable and similar specific information, as well as where and how to sell the goods and services one wants to produce;
- *contract costs*: negotiating and concluding a contract takes time and resources, not least because one faces inevitable uncertainty and has to guard against eventualities and contingencies, and
- *monitoring, adjudication and enforcement costs*: keeping oneself informed whether the contract is being fulfilled as agreed; if not, settling misunderstandings and conflicts (adjudication) and enforcing contract compliance, possibly with the help of a third party, such as an arbitrator, the judiciary, the police and jailers.

We have already noted that the costs of exploring new concepts and finding information before one can even contemplate a deal in the market have a rather insidious quality (Chapter 2). Before one has incurred sufficient exploration costs, one cannot know or evaluate whether or not it is worth one's while to even incur these costs. There is simply no way of assessing rationally the return from exploration before it has been done. It takes true entrepreneurial flair and a taste for risk taking to engage in this essential part of market activity. Many people feel intensely uncomfortable with the risks involved, in particular when knowledge search involves sizeable expenses. Most try to avoid the uncertain returns to exploration costs. Exploration costs are the major reason why there are limits to finding new knowledge, why the division of labour has limits, and why the economic problem of scarcity persists. The general conditions surrounding markets therefore must inspire a degree of confidence if we want economic development to take place.

The general climate of confidence, which makes it easier for people to embark on exploring new knowledge of (yet uncertain) value, is largely determined by a society's institutions, their quality, content and reliability. Where pioneers, who explore a new idea, cannot trust that they will be able to keep the benefits of newly discovered knowledge, they will desist from incurring the costs of new ventures. It is therefore essential to provide trust-inspiring institutions that guarantee pioneers the rewards of having found useful knowledge. In other words, the institutions must guarantee universal property rights. Failures to do so are the main reason why different societies vary greatly in their innovative dynamism, indeed why economic growth rates differ (de Soto, 2001; Roll-Talbot, 2001).

One good example to show that this is a realistic way of looking at knowledge exploration and risk-taking is the mining industry: Mining businesses are on the alert for new information from geological surveys and similar sources, drawing on their own knowledge and flair, until they judge that they know enough to sink a hole in the ground, a costly exercise. Millions of dollars may have to be spent on successive drillings until the explorer knows whether he has struck a bonanza — or found nothing. Entrepreneurial guesses drive mining prospectors to sink fixed costs for uncertain returns. Once a mineral deposit has been proven, the past exploration costs are genuine sunk costs – pardon the pun! They have absolutely no bearing on the decision whether to develop the mine or oil well to produce. This is solely determined by expected future costs and receipts.

The Spirit of Enterprise

Entrepreneurship is needed to find new opportunities in all walks of life. Thus, the real-estate developer may see an opportunity in a new location; the industrialist may respond to new technical opportunities and explore the commercial feasibility (profitability) of a new product or process; the young woman or man may be alert to the need for new skills and incur high costs in acquiring these skills; and the consumer may be alert to new products and be prepared to explore whether or not they will be as useful as expected. Lively, innovative markets require not only entrepreneurship on the supply-side, but also alert consumers on the demand side, who incur costs to find out new knowledge. The rapid development of computer software would not occur, if computer users were not prepared to buy and try new programs and did not share this knowledge around through magazines, web sites and intensive communication of their experiences, all a costly and time-consuming activity. A dynamic market economy thus is a continuous invitation to buyers and sellers to incur knowledge-exploration costs for uncertain gains. The more participants act entrepreneurially, the more useful knowledge is likely to be discovered and used to advance living standards and life opportunities.

To be precise, entrepreneurship requires two qualities:

(a) an alertness to scan the horizon for new opportunities, using one's own knowledge and inspiration to unearth new opportunities, sometimes turning liabilities into assets and often applying a creative mentality to imagine what no one else had seen before (Kirzner, 1984, 1997; Maley *et al.*, 1983), and
(b) the willingness to incur the necessary transaction costs by pioneering new activities and products, which is always a risky business (Streit-Kasper, 1998, chapter 8).

If entrepreneurs have guessed correctly, they will reap a profit. If not, a loss is incurred; the business may even go bankrupt. Profit thus has the important social function of mobilising and rewarding entrepreneurial creativity and the risk-taking of costly knowledge search. A profit therefore is not the result of mere luck (as people who assume perfect knowledge try to make us believe), although luck sometimes plays a role in profitability. It is the result of constant alertness and preparedness to incur the transaction costs of knowledge exploration. When people are poor and fatalistic, when profits are highly taxed, invoke social opprobrium or are poorly protected by prevailing institutions, there will be less "creative curiosity" and less innovation. Economic development and job creation will be correspondingly slow.

How do enterprising market participants handle those insidious knowledge exploration costs? Typically, some follow their curiosity and their "animal instincts" and do not worry about the cost of "the hunt for information", at least for a while. Others will be guided by experience in deciding how much of what they own to invest in search costs. Once entrepreneurs have a feeling that they are sufficiently informed, they will make a decision to buy or sell. With hindsight, they may find they have either spent too little or too much on knowledge search, and errors may have to be corrected. In this pragmatic process, aspirations may have to be adjusted (bounded rationality). New information searches will be started in the never-ending "film" of knowledge-generating market activity, an open-ended evolutionary process of discovering new wants and new resources.

After the Xerox company, a small office-products supplier at the time, discovered in the technical literature what had been found out about bonding carbon particles to paper with the help of light, they had to incur enormous information and transaction costs until the first photocopier could be marketed. Establishing its technical feasibility (does it work?) was the lesser part of their problem. The commercial feasibility test (does it make a profit?) required much entrepreneurial knowledge search:

- From what raw materials and suppliers to get the inputs?
- How to coordinate suppliers?
- How to finance the effort?
- How to train all necessary skills?
- How to find customers (there was no ready-made market for Xerox copiers at the time!)?
- How to distribute the machines and where? How to handle possible breakdowns in this, as yet untested, technology?

Such practical information problems require an entrepreneurial attitude and property owners who shouldered these many knowledge-search costs.

In a competitive system, people have a profit incentive to search for and test useful knowledge. Market competition therefore creates conditions in which people are most likely to learn how to improve their and their fellows' lot.

Finally, free markets have another important social role. Private property rights and autonomy in free markets not only support prosperity and economic freedom, but also enable us to enjoy wider civil and political liberties (Friedman, 1962, pp. 7-21). Free markets — as Joseph Schumpeter once said — provide "many private fortresses" in which people are free and from which they can defend their domain against the abuse of power by others and by the state. It is no coincidence that the new middle class in 19th century Europe and America fought for civil and political liberties, and that the new middle class in east Asia now does the same. Poor people can be easily dominated, but not citizens of property.

Tax and Compliance Costs

We have to mention two further types of cost in coordinating economic activities, namely tax and compliance costs. As we have seen, the internal institutions, which order most of our activities, sometimes require the back up of government by legislation, regulation, monitoring, and enforcement by legitimated compulsion. This is a costly exercise, causing what economists call the "agency costs of government." These have to be financed by taxes, fees and other imposts. In addition, there are compliance costs, which have to be borne by those citizens, who are monitored and governed. The agents of government often suffer major knowledge problems when trying to monitor what goes on. Therefore, they often impose considerable costs on citizens whom they oblige to keep records and accounts, report statistics, conduct business in disadvantageous ways and desist from certain, probably lucrative actions (compliance costs). If governments are careless in imposing such compliance costs, they create a major hindrance to the active use of property and talents.

Some jurisdictions have learnt to keep citizens' compliance costs to a minimum, even if that inconveniences the administrators. They will impose certain policy requirements, for example to protect health, safety or the environment, but draw on the art of administration to inflict the least cost and inconvenience on complying citizens. Such an approach has, however, rarely been a priority in the public administration of most developing countries. For example, it is not uncommon for a new business in the Third World that it has to run the bureaucratic gauntlet of obtaining some 20 or more permits from various authorities. These permits are often handed out by administrators who seem to believe that industry and production are necessary evils, which have to be "domesticated" by strict and virtuous administrative supervision. Many officials may use such a permit system to extract bribes for expediting approvals. One can contrast this with the business-friendly concept of a "one-stop shop", where an intending businessman files one single application. The relevant government office then goes around to obtain all necessary permits on behalf of the applicant, possibly within a fixed period (as is the case in some east Asian countries, for example). In such an institutional arrangement, most compliance costs for setting up new industrial ventures are shifted to a government agency. This has the additional advantage that government agents become aware of the costs, regulatory inconsistencies and obstacles to business development. They can streamline procedures to attract more job-creating capital and know-how. While such a user-friendly approach is often rather alien to the administrative traditions in the Third World, a switch in the style of administration can do much to enhance growth and job creation. A first step in this direction is to recognise the central fact that top-down coordination of economic activities imposes considerable costs on business and citizens and to deregulate, so that more is decided and coordinated in markets.

The costs of passive and active uses of property (the exclusion and coordination costs) vary greatly from one country to the next. Where the internal and external institutions ensure that there are few thieves, exclusion costs are low and property is worth more. Where the government's enforcement of property titles is lax and haphazard, private exclusion costs skyrocket. Property loses some of its value. This has, for example, become evident in those countries in areas where crime against property has gone up because of drug addiction, and in rural areas where land values have been affected by multiplying restrictions of land uses. Whether or not such regulations are justified, we should note that they greatly raise exclusion and coordination costs and reduce the value of land (Kasper, 2004). Those who set or alter the external institutions frequently, disregard the transaction and compliance costs, which they impose. Indeed, many in the judiciary or politics scorn the thought that they should consider these compliance costs, when they pursue justice or similar goals. Such disregard for the costs of private property use harms private welfare and economic development.

Prosperity comes to communities, which enjoy low transaction costs, where people are honest, punctual and ready to compromise in solving conflicts, the laws are universal, and the courts operate expediently. More opportunities can then be explored and tested, and much valuable knowledge is discovered and utilised. Big trading centres — such as Florence, Venice and Amsterdam in earlier ages, and New York, Zurich, London, Hong Kong, and Singapore nowadays — have flourished because the coordination costs of merchants and innovators were kept low by the conscious cultivation of market-friendly institutions. By contrast, peripheral locations often remained backwards and boorish because the heavy, visible hand of government and intrusive regulatory attitudes hindered competitive creativity.

Market Participants Rival by Incurring Transaction Costs

This uncomfortable business of incurring uncertain knowledge-search costs is driven by the rivalry with others on the same side of the market place. Thus, the — typically few — suppliers in a market are in continual rivalry with each other for the favours of the buyers. To position themselves favourably for deals with buyers, producers incur high costs of research and development to improve their product and to offer better or cheaper new products. This rivalry has driven ceaseless product innovations — in the case of motor cars, for example, progress has been enormous from Mr. Benz's rickety, sputtering cart to today's sleek limousines. The ceaseless rivalry among suppliers may be uncomfortable for them, but it is the motive force behind most of the technical and material progress of modern industry (see Insert below). One only has to look at countries where suppliers were protected from incurring knowledge-exploration costs by their governments. In India, for example, the car industry produced the rachitic 1948 model of the Morris Minor into the 1970s; and in East Germany, the industrially most advanced country in the socialist bloc, they produced the laughable Trabant car year-in, year-out!

Rivalry in the market always creates risks and uncertainties. You never know what your rivals might do next and whether their initiatives will eat into your market share and profits. As long as suppliers cannot be sure how secure their market niche is, they will strive to control their costs by seeking process innovations. As long as their market position and profitability are perceived to be temporary, producers will invest resources in knowledge search to find out cost-saving production processes (see Insert). The rivalry between suppliers is therefore essential not only to induce propertied people and firms to bear the costs of product innovation, but also for them to shoulder the costs of cost- and price-reducing process innovation. Private cartels and government patronage to release them from their rivalry (such as tariffs and market regulations) automatically reduce the intensity of an industry's rivalry and hence the willingness to incur beneficial search costs and risk innovation. As a result of such government intervention, the economy then displays less of what economists call "catallactic or dynamic efficiency". In other words, it generates complacency and ensures that market participants utilise fewer new ideas.

It is not surprising that the long-protected manufacturers in developing countries that adopted import-substitution have been poor innovators and tolerate high cost levels. They enjoy government-made certainties (such as guaranteed shares of the domestic market). Consequently, they do not have to live with "creative unease". The flip side of such a "welfare policy for big business" is an industrial malaise, poor economic growth and limited competitiveness. Once the government withdraws these protections, when it liberalises trade and allows the forces of globalisation to unfold, the adjustment pains are great. Like someone rising from a sick bed, manufacturers then have to relearn how to incur search costs and to compete. To the extent that they change the entire entrepreneurial culture, they begin to offer the buyers more advantageous products, often at lower prices. Cars for example then become more reliable and are better designed and cheaper. Of course, industry has again to face the discomfort of those insidious information-search costs. This induces many suppliers (firms and their previously featherbedded workers) to become politically active so as to regain a degree of political protection in exchange for offering government their political and material support (see Insert below).

What has been said so far about rivalry in incurring transaction costs among suppliers also applies to the demand side of markets. Buyers rival with each other by incurring information costs to find advantageous purchases. Housewives shop around for an a deal. Sometimes their costs of exploration are compensated by the pleasure of "the hunt" (market searches can be entertainment and consumer goods!). By acting entrepreneurially, consumers enhance the intensity and quality of the competition. Discerning buyers are indeed crucial for the health of an industry. Because the French have learnt to discern good food and complain of bad restaurant service, they can enjoy excellent restaurants. A tolerant, lackadaisical British clientele, who consider justifiable complaints bad manners, suffer from poor food at exorbitant prices. Customers, who tolerate bad service, deserve no better!

The fact that buyers rival with each other may not always be evident at first sight in shops with shelves full of stock. The need for buyers to use some of their assets to incur transaction costs is, however, evident when buyers rival for particular pieces of real estate or art. There, one's alertness and readiness to incur search costs may decide whether one is a successful bidder or not. In markets for industrial inputs, the rivalry of buyers plays a big role in driving innovation and quality performance. Car companies, for example, invest much R&D, as well as information and contracting expenses, into obtaining the most advantageous car components, and supermarket chains rival with each other to obtain fresh, cheap supplies.

Insert

How Producer Rivalry Drives the Innovation of Products and Processes

To understand how competitive rivalry motivates producers to take on the burdens of transaction costs, we can turn to a snapshot from the dynamic competitive process. Let us take a car producer as an example. The producer will realise that small price variations will not lead to much change in the quantity of vehicles he can expect to sell, because there are brand loyalties and frictions in the market. Indeed, he will see great advantage in widening the price band over which demand is — as economists would say — price-inelastic. The range of inelastic demand is called the "market niche". To create such a niche, a car producer will develop new car models (product innovation), advertise the merits of his cars and offer better after-sales services (for example, guaranteed spare part supplies, free 100,000 km warranties, or road-side assistance). Such non-price competition is costly, but it positions the car producer well in the market. His rivals, typically a limited number, will incur similar costs in the hope to crowd in on his market niche, in a competitive tug-of-war (Graph 7). The market niche is thus never certain, never reliable, always in need of fostering by investment in new transaction costs.

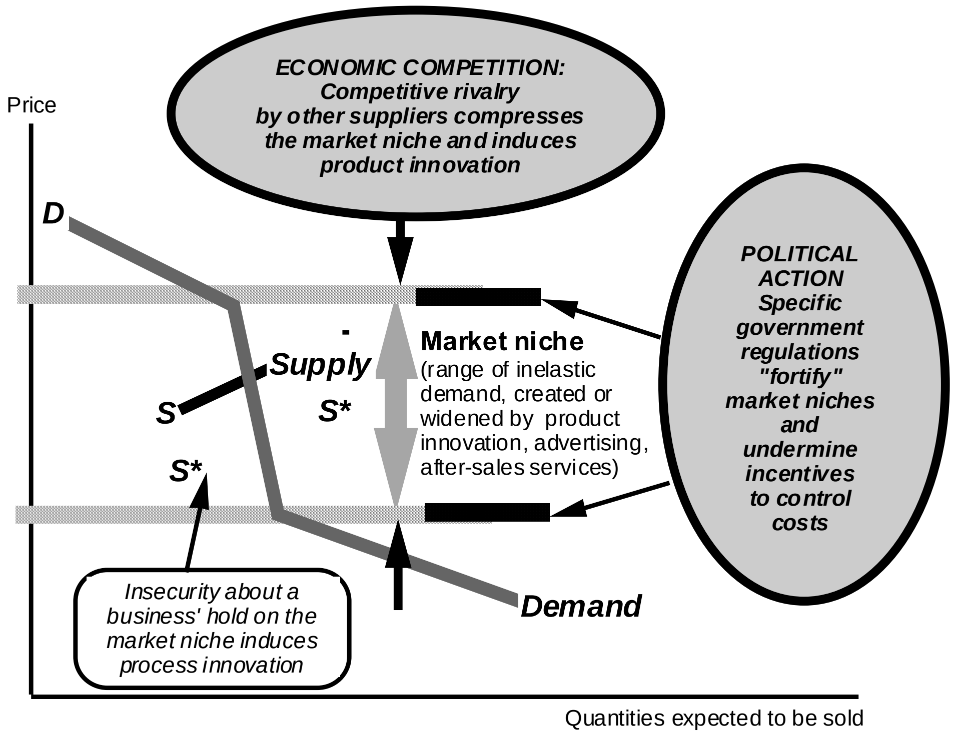
The uncertainty of the market niche keeps producers in "creative unease". This prevents them from driving up prices or resting on their oars with product innovation, advertising and improving the service. It also impels them to control costs or even bring costs down by process innovation (which is reflected in a downward shift of the supply schedule to S* in Graph 7). Process innovations of course cause expenses, often forcing producers to scrap old equipment and upgrade their production methods ("creative destruction" of old, but serviceable capital stock). Managers are forced by competition for market share to streamline procedures, risk innovations, control their subordinates, and eradicate avoidable costs and curb on-the-job consumption. All this is good for the wealth of nations. But it is not welcomed by managers and workers, who prefer a long tea break, a lunch at the club, or a leisurely overseas trip (principal-agent problem).

This explains why producers often demand political action to "fortify" their market niche. Thus, car producers will invest effort and resources in lobbying politicians, bureaucrats and the public for protection from foreign competitors. The few car producers will tell the industry minister and bureaucrats that their duty is to provide national industry with support and regulation. Politicians and bureaucrats can then easily lose sight of the fact that they are only the agents of all citizens, who want cheaper and better cars, and that their loyalty is to the citizens, not special interest groups! Lobbyists will argue that protected market niches are essential for job security and investment — conveniently confusing the job security and investment in one specific industry, which a tariff featherbeds, with the nation-wide employment and investment level, which are undermined by industry-specific measures, such as tariffs.

Graph 7

A Producer's Market Niche

– A Snapshot from a Dynamic Process –



As protected industries anywhere have demonstrated time and again, competitors who receive government patronage tend to incur fewer costs to develop new technology. They will implement fewer innovations over the long run.

The result is an economic system that generates less innovation, growth and job security and operates with higher costs. Protected firms acquire a habit of shirking search costs, and government patronage encourages them to do so!

Saving the Other Side of the Market Part of Their Transaction Costs

When one analyses the rivalry among potential suppliers and — parallel to it — potential buyers, the question often arises, which side of the market should bear the unavoidable transaction costs. Often, it is of advantage for rivals on one side of the market to reduce the transaction costs for those on the other side. Thus, competing suppliers often incur advertising costs. This has the advantage for buyers that they are better and more cheaply informed[19].

The knowledge problem in the modern economy is often complicated by the great variety of close substitutes on offer, by the complexity of products, and by the dynamics of economic evolution. Additional knowledge problems arise, as many goods and services are not simple "search goods", whose quality can be easily determined by prior inspection, but "experience goods", whose value can only be assessed by first consuming them (Nelson, 1970). A classical example for a search good is the fish one can pick up and smell in the

19 Socialist critics of advertising conclude that advertising is a waste, because they tacitly assume "perfect knowledge".

market, whereas a tin of tuna is a typical experience good. Its quality can only be evaluated by opening the can and eating the fish.

More and more modern consumer goods and most services are experience goods. New cars or holiday packages fall into this category. Here, potential buyers face a costly information problem. To ease the information problem of the buyers, sellers compete by a number of (costly) strategies. They advertise. They offer test runs (for example with new cars; in tertiary education, nightclubs and retirement villages). They offer free samples. Another important strategy to reduce the search costs of the buyers is to build up a reputation as a quality supplier, and then ensure that the costly investment in one's reputation is not quickly lost. Reputed sellers offer themselves — as it is called in the literature — as hostages to make their promises more credible. This reduces the information costs of the buyers. Another way of rivalling as a supplier in an experience-goods market is to offer warranties (new car suppliers introducing longer and longer warranties) or money-back guarantees.

Another method of reducing information costs is to network or enter open-ended, more or less permanent contractual relationships. Thus, buyers subscribe to electricity, telephone or internet services, instead of contracting anew for each week's supply, and firms hire labour on an open-ended contractual basis. Indeed, one reason for forming durable organisational ties is to save on transaction costs — as Ronald Coase "discovered" when he asked himself why firms existed at all (Coase, 1937/1952). To cope with the information problem, buyers and sellers may also form preferential, though not exclusive relationships. Buying at the same shop saves my wife search costs. Dealing with the same stockbroker or the same tax accountant affords me cost-saving knowledge. Suppliers may also offer reducing the search and buying costs of repeat customers, such as offering them frequent flyer points, rebates, and advance information on new products. All these examples, incidentally, serve to demonstrate how important information and other transaction costs are in real life. As a result, the market is far from a faceless, anonymous abstract. Frequently it takes place amongst long-term friends and business partners who stick to shared institutions of honesty, courtesy and reliability as a transaction-cost-saving strategy to beat the competition.

The Role of Middlemen

When community-wide institutions are ineffective and transaction costs high, there is often a role for intermediaries. Buyers may prefer to deal with a trader with whom they have regular business and who has a reputation to lose, rather than dealing directly with the many different producers of particular products. Sometimes, intermediaries confine themselves to conveying information, as is the case in the real-estate market. At other times, they become intermediary contract partners, as is the case in retail trade and financial markets. The banks offer borrowers, who wish to invest long term, credible long-term loans (a knowledge-cost saving device). At the same time, they offer depositors short-term contracts and the possibility of early withdrawal. They also bundle small savings into big loans. In the process, financial intermediaries generate valuable knowledge and solve numerous information problems.

Intermediaries are often unpopular, not only among people who assume that transaction costs do not, or should not, exist (the illusion of perfect knowledge again!). The Jews, the Chinese and the Indian traders of east Africa have often formed groups of middlemen who are of great service to their host communities. They convey knowledge and open opportunities. Yet, they suffer persecution (Sowell, 1990). One possible explanation — not an excuse — is that these groups make themselves exclusive (closed shop), or engage in monopolistic behaviour that gives the primary buyers and sellers the feeling that they are at the mercy of the middlemen. However, this is not solved by persecuting the middlemen. Then, the trade breaks down altogether, and buyers and sellers are worse off. The solution is to create better general institutions, which facilitate information search and equal market access for everyone. Then, middlemen may become redundant.

How Knowledge is Signaled to Others

How do rivalling buyers and sellers transact business?

Only after intending buyers and sellers have incurred sufficient search costs, will they strike a deal with someone the other side of the market. They will enter a voluntary contract, choosing among substitute offers and agreeing on a price and other contract conditions. Such deals, in turn, signal valuable information to other market participants. When a buyer and a seller enter into a contract, they do so voluntarily and on the basis of their (necessarily) imperfect knowledge. The question now is: How is this knowledge signalled to others who may find it useful, and how are inevitable errors corrected?

The main signalling device in the market is the price. It conveys much complex knowledge in condensed, coded form. If prices rise and make it profitable for suppliers to offer more of a certain product, then the high valuation of (and demand for) that product by the buyers is signalled to other potential suppliers. As long as suppliers are allowed to appropriate the gains, this will be an incentive to provide more of what the buyers want. If suppliers discover an idea that is new and particularly highly valued by buyers, they will reap a "pioneer profit". At least initially, the return will be high. But a high price will induce imitators to come in and offer more of what is in high demand, or at least to offer close substitutes. This will bring the price down and spread the advantage of the new idea to customers and the public.

Earlier, we considered what it took to launch the first photocopier. Once Xerox sales took off, because buyers welcomed the new product, the company became highly profitable, and its shares became the blue-chip stock of the 1960s. But the pioneer profits were temporary. Potential rivals got the signal and tried to emulate Xerox' commercial success, despite technical obstacles and patent protection. In the process, they discovered additional knowledge and applied it — making better copiers and bringing prices down. The competition enhanced the product, gave buyers a cheaper product and led to an unimaginable growth in the use of photocopiers. The talents and knowledge of thousands of people were drawn upon in the effort, and human knowledge expanded — a genuine contribution to economic growth.

The profit thus has an important dual function: to signal knowledge and to serve as an incentive to enhance valued human knowledge.

Alas, entrepreneurs frequently have to discover that their new product is not appreciated in the form of sufficient "dollar votes" to make a profit. Likewise, they may find that a process innovation — a new production technology or a reorganisation of the firm — does not produce sufficient cost savings. The resulting "signal of red ink" makes the error obvious. As this reduces the value of someone's property, it creates a powerful incentive to abandon the unwanted line of production or the failed process. The market economy thus not only gives incentives to search for and exploit knowledge, but also to abandon errors in spontaneous ways. Products, which buyers do not want sufficiently to justify their costs, are scrapped and disappear. The profit-loss mechanism is not anonymous, faceless and devoid of the will of the people, as it is sometimes portrayed. Rather, it reflects the informed, careful private choices of the many buyers (consumer sovereignty) and a continuing process in which the many place their "dollar votes". The market process is economic democracy, much more regular and detailed than the periodic popular vote between complex political programs.

Price changes (as well as corresponding profits and losses that affect someone’s property) constitute the "radio signals" which coordinate the complex, evolving market economy. They coordinate thousands of diverse people who typically do not even know each other, but whose coordinated efforts are needed to satisfy our diverse and complex material wants. If governments interfere with the "radio signals" by fixing prices, regulating or by allowing the "static" of inflation to overlay the price signals, they pave the way for mal-coordination. Less knowledge is used, fewer wants are satisfied, and fewer choices are available. Market interventions may become even more disruptive when they trigger social upheaval, for example, when increases in administered prices lead to street riots, such as in many developing countries when governments interfere with food or petrol prices.

To illustrate the practical relevance of the competitive system and its marvellous effectiveness in communicating knowledge, we may look at the "oil crisis" of 1973-74. At that time, petroleum supplies fell unexpectedly short of demand and an oil-supplier cartel (OPEC) tightened supplies. The price of crude quadrupled. This induced people around the world to drive less, and — in the longer run — to replace gas guzzlers by petrol misers. Industries switched from petroleum to natural gas and coal. Researchers explored new sources of power (ranging from oil shale and tar sands to wind, nuclear and solar energy). Much exploration for new oil, searches for new technologies to crack petroleum and many other costly knowledge-search processes were set in motion. The efforts by millions of people in all corners of the world were triggered by just the one signal — the higher price. The price increase also served an important motivational role. In the longer run, higher prices mobilised new supplies of oil and curbed demand. Eventually, the real petroleum price (adjusted for inflation) came down again. The Jeremiahs who had predicted the end of modern civilisation and the regulators who tried to stop the price increases by direct intervention were proven wrong. US President Jimmy Carter, who had tried to protect the American people from foreign-made petrol price increases by direct intervention, but had instead caused unexpected shortages and queues, was thrown out of office by the voters. The economists who had counselled the public to trust the power of the market were proven right! In the early 2000s, the process was repeating itself.

This illustrates a further point. The people whose actions solved the problem did not have to waste time on analysing what caused the petroleum crisis — whether it was a war in the Middle East, the OPEC cartel, long-term technological trends, the rise of China, or whatever? The simple-to-interpret price signal did the trick! The market thus economises on everyone's knowledge problem.

To sum up this part of the argument: Appropriate competition in the market economy fulfils three important social functions:

(a) It gives the incentive to be on the alert and to incur the costs of searching for valuable knowledge (the function of stimulating product and process innovation).
(b) It signals successes to others, leading to imitations and the diffusion of successful technology, at the same time eroding initial pioneer gains and passing lower prices to customers (signaling function).
(c) It signals failures through "red ink" and induces the spontaneous, automatic abandonment of property uses, which are not sufficiently highly valued (control function).

The Responsibility to Compete

We saw that most are naturally reluctant to incur those insidious knowledge-exploration costs and that the mental obstacles to intense rivalry and knowledge-search processes on both sides of the market are considerable. Yet, for the sake of economic development, it is important that these obstacles are overcome. Otherwise, there is little prosperity and freedom of choice. Owners of property are of course free not to engage in knowledge searches. But those who refuse to engage in knowledge search must anticipate that their property will lose its value, as rivals capture market share. Owners who refuse to accept the challenge of competition have to accept the consequences in the form of possible losses of their property values and a possible reduction in their socio-economic position. The maxim for property owners in a competitive market economy is “use it or lose it”.

In the interest of well-functioning markets and economic development, property owners must not be allowed to run to government or conspire among themselves to avoid the costs and risks of competing. In a dynamic economy, existing economic positions must be revalidated time and again. It is thus absolutely essential for prosperity and the functioning of the capitalist system that the unwelcome stimulus of competition be kept alive. As was said in the previous chapter, property rights not only establish claims to benefits, but also responsibilities. Governments who intervene to avert the impact of losses and search costs destroy an essential mechanism of coordination. If opportunistic parliamentary parties, ministers, civil servants and judges protect or compensate unwilling competitors, they undermine the constitution of capitalism and detract directly from our freedom, security, prosperity and justice.

Property owners, including the owners of labour, who shirk the costs of knowledge search, will of course resent losses of property values and costs of knowledge search. They will try to obtain political patronage. Thus, the guilds of the medieval cities of Europe mobilised political action to ensure that no outsiders could compete with them. The result was stagnation and decline, not only materially, but also intellectually, socially and militarily. Economic nationalism — by means of trade protection, the control of foreign investment, "Buy National" campaigns, phoney health regulations, and agitation against foreign investment — falls into the same category of harmful defence against the challenge of competition. Another example of an opportunistic reluctance to compete is the refusal by unions to face open competition, defending the closed shop and privileges that cannot be maintained in a competitive labour market. The fundamental freedom to associate — or not associate — and to compete is denied to workers in many industries around the world –– ultimately because governments have been captured by powerful lobbies that represent organised labour. In a market economy, workers, too, have an obligation to compete.

Competition and Equity

The responsibility of asset owners to compete, if they wish to maintain the value of what they own, influences the distribution of incomes and wealth. Positions of relative income and wealth evolve continually. In a truly competitive economy, there is no such thing as a permanently rich and a permanently poor class of people — unless political power play prevents competition. In competitive open economies, such as the American economy, few of the top 500 richest stay on top for generations. Innovators challenge them ceaselessly. But the creative ideas of established competitors may not flow ceaselessly. Established property owners will therefore seek collective action to freeze their socio-economic positions. If they are successful in obtaining discriminatory political protection, this will impede the opportunities of newcomers, the young, new ventures, new industries, the unemployed and new industrial countries. It will also violate the important institution of “equality before the law”. Many observed "social injustices" are the consequence of such political interventions and their unintended side effects. Thus, the tariff protection of textile and garment jobs in Australia by successive governments has been inordinately at the expense of poor families with children. Most monopolies survive only because of government support (Friedman, 1962).

One can find numerous critics of the system of property rights and free competition who admit that such a system is good for efficiency and economic growth. But they fear that it leads to an unjust and inequitable distribution of incomes. The mantra that the "rich are getting richer, and the poor are getting poorer" has been repeated so often that it is widely and uncritically accepted — despite the fact that most people in the affluent countries belong to a middle class and that there is constant turnover amongst the rich.

There can of course be no doubt that there are rich and poor people in any economy (inequality of outcomes). There are also great differences in opportunities (iniquity of opportunity). The suppliers of products, ideas, capital and labour are not "rewarded" equally. Some respond to diverse and changing demands more successfully than others, either because of their entrepreneurial alertness and their readiness to shoulder transaction costs or because of their luck. Some may not have the wherewithal to shoulder transaction costs and therefore remain mired in a less advantageous competitive position. Others may be less well-endowed by nature (most regrettably, this author has not been able to compete with Elle Macpherson in the modelling market....).

However, both in developed and developing economies, many observed differences in income distribution by market processes are the result of artificial obstacles to genuine competition. Inexperienced, low-skilled or handicapped people cannot easily compete in the labour market with their limited assets. They may not be free to compete because of minimum wage laws. The minimum wage, closed shops, the Byzantine structure of industrial relations, labour cartels and administrative practices are the source of much income inequality (Sowell, 2004, pp. 161-192). Ready access to welfare and a progressive income tax combine to keep many people from doing their best to help themselves and to deny them the satisfaction of self-responsibility (poverty trap). Numerous interventions in product markets — from building codes and industrial regulations to tariffs on children's clothing — are adding to the inequalities of market outcomes. Governments thus are habitually denying some citizens more equal opportunities. Those few who are well-organised have obtained political protection from open competition at the expense of the many unorganised. Positions of relative economic power in electoral democracies are all too translated into artificial political protection from the responsibility to compete at the expense of newcomers. As we shall see in the next chapter, public choice has often displaced private competitive choices.

One can, therefore, not legitimately criticise the competitive property rights system as discussed here with examples of iniquities from highly regulation-distorted economic systems. A glance at genuinely competitive market systems demonstrates that genuine, open competition and the protection of private property can yield a high degree of outcome equality and economic growth. Taiwan, for example, figures at or near the top of all international tables on equality of income and wealth despite — or because of? — a near-total absence of public welfare and coercive income redistribution! In a similar vein, the liberalisation of the New Zealand economy in the 1980s and 1990s opened many new opportunities to previously disadvantaged groups, as disproportionately large drops in the unemployment rates of Maoris, women and the long-term unemployed show. More generally, it is found from systematic international comparisons that free, competitive economies have a more even distribution of incomes than heavily regulated ones (for example, Gwartney-Lawson, 2004, p. 23).

In this context, it is also worth noting that total income equality would not be a worthwhile goal worth aspiring to. First, it is only natural that those with experience and skills should earn more than those with little human capital. Otherwise, there would be little incentive to acquire useful skills and knowledge. It is simply counterproductive to expect market participants to invest in search costs, when a large share of the returns is confiscated. The search-discovery-production face of the market system cannot be divorced from the distribution face of the same system! Second, the market is an ongoing dynamic process, so that "income distribution snapshots" at any one point in time tell only a partial story only. Naturally, elder citizens, with high work skills and experience and close to retirement, are richer than youngsters. One reason their incomes are higher is that they earn a return on the capital that they have accumulated for their retirement. An as competition is a risky business, today's glamour company may well make big losses tomorrow. A high-income job today may be in tomorrow's sunset industry. And a battler may well discover tomorrow's highly rewarding opportunities.

Once one takes a dynamic-evolutionary view of the market process, one is likely to favour institutions and a style of governance that increase the material opportunities for the community, and reject the notion that a given cake is to be redistributed.

Competition is a Public Good

In the final analysis, the debate harks back to one's conception of the economy and of modern economics, as discussed in Chapter 2: Do we deal with the rationing of scarcity (economising), or are we involved in the enterprise of discovering new wants and resources (catallaxy)?

The genius of competition facilitates innovation, freedom and self-realisation, as well as making for a cooperative rather than a politically divisive social climate. There is also a hard-to-prove psychological dimension to this. In my many work experiences around the world, I have invariably found that people who live under the conditions of competitive capitalism have cultivated a can-do optimism. Losses happen, but can be overcome by renewed effort. Competition produces more winners than losers, as is reflected in high economic growth and high employment. By contrast, people whose property rights have been curtailed by governments and who have lost the incentive to be self-reliant, tend to develop a passive claims mentality. They become cynical and pessimism, which stifles initiative, spreads.

A climate of competition and enterprise in all parts of the economy is therefore a valuable public good. Its benefits spread far beyond those directly involved in competing in a market. The institutions that make for genuine, open competition hence deserve to be cultivated by government. This means that collective action should protect the universal institutions of private property and freedom of contract for all citizens and that policy makers should desist from discriminating between different citizens by licensing, subsidies, specific taxes and other such controls of economic freedom that upset market processes.

In the following chapter, we will see just how harmful collective action through interference with private property rights and market processes can often be. Political agents nonetheless continue to undertake harmful interventions. To explain this apparent puzzle, we have to turn to the comparison between private action in markets and collective action through public policy.

CHAPTER SEVEN

THE LIMITS OF PUBLIC CHOICES

"[The] role of government includes facilitating voluntary exchanges by adopting general rules — the rules of the economic and social game that the citizens of a free society play".

M. & R. Friedman (1980), p. 50.

"Unless restrained by constitutional rules, special interest groups will use the democratic political process to fleece taxpayers and consumers".

J.D. Gwartney – R.L Stroup (1993), p. 79.

The Shortcomings of Collective Choices

So far, we have primarily discussed private choices in markets to coordinate decisions about property uses. It is not always possible to attach private property rights to assets, as we saw in Chapter 5. There are externalities, public goods and common goods. When either the supply or the demand for an asset cannot be made exclusive, collective choices may have to be made to use the asset. However, matters become much more complicated, when decisions are coordinated by collective choice (or public policy) instead of voluntary, bilateral contracts, which are subject to the discipline of market competition:

(a) Instead of two private parties agreeing on a contract, collective choice requires that numerous parties have to agree, or at least tolerate the decisions of others. This makes for complicated trade-offs between give and take. Instead of the reciprocal, direct give and take of a voluntary market contract, the exchange by public choice is multilateral, so that individuals may try to shirk contributions to what has to be given, but claim more than they would wish to take, were they to pay a direct price. Thus, people often try to shirk paying taxes, but claim as large a share of government handouts as they can.

(b) Whereas individual contracts can be tailored to suit the diverse requirements of the two parties involved in a market deal, collective solutions normally have to obey the maxim "one size fits all". Most people's diverse aspirations are then less well satisfied, even if some claim that a satisfying unity of purpose inspires the people. In other words, the market can serve you à la carte, whereas collective provision offers only one set canteen menu. What great joy could one observe in China in the late 1970s and early 1980s, after everyone in China had been forced to wear Mao suits, when individuals were again allowed to buy textiles and clothing to suit their own tastes! Where there is publicly chosen uniformity, there is also less potential for creativity and progress.

(c) Collectives, such as governments, have to aggregate individual preferences. In this they normally have to rely on appointed or elected officials. These may often not know what the people really want and have to incur high political information-search costs. In many circumstances, they may not even care about the interests of ordinary people. Instead, they may often be appointed on the basis of political allegiance and owe little loyalty to the ordinary citizens, whose preferences they are supposed to take care of (this is again the notorious principal-agent problem!). Thus, political cadres in Mao's China determined that the peasants could live on starvation food rations, so that China could export large quantities of food in the 1950s and 1960s. In other instances, ordinary citizens may decide that they need not inform themselves about what is at stake in collective action, since they as individuals have no influence over collective choices. Voters in democracies may, for example, decide that it is a waste of their time and effort to keep themselves informed about public affairs – in other words to remain in “rational ignorance”. In short, compared to the rich, bilateral information exchanges, which take place in the markets, collective choices are likely to be poorly informed.

As collective choices involve fuzzy, non-mutual, multilateral give and take, the temptations to opt out of the giving and to free-ride in the taking are considerable. Non-reciprocity induces people to succumb to “moral hazard”. Consequently, compulsion (and much costly monitoring) is required. Heavy reliance on collective choices therefore often causes feelings of powerlessness, cynicism and disenfranchisement among the (tax-paying) citizen-principals. The distribution of the benefits of collective action has also to be decided by the political agents, giving them great power and often placing then beyond proper evaluation.

(c) Since the re-election motive dominates much collective choice in democracies, it is likely that time horizons are shorter than in private choices. Whereas private citizens often look beyond their lifespan to that of their children and grandchildren, elected politicians, from the day of gaining office, think mainly about their re-election in two to three years' time. There is in-built political myopia.

(f) In modern democracies, the free will and the responsibility of elected people's representatives are limited by the discipline that political parties impose on parliamentarians. As a consequence, most political decisions are in reality made by small backroom committees, and not by majorities of representatives directly responsible to the citizens who elected them. It is quite common in political decision making that a few keenly interested persons dominate a committee, which then fixes party policy on a particular matter and that parties automatically and uncritically vote for committee recommendations. As a consequence, modern parliaments are turned into an instrument of the exploitation of the majority by avid, well-organised and self-seeking minorities.

(g) This problem is aggravated by the combination of (i) small, organised interest groups who have much to gain from political preferments, (ii) an electorate which faces high information costs and therefore remains "rationally ignorant" about the business of government, and (iii) organised political parties of parliamentarians, who will do almost anything to obtain the support and financial donations necessary to get re-elected. Rent-seeking, rent-creation and opportunistic crooks who operate at the expense of the citizen-principals are therefore endemic in political choices (see “Glossary” on rent seeking).

For these reasons, coercive collective action is very much a second best to voluntary private action in coordinating specific human activities, except in a limited number of circumstances. This leads one to conclude that government should be constrained to a minimum of areas, and that as most of human economic activity should be privatised (Graph 9). One also has to conclude that the agents of government have to be controlled, so that they do the bidding of the citizen-principals as far as possible.

Before we can discuss these important concerns any further, let us look at the functions which governments can and should take on.

The Functions of Government

At various points, we touched upon two roles of collective action by government. When discussing institutions in Chapter 3, we saw a role for government in backing-up the internal institutions of society by imposing and formally enforcing external institutions (protective function of government). And when discussing the various forms of property in

Chapter 5, we saw that not all assets can be assigned to exclusive private ownership. There may be a case for governments getting involved in providing, even producing some public

Graph 9

Private and Public Choice

	Private Choice	Public Choice (Collective Action)
Exchange:	reciprocal, direct given and take	multilateral, indirect
Shirking:	monitored, curbed by institutions (contract)	shirk contribution, but claim hand-outs
Cordination mechanism:	**voluntary**	coercive
Meeting of wants:	**diversity**; choice; creativity; "chaos", duplication	uniformity ("one size fits all"); "unity of purpose"
Principal-agent problem:	self-control among com-petitors economises on need to know (division of knowledge)	control by authorities; rent-seeking prevails; "**rational ignorance**";
Monitoring/ enforcemt:	often spontaneous	**costly**, cumbersome
Innovation:	markets generate infor-mation by *catallaxis*	political power used to resist change

Therefore:
Privatise where private action is feasible
(i.e. where property rights and the benefits/costs of
their uses can be attached to specific assets

goods (productive function). Therefore, government has legitimate protective and productive functions. In addition, elected parliaments in the affluent Western countries – and increasingly in some less developed countries – have greatly expanded an additional government function: redistribution by confiscating the property rights of some and allocating them to others[20]. Indeed, this has been the biggest cause for the relentless expansion of government over the past hundred years (Buchanan, 1975).

20 Some writers would assign government a further function: stabilising the economy. It seems, however, more appropriate to subsume the stability of the value of money under the protective function and to doubt the capacity of governments to stabilise aggregate demand, let alone of demand in particular

The protective function of government requires a commitment of policy makers to supporting abstract, universal rules without fear or favour. This may well mean that specific outcomes of applying the rules are sometimes unwelcome to some or politically unpopular. Placing the time-tested, non-discriminatory institutions above the pursuit of specific outcomes requires either genuine, far-sighted leadership, or strong constraints on political opportunism. In present-day electoral democracies, elected politicians, as well as unelected judges and bureaucrats, are ceaselessly under pressure from well-organised lobby and advocacy groups. These pursue particular outcomes ruthlessly, irrespective of whether this violates the time-tested rules of society or not. In their pursuit of votes and electoral finance, politicians easily become the captives of such groups. They may even abandon the core values of their professed political creed (Downs, 1957; Olson, 1965; Tollison, 1982; Sowell, 1990). When they do, they betray the traditional core function of government, namely to ensure the non-discriminatory protection of universal rules, which allow a spontaneous order to evolve. They also betray an important principle of individual freedom.

Governments of course also have to ensure certain outcomes, for example with regard to health, environmental and other specific, prescribed standards. This is widely accepted in the community as legitimate, because such government activities help citizens in feeling secure and in economising on their information costs. When government agencies, for example, license certain pharmaceuticals, they save the citizens high, if not fatal costs of finding out whether a certain drug is effective in addressing a given medical problem. However, the proliferation of specific, prescriptive protections can easily undermine private initiative and the entire spontaneous order. Most regulations take some specific private property right away from some. For example, the prohibition to cut down trees eliminates the traditional right that property owners can harvest the trees on the land they own. On its own, such a regulation may bot be of great import for the capitalist system as a whole. However, the cumulation of such regulatory expropriations gradually undermines the entire system and destroys the economy's capacity to develop and to respond constructively to new information and new challenges. Ludwig von Mises demonstrated more than half a century ago that proliferating and supposedly well-meaning interventions pervert the spontaneous market order and make the regulated economy as ineffectual as a centrally controlled economy (Mises, 1949). Parliaments should therefore beware that they do not, every time they meet, they take liberty and property away and – by doing so – destroy the very market order, on which our very prosperity and freedom rest.

Caution with the political supply of specific interventions seems advisable also because outcome-specific prescriptions tend to have unforeseen side effects. They tend to cumulate so that a competitive society becomes insecure and people of property shirk knowledge exploration. Another side effect of many prescriptive interventions are high compliance costs. Health or safety regulations may well save human lives, but the gain of one life saved may impose tens of millions of dollars in compliance costs (Viscusi, 1996). When one additional life saved by a regulation in the building trades costs the equivalent of several thousand dialysis machines, parliamentarians should pause and ask when to stop regulating. The question arises whether the resources absorbed in complying with and enforcing such regulations could not be employed more effectively to save human lives through other methods, for example by buying more dialysis machines. In any event, one has to approach this issue with the realisation that collective regulation cannot protect all citizens from all risks all the time!

The second function of government — the productive function — is often justified by writers in connection with public goods. When not all benefits and costs of certain goods and services can be appropriated, the incentives of private property and competition do sometimes not work well, or not at all, in allocating resources satisfactorily. But this does

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markets. Admittedly, such stabilisation may serve particular interests, but it tends to undermine the coordinative efficacy of the market economy.

not automatically justify the production of such goods and services by government-owned and -managed enterprises, as we already saw. In reality, public production has in most countries been extended far beyond cases of pure public goods. Governments often set up public monopoly producers — or entire nationalised industries — to control private monopoly powers, which in the first instance flowed from prior political preferment. Or governments wish to collect revenues without having to incur the political opprobrium of taxing. This is why many governments nationalised the telephone, power and rail systems last century; why governments ran salt mines and cigarette factories; and why many toll roads are in collective ownership.

In this context, one has to beware of a confusion of the language — "public good" means "public access good" (or "public domain good"), not "publicly produced good". All that is often required for the government is to ensure that the public have access and that certain quality standards are adhered to (see former New Zealand Finance Minister, R. Richardson's views in Kasper, 1996). Public utilities and public transport, for example, need to be accessible to all members of the public because of network and information advantages. But, to reiterate, that does not mean public ownership and the management of power, communications and transport systems under the unwieldy rules and disincentives to perform and innovate, which are prevalent in public administrations.

It is now increasingly accepted that there is general advantage in (a) the competitive production of goods and services (cost control, innovation benefits), combined with (b) the provision of access to such goods and services, possibly by government-provided vouchers or other funding mechanisms. Thus, communication, education and health services can normally be produced more effectively by private, competing operators. This does not preclude that they are paid for, at least in part, by tax-financed vouchers, if that is desired on equity grounds.

This realisation has given rise since the 1970s to an accelerating worldwide wave of privatisation. Between 1985 and 1995 alone, privatisations amounted to an estimated US-$535 billion worldwide (O'Leary, 1995), and in 1997 alone US-$ 157 worth of socialised assets were privatised. The countries with large socialised sectors, such as Italy and Australia, have been among the most avid privatisers. Since 1990, about $60 000 million worth of publicly-owned trading enterprises have been sold, more than two-firths by public floats to shareholders, many of whom gained a direct shareholding stake in the economy for the first time. Developing countries, which suffer from shortages of experienced managers and fuzzy institutions of political control, can now leapfrog to a more appropriate division of labour between the public sector and private enterprises by letting infrastructure projects be built and operated privately under public tender. Where governments give private entrepreneurs and capital owners a degree of monopoly, the conduct of such infrastructure providers needs to be monitored and policed. This may require an independent and expert regulator.

The benefits of private ownership and competition in controlling costs, stimulating product innovation and incurring transaction costs — as compared to public monopolies — are now increasingly evident. But privatisation is not necessarily popular, because it has often lessened the rents reaped by the public-sector workforce and the management of public corporations. It is therefore not surprising that organised labour, public-service lobbies and some managers of government-owned enterprises habitually oppose the sell-off of state-owned establishments.

The redistribution of private property rights, the third function of government, has expanded fastest for most of this century. In Australia, a very large part of Federal and State budgets does not go to protection and service provision, but consists of tax-confiscation for the purpose of handouts by subsidy. Much publicly-owned production serves in reality the government's redistribution and patronage function. However, the redistributive role of government does not stop there; in addition, governments interfere directly in many market processes with redistributive aims to reallocate incomes, for example by fixing minimum prices or licensing a limited number of competitors. To understand the enormous expansion of the redistributive function in the mature electoral parliamentary democracies (as well as in many less developed countries), one has to turn to the phenomenon of rent-seeking in politics.

The Game of Rent Creation and Rent Seeking

Citizens face high information costs about what happens in politics; they also have little influence over collective decisions. Therefore, the elected politicians and the bureaucrats will be tempted to act in their own interest to get re-elected or wealthy, rather than in faithfully representing the — often poorly articulated — will of the people. Political choice therefore gives rise to massive principal-agent problems (Downs, 1957; Stigler, 1971; Buchanan, 1987; Buchanan *et al.* (eds.), 1980).

This asymmetry can best be illustrated with the example of tariff making. Parliamentarians, ministers and bureaucrats have much to gain when they respond to organised industry, foreign investors or social interest groups by intervening in free trade. They do so typically to discriminate against the many buyers of imported goods and in favour of a few (existing or potential) local producers. A tariff intervention in the freedom of domestic public to buy cars from the best source excludes or handicaps the domestic public's access to foreign suppliers. This amounts to the expropriation of a specific property right. The local (possibly foreign-owned) vehicle producers can charge higher prices and save themselves many of the troublesome search costs for new models and cost cutting (compare Insert in Chapter 6). If, for argument's sake, the local market of a country is 500,000 passenger vehicles per annum and the average car can be sold, thanks to the tariff privilege, for $4 000 more, then each of four domestic car producers (and their workers) gains on average $500 million annually — a massive, politically allotted windfall! This is certainly worth lobbying and bribing cabinet ministers for, and brow-beating the public! By contrast, the average household may buy a car every ten years, in particular when cars are overpriced and of the uninspiring quality, which is so typical of cars from "tariff factories". Each household then bears an average politically imposed loss of some $400 per year — not worth the effort to inform oneself of the harm done by the politicians and the car industry. Few will get excited enough to lobby against such a "welfare policy for the car industry"!

Over the longer run, the loss of "creative unease" in the industry leads to less innovation and poorer international competitiveness. This is why protective, selective industry policies have been a worldwide disaster. Nonetheless, the costly game of industrial rent-creation and rent-seeking is alive and well around the world (see Insert). Another example of rent-creation is zoning of land. If local government zone some land as commercial, but not neighbouring blocks, the land values may go up by several hundred percent — again reason enough to seek or buy political patronage, in particular if one is big and well-connected and can gain easy political access. With the rapid growth of cities in the Third World, politicians or administrators often zone some land as residential, but neighbouring zones as recreational. Land values then often begin to differ by huge margins, with landowners of recreational land not being compensated for their loss of economic opportunity. With such sums at stake, it is little wonder that zoning around the world is plagued by graft and other forms of political opportunism.

Parliamentarians and other political agents opportunistically produce and supply market interventions, which redistribute income and wealth. In other words, they habitually allocate rents and property not earned in the market. They trust that those whom they surreptitiously deprive of valuable property rights and life opportunities will not notice or will soon forget. Those to whom they allot selective privileges will gladly share the windfall with them, maybe to contribute to party budgets at election time. Such redistributional interventionism now pervades every walk of life. Sometimes, organised suppliers of labour extract political preferments (for example, political exemptions from the normal rules of contract law) in exchange for their electoral support. At other times, organised professions and industries obtain political favours, for example in the form of subsidies for their research or special tax deductions.

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Industry Policy: Can Government Know?

The knowledge problem and consequent principal-agent problems in government are starkly highlighted in "industry policy", official attempts to identify industrial winners instead of relying on competing private investors to find profitable industrial activities. Government agencies in many developing countries have become involved in interfering in market processes and industrial structures with the aim of advancing overall growth. The main instruments of industry policy have been the tariff, industrial subsidies and licensing. All this is now widely recognised as a costly way "to pick losers" (Burton, 1983; Hughes, 1988). The more recent political fashion has been to identify and subsidise supposed growth industries. The results have been no better, and the fundamental insights stand: When governments intervene to allocate private property rights and second-guess markets, they hinder long-term development.

Can policy makers ever know any better than competing entrepreneurs, where the future growth industries will be, given the complexity and rapid evolution of the modern world economy? The question might perhaps be answered in the positive in new industrial countries where bureaucrats are able to identify what has been successful in countries higher up the income ladder (e.g. in post-war Japan, or in South Korea after the 1960s). But even there, gross errors have been frequent, e.g. the Japanese government telling Sony that solid-state technology had no future, the then motorcycle producer Honda that the car market was already overcrowded, and aircraft makers that they should build a Japanese airliner. The price for the close cohabitation of politicians, bureaucrats and rent-seeking industrialists has always been that political parties get corrupted and that industrialists shift their entrepreneurial energies from innovation to lobbying.

The rent-seeking leads to social tensions. It is instructive for example that in Korea, the 20 largest and preferred *chaebol* have greatly underperformed when compared to the S&P 500 companies in the USA (average 1990-96: 4.7% net profits as against 1.1% in Korea. Source: *The Economist*, 22 November 1997, p. 88). It is also worth noting that Korea has one of the most acrimonious industrial relations records. This is not surprising because industry policy is ultimately not about earning a rate of return, but about the good life for the managers.

Among economists and international economic organisations, selective industry policies have therefore long been in disrepute as an instrument of economic growth. Governments simply cannot know! Nor do officials have the same motivation to perform that competing suppliers have.

The industry policy problem is lessened when governments confine themselves to promoting generic supply-side policies, namely to mobilise resources through education, research, savings promotion, opening up land and providing hard infrastructures — but then leaving it to individual entrepreneurs how to use those resources. This has increasingly become the style of industry policy in the more advanced countries of East Asia. Recent experiences with specific industry policies have taught costly lessons, for example in South Korea, where government-sponsored *chaebol* conglomerates have accumulated huge bad debts, in Malaysia where firms close to the ruling political party made huge losses in government-sponsored projects, and in Indonesia where a small circle of favoured cronies have caused what is wrongly termed a "monetary crisis" — it is an institutional crisis.

The political temptations to gain influence through rent-creation of course militate against such general supply-side policies, as well as against the free-market stance for governments to treat industrial structures with benign neglect. Those in charge of collective choices must never pretend to know that car assembly, tourism and certain research-intensive activities are more promising in a given country and age than all the other evolving uses of capital and labour. Judging by copious international experience, there is always a real danger that selective industry policy will contaminate the probity of policy processes in the future. The dividing line between corruption and probity is hard to discern when a government is committed to providing corporate welfare. In any event, such discriminatory policies violate the equality of all before the law, confiscate private property rights of some, and hence undermine the institutional principle of universality. It is much easier for politicians to respect individual property rights, favour private, competitive search efforts and cultivate the equality of all before the law.

As selective interventions proliferate, private property loses its traditional meaning, market rules are upset and the overall intensity of competition — the risky, troublesome commitment to finding and testing new knowledge — is eroded. Market signals are then hard to read. The economic system loses some of its catallactic efficiency in uncovering growth opportunities. The opponents of capitalism then find much evidence to castigate capitalism and point to its failures to promote development and broad-based income growth. Those who favour capitalism are therefore well advised to also favour untrammelled competition, lest the system be overturned.

As of the beginning of the 21st century, one cannot remain naïve about the gross costs of excessive government to ordinary people. The empirical evidence of big government in the former Soviet empire, in developing countries, such as India, where central planning and government-driven industrialisation dominated development strategies, and the consequences of centralised public choices in Mao's China may be the crassest examples of what can happen when top-down commands replace much of the traditional market coordination. The most horrifying example is probably China's history between 1950 and 1975, when absolute ruthlessness combined with economic ignorance at the top: For example, Mao's central-planning target of overtaking Britain's steel production in a few years was translated in the "Great Leap Forward", a campaign in 1958-61 to extract a maximum of food for export to pay for imported Soviet arms and machinery and to expand iron output. Directed by Beijing Centre, backyard furnaces burnt the local forests to melt down iron bedsteads, tools and ploughs to raise national iron output, from which the people produced — iron bedsteads, tools and ploughs. The food extortion drive and the collectivisation of farms caused an estimated 38 million dead of starvation and overwork (J. Chang–J. Halliday, 2005, pp. 454-458). Central planning caused the biggest manmade famine in the history of mankind. When the Party shifted much economic coordination back to market institutions, China experienced massive economic development (Kasper-Streit, 1998, 422-428).

Other comparisons between market-guided and centrally planned development strategies tell a similar story. After forty years of socialism, East Germans were some 40 per cent less productive than West Germans, when the regime collapsed in 1989. South Koreans now produce at least ten times what North Koreans produce after fifty years of central planning and prohibition of private property in the north. Comparisons between more market-oriented Kenya and socialist Tanzania tell a similar story (Kasper-Streit, 1998, pp. 414-415).

The Failures of the Welfare State

One aspect of collective choice has dominated public policy over the past fifty years in the mature democracies, namely the expansion of cradle-to-grave public welfare. Nowhere has political opportunism by parliamentarians, bureaucrats and judges in interaction with single-issue groups had a bigger impact than in this area. Increasing doubts are, however, now being voiced in the mature welfare states with mixed economies as to whether the welfare state has not been a case of massive government failure. It now constitutes a costly road block on the path to high employment, growth, freedom and self-responsibility, and it undermines the constitutional state on which so much rests (Ratnapala, 1990; Minogue, 1997):

(a) Even massive redistribution policies have not eradicated inequality and poverty. One reason for this is that many welfare programs simply redistribute income and wealth from the middle-class-to the middle class (churning). In reality, the state rarely redistributes from rich to poor, but from the poorly organised to well-organised and vocal interests. This is readily understandable on the basis of the re-election motive.

(b) The long-term availability of public welfare has induced many to act opportunistically (moral hazard). Many have given up on making their private, self-responsible welfare provisions; they no longer bear the costs of acquiring work and life skills, or adjust their expectations to prevailing market. Progressive taxation adds disincentives, so that we witness a ballooning claims and dependency mentality — exactly as stated with regard to collective choices. Tax-funded welfare and heavy taxation have also reduced private charity, which is typical of well-functioning civil societies. Well-off people feel pushed aside by the public tax-hand-out mechanism, and most voluntary welfare organisations have been turned into clients of the government welfare machinery. They lobby for tax money on behalf of welfare recipients, rather than raising their own funds. Whereas the Good Samaritan gave the beggar his own cloak, most charities nowadays argue for the coercive distribution of other peoples' wealth.

(c) Much public welfare is provided through public-sector monopolies. These have been captured by well-organised producer groups, for example unionised health and welfare workers. Consequently, public programs are often managed in the interest of organised labour, and not necessarily with a view to efficient welfare provision.

(d) The shift from self-responsibility to reliance on government agencies has produced much public spin-doctoring, posturing and lobbying. Social harmony is lost in growing political confrontation and recriminations, on the mistaken notion that inequality is injustice (Flew, 1989). The growing reliance on rationing demand for handouts by non-price means, namely queuing, waiting lists, political interventionism and public admonition, is another source of political acrimony. Worse still, a growing part of public welfare administration now escapes judicial and parliamentary scrutiny (Ratnapala, 1990, pp. 8-18). This paves the way for what Hayek called "the miscarriage of the democratic ideal" (Hayek, 1979, pp. 98-104).

(e) The growing welfare burden of the progressively ageing populations of OECD countries disgruntles the young generation. The 20- to 30-year olds expect high tax burdens and a gradual deterioration of public services. Indeed, the high and unsustainable claims of the ageing baby-boomers constitute political dynamite for the future. While initially there were political gains from redistribution policies in terms of political loyalty, nation-wide solidarity and support for government assistance to those less well off or less lucky, these political gains are now over-shadowed by a growing disaffection with public-sector inefficiencies and compulsory redistribution. Many now find that they do not simply want to be passive recipients of government handouts, but want to take responsibility for their own lives.

(f) High socialised welfare makes for poor private saving. Public welfare burdens are dominating the budget. They have produced high public debts and high interest burdens, frustrated overdue tax cuts and squeezed out other priorities, such as national defence, education and the provision of modern infrastructures. The macroeconomic flipside of high public welfare burdens is poor private saving, hence reliance of American or Australian investors on foreign savings (as reflected in huge current-account deficits), the prospect of taxpayer revolts, weakened international competitiveness, and a weakening exchange rate.

(g) On a more fundamental level, it has to be noted that governments cannot fulfil their traditional protective function (protecting private property rights and individual autonomy) and at the same time continually and massively confiscate and redistribute private property by compulsory political fiat. In most welfare states, the rulers now witness an erosion of their political legitimacy and authority, because they have promised too much (Sowell, 1990). Driven by a welfare commitment, government deprives people of life opportunities and freedom, and destroys their confidence by undermining the fundamentals of private property and autonomy. Ultimately, this saps freedom and social optimism.

Many in the developed countries have a long and emotional commitment to redistribution and egalitarian outcomes. However, the increasingly obvious failures of the welfare state have triggered much thinking about reprivatising welfare by radical reforms. It is now increasingly accepted that people must assume greater responsibility for funding, or insuring for, their own health, education and old-age expenses and that government can only serve as a last line of defence against personal misfortunes. This will be made easier as and when personal tax burdens are reduced to reflect the shift in welfare expenditures from the collective to the private households.

One important reason for the rethinking is globalisation. Workers in the affluent countries are now frequently losing competitive position vis-à-vis workers in less developed countries, because rich-country wage costs contain huge, government-mandated on-costs for social welfare. This is one reason why jobs migrate to developing-country locations. Thus, the East Asian governments have, as a rule, so far committed no more than marginal budget resources to the provision of public welfare. Welfare is a private family's or a firm's responsibility. At most, income earners in several Asian countries are compelled by the law to save for their retirement. This is the major reason why government burdens on East Asian producers are comparatively low. In 1995, the new industrial countries there had a share of general government spending of only 27% of GDP, as compared to about one -third in the United States or Australia and 54% in western Europe. As the public-welfare habit constitutes such a heavy and job-destroying burden on globally competing producers in the affluent countries, there is a good likelihood that massive social-welfare reforms will be eventually undertaken.

If one adopts a global standpoint, one may of course argue that the self-inflicted social-welfare handicap of the affluent societies helps to shift mobile capital, knowledge and enterprise to lower-income countries, evening out global income differentials. Another effect of broad-based social welfare in affluent countries is that many of the world's poor migrate into the social-welfare states, legally and illegally. Only institutional changes that do away with present-day collective welfare provision will rectify these global shifts.

International Welfare: Development Aid

Although the failures of redistributive policies at the national level are now coming under critical scrutiny, the logic of redistribution is alive and well when it comes to international redistribution: development aid. Of course, there have always been some critical voices (Bauer, 1972; Bauer *et al.,* 1991), but they were in a minority and often denounced as reflecting a heartless economic rationalism. Only towards the end of the 20th century have more critical voices been heard, including from citizens of poor countries. It is being pointed out that

- massive aid transfers have done little to eliminate poverty in the Third World, whereas countries that have gone for export diversification and a competitive market order (most notably East Asian countries) have been graduating from the Third to the First World (Bhalla, 2002);
- aid is in reality – to use Lord Peter Bauer's words – is "a transfer of coercively extracted funds from the poor taxpayers in the rich countries to the rich elites in poor countries; indeed, foreign funding of Third-World regimes with no commitment to freedom, the rule of law and equity has helped to entrench ruthless power cliques and counter-productive institutions; where aid was cut, rule systems more conducive to spontaneous economic development emerged;

- much foreign aid was diverted into corrupt channels, not only the accounts of Third World elites, but also to preferred groups in donor countries and international organisations, as well as to the highly-paid officials in the foreign aid industry; indeed, much aid allowed the purchase of weapons and the waging of wars;
- economic development is not hindered so much by lack of capital as by bad institutions; indeed that much capital in the hands of Third World citizens cannot be used optimally because the institutions of capitalism are suppressed by abundant regulations and their corrupt implementation (de Soto, 2001);
- the notion of import substitution (through tariffs and quotas that distort markets in favour of domestic producers) has produced high-cost industries, which produce poor quality goods, as well as entrenched cronyism, which corrupts political and industrial life; and
- aid and trade preferences have turned Third-World people into mendicants, who display a self-destructive claims mentality similar to what can be observed in long-term welfare recipients in the rich countries, and have allowed selfish rich countries to uphold unfair trade barriers against the goods in whose production the Third World has comparative advantages (for example, the trade barriers of the European Union and Japan against Third World farmers).

The same destructive attitude changes that the welfare state has brought about within rich countries can be observed at the international level amongst those countries that have fallen into the aid trap — and stayed there. Institutions, which militate against self-help, competition and innovation, have become entrenched and colonial-era market institutions have been degraded. The transfer of no amount of capital and other types of "hardware of development" will be productive in generating Third-World development if the hardware is not combined with the right software, namely the institutions of secure private property, free markets and the rule of law. And when aid transfers are destructive of good institutions, they only worsen the problem for the vast majority of citizens in these countries.

Despite the logic of institutional economics and the empirical evidence of successful developing countries, the advocates of copious aid carry on. After the turn of the century, the painful evidence of Third-World poverty, mostly in Africa and the Middle East, has led to various 'Millennium Initiatives' to pump even more aid into mismanaged, failing economies and 'forgive' bad loans given by the World Bank and other such loan organisations[21]. Some supporters of these new programs argue that greatly increased aid will remedy the outcome of persistent poverty, others (mainly the US government) stipulate that future aid should be selective and tied to the condition of institutional reforms to implement democracy and the market economy. Given that there is no world government that can force sovereign Third World regimes into obeying conditions and changing their ways, and that aid givers have severe knowledge problems as to what is being done in Third-World countries, one has to remain sceptical about selectivity and conditionality. Some from Third World elites already protest against conditionality being a sign of a new post-colonialism, others resent the discrimination.

Furthermore, one has to acknowledge that many operators in the affluent countries are not innocents in the political economy of global aid redistribution: Many have a material interest in keeping African or Indian producers in the frame of mind of beggars and aid recipients, rather than competitors, for example in food stuffs or textiles. Many, who benefit from domestic redistribution policies, oppose the open economy and globalisation, which only undermine the scope for domestic redistributive politicking. Many cannot think beyond the first step – "donations to the poor obviously alleviate their misery" – and totally ignore the side effects of handouts on the likelihood of institutional evolution and attitude

[21] Incidentally, widespread debt forgiveness has the side effect that the World Bank, other loan organisations and UN bodies are able to carry on as before — and that numerous highly paid careers in the international aid business will be saved from the consequences of handing out bad loans.

changes, which are a core condition of economic growth (Chapter 1). Above all, many of those who promote new aid initiatives benefit handsomely, from the industrial exporter, who can offload overpriced equipment under aid programs, to the activists in "non-government organisations", who enjoy well-paid adventures in the Third World, and aid advisory professionals on high international salaries and bountiful expense accounts.

What has been said in this section applies to sustained development aid – making the citizens of rich countries to become their brothers' keepers forever – , not to emergency aid, for example in the case of natural catastrophes. For example, the *tsunami* catastrophe of Christmas 2004 in the Indian Ocean merited practical and massive help. This was realised by the citizens of the rich countries, who gave generously and supported big government donations, whereas normally they have displayed an 'aid fatigue'. Many ordinary citizens in the affluent countries are increasingly regarding international aid transfers as critically they regard domestic welfare transfers. The post-*tsunami* generosity revealed that this incipient rethinking about international redistribution is not based on stinginess and lack of empathy with the poor, but on the lessons from the consistent failures of government-to-government aid transfers — perhaps even on the realisation that development requires systematic institutional changes.

These cannot be exported or imposed from above – let alone with military force, as in Iraq. The institutions that matter most, as we saw in Chapter 3, are the internal institutions of society, anchored in shared social values. The external institutions, which governments can shape and enforce, can never go against the grain of internal institutions, and it is only the external rules over which public policy has a direct influence. The internal and external institutions that support economic success in the era of globalisation have to be homegrown in the light of experience. They can hardly ever be an export article.

How to Control the Opportunism of Political Agents?

The opportunism of the agents of government is an age-old problem. It has exercised the minds of many great thinkers and reformers, though with limited success. A number of institutions and control devices have been tried and will probably have to be applied again, as principal-agent problems in government can only be contained by eternal vigilance and concentric, multi-pronged efforts (Olson, 1965):

(a) Ancient philosophers, such as Plato and Confucius, saw great merit in relying on the moral education of future leaders. Nowadays, most are rather cynical about this. However, public vigilance and intolerance of selfish, shortsighted opportunism in high political office are important bedrock conditions for good government. There is still a place in public life for high moral community standards and the public censure of those who tolerate breaches of the rules of law and of ethical standards by those who hold high office. In numerous cases of official corruption, the innate probity of the public was the ultimate line of defence against the opportunism of office holders and their camp followers.

(b) Political writers of an earlier age, such as Charles de Montesquieu (1689-1755), and the shapers of the US constitution proposed and implemented the separation of the powers of government between the rule-makers (parliament), the rule implementers (administration) and the rule adjudicators (judiciary). Bi-cameral parliaments have a similar function (e.g. the US' House of Representatives and Senate).

    The merits of the division of political powers are now widely recognised. However, in the Westminster-style system of government, the separation of powers is rather weak. In practice, the parliamentary majority party or parties — or rather its leadership group — of the day dominate not only the legislature, but also the executive. Over the long run, the elected political party also has great influence over who is appointed to the High Court. Only when the Lower House majority is not matched by an Upper House majority, is there some parliamentary check on executive power — unless, of course, political deals are done with the opposition inn the Upper House. Nowadays, both houses of parliament tend to decide along party lines. As a result, parliament and executive are exposed to massive interest group lobbying and can get away relatively easily with discriminatory political interventions.

(c) Another method of controlling agent opportunism in politics is the separation of powers between local, State and central governments (federalism). If these three levels of government are assigned separate tasks and empowered to raise requisite taxes to fulfil them, there is not only much scope for effective mutual control, but also a considerable incentive to foster prosperity and a growing revenue base. Competing jurisdictions then tend to offer competitive administrative solutions to collective problems. Competitive federalism induces governments to incur knowledge-search costs and to mobilise much valuable political-administrative creativity (Kasper-Streit, 1998, pp. 404-406). On the other hand, it must also be recognised that certain tasks of government are best left to a central agency (where there are distinct scale economies, such as in defence, where there is great interaction, such as with standardised traffic rules, and where competition amongst jurisdictions may have undue harmful consequences). Ensuring the same living conditions throughout the territory, irrespective of location, resource endowment and political behaviour can, however, not be an objective of policy, if one wants administrative creativity and power control. This objective is the equivalent of income redistribution. It stifles self-reliance and competition.

Many, originally decentralised federal constitutions have been increasingly centralised by national politicians and High-Court judges. Moreover, most State constitutions leave little scope for truly independent and responsible local government. In the European Union, many collective decisions are now moving from elected national parliaments to unelected, anonymous Brussels bureaucracies, which is widely resented. In the Third World, too, national governments regularly take collective decisions out of the hands of lower-level administrations, often claiming local-government failure without proving that central-government failure is equally likely. The centralisation of so much government business around the world means that governments are becoming more and more remote from the citizen. This enhances the influence of organised pressure groups and political parties, and diminishes direct citizen-control of collective actions.

(d) When discussing the failures to effectively check the concentrated powers of political parties over central governments, Friedrich Hayek proposed a separate Third Chamber of Parliament (Legislative Assembly). It would set the fundamental framework rules, which constrain what elected politicians can do. The Legislative Assembly would be elected for a comparatively long period by age cohorts, so as to ensure, so he hoped, a degree of independence from the party system (Hayek, 1979, pp. 147-65). He proposed that a party-based, normally elected Governing Assembly should, by contrast, pass enabling legislation, which compels citizens to act in certain ways, and which appoints the administration. Hayek's hope was that this would turn at least some parliamentarians into protectors of the citizen's liberties, a role British parliamentarians had fulfilled in the 18th century. It must remain an open question whether such an arrangement would escape the pervasive dominance of modern political life by organised political parties.

(e) Another device to control agent opportunism in government is of course the periodic check of parliamentary elections. One may also popularly elect heads of state, government leaders and other officials, such as judges, police chiefs and auditors. In most countries, candidates are nowadays typically supported by party organisations, although there are exceptions. This makes at least some public offices contestable. But how far this device goes to control agent opportunism in public office, depends ultimately on informed citizens and their fundamental values.

(f) Other controls of political opportunism, which are practiced in some jurisdictions, are term limits for office holders, to ensure that political agents do not lose contact with the mindset of the citizen-principals and do not get captured excessively by organised rent-seeking groups. In some jurisdictions, citizens can also exercise rights of recall and impeachment to constrain evident abuses in office. To the same end, provision can be made to indict politicians before special tribunals.

(g) If the citizens are the principals, whose free will is ultimately to determine collective action, and the democratically elected office holders are only their temporary agents, then it seems appropriate for the citizens to claim the freedom to vote, which includes the freedom not to vote. The free ballot, which is common to almost all democracies (though not in Australia and a few other countries), obligates the candidates to make an effort to attract the vote. That, in itself, serves as a useful reminder, which limits agent opportunism. The compulsory vote, by contrast, is based on the assumption that the collective agents have a right to command the citizens and that they somehow are ultimately in control.

(h) Transparent information is needed about the conduct of collective action so that the electorate can judge whether office holders have properly represented them. Such information is contained in annual budgets, public audits of budget accounts, and the scrutiny of the conduct of office holders by the press and other outside observers. Frequently, government officials manage to disguise relevant information or avoid scrutiny. Parliamentary privileges, limits on the freedom of information, defamation laws and other such devices are used by officials to limit access to information about the collective actions of government.

One way to promote transparency has been the proposal of Budget Honesty Charter. As far as I know, the pioneering such reform was the successful New Zealand Fiscal Responsibility Act of 1994 (Kasper, 1996). Under such reporting devices, governments have to notify not only flows of annual receipts and expenditures, but also their balance sheet of assets and liabilities. This reveals whether governments acted to add value to its net assets or whether the business of government was "value destruction". One merit of reporting government balance sheets is that they reveal inter-temporal effects of public choices, making it harder to make opportunistic decisions whose benefits accrue before an election, and the costs thereafter.

(i) Agent opportunism in high office might also be controlled by rules of an over-riding, constitutional quality. Critics of parliamentary democracies have proposed constitutional rules that constrain "vote-seeking auctions" by parliamentarians (Hayek, 1960; Buchanan, 1987; Brennan-Buchanan, 1985; McKenzie, 1984). Such rules may take the form of procedural constraints, for example prescribing the requirement of a two-thirds majority to raise taxes or authorise deficit finance. Strict limits could also be imposed on the government's claim on resources, for example by sunset clauses on specific government programs and formal limits on the size of the budget or rates of taxation. Another result-oriented limitation is to oblige government to adjust income tax rates automatically by the rate of inflation (so as to prevent the insidious method of tax creep which has pushed many ordinary income earners into high-tax brackets).

Many reject such formal limitations of parliaments on the basis of the doctrine that parliaments must remain absolutely sovereign, indeed that they cannot even bind themselves against future opportunism. However, a variation of Lord Acton's famous dictum applies: "Power corrupts, and absolute power corrupts parliament absolutely!" It seems worthwhile for many communities to explore the uses and limits of such constitutional constraints (Epstein, 2005).

(j) Another institutional device is the citizen-initiated referendum (CIR) which allows citizens, when they observe what they deem abuses of their will, to throw out government measures they do not like (Walker, 1987). The experience with the CIR device in Switzerland shows that citizens hardly ever initiate more government activity. Normally they vote to reduce the ambit of collective action, defending their own autonomy. In most democracies, there are only politician-initiated referenda, as politicians seem to fear interference from citizens.

(k) Given the increasingly political role of the highest courts in most mature democracies, it seems appropriate to ask whether the appointment of judges should not be subject to new constitutional rules. One check might be the appointment of judges by confirmation in public hearings, as is done in the United States. Another would be to alternate the right of candidate nomination between Federal and State governments. Yet another would be to introduce the possibility of repeal by the people. As long as judges concentrate on procedural justice and on keeping the legal system coherent and universal, such checks would not seem necessary. But many courts have shifted to reformist activism, and this would seem to require methods that allow the people to signal their will.

(l) Arguably the single most powerful control of political and bureaucratic opportunism is openness. When citizens disagree with how the government taxes, treats them and their property, and provides for them, some may vote with their feet and exit. They may relocate to other jurisdictions to invest their property, to spend their free time or even to reside permanently. In closed economies, government officials can only be controlled by the "voice option" (protest, agitation, elections etc.), but in open economies, some citizens also exercise the normally more effective "exit option" (Hirschman, 1980)[22]. The exit challenge in early modern Europe paved the way for constitutional government, private property rights and the rule of law, as we saw (Chapter 4). Now, new international economic strictures are constraining the autocratic power brokers of East Asia, who have been yielding to more democratic rule. The economic strictures of globalisation are resented, but, ultimately, they are fairly effective in controlling political power. When the power instincts of rulers are constrained by the exit option, they normally learn to offer rule-bound, limited government as a way to attract resources (such foreign investment), often despite themselves.

When international investors are courted for the sake of economic development, openness becomes the driving force to establish effective institutional constraints on official opportunism. When politicians can avoid inter-jurisdictional competition, economic growth tends to be slow and unemployment high.

Like a mother's job, the fight for citizen-serving government is never quite won! No single device will ever suffice to control the pervasive problem of agent opportunism in government. The problem can be contained by leaving as little coordination as necessary in the hands of collective action (minimal government) and by subjecting the agents of public policy to as many of the above control devices as is possible. The linchpin to all these controls of agent opportunism in public office is openness to trade, travel, and the flow of ideas, investment and enterprise. It is the rock on which good government, reliable property rights and individual autonomy have to rest in the face of ever-present political temptations of rent seeking and rent creation.

This verity has not yet sunk in fully in most countries, rich and poor. Once people wake up to the challenges of globalisation, they will have to think hard how to create attractive institutions that empower them to beat the global competition. Then, they will have to consider reshaping and universalising the fundament rules of economic cooperation. In other words, the constitution of capitalism will then be high on the agenda.

[22] When “exit” and “voice” are suppressed by the political masters, the citizens only have the option of withdrawing their loyalty and going more or less on strike — as they said in Soviet times: “They pretend to pay us, we pretend to work”. Then, economic development fails to materialise.

Finally:

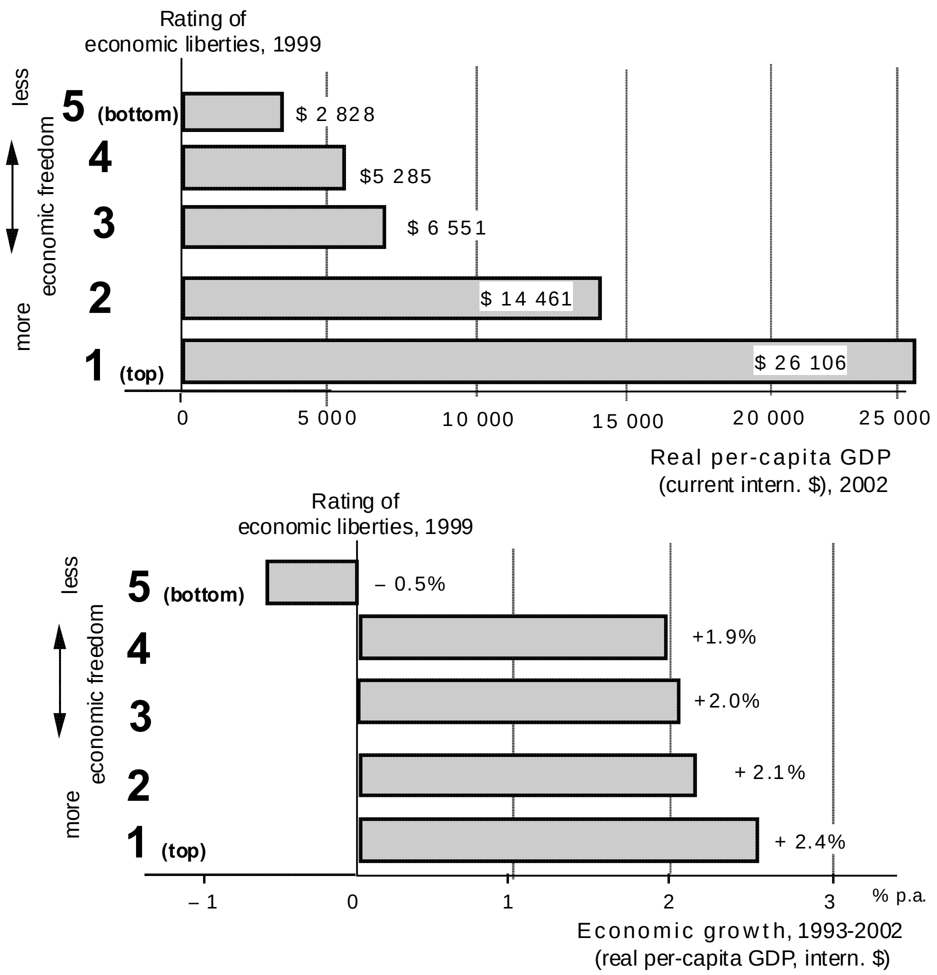
Measuring Economic Freedom and Development

"Freedom is that faculty which enlarges the usefulness of all other faculties'.
Immanuel Kant, Lecture at Königsberg, East Prussia, 1775.

The logic of institutional economics shows conclusively how beneficial the protection and clear definition of private property rights, the freedom to use these property rights in voluntary contracts, and the rule of law are for the average citizen. What we sometimes call economic freedom may interfere with political power and rent seeking, but it is more supportive of the wealth of nations than any other system yet discovered.

Graph 10

Economic Freedom and Prosperity



Source: Gwartney-Lawson, 2004, p. 22.

The Chicago free-market economist Milton Friedman and some of his friends tried to popularise this insight by giving it quantitative expression. A group of researchers and think tanks from around the world came together under the umbrella of the Vancouver-based Fraser Institute in 1986 to determine how economic freedom could best be assessed in a great number of develop and developing countries (Gwartney-Lawson, 2004; www.freetheworld.com). With the help of telling international statistics and surveys, an estimate of economic freedom is constructed annually to offer an imperfect, but information-rich index of the size and quality of government, the legal structure and the security of property, the stability of money, the openness of product and capital markets, labour markets and business regulation. Both inter-temporal and international comparisons depict a clear picture that economic freedom strongly correlates every year with the level of real per-capita income and its medium-term growth rate. Graph 10 presents the evidence for 2004. It can be seen that the average inhabitant of the world's freest 20% of economies enjoyed incomes nearly ten times those of the citizens in the economically most repressed 20% of nations. Year after year, the "Economic Freedom of the World Reports" also show that the freest are getting richer and the most repressed are left behind in economic growth.

It may be argued that association (of freedom indicators and the level and growth of per-capita incomes) does not prove causation. It might be argued that only rich countries can afford the luxury of free markets and secure property rights. However, the logic of institutional economics that has pervaded this book tells us that freedom causes development and prosperity.

High degrees of economic freedom, in rich and poor countries alike, tend to go along with other benefits: People in the freest economies tend to live about 22 years longer than those in the least free (75.9 years as against 53.7 life expectancy). Absolute poverty also declines as economies become freer, as does illiteracy, infant mortality, child labour and the quality of political and civil liberties. With less reliance on government controls, corruption also declines (Gwartney-Lawson, 2004, pp. 22-26). It is very hard to argue with this empirical evidence from across 123 countries.

The evidence supports the main message, which the reader should take away from this book: Economic freedom is the essential ingredient in economic development ... and in the pursuit of happiness.

GLOSSARY OF IMPORTANT TERMS

The **AGENT-PRINCIPAL** (A-P) **PROBLEM** arises when someone (an agent) acts on behalf of another (the principal), when the agent has superior knowledge of the task and tries to exploit this to act opportunistically, for example by shirking risks, enjoying high on-the-job consumption and enhancing his income at the expense of the principal.

The A-P problem has been diagnosed in business companies. There, it is constrained by competitive markets that surround the business: managers (the agents) cannot get away with massive opportunism at the expense of poorly informed shareholders (the principals), because capital markets, markets for managers, and markets for the control of companies (takeovers) will soon reveal manager opportunism. Similar competitive checks are, by and large, lacking in government, so that the citizen-principal can be less sure that the agents (parliamentarians, bureaucrats) will not act in self-serving ways at his expense, for example by rent-creation which assists their re-election or which simply serves to give them political clout.

It is not uncommon that the agents try to conduct themselves as if they were the principals and masters. For example, politicians elected to temporary office start to speak of "their citizens" and "their country", or even start to treat tax revenues entrusted to them as if these were their own to dispose off. In history, there have been many episodes, in which the agents used their knowledge to become the masters, for example the Mamluke soldier-slaves of Ottoman Egypt becoming the rulers, or military commanders in Third-World countries seizing absolute power.

The numerous scandals with corporate governance, such as for example the Enron collapse in the United States, testify to the fact that fighting agent-principal problems is an ever-present task, also in business.

CAPITALISM is the system of coordination of human economic activity, which is based on institutions that support private property and individual (or small-group) autonomy in using these property rights. It facilitates decentralised, spontaneous responses to changes and emerging problems.

CATALLAXY refers to the process of exchange that generates and tests new knowledge as to its usefulness to potential buyers. Catallactic market processes facilitate ongoing discoveries of new wants and new resources to meet them. This dynamic-evolutionary concept is appropriate to the growing "knowledge economy" –– rather than "economising", i.e. the rationing of the scarcity, using *given* resources to maximise predetermined ends.

Economic **COMPETITION** takes place in the **MARKET**, (a) between rivaling suppliers who incur market-transaction costs to position themselves as attractive contract partners for potential buyers, and (b) between rivaling buyers who incur transaction costs to position themselves favourably vis-à-vis sellers. Since one can never be sure what return one gets from incurring transaction costs, competitive rivalry is unpopular. But the incurring of transaction costs is essential for prosperity and the control of economic power. Therefore, the agents of public policy should resist protecting buyers or suppliers from the need to bear transaction costs (see RENT SEEKING).

CONSTITUTIONAL ECONOMICS is a fairly new line of inquiry, which has developed out of **PUBLIC CHOICE ECONOMICS**. It is based on the insight that institutions matter, and that alternative institutional arrangements can make a great difference to economic outcomes. It focuses in particular on institutions of a constitutional character, i.e. fairly abstract, overriding rules that are considered fairly permanent and that govern adjustments in lower level rules. 'Constitutional" in this sense does not necessarily relate to a nation's written or unwritten political constitution. Constitutional economists raise the question what economic and political principles and *meta* rules are desirable (normative constitutional economics) and what constitutional redesigns are needed to obtain certain economic results.

ECONOMIC FREEDOM is a shorthand to describe the core institutions of (i) secure property rights, (ii) the freedom of their use, and (iii) the rule of law and the equality of all before the law in exercising their property rights. It is an empirical observation that jurisdictions with small, rule-bound government, a lightly ruled economy, and open borders tend to offer greater economic freedom than others and that less corruption can be found in economically free countries.

ECONOMIC GROWTH in a community occurs when real (i.e. inflation-adjusted) per-capita incomes and productivity rise in a sustained way. It relates primarily to the supply-side of the economy, i.e. the potential of an economy to supply goods and services, using labour and skills, capital and technology, technical and organizational knowledge and know-how, and natural resources. These production factors are combined to produce outputs when entrepreneurship is present, an input that acts like catalyst which enables the economic chemistry to interact. **ECONOMIC DEVELOPMENT** is often used as synonymous with economic growth, but other authors stress the need for economic structures to change and the institutional settings to evolve to match the changes in various stages of development.

EVOLUTION was seen as the fundamental phenomenon of economic life by the classical liberals of the 18th and early 19th centuries. Since then, Austrian economics and evolutionary economics have continued that intellectual tradition (whereas neoclassical economists closed the model to new, unpredictable developments and reduced it to comparative-static analysis). The wants of the citizens, and resources to satisfy them, are subject to variations, selections and rejections by numerous, decentralised market participants. What survives in market processes is ultimately determined by the valuations of buyers (consumer sovereignty). Products that attract enough "dollar votes" to make a sufficient profit will survive. Those who do not will lose critical mass and disappear. Different from biological evolution, the process of economic evolution is fed by the willful, intelligent actions of entrepreneurs and buyers. Like biological evolution, it tends to follow a path that is evident in hindsight, but that is open-ended and unpredictable in its future detail.

The term **EXTERNALITY** is used by economists to denote costs and benefits that cannot or are too expensive to be sheeted home to the decision maker who causes them (they cannot be internalised). Thus, industries that burn fossil fuels cannot easily be burdened with the full costs they impose on humanity (external costs) and other activities cause benefits, which they cannot (cost-effectively) capture (external benefits, for example when people vaccinate themselves and thus reduce the contagion risk of all others in a community). Better measurement technology now often permits the conversion of externalities into internalisable costs and benefits. In other cases, collective action will be the best way to compensate for externalities, taxing the creators of external costs ("polluter pays") and subsidising the originators of external benefits. Cases of extreme externalities come close to pure PUBLIC GOODS (see below).

The reason why externalities should be compensated for is that private economic choices only yield the highest attainable economic welfare in the community if activities, which cause external costs are not, overextended (because they seem too profitable) and activities that cause external benefits are produced sufficiently (despite the fact that they do not seem privately profitable).

FUNDAMENTAL VALUES (or beliefs) are widely shared high priorities that inform human conduct, namely freedom, justice, security, prosperity and peace. These values tend to inform human action in invisible but dominant ways, similar to DNA information influencing the visible characteristics of a body. Fundamental values tend to remain fairly constant over time, but many social reformers have tried to influence them by education or propaganda. Thus, we witness current attempts to reshape basic values with regard to the environment.

INSTITUTIONS are defined here as rules for human behavior whose violations incur sanctions of some kind or another. The sanctions can be informal, as for example when cheats are spontaneously excluded or suffer the loss of their good reputation, or formal, as for example when thieves are punished by law courts. Most institutions are internal, i.e. they emerge from experience and are adopted in a community because they have been found useful. But some institutions are external, i.e. are designed by authorities that have been empowered by a political process and are enforced by formal coercive means.

Institutions are not organisations (see ORGANISATIONS), and numerous institutions "live" in communities without being embodied in organisations.

Institutions define what is the framework for social interaction, and they are essential for cultural and social cohesion. Institutions reduce uncertainty and thereby facilitate human interaction, for example in allocating resources and in finding and testing innovative knowledge. By encouraging the search for and the finding of useful new knowledge, institutions enhance economic prosperity. They also help to reduce many conflicts and to settle remaining conflicts in predictable and constructive ways. Thereby, they advance social peace and confidence, which again is conducive to prosperity. Universal, non-discriminatory institutions give people the feeling that they are justly treated. Appropriate institutions are also likely to induce people to conserve scarce resources.

The **KNOWLEDGE PROBLEM** constitutes the central, fundamental issue of economics. People often do not know what their wants are and where to find resources to satisfy them. In the modern, complex economy, growth depends on how new knowledge is explored and tested as to its usefulness to many diverse people. One way to do this is to ensure that enterprising people can appropriate the gains from useful new knowledge and must bear the losses from unwanted property uses and innovations. Competitive market processes (see competition) force resourceful people on both sides of the market to tackle the insidious knowledge problem by spontaneous exploration and testing procedures. An alternative way to gain knowledge is for appointed analysts and planners to engage in systematic research and development. But this tends to work successfully only in settings which are not very complex.

Economic **LIBERALISM** is a philosophy and program of collective action that favours individual autonomy and responsibility (civil, economic, political freedom) as an end in its own right. It advocates the largest possible use of private property and competition to coordinate autonomous human actions. While not denying a role for the state, it rejects most types of coercion and interference in economic life by governments and interest groups. Contemporary economic liberalism owes much to the classical liberalism of 18th century French and British writers, such as John Locke, David Hume and Adam Smith, arguing for a minimal state and against political power to discriminate among the economic interests of different citizens. (This concept of liberalism aims at enhancing negative liberties from coercion, in contradistinction to the modern American meaning of "liberal", which means "generous with the taxpayers' resources to promote the material ends of organised groups by coercive redistribution and intervention" and in contradistinction to Australian and European "Big-L Liberalism" which has often been a political program of intervention and of support for well-organised interest groups).

ORDER is defined as the existence of recognisable patterns in nature or human society. Order is useful because people with inherently limited cognitive capacities can interact more confidently and effectively when it exists. Order can be imposed on the basis of a design (example: train traffic is ordered by schedules, signals and other coordinating devices), or it can be the result of all component elements following spontaneously a set of shared rules (example: car traffic is coordinated and expedited by adherence to traffic rules). The centrally designed, **IMPOSED ORDER** can be an effective way of pursuing human purposes when the subject matter is relatively simple. The more complex and changeable the phenomenon that needs to be ordered, the more likely it is that **SPONTANEOUS ORDERING** is more effective. This became clear from the resounding failure of the designed, imposed order of central planning in communist countries.

Human conduct is more likely to be ordered effectively, if the rules themselves are ordered, i.e. do not create contradictions. Such an **ORDER OF RULES** is more easily achieved if the rules are predominantly proscriptive, ruling out harmful actions, and not prescriptive, commanding actors to do certain things.

ORGANISATIONS are more or less permanent combinations of production factors under some form of leadership that imposes elements of hierarchical order. This does not mean that organisations, such as business firms, clubs, or government agencies, do not have to rely in part on coordination by spontaneous rule compliance, as well. Indeed, many organisations embody institutions, such as work practices, that cannot survive outside organisations. Nevertheless, organisations must not be confused with institutions (as is often the case in common usage).

PRIVATE CHOICES occur when people use their own property through voluntary, bilateral contracts. **PUBLIC CHOICES** (or **POLITICAL or COLLECTIVE ACTION**) involve groups of people who are expected to contribute resources (e.g. through taxation) and gain advantages (e.g. from using public services). This frequently involves the appointment of agents, for example the election of parliamentarians. Since the trade-offs between give and take in public choice are typically less direct, the motivation to perform is often weak and principals often find it rational to remain ignorant, so that agents have scope for opportunistic, self-seeking behaviour (see agent-principal problem). Public choices also tend to require more costly monitoring and adjudication procedures to ensure that the will of the principals is done.

PROPERTY RIGHTS allow the owners to exclude others from using their assets (passive rights) and to use, benefit from, and dispose of assets in cooperation with others (active property rights). The enjoyment of property rights causes exclusion and coordination costs, largely because of knowledge problems about how others will behave.

Property rights attach to assets; they must not be confused with the asset itself. Property rights are not only attached to physical assets, but also to many intellectual assets, as well as to one's person and labour. To be of full use, property rights should also be divisible and transferable.

Pure **PUBLIC GOODS** are goods and services in whose provision the costs and the benefits cannot be internalised (see externalities), either because potential users do not have to rival with each other, and/or because potential providers cannot supply such goods exclusively to people who would buy them. Examples for non-rivallous demand are street lighting and national defence: the enjoyment of these services by some does not detract from the enjoyment by others. It is impossible to provide protection from external aggression exclusively to some, but not other citizens. Once security is provided for some members of a nation, the others can free ride.

It does not necessarily follow that public goods have to be provided by socialised means of production, only that government secures access. Thus, street lighting can be produced by private suppliers and paid for out of taxation. The case for **PUBLIC OWNERSHIP** rests on the need to exert direct control by the purse strings over activities where competition would be costly (example: national defence, rather than hiring competing mercenary battalions).

RATIONAL BEHAVIOUR in simple, static, contexts can be guided by known ends and known means (**END-MEANS RATIONALITY**). But frequently one observes other types of economic behaviour. Given limited knowledge of the means, people adjust their ends in the light of past experience (**BOUNDED or ADAPTIVE RATIONALITY**), or behave in creative-entrepreneurial ways to overcome existing physical or institutional obstacles, typically without being able to fully assess the costs and the benefits *ex ante* (**CREATIVE** or **ENTREPRENEURIAL RATIONALITY**). These types of behaviour are entirely rational. They are indeed necessary for widespread and sustained prosperity.

RENT SEEKING is an aspect of collective action based on the knowledge problem. It is a manifestation of the principal-agent problem (see above). Organised suppliers typically seek material advantage by obtaining an intervention in competitive market processes. Political agents (parliamentary parties, politicians, bureaucrats) provide such interventions (a) because that will give them augmented influence or financial rewards and (b) because the citizen-principals find it to costly to inform themselves about such interventions and to organise themselves against such selective preferments. Rent seeking tends to undermine genuine competition among suppliers and hence stifles their efforts at incurring transaction costs (essential for innovation and growth). It also corrupts political life.

The term **SOCIAL CAPITAL** is sometimes used to refer to the system of internal and external institutions of a society to underline that the institutions have an effect similar to physical or skill capital on the productivity of the other production factors, such as labour or natural resources. Just as better tools enhance the productivity of labour, so do more effective, more credibly enforced institutions enhance the division of labour and knowledge, and hence the productivity of labour. Social (or cultural) capital must not be confused with socialised capital, i.e. the ownership and control of assets by large community collectives, such as the state.

TRANSACTION COSTS are the costs of coordinating people in markets. They arise because of the knowledge problem and have to be incurred to find and test knowledge, specifically by finding contract partners, materials and production knowledge, negotiating and concluding contracts, monitoring contract fulfillment, as well as obtaining redress and tort compensation for non-fulfillment of promises. In modern economies, the division of labour is so complex that transaction costs have risen to close to half of all the costs of producing and distributing the national product. Devices, such as modern communications and computing technology and appropriate, business-friendly institutions, can economise on transaction costs.

(When coordination is done within organisations, we speak of **ORGANISATION COSTS.**)

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