ECONOMIC FREEDOM & DEVELOPMENT

An essay about property rights, competition, and prosperity

Wolfgang Kasper

Overpopulation, colonial exploitation, pervasive corruption, chaotic democracy, high illiteracy, and antimaterialist and fatalist culture do not explain India's poverty. Lack of economic freedom does. Let the natural propensity of the Indian to truck, barter, and exchange flourish within the spontaneous order of the market. — PARTH J. SHAH

Economic Freedom and Development

An Essay about Property Rights, Competition and Prosperity

WOLFGANG KASPER

Centre for Civil Society
New Delhi • India

ISBN: 81-87984-05-8

Published by Dr Parth J Shah on behalf of Centre for Civil Society,
B-12, Kailash Colony, New Delhi 110 048
Website: www.ccsindia.org Phone: 6468282 Fax: 6462453

Rs 200

Designed and typeset at Tulika Print Communication Services, New Delhi.
Printed at Glorious Printers, Pataudi House, Daryaganj, New Delhi 100 002.

This essay is dedicated to the collectivists of all political parties and academies in the third and the first worlds, who keep telling us all the time that economic freedom is not good for us!

Other Titles from Centre for Civil Society

Free Your Mind: A Beginner's Guide to Political Economy
Profiles in Courage: Dissent on Indian Socialism
Money, Market, Marketwallahs
Friedman on India
Self-Regulation in the Civil Society
How Markets Work: Disequilibrium, Entrepreneurship, and Discovery
Agenda for Change: Action Plan for the Economy
Kisan Bole Chhe (Gujarati) [The Farmer Speaks]
Do Corporations Have Social Responsibility?
Population Causes Prosperity
The Indian Financial Sector after a Decade of Reforms
Peter Bauer: A True Friend of the World's Poor

Contents

Summary

- It has become increasingly obvious that people in free, open societies generate relatively fast economic growth, whereas planned and controlled economic systems make for stagnation or decline. This essay addresses the factors and rules that expand productivity and incomes and those that retard economic progress or even lead to economic decline. Although India lagged behind East Asia, the easing of bureaucratic controls and central planning in recent years has allowed the spontaneous forces of growth to emerge in India too. Much remains to be done, including the tackling of discrimination on grounds of caste, religion and other such criteria within civil society, apart from reforming the State and its interventions and opening the economy so that Indians can freely compete in world markets.
- It is the purpose of this essay to explicate the connection between freedom and growth to an Indian audience, where remnants of an opposing philosophy—that growth can be generated by planning from the top down and by copious controls and regulations—still have lingered, despite much global and historical evidence to the contrary.
- We begin by asking about the causes of economic growth: Is it investment, learning, innovation, resource development, or something else? All these factors have played a role in economic progress throughout history and around the world. But focussing on these factors begs the question *why* people invest, learn, innovate in some and not in other societies! The reason for such differences in behaviour lies in different sets of rules of coordination, which we call 'institutions'. The institutions have to evolve if economic and social development is not to stall in its tracks. What might have been good 'traffic rules' to coordinate a tribal society are not necessarly the institutions that help a nation's prosperity in the era of globalisation. This essay therefore restates the fundamental insights of the new and rapidly spreading discipline of Institutional Economics. It explains in particular what has come to be known as the "constitution of capitalism," which has been widely recognised as essential for general material progress, as well as a free, peaceful and just society.
- A modern economy is a complex system that evolves in ways similar to a

natural ecological system. Enterprising people search spontaneously for new wants and new resources, if they are able to rely on simple, stable and non-discriminatory ground rules. Discretionary market interventions by governments and powerful groups tend to have unforeseen and harmful side effects and, if allowed to cumulate, make the entire economic system dysfunctional. This applies *a fortiori* to developing countries. They are going through disorienting and confusing structural changes, so that past experience is frequently a poor guide in coordinating people. Economic development therefore depends on the cultivation of good, citizen-friendly institutions and habits that enhance economic freedom and an effective, honest and just division of labour.

- The most successful set of ground rules for coordinating economic activities is the system of protected private property rights, as well as private autonomy to compete under the rule of law. An important part of this is the protection of life and limb, a condition regrettably absent in many shantytowns and rural areas. Under well-run protective institutions, propertied and talented people have an incentive to compete. They incur the costs of searching for useful knowledge and test whether such knowledge is sufficiently valued by others (reflected in a profit). Genuine competition thus stimulates innovation and economic growth. It also induces people to abandon errors that are signalled by losses. In a competitive market economy, property owners who shirk the shouldering of the costs of knowledge exploration probably incur losses in the value of their assets.
- Governments must therefore not protect the existing socio-economic positions of the competition-shy. Yet, such favouritism and interventionism are frequent pursuits of corrupt politicians and officials.
- A genuine competitive system tends to go along with a high degree of equality of opportunity. Therefore, the control of competition- and growth-impeding collusion between corrupt officials and 'crony capitalists' must be made one of the fundamental tasks of economic development.
- Public policy and collective action normally do not coordinate human conduct as well as free markets. Many traditional collective pursuits—such as the provision of water or electricity—are nowadays satisfied more effectively by competing private providers. Nevertheless, public policy and the visible hand of government are sometimes needed to back up the institutions of civil society and to control concentrations of power. It must, however, be kept in mind that governments cannot protect the private property rights and other economic freedoms of *all* citizens, when they engage in the promotion of specific industries or intervene in trade. This always occurs at the expense of some property owners, typically the weaker and less keep 'well' organised members of society.
- The domain of collective action has been relentlessly expanded over the past 100 years by self-serving military men, elected parliamentarians, an

activist judiciary and bureaucratic influence-seekers. Where the power of well-connected political and industry groups is unbridled, public policy has not served the ordinary people well; and where economic freedom and the ground rules are poorly protected (as in India), economic growth, which benefits all, remains an illusive goal. Political and economic power therefore have to be constrained by just rules if the challenges of economic development, the open economy and the communications revolution are not to inflict further pain and traumatic experiences on the majority of citizens.

About the Author

Wolfgang Kasper is an *emeritus* Professor of Economics at the University of New South Wales in Australia and a Senior Fellow of a privately financed free-market think tank in Sydney, the Centre for Independent Studies.

After school and university studies of modern languages, economics and law in post-war Germany, Switzerland, Paris and London, Kasper worked on the research staff of the German Council of Economic Advisors, the Kiel Institute of World Economics in Germany, and as an Advisor to the Malaysian Finance Minister in Kuala Lumpur (under the auspices of Harvard University). In the 1960s, he was also involved with a study by the OECD's Growth Centre of India's socialised and private steel plants, and he looked into the economic consequences of the Rupee devaluation of June 1966. In 1973, he joined the Australian National University in Canberra. From 1977 to 1999, Wolfgang Kasper was the foundation Professor of Economics at the School of Economics and Management, which the University of New South Wales maintains in the Australian Defence Force Academy at Canberra.

He has contributed to numerous public inquiries in various countries, has served as a consultant to industries and governments, and written occasional newspaper columns in Australia and overseas. He has also worked at the Reserve Bank of Australia, the Naval Postgraduate School in Monterrey, California, the Federal Reserve Bank of San Francisco, and the OECD in Paris. He has also gained first-hand working knowledge of virtually all East Asian economies and has visited India and Latin America repeatedly.

In 1986, Professor Kasper was elected a member of the Mont Pèlerin Society, an international academy, whose members are interested in freedom and limited government. He has had a long association with the Centre for Independent Studies in Sydney which published an earlier version of this monograph, as well as other books and articles, and is a member of the Presidium of the centre for the New Europe in Brussels, Belgium. Some of his more than 220 articles and a dozen books have been translated into Chinese, Spanish, French, German, Italian and Russian.

Foreword

An essay such as this could not have been put together without drawing on the wisdom of many. Some of them are explicitly cited in the references, but I am probably not even aware of many others to whom I am indebted intellectually. This essay has benefited in particular from the joint effort of writing a book on institutional economics with my colleague and friend Professor Manfred Streit, the Director of the *Max-Planck-Institute for Research into Economic Systems* at Jena, Germany[1].

The present essay is a completely revised version of a small monograph, which *the Centre for Independent Studies*, a free-market think tank in Sydney, Australia, published in 1998. In a slightly adapted version, it is also being published by a liberal think tank in Nigeria, *the Institute for Public Policy Analysis* in Lagos.

The main purpose is to introduce the reader to the new discipline of institutional economics, which explores the connections between certain types of rules of coordination—called 'institutions'—and economic performance. Differences in the rule sets that govern economic life can explain most of the differences between the richest and poorest countries on earth. Admittedly, this is not (yet) a central position of standard development economics, but it is obvious from numerous real-world comparisons: living standards from 1948 to the fall of the Berlin Wall grew enormously in capitalist West Germany whereas socialist, planned East Germany reached only 40 per cent of West German living standards from the same basis; the contrast between the rising affluence in the market economy of South Korea and starvation in centrally planned North Korea; the acceleration of economic growth in China, since farms and many other productive assets were privatised, private firms were allowed to seek contract partners in fairly free markets, and the economy was opened to a measure of world market competition; and the observation that Indians are often very successful in business and industry when they

[1] W. Kasper-M.E. Streit, *Institutional Economics—Social Order and Public Policy*, published in 1998 by Edward Elgar in the *John Locke Series*, and in 2000 by Commercial Press of Beijing in a Chinese translation.

work outside India, but have managed only moderate growth under Nehru-style central planning and the heavy hand of the Indian bureaucracy, prior to the partial economic reforms of the 1990s. In each case, the institutions of capitalism—private property rights, free contracts and the rule of law—have made all the difference between misery and prosperity! It is the role of this monograph to discuss the nature of the relevant institutions and to indicate how their quality might be enhanced by public policy.

Trying to make constructive suggestions and discuss policy issues for the benefit of Indian readers is, however, risky for me, for I have only limited first-hand knowledge of India and its economy, having visited the various parts of the country only some five or six times over the past thirty years. All I can claim is to have asked the general questions about growth and institutions throughout my professional life, both as an academic and a policy adviser in a diversity of rich and poor nations alike. And it seems to me that the general insights hold for India too.

Ultimately, it will of course have to be left to my Indian readers to accept or dismiss the general lessons that I wish to share with them. They may know the reasons as to why the worldwide growth experience and the concepts of institutional reform cannot or should not be applied to India. If so, it would be most instructive to learn why universal lessons about human behaviour do not apply here. The reader should also be warned up-front that fast economic growth is not easy. It has never been anywhere in history. Yet, the only thing tougher than launching into a broad-based economic growth is to cope with stagnation, let alone economic decline!

Last but not the least, I wish to record sincere thanks to my wife Regine for her help with proof-reading and getting this manuscript into acceptable shape—apart from everything else—and to Dr. Parth J. Shah of the Centre for Civil Society in New Delhi for his encouragement and cooperation over the internet between Australia and India.

WK
Sydney, Australia
August 2002

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 per cent of the international variation in income per capita can be explained by . . . [manmade 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 incomes levels , Roll—Talbott (2001)

Economic growth—the sustained rise of productivity and hence real per-capita incomes throughout the community—is a relatively new human experience[1] . It has now become the norm around the world, except in some socialist and ex-socialist countries and many of the war-and corruption-wrecked states of the third world. Real per-capita incomes have trebled over the past half-century, both in the first and the third worlds. This has been accompanied by big reductions in child mortality, massive improvements in health, longevity, job satisfaction, life opportunities and 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, stagnant societies (Simon, 1995). Since the beginning of the Green revolution some 40 years ago, the share of malnourished people on earth has dropped from 35per cent of the world population in 1960 to 18 per cent now (Lomborg, 2001). For most people, the quality of nutrition has greatly improved and education levels have risen. 100 years ago, 75 per cent of mankind was illiterate, now all but 20 per cent can read and write. And all—except a few snobs and single-issue environmentalists, who have never known

[1] See 'Glossary' at the end of this monograph for a definition of economic growth.

genuine poverty—would agree that economic growth is highly desirable, for economic and non-economic reasons[2].

The world wide growth record and the limited number of cases of continuing stagnation suggest the questions which are at the core of this monograph, namely: What explains the take-off into sustained economic growth, first in western Europe and North America and then in Japan, East Asia, and Latin America? Why has economic growth lagged until recently in South Asia? Can one derive general lessons from this experience for India and other countries? What changes in public policy is needed to facilitate a catch-up of living standards in India with those of the affluent West?

It will be the main purpose of this essay to highlight the importance of simple, stable and universal ground rules (institutions) in coordinating human conduct in the economy and in establishing trust[3]. We will argue that certain simple rules of an overriding, constitutional quality serve to constrain 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 imperilled by the next confiscation, the next arbitrary act by a corrupt official, the next subsidy scheme, prescriptive regulation or lawless act of someone powerful. Sustained economic growth requires that basic economic institutions are universal and are credibly enforced equally on everyone, in order to reduce the costs of transacting business. Also, proper institutions constrain social and inter-ethnic conflict and de-emotionalise political life. 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 arbitrary or corrupt public administration.

Another way of reiterating the same would be to say that this book is about the costs of corruption in terms of economic growth and all the ensuing benefits, since corruption means nothing else but the degradation of universal and credibly enforced institutions.

---

[2] If the reader has doubts about whether economic growth is worth having, he is referred to the "Insert" at the end of this Chapter.

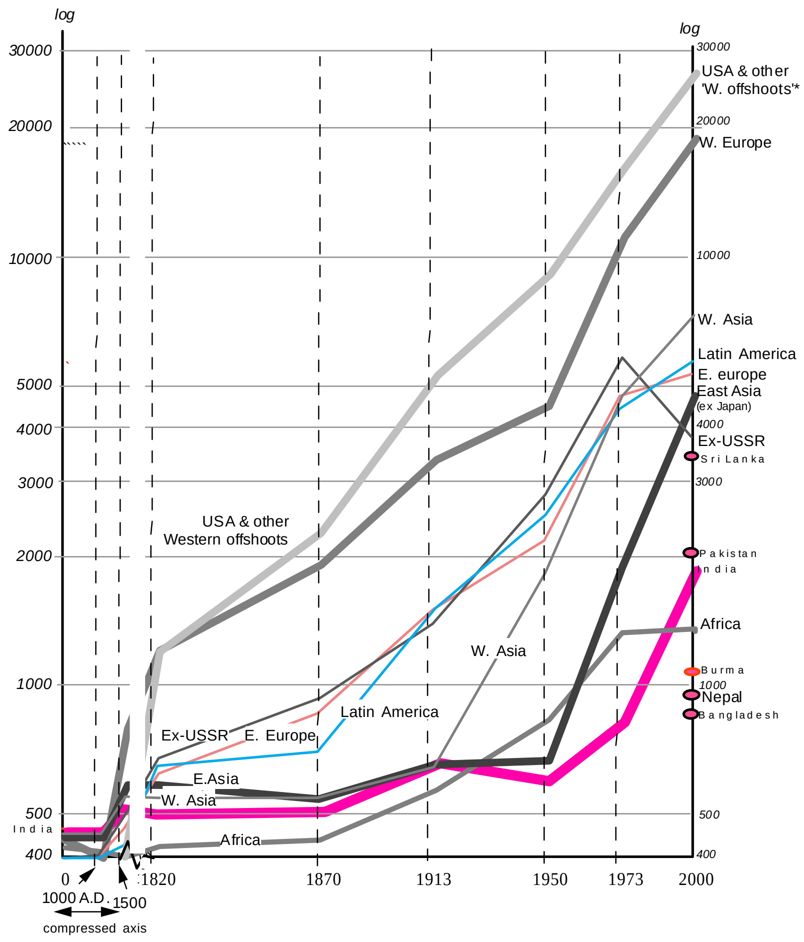
[3] See "Institution" in the Glossary at the end of this monograph. A number of terms have to be given specific and precise definitions, if we want to analyse policy issues. To assist the reader, the most important definitions have been collected in the 'Glossary' at the end of this book.

In line with a rapidly growing academic literature on Institutional Economics, the word "institution" will be used here exclusively to describe rules that carry sanctions. In the social-science literature, the term "institutions" carries many and conflicting meanings, to the extent that it becomes meaningless. Moreover, everyday language often refers to banks, universities and insane asylums as institutions; but these are organisations—durable combinations of production factors to pursue specific purposes.

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 data as a basis (Maddison, 2001). On the vertical axis, we show the logarithms of real per-capita incomes (measured in US-$ purchase power equivalents). This means that accelerated growth is reflected in an upward bend of the curve, and decelerations in a downward bend. Decreases in living standards—for example the decline over the past quarter century in the former Soviet Union and in a number of African countries—can also be clearly seen. On the horizontal axis, we have compressed the (necessarily crude) income estimates for the year 0, 1000 AD and 1500 AD and show the broad development since 1820. The graph draws attention to a number of important insights:

Graph 1: Long Term Economic Growth
India by International Comparison



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

Source: Maddison. 2001

- In the first millennium of the Christian era, all people were poor (except a very few powerful members of the elite). Material living standards, were on an average even lower than the poorest third world countries of today. This was so because improved 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 normal. And no one believed that human misery could ever be overcome.
- With the Renaissance in Western Europe, and even before the start of European colonialisation, something revolutionary happened: general living standards began to rise. Some 'new-world offshoots' of Western European civilisation (North America, Australia, New Zealand) rapidly achieved, for those times, unprecedented living standards, and then kept growing relentlessly. The growth process began during intense inter-State rivalry in Europe (wars of religion) and with the emergence of individualism, the rise of critical, sceptical thinking, a market economy and slow improvements in the rule of law (see below).
- After 1820, eastern Europe, Russia and its neighbours, and Latin America took off into sustained growth. In the 19th century and the first half of the 20th century South Asia and India showed little growth in per-capita incomes, with added production being largely matched by accelerated population growth (extensive growth). Since 1950, per-capita incomes have risen, though much less than in the export-oriented East Asian countries. With a degree of liberalisation incomes rose faster towards the end of the millenium, albeit at a much lower level of income and with much less vigour than in the open, more lightly governed and more developed East Asian economies. Growth also spread to parts of the Middle East (West Asia) from the early 20th century when oil launched some countries there on a growth path. However, modernisation there did not lead to a significant rise in female education, which would have reduced birth rates as it had done almost anywhere else. West Asian countries continue to have among the highest population growth rates in the world.
- 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, where war, corruption and civil chaos had previously inflicted untold misery and where now one

---

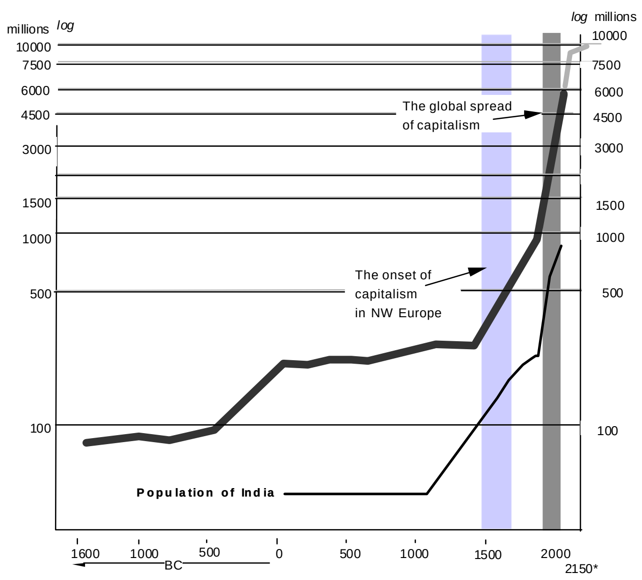
[4] This was the so-called 'Malthusian trap', named after the British economist, who in 1798 stipulated that the number of hungry mouths would always outstrip the resources to feed them. Oddly, he published this theory just when the beginnings of the industrial revolution created conditions under which this was no longer true.

autocratic government 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 privatisation, decontrolling economic activity and opening the economy to the world market forces. More recently still, India and other south Asian countries have managed a take off into growth.

- Only Africa as a whole has remained nearly stagnant, despite rich natural resources. Some countries, like Nigeria, even managed a decline in living standards. Similarly, people became poorer in the former communist states of the USSR, where the old system collapsed and a new order was yet to emerge.
- On the other end of the spectrum, the Anglo-Saxons outside Europe and the western Europeans are now producing annual average incomes between US-$ 20-30 000 per inhabitant, i.e. some 10 to 15 times what the average Indian manages to produce.

The progressive rise in productivity and living standards has spread to more and more communities since the year 1500. The take-off into economic growth was invariably accompanied by an accelerated rise in population. The spread of economic growth beyond the old industrial countries and globalisation in the second half of the 20th century went along with an accelerated population increase (Graph 2). The main reason for this has been that greater productivity

Graph 2: World Population. The Most Recent 3600 Years and Medium-Term Prospect*



* 2150 = Medium-fertility forcast by United Nations

Sources: J. Simon (1995), p. 35; UN Population Project has allowed more people to survive and live longer and more productive lives. More people meant bigger markets and more productive knowledge. This seems the most hope-inspiring aspect of the extraordinary history of the second half of the 20th century.

As societies grow richer and more educated, birth rates drop, so that population growth in the rich countries slows down and the population ages progressively. However, in low-income countries with low rates of female education, mainly in the Middle East and Africa, the number of poor youngsters with poor life prospects is still rising fast. Generating life opportunities in these places will have to be a major priority. An understanding of the causes of prosperity and stagnation will be crucial for this task.

The distribution of the world population is shifting considerably, with the share of Europeans and Russians—who were the focal point of the big historic conflicts of the last century—shrinking dramatically. By 2020, they are estimated to constitute only 12 per cent of the world population. By then, most people will be living in East and South Asia (nearly 30 per cent and some 26 per cent, respectively) and 13 per cent of the world population will be living in the Americas and sub-Saharan Africa each. The economic ascendancy of East Asia and a continued economic rise of North America will mean that the weight of the global economy will shift even more to the Pacific.

Economists have investigated this broad-brush picture for the past 200 years. Some have stressed that growth requires the sacrifice of current consumption for investment (saving and capital formation), better exploitation of natural resources, technical innovation, and the learning of new skills through 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 have the Europeans invested more, developed their natural resources better, had more innovative entrepreneurs, and learnt more than, for example, the Indians?

Clearly, the answer cannot lie in biological traits. If this were so, one would find it hard as to why so many African Americans prosper, but not Africans in Africa and why Mexicans, once they cross the Rio Grande become economic achievers. Nor could one explain why so many East Asians, who used to live in abject misery up to the 1960s, have suddenly joined in the economic growth experience, some—such as the inhabitants of Singapore and Hong Kong—are even outperforming the West.

The Importance of Institutions

The answer lies instead, as already indicated, 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, the ‘institutions’, which 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 effort. Free economies tend to be prosperous, whereas societies with pervasive restraints on economic freedom are poor (Bauer, 1972; Berger, 1987; Scully, 1992; Kasper, and Streit, 1998, and Gwartney, and Lawson, 2001; O'Driscoll, Holmes, O'Grady, 2002; Roll, and Talbott, 2001).

What are these liberating institutions? They protect individual autonomy to make free decisions. They can be considered as the software of economic development, so to speak. Good institutions make the hardware—the infrastructures, labour, skills, knowledge, natural resources, and capital—productive.

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 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 are not spelt out in the contract, will be handled reasonably and without your boss exerting undue arbitrary power. When you order a book from an overseas supplier over the internet and enter your credit card number to pay for it, you rely on a large number of people, whom you have never met and never will meet. When foreign-exchange dealers conclude telephone contracts worth billions of dollars every day, they deal with complete strangers in other 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 goods and services that allow us to enjoy high living standards. High living standards, indeed our very survival, thus depend on a gossamer web of rules that establish trust and coordinate our manifold, diverse activities with the plans of others. In good societies, the rules work most of the time, despite the well-known fact that people are opportunistic, forgetful and unreliable. The almost invisible rules that guide human conduct threaten rule breakers with sanctions. In corrupt societies, the rules are seen as not to apply to the powerful. People who strike deals cannot be sure that promises will be delivered. Therefore, they abstain from even attempting certain transactions. The consequence is a poor division of labour and little experimentation and innovation. As a consequence, economic growth remains elusive.

In the modern world, humanity is engaged in an incredibly complex, ever-changing division of labour. Just imagine what your living standard would be like if you were put down, all on your own, in the most favourable spot of India, but had to fend for yourself without the help of others, and the tools and provisions supplied by others! Or imagine how many people—most of them total strangers—have interacted to produce this book which you can buy for a few dollars: among them, the timber cutters and paper mill workers, the oil and chemical workers who made the printing ink, the writer, the independent reviewers and the editor, the international traders who brought some of the inputs to India, and the postal workers who transported the book. These numerous highly specialised people rely on the knowledge of yet thousands of others. Indeed, a book like this could not be written without relying on the thoughts and the discourse of innumerable 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 ordered by effective institutions.

Institutions of course matter also in non-economic relations. 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. The institutions are central to how people define themselves. If you are asked who you are, you are likely to respond: "I am a Parsi . . . a Bora", which means that you want to be known as someone playing by Parsi or Bora rules of behaviour. Institutions matter because people are not isolationist individuals, but rely on the company to bring out the best in them and to be creative and confident. They can interact with others productively only if human behaviour is by and large predictable thanks to shared and respected institutions.

People, who are guided by appropriate institutions, will find that they are not lonely. To a large extent, loneliness—the involuntary lack of personal contact with others—seems to be the consequence of a lack of effective rules of social conduct. Modern cities or shanty towns are full of many migrants who are yearning for the simple certainties and direct contacts of traditional village communities. In the modern mass society, much coordination has been shifted from the interpersonal to the collective level, from civil society and voluntary associations to administrative coordination by coercive, top-down rules. Many regret the downgrading of simple internal institutions that give scope for individual spontaneity and diversity. Imposed institutional arrangements are all too often tailored for "the masses" and breed uniformity. After all, civil society offers, so to say, an à la carte service for individuals, whereas collective government only offers a set canteen menu.

Human wellbeing in general and material productivity in particular thus depend crucially on the right kind of institutional system.

A society's institutional foundation sometimes consists of formal laws, enforced by courts and the legitimated use of force by certain government agents. But more often than not, social interactions are based on institutions that evolve and are spontaneously enforced within a community: ethical norms, customs, conventions, work practices, and professional standards. These rules are enforced in informal, but nevertheless 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. Thus, dishonest traders in international currency markets will soon lack trading partners, as their reputation spreads. This is the reason why these markets function smoothly and often with surprisingly small costs and trading losses. These society-internal institutions are anchored in fundamental values that most of us share, such as high preferences for freedom, justice and equity. Where shared values are missing, institutional structures stand on uncertain ground and people feel insecure.

Rule adherence or otherwise by communities and governments is now widely known and communicated internationally. For example, an agency in Berlin, Germany, regularly evaluates and reports international perceptions of corruption, i.e. the quality of national rule systems and the reliability with which they are enforced (Lambsdorff, 2001). In line with what is said here, the empirical evidence shows that corrupt institutional systems reduce a nation's benefits from economic growth and globalisation. Indeed, corruption has more immediate dire consequences under contemporary conditions of global exchange (Wei, 2001)[5].

Yet, despite their central importance, the institutions and shared fundamental values are normally 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 and others fail[6]. They tacitly assume the right institutions to be given. However, if not cultivated with care and defended against corrupting assaults of opportunistic operators, a society's institutional infrastructure might remain stunted or might even decay. Then, the best resource endowment, the best technological knowledge and the hard work of individuals yield little economic gain. 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, and North Korea and even in certain states in India. Observers then often blame freak weather or foreign boycotts for economic failure, rather than a lack of effort-inspiring institutions and shared values.

Competition-supporting economic rules and the rule of law are likely to emerge and be adhered to more consistently in electoral democracies, a system of competition for (temporary) control over political and rule-making power.

---

5 We note that India was rated a paltry 71st out of 91 countries in 2001 (Lambsdorff, 2001, 14). More generally, pervasive bureaucratic corruption has made the institutions of much of South Asia fairly unreliable (Court, 2001). Modern growth theorists with a grasp of institutional economics are therefore not surprised at the low living standards and poor human condition in India.

6 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 action of the 'visible hand' of the state rather than market-driven evolution.

But in many developing countries, including India, elites have often considered democracy as a way to rule society and the economy (eg. Nehru era planning and *dirigisme*), not as a way to control the powers of the rulers.

Institutional Change: From Tribal to Global Society

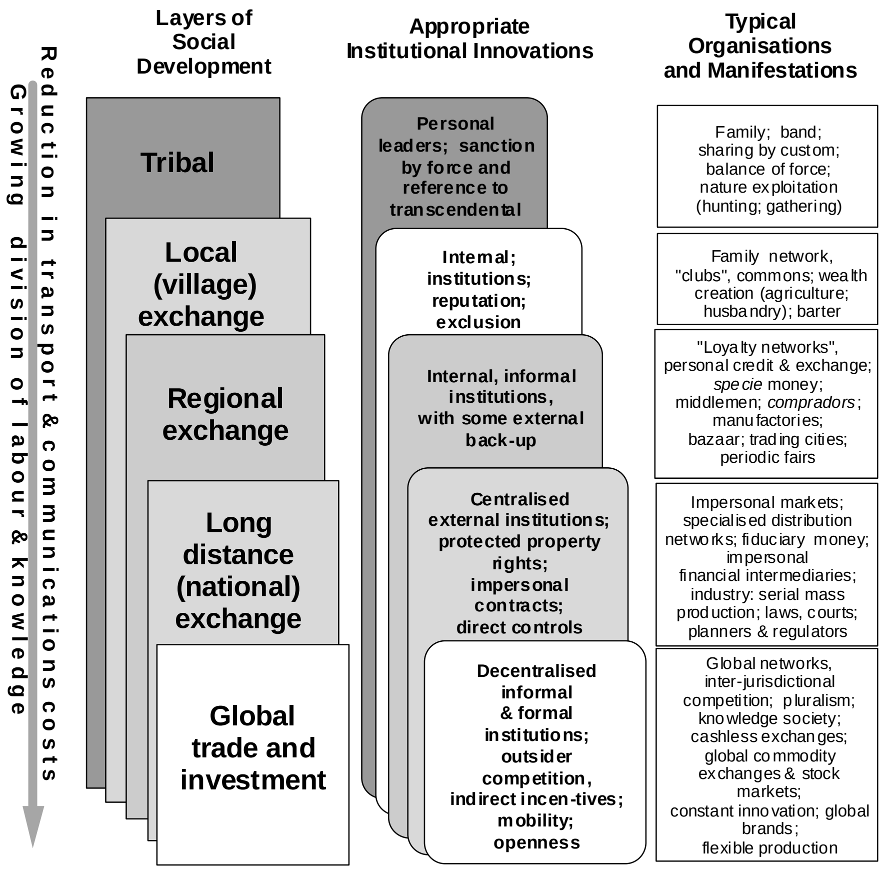
Institutions can—fortunately—be learnt and adapted, although that is a harder task than adopting new crops or investing in new infrastructural and industrial hardware. The reason is that the rules which shape social interaction are so deeply entrenched that we consider them a part of ourselves. Relearning them or adding to them also affects power structures, challenging some at the top and exposing past power and wealth to new, competitive challenges. Of course, this inflicts uncertainties on the rich and powerful, who will often resist change. The wider public will often support a conservative stance. It is after all not easy to expose familiar hierarchies and communities to open competition and the challenging, confusing dynamics of the open society.

Obviously, different "traffic rules" are needed for different types of traffic and circumstances. The foot traffic in a village may need very simple and informal rules, road traffic in Delhi requires more detailed institutional arrangements and organisational back-up, and air traffic rules have to be different yet again.

The same can be said for different types of societies. As societies developed from small tribal bands, such as pygmy hunters, to local agricultural economies with regional exchange economies, such as those of pre-colonial India, to national economies, and now the open global economy, the rule systems had to be adjusted. Each step requires that we learn an additional layer of new rules and learn to reconcile these rules with older 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 the familiar tribal habits of interacting in a small group, perpetuating rules, which our paleolithic ancestors had developed.

Graph 3 indicates the various stages of economic development and the layers of additional institutions necessary. We know from history that refusal to adopt new rule systems can stop economic development. Institutional rigidity and corruption pave the way for persistent poverty. Thus, the Soviet central planning system proved to be acceptable for the rapid development of crude, basic industries at the expense of everything else. But the regime was incapable of coordinating broad-based innovation and the modern 'knowledge economies' on which the wealth of the West and of East Asia is based. When the Soviet system collapsed under the weight of its own failures, the very imperfect central planning system was jettisoned. Few new rules were, however, put in place in the confusion—hence the terrible economic decline, rise in mortality and poverty throughout much of Russia and its neighbourhood during the 1990s.

Graph 3: Social, Institutional and Economic Evolution



Source: W. Kasper (1997)

Small tribes of hunters and gatherers are coordinated by personal leaders, who may use force, but their rule tends to be tempered by personal empathy and bonds of kinship (Graph 3). Once a society moves from the paleolithic economy of nature exploitation to the neolithic economy of wealth creation by agriculture and animal husbandry, societies become bigger, and the rules have to be adjusted. Rules have to be developed which are anonymous and permit networking by barter and joint ownership in an exchange economy. Success in agriculture will, for example, depend on the delineation of private or group property in land and respect for the ownership of the crops growing on it. Persistent raiding and stealing may prevent a society from realising the 'neolithic revolution' (Kasper 1997a).

Once societies and economies develop regional exchange around market towns, political leaders tend to emerge who codify, refine and enforce the traditional rules of ownership and exchange. And when the exchange grows beyond regions, governments that develop more centralised, external institutions arise. For example, princes, public administrations and *kadis* cultivated sophisticated commercial law in the Arab world and parts of South Asia to facilitate trade at that level of development. In such societies, the rulers tend to enjoy considerable privileges, for example in Feudal Europe or traditional India. In early modern Europe, the institutional structures were further developed. They moved in the direction of non-discriminatory enforcement and non-discriminatory individual rights, once various rulers competed with each other to attract mobile producers and merchants (the following section will deal in more detail with the emergence of the institutions of modern capitalism).

As big nation states emerged, more emphasis was laid on public policy by national governments and national institutions that favour impersonal contracts between strangers in the market and formal controls to enforce them. In Asia, this often happened under European colonial influence and was taken much further by many of the newly independent governments, despite the fact that they lacked the organisational means to give effect to these rules they adopted. When this was combined with central planning, official import substitution and massive, ideologically driven regulation, as in India, much of the growth opportunity was wasted.

Now, as more exchange is on a global level, as investors shop for the most promising location around the world, and as the knowledge economy grows thanks to exchanges over the internet, new rule sets are needed. Many ineffectual, rigid government-run institutions are now being replaced by more decentralised, less formal institutions. Closed economies and societies with corrupt organisatons are now losing out. Openness to outside competition is productive and benefits societies if they have simple and reliable institutions that facilitate rapid change (Wei, 2001). Clearly, this requires a lot of trust and mutual understanding. People, groups and leaders who cannot be trusted, are now losing out very quickly, as their poor reputations become known around the world and no one engages in exchange with them. It is not a case of the Marxian assertion that 'the rich are getting richer and the poor poorer', but rather that the trusted are getting richer and those under a corrupt government are getting poorer.

The priority task for communities and public policy around the world is now to acquire the new rules and harmonise them with the old, inherited rule systems. Sometimes, traditional, but now counter-productive rules have to be jettisoned. Thus, economic reform—privatisation and deregulation—is being pursued under the pressures of global competition in most countries, from the US to China, from Russia to India. Old power structures, that have a vested interest in old rules, often fight back. The powerful, who make corrupt use of old rule systems, resent the disciplines imposed by global markets and the quick response of investors to corrupt or opportunistic political behaviour.

Yet, in the process, people learn that a good reputation, reliability, punctuality, good will, and flexibility constitute valuable capital assets and are worth cultivating in the interest of prosperity, freedom and justice.

The Emergence of the Institutions of Capitalism

Modern economic growth began when the institutions of capitalism—secure private property rights, freedom of contract, and the rule of law—emerged in northwestern Europe from the Renaissance onwards. Institutional evolution preceded the industrial revolution, which ushered in the extraordinary, sustained rise of living standards and its spread to a growing number of people.

Early last century, the famous German sociologist-economist Max Weber drew attention to the institutions that made capital accumulation, innovation and industrial enterprise possible in the post-Medieval Europe (Weber 1927/1995). More recently, American, Australian and European economic historians have again high-lighted how appropriate institutions and enforcement mechanisms had to be established before confident, enterprising and innovative capitalists could start the industrial revolution and augment economic growth (North-Thomas, 1973; Berger, 1987; North, 1990; Jones, 1982/87; Rosenberg-Birdzell, 1983; Weede, 1996).

Before the industrial revolution in Europe, an observer would probably have predicted industrialisation to occur in China. The technical preconditions had certainly appeared excellent for an industrial revolution in Tang and Sung dynasty China between the 7th and 12th centuries. Sustained growth might have been predicted to take off in India, where artisans and thinkers had long had skills and knowledge far superior to that of the Europeans. Why did the industrial revolution nonetheless occur in Europe?

The explanation points to the central role of institutions. European and Asian rulers had probably been equally arbitrary and opportunistic, with little interest in the material welfare of their ordinary subjects. Unlike the large Asian empires, however, 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 in a particular jurisdiction. 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 through general rules. They promulgated and enforced laws that protected private property, individual autonomy to make contracts 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 attracted the bright and the enterprising who contributed to the prosperity of the cities (Kasper, 2001–02).

In the Middle Ages, feudal law had given each class of citizen specific privileges and obligations. However, merchants who traded between different jurisdictions found this system too uncertain and cumbersome. Corrupt, arbitrary rulers and judges were simply bad for their business. So they 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. This came to be known as the Medieval *lex mercatoria* (Custom of Merchants). It inspired certain princes, who were eager to attract trade and talented people as a means of enhancing their revenue base, to support simple and reliable rules. They began to guarantee economic, religious and civil liberties (Jacobs, 1992). Laws and courts were set up to protect the fundamental rules that became the institutions of capitalism, which secured private property and a high degree of private autonomy in using those property rights. Fraud and the arbitrary use of violence were controlled, and citizens were no longer treated like immature dependents. The rule of men became 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 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 power 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 was amazing since the Chinese had benefitted greatly from the expansion of international trade and low taxation in the preceding century when there had been a population explosion. But there was no competition among differing jurisdictions in the Ming and Manchu empire, no control on the central power, and hence little innovation in institutional and administrative practice. The same was true of other large empires in Asia (Jones, 1982/87). The authorities could therefore treat the merchants and the producers arbitrarily. Bureaucrats were able to discriminate with impunity. Courts could be run without due process or obeisance to any notions of procedural justice. Private fortunes could be confiscated almost anytime by opportunistic officials. Hence, there was much less incentive to accumulate and use wealth in productive, but visible ways. Much of the useful knowledge was never exploited commercially in China despite its scientific lead over Europe.

The difference between the petty states of Europe and the closed empires of Asia is highlighted 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 till he obtained the material support of the Spanish kings—the rest is history.

In a way, the beneficial impact of open and competing jurisdictions has been replicated more recently in East Asia, where it has led to the evolution of—albeit imperfect—institutions that now constrain political power and empower citizens. In the first instance, the Japanese economy was opened up by American intervention in 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 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 went into seclusion when it became the People's Republic of China. As a consequence, several small jurisdictions in East Asia during the 1950s and 1960s had to cope with the experience of openness and external exposure—Hong Kong, Taiwan, South Korea, Singapore, Malaysia and others. Political entrepreneurs and 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 spontaneous private enterprise and facilitated access to world markets, while African, Indian and Latin American rulers engaged in import substitution and protectionist intervention. Of course, the likes of Nkrumah, Nehru and Perón and their advisers had no idea what industries to develop and how—other than what their self-seeking cronies told them and what served the short-term interests of their political "tribe".

The reformist political entrepreneurs who laid the foundations of East Asian development did not act out of deep philosophical insights or the kindness of their hearts. They developed good institutions as a by-product of their pursuit of power and tax revenue, because the economy was open. At the same time, the populations of those countries adjusted their traditional internal institutions to master their precarious circumstances. Though long considered a handicap to development, Confucian ethics soon evolved from a hierarchical-static to a forward-looking set of effective institutions. Without these institutional changes, the subsequent industrial revolution would not have been possible in East Asia. The monetary and banking crisis in 1997 reminded many East Asians again of the importance of an open, non-discriminatory rule system (Kasper, 1997a). Some are now trying to enhance the rules. As their economies are maturing and the cost of land and labour is rising, institutional evolution and reform will indeed become crucial for further growth, confidence, and social harmony. And those political leaders who corrupt the rules in order to retain or exploit power (crony capitalism) will discover that capital outflows, currency depreciation and slower growth are a high price to pay.

Institutions and Value Judgements

Before we can wind up this introductory chapter, an explicit word is required about a fundamental methodological point. The discussion of institutions cannot be value-free. What follows is therefore an essay in normative economics. The arguments are influenced by the author's personal preference for a free, prosperous, secure and peaceful society. Some readers will be more comfortable with purely positive economics, for example the choice between known alternatives of how to meet human wants with known resources. But this is not very useful for understanding economic development and guiding public policy in a country like India. One has to judge what is good and bad, if one decides to suppress thievery so as to promote wealth creation by everyone (Olson, 1996).

The choice and the reform of institutions require a subjective preference for wealth creation for the benefit of the majority of citizens. The 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 a community, which are dear to most people of all races. It is of course not easy to evaluate alternative institutions against such abstract criteria. But a good starting point in sorting out good from bad institutions would be to ask two questions: (a) Does this rule enhance people's freedom of choice? (b) How does this rule affect the life opportunities of the poorest 20 per cent of the population? The answer to the first question will give pointers to the central quality of liberty, the answer to the second to the equity.

I hope to show that the competitive efforts of the many in discovering and testing what serves them best normally offer superior outcomes than the centralised top-down approach of the government. 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 Nobel Prize lecture (Hayek, 1974/84). Political leaders are typically driven to activism by their own political and material interests. They care little what uncertainty, disadvantages, compulsion and conflict they impose on ordinary citizens. It therefore seems appropriate to explicitly acknowledge this basic fact and to foster a system of rules which empower all citizens to freely pursue their own purposes, as long as this is not to the detriment of the aspirations of others.

Insert

Economic Growth: Is it Worth Having?

Before we can leave this introductory chapter, it seems useful to discuss whether economic growth—the sustained increase in average real per-capita incomes—is desirable. Maybe this is not an issue in a poor country, such as India. But many people in the affluent West, who take high living standards for granted, have doubts about the desirability of continuing economic growth.

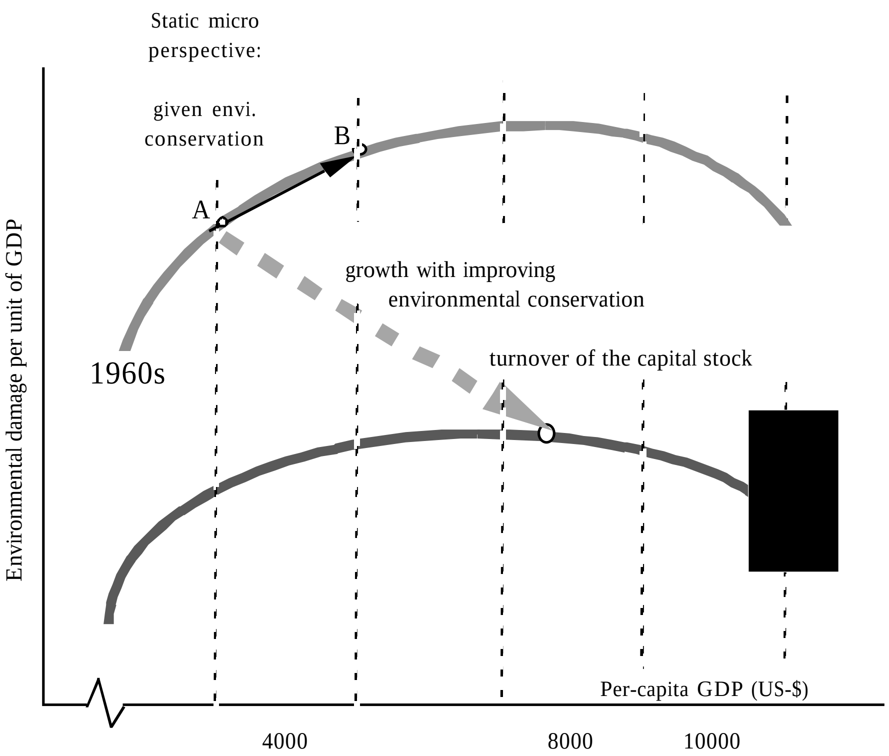
There can be no doubt that economic growth inflicts costs: The present generation has to sacrifice instant satisfaction and consumption, to put some production aside for capital formation, so that subsequent generations can produce more. Our ancestors, who gave up time to search for more food in order to shape digging sticks incurred that 'savings sacrifice'. Now, parents are forgoing consumption to send their children to costly schools (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. 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 that are familiar to the citizens of the third world now. Experience in the old industrial countries—and more recently in the new industrial countries of East Asia—has shown that this is a transient phenomenon; continuing growth goes along with better living and environmental conditions. Moreover, as incomes keep rising, manufacturing ceases to be the growth engine, and the service sector—the knowledge industries—take over, generating high incomes and relatively less pollution. Instead of an impoverished proletariat, which Karl Marx predicted, an affluent middle class grows that enjoys 'democratised amenities', going on annual holidays, driving their own cars and enjoying amenities like air conditioning, washing machines, access to the internet and modern medical care.

This evolutionary-dynamic 'macro picture' of economic development cannot always be seen clearly from the 'micro perspective' of an individual developing country. It is a common fallacy to equate economic growth with worsening pollution. A reference to the adjoining graph should expose this 'fallacy of distorted perception': When a society raises its real income from $ 2000 per annum to $ 4000 from the 1960s onward (a typical East Asian experience), people observe a rapid rise in environmental damage. Were these people able to travel abroad, they would note that rich societies (say, at incomes of $ 10,000) enjoy better environments, despite higher levels of economic activity. Switzerland or the USA cleaned up the environment as their living standards grew. But, overall, there is a much more powerful effect at work, namely the improvement of production technologies over time. By the year 2000, every level of income tends to go along with lower pollution (see graph), and progress has been the fastest in fast-growing economies because old polluting old technologies are depreciated and replaced the fastest.

The upshot is this: If one looks at one place (such as Port Harcort) and for a short period of time (static micro perspective), one has to conclude that growth is accompanied by environmental degradation. In reality, the opposite holds true if one looks at long-term evolution and the global evidence (dynamic macro perspective). As societies grow richer, they can afford to invest in cleaner environments, and innovators respond to environmental problems by developing better technologies. Environmental problems are indeed often the

Environment Textgraph: Growth and the Environment: Two Differing Views



Source: J. Norberg (2001), p. 216

result of deficient economic growth. The same can, incidentally, be said of many other alleged drawbacks of economic growth, and the lesson should be to look long term and global.

At the same time, economic growth has many benefits. It is worth listing the following (Simon, 1995; Norberg, 2001):

- Economic growth does not only 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 entertainment, cultural goods, education of their children, health care and better nutrition, suppliers will offer these benefits. Growing economies allow people to overcome natural calamities, for example by the distribution of emergency food aid after a bad harvest.

- Economic growth is 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 1 US-$ a day. Where economic growth was high, the very poor benefited too:

Region	Real income growth (%)	Change in poverty (%)
East Asia/Pacific	+ 7.1	– 12.9
South Asia	+ 3.9	– 4.0
Mideast/N. Africa	+ 0.6	– 0.3
Latin America	+ 1.8	– 4.7
Sub-Saharan Africa	+ 0.4	+ 0.1

- Growth goes along with less child mortality and longer life spans. People live healthier lives, and to remain self-sufficient into their 80s, whereas the average life expectancy in poor, traditional societies was around 40 years of age[7].
- One of the benefits of rising living standards that almost all communities desire better education, which in turn facilitate 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 innate rights and more sceptical of autocratic political control. Thus, the 1960s generation in the East Asian growth economies concentrated on economic opportunity and accepted autocratic rule. Their children had the education and material means to demand more democracy.
- If there is a political preference for economic growth, politics will promote freer international trade and investment, which experience shows to be the main driving forces of economic progress. A greater material stake in neighbouring countries, in turn, promotes peace—as the 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

[7] Some observers have commented that globalisation and economic growth around the world have contributed to s spread of diseases, such as AIDS. This is true, just as it is a historic truth that big changes—in particular the start of animal husbandy 7000 years ago, the trade contacts between the Roman Empire and Han Dynasty China 2000 years ago, and the new trade between the Old and the New Worlds 500 years ago—have entailed the spread of new diseases. But, even allowing for these, and on balance, economic growth and long-distance exchange have helped to improve human health.

process benefits only some, who become wealthier, but not others. Moreover, the take-off into economic growth tends to offer the poor a little more, so

their forebears had just died. Over the longer term, however, higher incomes trickle down and "democratise" rising living standards. It is one of the most

economic opportunity from growth spreads quickly and evenly, and free markets and the fight against political corruption are the most effective means

- The less developed countries have also benefited from the growth in rich,

from affluent countries select those jurisdictions that offer them economic freedom and secure property rights. Attractive locations in the third world

modern industries within one generation, accompanied by most of the blessings of economic growth, as discussed above.

The Economic Problem: Coordination, Knowledge and Motivation

"If a man will begin with certainties, he shall end in doubts. But if he will be content to start with doubts, he shall end in certainties."

Sir Francis Bacon (*Advancement of Learning*, 1605).

". . . 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 to first understand what an economy is. It is an extremely complex, evolving system. An economy is not an organisation where top-down commands can be relied on to produce the wanted results. Rather, it is a living organism with an unimaginable multiplicity of complex interactions that evolve over time. The core problem of economics is scarcity because we tend to discover diverse and changing wants much faster than the resources required to satisfy them.

In the venture of matching wants and resources, the pervasive knowledge problem is compounded by frequent problems of motivation. We have only limited solidarity with complete strangers, on whom we frequently depend. Other people often make insufficient efforts to satisfy our wants. We therefore need to be specifically motivated, either by compulsion or by appeals to our self-interest.

As we shall see later, institutions are devices, which economise on what people need to know to be effective. They also assist in the motivation to contribute to the satisfaction of the wants of others. Therefore, institutions are central to everyone's economic pursuits.

The Economic Problem: Scarcity

Every beginners' textbook on economics makes 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.

Scarcity forces people to choose between alternatives. The choice of one use of resources means that other opportunities have to be foregone, for example your decision to organise a big wedding for your daughter may mean that you cannot afford an air conditioner. Economists speak of "opportunity costs" to describe the concept that every choice costs alternative enjoyments. It is clear that 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 it might mean that she cannot flirt with her boyfriend, etc. In this age of dynamic changes, the economic problem is a dynamic concept. 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; it will appear as the attempt to ration scarcity. But it becomes a cheerful subject when one studies how people have incessantly searched for and found ways of satisfying their diverse and growing wants and of attaining their changing purposes. As we saw in the preceding chapter, the past 200 years have seen an enormous rise in living standards, and, over the past generation, the experience of economic growth has spread to an ever-wider circle of communities around the world. Hunger, filth, epidemics, ill health, boredom and early death are being overcome in more and more societies, although stagnation and acute human misery still persist in some places.

The main source of this economic growth is human knowledge, not only the wisdom, knowledge, know-how and aptitudes that reside in the individual, but just as importantly the shared human capital that allows individuals to make the best use of their assets, the institutions that guide human interaction.

The Economy as an Evolving, Complex System

Since people satisfy their diverse wants in the pursuit of changing and self-set purposes by using increasingly diverse inputs, they have to draw on the productive contributions of more and more people. As a consequence, the modern economic system has become incredibly complex and inter-dependent. It never stands still or simply reproduces what was done before. Much of economic life is about innovative use of resources, 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.

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

We speak of a "system" when various elements interact on 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 systematically interacting systems. A system is simple if the parts interact only with regard to one characteristic, for example the battery in my watch driving the clockworks. We speak of complexity when elements interact with regard to more than one characteristic. My university department, for instance, 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.

In relatively simple systems, someone in command can establish order because he or she 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.

Some systems are static, repeating the same interactions in each period (such as 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 our results, so that some concepts and elements gain critical mass and become widely accepted, others disappear again. Economic evolution follows a path, since structures, as well as memories of the past influence what evolves. Future directions are in our diverse imaginations. They can therefore not be precisely known to any one person—or a committee or government for that matter. With hindsight, the evolution of a system is evident. But its future path and detail cannot be easily predicted, as no-one knows beforehand what selections the many individuals will make when faced with changing circumstances (see "Evolution" in the Glossary at the end of this volume).

When too many elements change, 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 keep changing randomly, cognition breaks down and we can make no sense of what we see. Similarly, overwhelming changes in economic life often lead to serious disorientation and breakdown of coordination, because people are confused. This may, for example, be the case when traditional village societies are exposed to overwhelming modern economic development. Economic and social chaos may easily result. People may miss guiding institutions that make their cognition task more manageable and restore a measure of confidence. It is therefore in most people's interest that systems change gradually and in a pattern that people can understand.

Even when complex systems evolve in a broadly predictable pattern, specific outcomes may not be predictable and may not be easily achieved. If an "ordering hand" intervenes in such a complex, evolving system, 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 (Arthur, 1995; Parker-Stacey, 1995). We have, for example, learnt that ecological systems are complex and dynamic, so that interventions often have unintended, harmful consequences. 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. We have learnt that often we do not know enough to intervene and that it is always wise to tread with care when tangling with complex systems.

This insight is, however, still rare when one turns to complex, evolving national economies. Here, millions of individuals interact in incredibly complex ways. They do so as producers and suppliers or as buyers of goods and services, or as owners and as 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, this affected virtually everyone on all five continents. The price rises sent a coded signal to millions of car buyers to drive less and to buy energy-saving cars. Others got the signal to save energy by setting their air conditioners to higher temperatures, to change methods in industry and transport, to replace petroleum by coal, 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. Some observers thought the problems were unsolvable and predicted the end of modern civilisation. They were wrong. Numerous decentralised, spontaneous, flexible, creative adjustments overcame the energy crisis—admittedly costing effort and sacrifices—because people around the world heeded market signals. Humankind went on prospering. When an ordering hand intervened in this complex system, for example by fixing gas prices, chaos and unforeseen complications resulted.

Does it not seem paradoxical that people who preach caution when intervening in complex eco systems, frequently advocate interventions in equally complex and evolving economic life? They pretend that such interventions are feasible and that 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 causing unforeseen, hurtful side effects. Many intellectuals, academics and policy commentators 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 are not seen as proof that such a style of economic policy is not feasible. Many academic and media commentators have persisted with a preference for what has long been castigated as "social engineering", based on an unrealistic "pretence of knowledge" (Hayek, 1988). Policy advisers and academics have typically operated with econometric models that are closed off to future evolution, assuming that interactions will continue as in the past. The more realistic and evolutionary, so to say "ecological", view of economic life has not yet been widely absorbed into popular culture, or into development policy in many third-world countries (Kirzner, 1998).

Ignorance, Discovery and Knowledge

In complex, evolving systems, knowledge becomes a central focus. Who can master what knowledge? How can the limited knowledge of various people be coordinated? How do people discover new information and build it into cohesive bodies of knowledge? How is knowledge tested and rejected in the course of evolutionary change? What are the best conditions for discovering and testing knowledge that other people find useful?

When discussing knowledge, one has to begin with a fundamental insight: Everyone has cognitive limitations. Our five senses—sight, smell, taste, hearing and touch—do not allow us to fully read the complex world around us. 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.

This knowledge problem is pervasive; it is *constitutional* to the economic problem. Therefore, it makes no sense to build models of human action and public policy assuming that people, or committees of policy makers, have 'perfect knowledge'! One cannot simply assume away the vexatious knowledge problem and still hope to explain economic issues. Were we all-knowing, scarcity would not exist. 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). 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, for gravity is a first-order (or constitutional) element of the subject matter. 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 disregarded the essential economic problem—how to find and use evolving, complex knowledge. They have reduced economics to the petty issues of 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, abstract world, there is no need for profit, entrepreneurs, and business management. When economists make the assumption that all relevant knowledge is available, businessmen and other practitioners—rightly—switch off, because they know that this is not so.

Knowledge is best understood if we consider it an open-ended, evolving stock of abstract ideas, information and concepts which are held in millions of human minds. All the time, completely new facts are discovered. New ideas emerge. By wilful search or chance discovery, complementary information is found and tested. As circumstances change, ideas that were once useful may lose their usefulness and new ideas are selected and accepted. All human knowledge cannot possibly be concentrated in any one place or any one human mind. Instead, the body of human knowledge continuously evolves under the influence of millions of decentralised human choices.

We have to distinguish in this context between genuine discoveries and new 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 quite obvious. For example, we speak of Vasco da Gama's discovery of the passage around the Cape of Good Hope to India and the discovery of America at a time when Europeans were unaware of the existence of that continent. A second-order type of ignorance exists where the big, general outlines of 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 details of India's 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 all search for information. They are not after big discoveries. When we deal with such 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 genuine 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 curiousity 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.

The knowledge problem in economics is further increased by the fact that everyone has different knowledge and that diverse people have various tastes and pursue their own, differing, subjective purposes. Everyone values options in her or his personal manner. People will not necessarily chose what others have chosen. Since any individual's opportunity costs depend on subjective and changing preferences, they cannot be readily known to others. This adds to the knowledge problem in economic life. It also means that given 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 has profound implications for one's view of the world and how one wants public policy to be run.

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 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.

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. Once presumed collective motivations are brushed aside, one comes to a much better understanding of public policy. For example, one should not say: The government wants to maintain tariffs in the national interest", but rather: "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 phony collective actors (such as "the world community", "the UN", "the Indian public", "the national will") and to translate these statements into subjective, individual terms, naming who really decides. Consider this an exercise in truth-finding!

Three Kinds of Rationality

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

When faced with incomplete knowledge, decision makers do not go on indefinitely chasing additional knowledge indefinitely. After all, knowledge acquisition costs resources, time and effort—it causes what economists call "transaction costs". 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, rather than remaining locked into "paralysis by analysis". When past experience shows people that they consistently under- (or over-)fulfil their aspirations, they will adjust their aspirations accordingly (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 means and is then expected to maximise his utility. Standard textbook economics is based on the assumption that people set themselves fixed goals (such as 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, the master of a self-contained household in Ancient Greece could, after the harvest, plan his household's survival through the winter by "economising" (the rationing of scarce resources was called "oikos" by the Ancient Greeks). Or engineers may "maximise" the performance of a given machine. Similarly, we may aspire to maximise the distance we can jog within 30 minutes. However, in more complex constellations, we normally do not know enough and cannot control what is going on to pursue a given end "rationally". 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 shirt to wear today, but I cannot make a rational choice as to where on earth I will optimally live for the remainder of my life! Likewise, it makes no sense for the industry ministry of a developing country to choose what industries should be created — no-one has sufficient knowledge for that in a world, which keeps changing anyway. The narrow rationality of neoclassical economics would be totally inappropriate for such choices. In other words, the end-means rationality of economic textbooks is an inappropriate guide for analysing evolving complex constellations that are typically the concerns of economic policy.

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 like an entrepreneur. 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). Entrepreneurship is at variance with the end-means rationality of *homo oeconomicus*. But such 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, even though they can never be absolutely sure of the results. As we shall see, discovery and the use of knowledge, which are so important for economic development, depend greatly on the prevalence of the entrepreneurial spirit to break away both from end-means and the adaptive kinds of rational behaviour and on the institutions that create a degree of confidence.

When one allows for adaptive and entrepreneurial 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 evolution with the familiar assumption of *ceteris paribus* (all other things being known and remaining the same) and who operate with the construct of *homo oeconomicus* are blind to the different kinds of rationality in the real world. They fall into the trap of an unrealistically narrow kind of "economic rationalism" and will contribute little to the understanding of economic development.

What Motivates Us?

Another fundamental consideration in discussing the economic problem and economic development is motivation. Individuals are sometimes motivated by altruism and by coercion, but—in the modern mass society where millions interact—people are best motivated by self-interest.

Most of us have of course experienced motivation first on the plane of altruism, solidarity, and love. In the small setting of our family we know each other fairly intimately. We could also influence their reactions. Altruism is a highly effective way of cooperation in such small communities (Hayek, 1988; Giersch, 1989). Yet, even in small communities, love and solidarity have to be backed frequently by authority and coercion. At times the parents—or tribal elders—have to coerce other members of the group. This tends to be tempered by empathy and intimate knowledge of the others. However, 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, solidarity and benevolence alone because we do not even know many of those people with whom we interact. 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 not because they like you, but because they want to earn an income! Your bread, health care, and job are mere by-products of their selfishness! Whether such a system works well, depends—as writers from David Hume (1786/1965) and Adam Smith (1776/1965) to Friedrich Hayek (1988, pp. 6–47) have pointed out—on an 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 some church leaders—implicitly advocate coercion. This requires, however, (i) that the leaders know what they want, what they are able to achieve, and what their agents are doing, and (ii) that they can induce discoveries by central directive and coercion. These conditions are rarely fulfilled, as we know—at the latest since the demise of coercive socialism in the Soviet bloc and the massive failures of industrial development plans in the third world.

The voluntary coordination of self-interested people and organisations through markets 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 attracts punishment (a sanction). In other words, an effective division of labour through the marketplace 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. Frequent regime changes will hamper economic development through market interaction.

Human interaction in complex macro societies, such as a national economy, can—on the whole—be coordinated only by relying on spontaneous actions in response to individual incentives through voluntary cooperation (people agreeing on contracts). Individuals take responsibility for their actions, which must remain compatible with a system of shared, mutually enforced rules of conduct. This is normally preferable to a coercive, collective planning approach to the economy, because the planners, too, suffer from limited cognition and motivation. Besides, a coercive planning approach imposes high costs of supervision, monitoring and enforcement if it is to work at all. It was, for example, found that slavery, which required a planner and numerous supervisors, was very inefficient and costly. When slavery was abolished in America, it was discovered that free, paid workers had much higher productivity and needed much less monitoring.

When previously stagnant, hierarchical economies make the transition to undergo modern economic development, as is the case now in most parts of India, a problem arises with motivation. Motivation to perform and compete requires of course (i) that people are aware of desirable goods that they can obtain if they put in more of an effort, and (ii) that those who make an effort and innovate are able to keep the rewards that they earn in the market. These conditions are not automatically fulfilled. While news of new products and desirable services reach people even in remote parts through markets and communications, many societies do not favour the individual accumulation of market incomes. Instead, automatic sharing is the norm. Such behaviour was appropriate to local village economies (see Chapter 1), indeed served as the only 'social security system' available and enabled poor societies to survive through famines and other crises. But the modern market economy is coordinated by expected individual gain, which requires a degree of selfishness. Only when enterprising individuals and their immediate families can accumulate incomes, will they be able to invest in further economic development. Where such selfishaccumulation is considered a vice and sharing is the social norm, people have little motivation to compete in markets and exploit their skills and assets to the fullest. This motivation problem occurred in the early phases of European development, too. In the early 19th century, British entrepreneurs who set up factories in Germany found the local population indolent and incapable of being productive factory workers. Only when the big clan and the village tradition faded, because young workers had moved to the cities and had learnt to act more selfishly, or far-sightedly, was it discovered that German staff were hard-working.

It always takes some time for learning and attitude change, until new sets of rules work effectively when they are transferred from one society to another.

Principal-Agent Problems

What has been said about knowledge and motivation is closely related to another pervasive problem of economic 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. The agent is closer to the action and will thus know more about what can be achieved and whether the best is being made out of given opportunities. But the agent will of course 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 high 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 a lot of useful information for the share-owning principals. Competitive markets exert control over agent opportunism because the principals, once informed, can act to assert their interests. The competitive discipline that matters here results 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).

The principal-agent problem has proved to be a much more serious handicap to motivating the agents in areas that are not subject to competition. Serious motivational deficiencies can, be observed in centrally-planned economies where most resources are socialised. This can extend to the point where lackin motivation leads to widespread starvation, as was the case in Marxist-era 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 than the citizens about the task at hand and exploit this in their self-interest. The citizens face high information costs, so that the agents—the parliamentarians, bureaucrats and judges—are frequently able to run the government to suit their own purposes, even when this is at the expense of the citizens. The problem is particularly acute in poor countries, where ordinary citizens lack not only the education but also the material means to defend their rights and liberties and to confront corrupt officials (Friedman, 1962)

We shall return to this important problem in Chapter 6—Limits of Public Choices.

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 all the time. Because the knowledge necessary to tackle the economic problem is evolving continually and is dispersed, complex coordination is necessary to satisfy human wants. This coordination tends to be motivated by empathy and love in small, intimate communities. But in complex modern mass societies, this does not suffice. Then, either compulsion or self-interest channelled by institutions have to be relied upon. Experience has shown that voluntary, rule-bound interaction through markets and motivated by appropriation of returns is—a large communities—the far superior system to deal with the constitutional problem of human ignorance and inertia.

Since it is necessary to understand what the rules for a healthy economy are and what it takes to discover better ways to satisfy human wants, we will need to explore institutions that facilitate human interaction and discovery.

A Postscript for Those Whose Perceptions Have Been Deformed by "Economics 101"

The Knowledge Problem and Some Commonsense Consequences

Cognitive limitations are a constitutional part of the human condition. This is why one cannot simply assume "perfect knowledge", as neoclassical 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 nonsensical answers.

If one takes the knowledge problem seriously, as Austrian economists have done (Hayek, 1945; O'Driscoll, 1977; Boettcke, 1994), 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:

(a) The pursuit of "efficiency" requires perfect knowledge of all the inputs and the processes to generate outputs. In simple contexts, this is a realistic assumption. One can say that "A moves his cart faster from this suburb to the central market than B", or "washing powder C washes whiter than D". But in more complex, evolving situations, where different people may value inputs and outputs differently, it is not readily clear what we should call most efficient. If you were asked "what is the best book", you would hesitate and first 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 practical 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 the same as mine or yours! The simplistic end-means rationality of *homo oeconomicus*, which often dominates the policy debate, is not applicable where the means and the ends are unknown, as is for example typically the case in development policy.

(b) In complex situations, rational choice is typically not based on a maximum or minimum (which cannot be known), but is based on the limited information at hand. Utopian assumptions about what they assume easily mislead economists to pass critical judgements about an assumed maximum which markets should achieve, but have failed to achieve. 'Nirvana judgements' of 'market failure' frequently lead to policy interventions. In realty, all these end up frequently 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, based on limited information. To say that the outcomes of such rational behaviour are "market failures" only betrays the arrogance of eggheads 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 of real-world economic activity deals with this problem. Over half of all costs of producing and distributing the national product in advanced modern economies are such transaction costs (North, 1990). Because of a lesser division of labour, these costs are likely to be lower in less developed countries, but they are rapidly rising in the course of economic

> development. Indeed, the fastest-growing part of national economies everywhere is now the transactions-and-communications services sector that deals with transactions: the law, communications, advice-giving, accounting, finance, business services and the like. Traditional mainstream economics has little to say about this important and dynamic part of the service sector because it assumes that all is known, and that market transactions are cost-free.

If one assumes away the knowledge problem and deprives 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 wrong, because many complications and consequences have been simply 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 modellers and econometricians with a Cartesian, deterministic world view on the other. The two approaches are mutually exclusive. They will often lead to policy conclusions which differ diametrically.

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

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

Order and the Knowledge Problem

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

Predictable patterns and the elimination of arbitrary disturbances create order, as opposed to chaos (refer to Glossary). Order means that various elements in a system remain in a recognisable and predictable interrelationship, though not necessarily a totally static one. When the system changes, change should, therefore, follow some general, orderly pattern, so that total surprises, disorientation and cognitive overload are avoided. Order is essential to the effectiveness of our actions—just think 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 imposed. A pattern that someone has designed in her or his mind can be implemented from the top down. 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, high search costs and a poor use of my resources. It is often also effective to coordinate people

> by a plan and by top-down command, for example in a firm or a work team where leaders lay down an action plan and exercise some degree of control over collaborators. Such order depends on the visible, ordering hand of someone in the know and in control.
>
> Order can also arise spontaneously: Flocks of birds fly in orderly patterns and do not collide in the air, although no 'boss bird' or flight controller directs them. The herds of animals that crowd around a waterhole drink in orderly succession without a bull being 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 in markets as if ordered by an "invisible hand". Recognisable patterns emerge in these instances because all participants obey shared rules. If they know the rules, participants find it easy to interact constructively with others because they can rely on predictable patterns.

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

We therefore must now take a closer look at rules (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

An institution is a rule of human conduct whose violation normally carries some sort of a sanction. They serve to make repetitive actions and reactions more predictable[1]. 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, often without making specific outcomes certain. And often it is sufficient for us to depend on broad patterns of behaviour, which save us costs and risks of knowledge search and other transactions. Without institutions, the transaction costs will, in many cases, be so high that no production and exchange comes about. Economic backwardness is often the consequence of prohibitive transaction costs.

Institutions in the sense just defined have a pervasive influence over economic and social life. Their quality is central to our well-being. People identify with communities which are defined by shared institutions, because they can function within them without costly information-search efforts. We feel relaxed when transaction costs are low, order and mutual trust is safeguarded. Nevertheless, frequently we are totally unaware of the institutions that order human behaviour. This is amazing because different institutional

[1] In this essay we shall therefore use the words "institutions" and "rules" interchangeably.

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 institutions disappear. For example, the Soviet rule system collapsed and effective new rules of conduct did not emerge quickly enough in Russia over the past decade. Thus, there are few accepted rules in street markets and order is not enforced by impartial officials, but by hired thugs and the mafia. The result has been a lot of suffering, material decline, disease, crime and a steep drop in the population.

In a similar vein, the corruption of the time-tested institutions that govern social life in a country, detract from economic performance, community cohesion and hence stability and security, as well as social harmony and civility. What in reality has been behind the economic reforms in many countries around the world during the 1980s and 1990s has been an attempt to redefine the basic rules of economic conduct of individuals and political operators. An explicit analysis and understanding of the relevant institutions therefore seems fundamental to analysing public policy and socio-economic reform.

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).

Institutions are not to be confused with organisations (as is frequently the case in everyday usage). Organisations are more or less permanent

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*	**Informal 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")*
	family organised procedures of sanctioning	**Formal Institutions**	*Examples: A professional code ofconduct that is administered by a professional body; rules of a club*	*Examples: A legal code which is enforced by court and police procedures*

combinations of production factors which are marshalled by a leader 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 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 stock exchange (an organisation) 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 specific organisations such as firms of auditors, accountancy firms, land registers and the legal profession. In other words, many institutions are implicit (or embodied) in organisations. Yet, many others are disembodied and require no formal organisational back-up, as we shall see below.

When we speak of "the law", we refer not only to formal legislation and regulations which emanate from parliaments, administrations and courts, 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, as well as former British colonies, evolved rules have had a relatively high status. Internal rules and unwritten laws therefore 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 and may even override formal constitutional and statute law.

Before we go on to theorise about institutions in the remainder of this chapter, it may be useful to stop and elaborate on the basic definitions with the example of weights and measures. Members of any society share certain concepts of weights and measures as part of their inherent mental make-up. These may be evolved and imprecise measures of distance, volume, duration and value. When I asked a farmer in the Philippines how far it was to walk to the turn-off of a certain mountain track, he responded: "As long as it takes to smoke three cigarettes!" In a traditional society, cigarette-length walks are a meaningful measure of distance and duration. Such measures became standardised within communities; for example, every German city had its own definition of a yard measure, and English merchants knew exactly how many gallons there were to a barrel of smoked herrings (26 3/3 gallons), as compared to a cran of fresh herrings (37 1/2 gallons). The institutions of money varied greatly from place to place. Whilst money was a highly productive invention, which facilitated trade and allowed people to compare values, the great variety and likelihood of debased currency imposed high transaction costs on people. There was room for improving the institutions: rulers standardised weights and measures, and produced more reliable money. These external institutions were seen as great contributions to economic welfare, because they enabled more production and exchange, and cut the costs and risks of transactions.

Not all rule systems were of equal value, however. The British Imperial system operated with strange and hard-to-learn rules: One ounce, e.g., was 0.0625 of a pound avoirdupois, or 0.08333 of a pound Troy. School children were not the only ones who found it hard to multiply £ 15/8 shillings/3 1/2 pence by 18. The French-Continental metric rule system was a lot easier, with 1000 grams making up a kilogram, and the sum of 160.13 Francs was quickly multiplied by 18. Both imposed and standardised systems of rules create differing levels of transaction costs, so that the reform of metrication was seen as progress by most people. As the world develops, new measures evolve to help people communicate about new phenomena. Not so long ago, no one knew the meaning of a Giga byte, now every computer nerd in the local internet café discusses his computer equipment in terms of GBs, although the local or national government may not have defined and decreed its definition. GB is an internal institution in many countries, whereas the US and European governments have meanwhile ratified it externally.

The basic conclusion is that we need institutions to interact and communicate effectively, that we often adopt them spontaneously within certain limits, that governments often step in to standardise and decree precise definitions, and that such external institutions can be of lesser or greater value in expediting exchange and communication. It is also important that uniform institutions are effectively enforced, for example that the value of the money is maintained at a fixed and expected level and does not diminish through government-made, rampant inflation.

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 are not free of 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. Violations 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 Tamil, because I want to be widely understood throughout India);
- rules that we have internalised by education, acculturation, and practice (examples: ethical behaviour, civil virtues such as punctuality and honesty);
- customs and manners that are obeyed and enforced by spontaneous reactions to facilitate smooth human interaction (examples: 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, where violations attract formal, i.e. organised sanctions, which are decided and imposed by selected senior members of the group (example: professional standards, sanctions which are handed down by boards of medical practitioners and similar appointed professional bodies).

The first three categories of internal rules are informal in the sense that violations incur sanctions in the form of spontaneous, self-enforcing responses. Thus, we control our whims often out of self-interest, simply because we would be fairly 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. Within decent societies, informal, spontaneous enforcement works in most cases. Self-enforcing mechanisms can be extremely effective. People with poor manners get reprimanded, ridiculed or shunned. And the damage to a firm's reputation may cost it much business. They are the cement that holds civil society together.

A stunning example that shows to what extent self-enforcement works can be found in global currency markets. Traders, who daily transact billions of dollars, do not write and sign formal contracts and 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 loss of reputation. Opportunistic currency traders who lose their reputation in the trade, do not find contract partners and are soon out of the business.

Most human conduct is guided by such internal (or evolved) rules that are enforced informally. These rules incorporate the wisdom of past generations. Internal rules arise because they usually have been tried out once or on the initiative of a few. When the arrangement was considered a success, others imitated it, and the rule gained wider acceptance and sufficient support to become a community institution. At times, established internal rules are rejected by people whose circumstances they no longer fit. While some may still accept the sanctions for rule violations others may hope that they can explain why sanctions should not apply to them in their particular circumstances. Such variations may be seen as successful and may gain critical support 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 the US, Australia and a big city like Delhi, 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 wilfully or out of ignorance about the prevailing rules. This raises the costs of coordination and creates irritation among the incumbents who rely automatically on familiar institutions. But this may also trigger innovative changes of the shared rules, which cause adaptation costs, even if they are welcomed by sufficient numbers of old residents. Thus, a poor "payments morale" (lack of reliability in paying debts) and low honesty standards of certain members of society may force everyone to incur higher monitoring and enforcement costs. On the other hand, the work practices of new groups may be seen to yield better productivity and income than those of the existing groups. If members of both groups are free to compete in markets and to keep the rewards, this will gradually induce more and more people to adopt the visibly more successful work ethic.

Some internal, evolved institutions carry formal sanctions. Thus, a community of legal, journalistic or medical professionals may have organised an internal mechanism to deal with professional misconduct, for example by expelling violators from their profession (see Desai, 1998 for a discussion on the role of reputation and self regulation). They do so either to facilitate the expedient interaction within the profession or to ensure that the group's reputation does not suffer due to the opportunistic behaviour of some of its members. Senior members of the group are chosen to deal with rule violations. The 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 that harm their community and their collective reputation. There are costs in such self-regulation, but they tend to be moderate.

External Institutions Depend on Political Action

The second major category of institutions is external (Graph 4). They are designed, imposed and administered by authorities who are above and outside the community as such. This always requires some collective action, a political process, and the appointment of agents who have interests of their own. The designers of external rules, as well as the administrators, are political agents, whether legitimised by inherited status, 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, for example, 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 accounts, or to conduct themselves in specific ways. External institutions are normally much more costly to implement than internal ones. A well-run community requires strong checks on the costs of external institutions and on the behaviour of the agents of government. Many external institutions require specialist agents, who normally derive their livelihood from designing and implementing them (tax agents, lawyers, etc.). Often, there is an understandable bureaucratic self-interest in having a complex and costly-to-administer external rule system (just think of India's import regulations, past and present!). This provides jobs, income and influence to the agents, but inflicts high costs on citizens. It is a case of the principal-agent problem, which we mentioned in the preceding chapter. Governments that are 'captured' by professional groups and shape the institutions to benefit themselves are a frequent cause of citizen discontent.

External institutions are, nevertheless, often necessary to obtain order. In modern mass societies, the rules are often better known when 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. In the last century, the attempt of socialist revolutionaries and third-world leaders to replace the traditional, grown institutions of societies completely by "scientifically designed" rules has been a resounding failure. The new, decreed rule systems imposed very high monitoring and enforcement costs. Frequently, ordinary people could not understand the new institutions and suffered from confusion, after the spontaneous incentives and the traditional internal rules had been suppressed. Thus, newly collectivised farmers in China after 1957 and in southern Vietnam after 1975 had little incentive to produce. Indeed, newly "liberated" peasants failed to produce food sufficient to feed the population. Only when the rule set was changed again with the economic reforms of the 1980s, did the food problem in China and Vietnam end. Vietnam even became a 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 in the 1990s as if South Korea had not had the same climate!).

The methods by which to co-ordinate modern mass society, and in particular its economic life, have arguably been the most fought-over social issue of the 20th century. The imposition of a top-down socialist order in the communist countries had cost about 100 million lives in that century, among them some 20 million to enforce a new order in the Soviet Union, and 65 million in the Peoples' Republic of China (Courtois *et al.,* 1999).

The Qualities of Effective Institutions

Not all institutions are equally effective in creating order. One therefore has to ask: What are the essential criteria of—external and internal—institutions which order human conduct effectively and foster confidence, justice, prosperity and peace?

Given the limitations of human cognition, one important quality of rules 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 a president rules that his son's brewery has preferential access to the local market, or when national governments hand out tariff preferments and import concessions to particular industries. Rules, which discriminate between citizens, fail the test of universality and open the door to burgeoning corruption.
- Universal rules should also be *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 the politicians and tax officials continually re-jig the tax rules. In the course of the 20th century, the volume of laws and regulations in most nation states 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 are part and parcel of any effective institution. This aspect of universality is violated for example when trade unions or military groups are not subject to the law and get away with the exercise of undue force. Universality is also violated when certain exemptions to the general laws are negotiated with the government. Just imagine how the traffic would move if every give-way sign were subject to bargaining, arbitration and doubts about effective sanctions! When the law loses its teeth, coordination breaks down and the community's capacity to generate spontaneous growth wanes.
- Universal institutions should also be *open*, so as to allow actors to respond spontaneously to new circumstances by confident actions. In other words, the criterion of openness is met when the rules offer general

guidance to actors engaged in new experiments. Thus, existing property rights and tort law offered guidance when people began to market their services on the internet. By contrast, intricate and case-specific rules offer little normative guidance.

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. Among the ten commandments passed by Moses to his people, eight are prohibitive rules, such as "thou shalt not steal". The ten commandments 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, that aim at attaining specific outcomes, are much less likely to offer certainty and openness. Thus, the promotion of specific industrial activities by government decrees and subsidies violates the maxim of universality. Therefore it tends to be fairly ineffectual. Once prescriptive institutions proliferate, the whole rule system becomes ineffective because people suffer from cognitive overload and enforcers are overtaxed. For a rule system to be effective, it cannot prescribe all that many specific outcomes.

Good institutions should also remain reasonably stable over time, because rule changes impose adjustment costs on citizens. The conservative dictum that "old rules are good rules" certainly has much to recommend itself in the face of our cognitive limitations. But it does not follow that the conservation of 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). We always have to ask what serves our purposes best and accept that new rules will sometimes be preferable.

Rule changes are made more predictable (less order-disrupting)

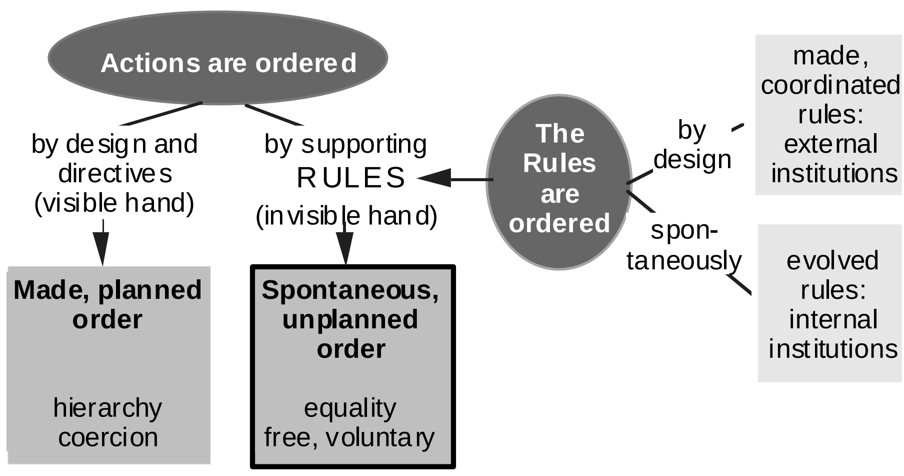
- when the institutional system consists of a hierarchy of rules, ranging from more specific institutions that are changed within a stable framework of more general, overriding rules, and
- when there are so-called *meta* rules that lay down predictable methods of rule change, for example the Constitutional 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 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. They are so fundamental to the economic and general well-being of a community that one may rightly say that "Switzerland has a healthy economic constitution, whereasIndia's socio-economic constitution has deteriorated", referring both to the fundamental rules and the economic performance.

Institutions to be effective in establishing an order of actions, must not be contradictory. They should form a cohesive, ordered system (Graph 5). The rules themselves can be ordered (coordinated) in two different ways: they may be ordered by the spontaneous acceptance or rejection of certain rules (common in internal rule systems) or they may be made compatible in designed ways by formal mechanisms, such as the Constitution and procedures of judicial review. All new legislation and all new decrees have to be compatible with the Constitution. If necessary, this can be tested before the High Court. Legislative and judicial activism and rule by decree are likely to destroy the stable order of rules and introduce inconsistencies among the rules and over time. People then resent the chaos of rules. People also resent incompatibilities between the promulgated rules and the internal institutions—legislation is widely resented when it clashes with the grown standards of the community. Many, if not most, regulations and formal laws which are on the statute books, are then widely disregarded or even completely forgotten. In a society where the citizens are the ultimate arbiters of institutions, laws should be revised if a critical mass of rule violations occurs and it becomes obvious that "the Emperor has no clothes".

The tendency of opportunistic rulers, political parties and judges to create specific, outcome-focused rules to please vocal single-issue groups and

Graph 5: Order of Actions and Order Among Rules



organised lobbies invariably leads to chaos in the rule system. The consequences are disorder, corruption, loss of confidence and systemic weaknesses in the community's institutional infrastructure. One poor decree then often generates unforeseen side effects, which need to be corrected by further specific rulings. This may make the rulers seem important, but it triggers a slide into a torrent of prescriptive and hampering rules. The evolution rule by government decrees in South Asian countries offers numerous examples for burgeoning incompatibilities and the resulting system-wide chaos (Chapter 6).

The Benefits of Effective Institutions

Institutions that are universal and that form an orderly system have major advantages for the community that shares them:

a. As already noted, respected institutions economise on 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 the division of labour and of specialised knowledge, the most critical source of widespread prosperity and growth.

   Human interaction always causes frictions (transaction costs), and universal institutions help to economise on these costs. Particular problems arise when people search for new knowledge. They simply cannot make rational choices as to the extent to which search costs should be incurred, because 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 the importance of such activities to a prosperous, free society, it is essential to foster institutions that 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 complicate knowledge search and hamper innovation.

   Saving transaction costs is an extremely important consideration for modern societies which unavoidably rely on a complex division of labour and continued innovation. 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 (North, 1990). In recent decades, transaction-supporting services have outgrown most other sectors in the advanced economies (business advice, communications, finance, trade, logistics, research, development, information exchange etc.). Internationally, cost-saving institutions constitute an important source of a country's competitiveness.

b. Good institutions are also of non-material benefit, in that they create a sense of security and facilitate social contact. After all, people are not isolated individuals. They strive and function best in the company of others. The pursuit of happiness—and its enjoyment—is typically a group experience. Appropriate institutions enable us to build bridges to our fellow human beings and are therefore essential to what we call a community. This is why we share a feeling of kinship or fellowship with those who obey the same institutions, in other words with those in our own community.

c. A major function of effective institutions is to protect individual spheres of freedom. Appropriate rules constrain the use of power. Good institutions rule out undue coercion and delineate how far the autonomous pursuit of our own subjective purposes can go without infringing on 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 preserve peace 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 rules, conflicts cannot be avoided altogether. Where conflicts occur, institutions tell us beforehand how such conflicts are to 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 or other fierce and often futile forms of conflict resolution are thus avoided. In most Western societies, violence meets with strong popular rejection—a spontaneous, informal sanction to preserve social peace and harmony that most consider as 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 in its own right.

e. Finally, 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 available assets. Only when stable, predictable institutions provide long-term certainty, will people accumulate human and physical capital with the trust that they will, in due course, reap the returns. Deficient institutional systems are, by contrast, characterised by short-termism, quick gain, ripping of resources and little commitment to long-term skill and capital formation (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 we derive from it. In the rapidly changing, globalised setting in which most people on earth now inevitably operate, appropriate institutions can serve as an important source of confidence. If there is a growing lack of confidence in the community, as is attested by sections of many developing societies, it is implied that the search for more effective institutions and better underlying political and economic constitutions should be a priority. The community needs the experience of trust and confidence, which often were the hallmarks of an earlier era.

Shared Values Underpin the Ordering of Rules and Conduct

The cohesion and effectiveness of a community's rule system depend on an underpinning by shared fundamental values, i.e. very high priorities which inform the daily actions of individuals, such as a commitment to freedom, justice, security and prosperity[2].

Shared fundamental values tend to be fairly 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. Shared values are the normative anchoring points of a rule system that we judge to be effective. They inform our daily actions in fundamental and pervasive ways, similar to the DNA information influencing biological characteristics and processes in invisible, but powerful ways (Arthur, 1995). However, different from its biological analogue, fundamental values can be shaped by intelligent and wilful efforts. Where fundamental values are not shared, this can be the source of continuing conflict, and secession and political separation of two conflicting communities may sometimes be the only solution.

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 make a community's rule system inoperative. 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.

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

---

[2] When we use the word "justice" here, we intend this to mean formal or procedural justice, namely the application of the same rule to all equals. Security here refers to the future freedom to make free 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, social justice and social security tend to undermine freedom, peace and security as defined here (Hayek, 1988, pp. 112–119).

apply the insights to shape concrete rules, we cannot—and should not—avoid value judgements.

Some Consequences for Public Policy

Parliamentarians, politicians and industry representatives in all countries often rely on case-specific interventions to obtain predetermined economic outcomes by ordering matters from above. They seem to assume that the national economy is simply an organisation, like a business firm, where simple commands produce the desired results. Yet, even in modern business organisations, management nowadays relies on "participative management", a style of spontaneous cooperation in teams that follow shared rules. In the west, at least, firms are now run less and less by command-and-control as was typical of an earlier, simpler and less dynamic industrial era (Parker-Stacey, 1995).

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 of the educated public, parliamentarians, ministers, bureaucrats and judges presume to rely on ordering economic life from above by a visible hand. Few observers ask, when confronted with clever new government schemes: "How do politicians and their advisers know? Indeed, do they have any relevant knowledge at all?"

We now possess ample evidence that "know-all interventionism" often overtaxes human knowledge and the administrative 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, because circumstances change continually. For example, the scheme to shore up the world tea prices at various times by stockpiling or prohibiting exports of tea by India, not only cost considerable resources, but led eventually to a protracted depression of the world cacao price. We know that schemes to control housing prices in the interest of the poor only serve in the longer term to restrict the supply of dwellings and to make housing less available for low-income earners. The distribution of subsidised wheat by government to control inflation is likely to have the unintended consequence of depressing farmers' incomes and reducing future grain supplies. Subsidies for petrol and food lead to waste and budget problems, they can often be undone only with the risk of popular and costly riots. Government-decreed minimum wages hinder those less well-equipped with labour skills to get their foot on the training-and-income ladder and exacerbate unemployment. Indeed, persistent unemployment in rich and poor countries alike is a consequence of interventions based on assumptions, which are simply not true. Industry ministers may argue for the simple-minded means of tariff protection, import licensing, 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 interventions sooner or later fail and produce unintended side effects. Local and provincial leaders may promote specific new business ventures, often with great fanfare and at great expense to the budget but we hear little about the subsequent failures of such ventures. All too often, interventions by subsidies are harvested, and later these ventures are closed down again.

Despite numerous such experiences, politicians around the world are habitually promising specific outcomes, and—in the end—still seem surprised their actions so often disappoints. Ultimately, politicians of course earn themselves a reputation for cynical disinterest. Central planning and state ownership of resources became the religion of many newly independent governments with dire economic and social results similar to those in the Soviet Union.

The experience with development policy around the third world is replete with costly and wasteful cases of ill-informed and discriminatory actions of the government's clumsy 'visible hand'. Donated or borrowed money was used to build capital cities, ports and infrastructures for which there was no demand. Bureaucrats picked 'winners', promoting import-substitution industries that were profitable for foreign equipment exporters, administrators and politicians, but costly to consumers (Burton, 1983). Import protection simply became a privilege, which corrupt politicians sold to the highest bidders at home and abroad. No wonder corruption spread. Agricultural prices were centrally controlled and kept low to benefit the politically more important urban populations at the expense of farmers. No wonder, city slums grew fast with migration from impoverished rural areas, and ruraly areas remained depressed.

Only in very few third world countries did governments concentrate on cultivating a fundamental market order, ensuring private property rights for everyone. In most new ventures, even small informal enterprises were subjected to complicated licensing requirements, which no poor young entrepreneur could ever hope to meet. No wonder that black markets and personal insecurity rose, and small traders found it hard to become big traders and employers.

Interventionist and politically opportunistic policies the world over have had another dire consequence: the politicisation of markets promotes social and ethnic tensions. Where people of different ethnic backgrounds meet in markets to trade and barter freely, they discover that both sides can benefit from this interaction. Commercial contacts lead to a better mutual understanding and tolerance of different people. Of course, sellers want a higher price than buyers wish to offer but this conflict of interests is depersonalised and diffused in the competitive market place. Failure is not due to the lack of political support, but due to products of insufficient quality or excessive price, aspects for which the seller is responsible and which he can and will have to change. By contrast, political intervention advantages one group over another. This breeds resentment among groups. Where people are expropriated or lose their freedom to negotiate for the best possible price, they band together for adversarial political action, often even with the result of destructive civil conflicts. Leaders may blame these conflicts on long-departed colonial masters or other unconvincing reasons, but should instead act on the principle that free markets are schools where people learn the habits of racial harmony (Rabushka, 1974; Sowell, 1983; Kasper, 200a). Immigrant countries, such as the United States and Australia, would not be such harmonious and prospering places for disparate people from all around the world, if political manoeuvres and administrative regulations had the deciding influence over economic coordination. Markets give different people more freedom and allow them to live alongside each other, because they encourage diversity. There are important lessons in this for ethnically diverse developing countries, which have suffered from ethnic strife, such as India.

Instead of coordinating economic activity by such "visible hand" interventions, governments should desist from interventions and simply protect the free market order, by enforcing universal rules, such as protected, private property, control of the use of force, guile and fraud, and the enforcement of freely negotiated contracts. Governments should simply promote the institutions that facilitate a spontaneous order (Kasper-Streit, 1998, ch. 10).

Most 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 *ceteris paribus* and 'perfect knowledge' (see preceding chapter). Their pretense of knowledge has given them great but undeserved influence in economic policy. 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 at the latest, when mass unemployment again reappeared in OECD countries and governments tackled the problem by simply boosting demand management, it was discovered that—alas—this led to unexpectedly high inflation, indebtedness and instability. Unemployment went up despite the expansion of aggregate demand contrary to what Keynes had predicted, when he wrote his famous book in the 1930s. In the 1990s, Japan engaged in the biggest spending-and-stimulation drive in history, but attained little by way of a lasting economic turnaround. At least in this respect, most policy makers in OECD countries have learnt to be more cautious about the feasibility of this outcome-targeted policy.

Similar caution about relying on government interventions is still rare in microeconomic and social policies. The naive belief in the feasibility of ordering the economy from above is still rampant, although it should have been dealt a massive blow by the collapse of central planning in the former

Soviet orbit and the many failures of development planning in other countries. 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 confusion on a hard-to-imagine 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. By the Brezhnev era, it was obvious that the ‘scientifically designed order’ delivered inferior results. This was realised by Gorbachev whose attempt to reform the system led to its demise. It was also realised from the late 1970s by the leaders of the Peoples’ Republic of China, who have gradually scaled back the sphere of central planning since then. Now over 55 per cent of China’s national product is subject to the decisions of private producers and buyers. The residual, planned state sector is mired in a deep and costly crisis, and its share continues to contract.

The experience of the demise of the communist command economies has underlined another crucial point, that the spontaneous coordination by market processes does not take place in a vacuum. Markets may function, but they will not do so very effectively. One cannot assume that they do before a reasonably universal 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 drop in Russian living standards. The old order lingers, as former bureaucrats pursue their interests as members of criminal gangs. As a consequence, mortality rates have risen, so that the population of Russia is now plummeting by 3/4 million people a year. Only gradually are new rules of economic conduct emerging, or are imposed, so that sufficient spontaneous private initiatives materialise to generate new economic growth. This minimum of institutional infrastructure is now in place in some east European countries, and the long-suppressed internal institutions of civil society are re-emerging in Poland, the Czech Republic, Hungary and Estonia. Consequently, these economies are now showing visible improvement, although the process of institutional reform is far from complete (Kasper-Streit, 1998).

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

A simple, reliable order of rules cannot emerge as long as arbitrary and industry- or product-specific interventions proliferate, triggering impossible-to-predict and often unsettling side effects. In former British colonies, where the inherited, time-tested British rules were long implicitly taken for granted and where the new rulers degraded the colonial rule system after independence, insufficient attention has been paid to the need of cultivating the underlying institutional system. The notion that order is a precious possession, which requires nurturing, is not popular, nor is the understanding of what institutional qualities are needed to facilitate order. Not much attention is paid to the character and shape of the best possible rule system, although many of the existing rules have become counterproductive to the people's aspirations (see Chapter 7).

Creating Institutional (or Social) Capital

In the Anglo-Saxon and many East Asian countries, it has been increasingly realised that appropriate institutions are a central condition of freedom, security, prosperity and economic growth. A universal rule system is considered by at least some as a precious possession of a community, which enhances the productivity of labour in ways similar to the availability of good 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; Weede, 1996).

A renewed awareness of the need for effective institutions has been created by much recent systematic research about institutions which facilitate superior outcomes in terms of freedom, security, justice, peace and prosperity. The pursuit of piecemeal microeconomic reform has given way to new discussions of the overall design of economic and legal constitutions. Do the fundamental rules constrain corruption, political whim, discrimination and power abuses, or not, and where are they effectively enforced?

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

One standard conservative response to such a comprehensive and ambitious attempt is that changes are too difficult. In a rapidly changing world, such a defeatist attitude needs to give way to an enterprising approach to the future, to a conscious exploration of how to reshape the underlying rule system in the light of historic and international experience and in the light people's aspirations. Politics needs to be approached with an innovative, entrepreneurial spirit. It should be based on the insight that enormous gains can be made by a streamlined, simple and universal framework of the underlying rules. Potential gains promise to exceed the marginal improvements to the allocation of resources that can be had from piecemeal microeconomic reforms. Why not focus on "picking up the big bills", as many East Asian countries did in the 1960s and 1970s (Kasper, 1994a; 1997a; 1999), and some European countries are beginning to do now?

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, generated the most sustained rise in population, in material living standards, and 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 assets to specific private owners—individuals, families, clubs or firms—and which guarantees the autonomous, self-responsible use of private property (freedom of contract). It functions best without political discrimination, ie. when it is based on the rule of law.

On Private Property Rights

Private property rights form an open-ended bundle of rights to possess, to use, to benefit from and to dispose of valuable and scarce assets (freedom of contract). These rights must not be confused with the assets themselves. They are attached to assets, not only to physical assets—such as land, buildings and equipment—but also to one's own body and labour. When people are denied autonomy over the use of their body and labour, they are slaves. Property rights can also be attached to intellectual creations (intellectual property rights).

Property rights establish protected and 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 the owner consents to grant them such rights. Secondly, they encompass rights of autonomous "active use"—to combine the asset with the property of others in pursuit of expected gains and to appropriate the gains that accrue. This is done through voluntary private contracts, which are concluded only when both parties expect mutual benefits from the transaction. In a world full of risks, 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 to 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 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 our 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 protection of property in a community, the lower are the exclusion costs and, consequently, the higher is the value of a given property. Property owners therefore have a direct interest in effective institutions. 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 who helps in excluding unwanted property uses. This may be a private protection agency, or a government organisation that sets up formal, external rules and enforces them through the police, the judiciary, prisons and similar forms of legitimated force. Property owners in most countries rely on both, with private security services often employing people several times more than the police do.

Active uses of property have other costs. The owners of different rights to physical and intellectual property have to be coordinated. Firstly, they need to search for potential contract partners and find out their characteristics, to engage in research and development so as to identify new, but needed intellectual property or resources, negotiate and execute contracts, and 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 or a government department. The levels of these coordination costs depend greatly on the internal institutions of society—such as spontaneous honesty and a spontaneous disapproval of rule violations—as well as the external institutions, namely the universal quality of law regulations, and the reliability of the judiciary. Effective institutions, therefore, not only determine the value of property in a society, but also the ease of active property uses. In today's open economies, property owners often go to where the rule system is most conducive to using private property and where the exclusion and coordination costs are low. Fuzzy, complex rule systems thus lead to low competitiveness and the flight (exit) of financial, physical and intellectual capital.

Historically, the state has had an important role in protecting private property. Indeed the government probably came about soon after the emergence of property rights in the full, modern sense of the word in the "neolithic revolution" some 10,000 years ago. Humans then engaged in agriculture and domestication of animals. This revolution occurred in a number of different regions, such as the Middle East, northern Thailand and the Americas. It is not imaginable without the discovery of respected property rights. Who would dig the soil and sow crops, capture and care for animals, if possession was constantly threatened and the fruit of these efforts could not be appropriated? Without respected property rights, the exclusion costs could have been so high that agriculture would have been impossible and people would have remained paleolithic hunter-gatherers.

In this context it should be noted that the mere possession of a useful asset, for example a dog or a chimpanzee, does not constitute property; what matters is the social recognition of property rights. It can be compared to a social truce, a multilateral agreement that people will not steal or trespass, because then everyone will be better off than in an anarchic "war of all against all". When 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 rules on property ownership. Since this activity cost resources (agency costs), the rulers and judges had to collect fees or impose taxes (Benson, 1995, 1997).

The invention of private property had an important consequence for mankind's 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 exploitative tribal mentality gave way to cooperative, creative efforts, were a great variety of goods and services produced for the enjoyment of others (see Insert below). Only then does the mistrust of strangers 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 still prone to fall back instinctually onto the atavistic, tribal mentality of the palaeolithic age (Hayek, 1988, pp. 11–28; 48–65).

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, group or organisation, and that others are excluded. When private property is used actively, all the benefits and costs should ideally impact on the owner (They 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 find and use resources. Where it is not possible to attach private property rights to assets (i.e. where externalities exist), complicated interventions by political action have to be contemplated (see Glossary on "Externalities").

Ownership of Oneself

Without a doubt the most important asset an individual owns is her or his body and the inherited and learnt skills. Self-ownership played a big role in the historic discussion of property rights and was a part of the attack on the traditions of serfdom in Europe. Early liberal economists in Spain, Britain and France were among the most vehement opponents of slavery, pointing out—correctly—that slaves were not very productive, apart from slavery being an outrage against fundamental human decency. Similar sentiments inspire discussions on labour-market deregulation in many advanced countries: it is a fundamental right of workers to sell their labour and talents in conditions where they negotiate freely and not at the bidding of union officials.

In many third world countries, one of the priority tasks of government is the protection of life and limb. In some cultures, for example in East Asia, the internal institutions of society mitigate against violations of personal safety; in others the concept of the spontaneous protection of life and limb are less deeply entrenched. This poses serious and very fundamental problems for economic development, too. Where the incidence of murder and rape is as high as in Soweto in South Africa or in Rio de Janeiro in Brazil or say, the Bihar-Uttar Pradesh belt in India many ordinary people cannot act with confidence to better their material lives. In highly insecure areas, other types of property like material objects are seen to be less important than personal security and are therefore not used to best advantage. Moreover, the mere protection of one's safety takes up so much time and resources that the return for one's work and risk taking is very low—in other words economic growth is very difficult and people remain locked in poverty traps.

Sometimes, informal networks and organisations protect people and their meagre property from murder, beatings and theft, for example the *mafia* in southern Italy, gangs of thugs in many shantytowns around the world, or protection racketeers in the back streets of Moscow or say the underworld in Mumbai. The safety they provide tends to be costly and unreliable, but is preferred by those who are able to pay to the brutish conditions that prevail without. Sometimes, such gangs establish a truce on brutality and offer more formal protection. And sometimes in history such 'violence professionals' have established themselves as political power brokers, seeking some legitimisation and formal limits on their use of power. They then become princes and kings who enforce a monopoly over the use of force and bind the uses of force by subjecting themselves to clearly understood laws. If this is exercised without favouritism and with constraint, the rule of law emerges and economic development can take place (Benson, 1997).

The eternal task in any society is, however, to protect the people from the protectors by orderly and just ways. Law and order and the control of government officials are therefore important pursuits in developed countries. In many third-world countries, they have to be the tasks of the highest priority if ordinary people are to make the most of their energies, their talents, and their intellectual and material property. Economic development starts with this most basic form of institutional guarantee.

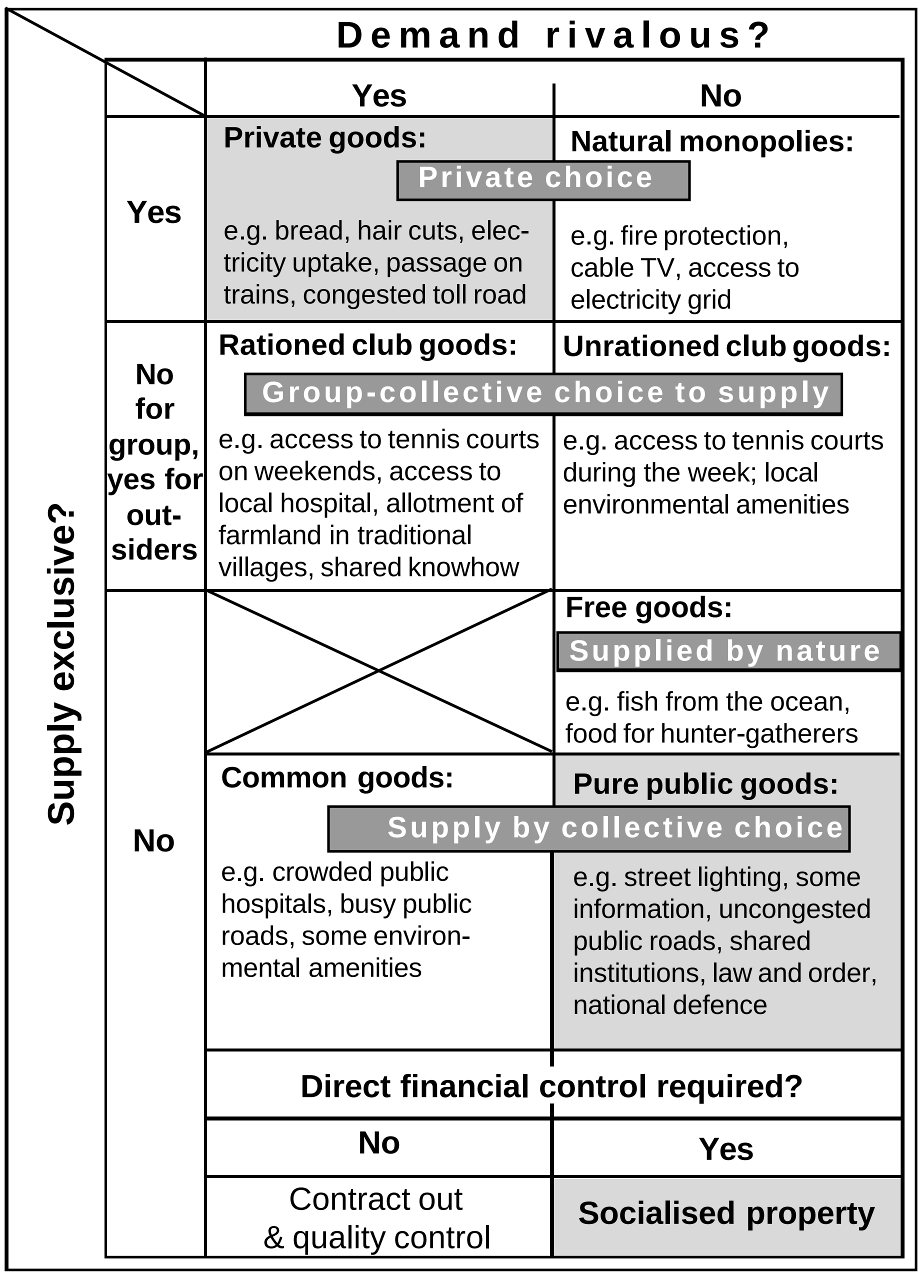
Free Goods, Club Goods, and Public Goods

When early humans roamed in nature, no property rights were needed. Hunters and gatherers found free goods, i.e. goods that were not scarce because the few humans hardly competed with each other for resources. In the Garden of Eden, there was no need for private property. 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 human numbers rose, demand for certain assets became rivallous. Humanity began 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”. Where scarcities arose within such clubs, more or less elaborate informal and formal rationing devices were invented (Graph 6).

Small groups that possessed such “commons” rationed individual uses by internal, informal institutions, for example by mutual reprimand or taboos against overuse. When people know each other and meet frequently, informal institutions 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, informal institutional mechanisms break down. This leads to over-exploitation and internal conflicts (Hardin, 1993). Therefore, internal institutions have to be enforced more formally. Probably, they have to be backed up by external institutions—a king or chief may allocate land uses or hunting rights, which are formally enforced. Thus, people are allowed to collect oysters, lobsters and abalone in coastal areas or hunt for wild game, but the bag size is limited under the law.

Where such rationing mechanisms are not invented and enforced, the “commons” deteriorates, as each member appropriates “common wealth” without constraint. Everett Hardin described a telling case of this “tragedy of the commons”. When the first satellite images of the Sahel region in Africa were made during a major, catastrophic drought, patches of well-grassed

Graph 6: Private, Club and Common Property



land were discovered amid overgrazed, durably damaged land. Ground investigation revealed the consequences of good and bad institutions. The grassed areas belonged to 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 could only appropriate benefits from the land by intensive grazing. The institutions that secured private property thus limited the damage of the drought—an instructive illustration of the fundamental effect of universal institutions on resource conservation (Hardin, 1993). With the increasing numbers of people on earth, property rights can thus 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. Property rights can then be exchanged in markets on the basis of voluntary, bilateral contracts (Graph 6). 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 owners (see Insert below). The 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 Central business district or previously free commercial fishing access is auctioned off to exclusive license holders. These are steps towards a more effective, less conflict-ridden way of allocating 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 observed in "ownership clubs" which the Canadian or Australian governments have established for Aborigines. If human experience is anything to go by, common ownership by large groups whose members rarely meet, inevitably leads either to excessive use or to the diversion of the benefits to influential insider groups who *de facto* control 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 different private individuals, families or clans. Private property of land in the hands of families and clans would have the advantage of inducing some individual Aboriginal owners to seek more creative uses of their land. This would give Aboriginal families the chance to test alternative ideas as to how to make use of the newly reconfirmed property titles to their own best advantage, rather than to the advantage of their bureaucratic elite. It may also be learnt in these cases that the move from free goods and traditional, informal club ownership to private property is inevitable.

In practice, it is not always feasible to exclude non-owners from enjoying some of the benefits or costs of certain assets. 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 the society at large (see Glossary).

We speak of “external costs” when non-owners and non users have to bear some of the costs of property uses. For example, the emission of noise or pollution from an industrial activity has an impact 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 may enjoy the amenity for (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 assignment would create inordinately high costs. 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. Property owners 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 by governments. Recent advances in transponder and computer technology now make it possible for private owners to build public-access roads and to charge individuals 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 governments often capture such neighbourhood benefits. Recent 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 capturing all benefits within self-administering associations. A similar case occurs in clubs when one individual cannot capture the full benefits of a sports field 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, as was originally the case with the commons in Medieval Europe. 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 therefore a mixture of collective and private choices (Graph 6).

When external costs and benefits 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 that are most highly valued in the community. Activities where private owners are able to avoid bearing a part of the total costs which they cause, will be over-expanded. These activities appear more beneficial to private property owners than they do 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. Externalities thus cause the profit-loss motive to be a poor guide on the valuation of goods and services and their consequent supply or demand. 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 through voluntary, bilateral contracts.

While many externalities of property use impact on neighbours, there are some externalities that even transcend the reach of national jurisdictions. For example, if an up-river country, such as Turkey, uses irrigation water, it causes external costs to down-river countries, such as Syria and Iraq. Likewise, greenhouse emissions by high-energy users 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 current trend—if a trend it is—tends towards uniform, centrally planned and hard-to-enforce targets for the reduction of emissions. The alternative to this "one size fits all!" approach is to take a page from institutional economics and to think of globally tradable emission rights. Such rights could 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 rationed CO_2 emissions to do so up to a certain safe level. It would ensure that the cleanest producers would reap a benefit, creating a material incentive to economise on activities that burden the atmosphere. However, such an arrangement will have to cover all countries on earth and will be complicated by intractable monitoring and enforcement problems. This is why many nations are reluctant to endorse the Kyoto Protocol, which the European Union has been promoting.

There are some cases where exclusion by private property rights is not necessary because private users do not rival with each other. Economists call these "pure public goods" (see Glossary). Their demand is similar to free goods, but—different from free goods which are provided by Nature—the supply of pure public goods costs resources and effort. Provision of such goods have to be decided upon and provided by collective choice (Graph 6). A classical example is the case of street lighting. If one citizen provides street lighting, all street users benefit, and they do not diminish each others' enjoyment of the light. It would therefore not be practical to collect fees from the passing traffic to compensate the provider for incurring the cost of the streetlights. Instead, government should fund street lighting through 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 law and order

It makes sense for governments to finance general access to these public goods and to raise funds through politically determined taxes. Governments may also get involved in providing widely useful information, for which individual citizens would incur disproportionately high costs. 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 such 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 a vital matter. A similar argument can be made for the public provision of money, i.e. a national currency. Government money reduces the information costs of the public as compared to a payments system based on diverse private moneys.

The conditions that make for pure public goods are rarely given. Governments nevertheless 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 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 pay for the provision of these common goods, and 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 Domain 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 administrations (Demsetz, 1970). What matters is access—providing these goods and services in the public domain (Graph 6). Thus, a good case can be made for financing street lighting and roads from taxation, yet to have these services produced by private, competing producers. Many public domain 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 abuses, which are common in monopolies. 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 choose from. This has been demonstrated since the time privatisation became a worldwide phenomenon.

A government has two roles in the competitive, private provision of public-domain goods. One is to ensure quality standards. The other is to ensure that less affluent citizens have access to these goods e.g. through vouchers (Kasper, 1996). Thus, poor kids in Puerto Rico and many States of the USA were recently given the option to access private schools through government-endowed school vouchers.

There is a case for direct public ownership of certain assets, but it rests on a completely different consideration. Sometimes, there is a need for the complete control of certain asset uses because competition might be too costly for the citizens or because asset owners cannot be trusted to act in the public interest. Thus, military forces, police officers and other "violence professionals" normally come under the direct financial control of government. This is part of an arrangement whereby they are controlled by non-violent means. The alternative might be that they use weapons and other assets against the citizenry or that they compete privately by using force. The competition between hired mercenaries (as occurred, for example, during the 1990s in the Congo) and competitive police protection rackets are decidedly unattractive forms of competition! In a similar vein, most law courts are nowadays run by governments, because private judges are seen to 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. Public officials may act opportunistically. Police and judges, who favour members of certain ethnic groups, come to mind as examples of the failure of political controls. Some observers therefore make a case for private policing and competing private jurisdictions.

In modern economies, many more ventures are publicly owned 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 criticism of private property. Public ownership is 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 for 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 economic growth. The history of the USSR provides many textbook examples of this analysis.

Divisibility and Tradability of Property Rights

The private property rights system hinges—as we saw—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 landowner may lease the land to someone for farming, to someone else for cutting timber or mining, to yet another for fishing in the stream through the property, and to 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 valued outputs from it than a single owner-user ever could. Divisibility is based on institutions. The Ancient Romans, for example, refined existing property laws to allow loans and partial uses of assets, giving people who could not afford outright property ownership access to those parts of properties which they valued highly. Roman law secured relevant contracts and reduced uncertainties and transaction costs of divisibility.

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 can often not acquire the asset in exchange for money or other assets.

If a property is inalienable, for example by an inheritance clause or by custom, it loses much of its value. This is often resented. Where land is made inalienable and held collectively on behalf of traditional native owners, new ideas and opportunities cannot be readily discovered and exploited. The non-tradability of land 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 by traditional owners would enhance their life opportunities. The lesson of human history certainly is that inalienability reduces the value of property and discourages its creative uses.

Secure Private Property Rights and Economic Development

The crucial role of secure private property rights for all—not just a well-connected, rich *privilegentsia*, but the poor and the young—is nowhere more evident than in developing countries. Peruvian economist Hernando de Soto has shown

- that the poor in third-world cities own considerable assets and save quite a lot, often more than third-world governments manage to borrow from overseas sources,
- that their property rights are not protected from private and public

fraudsters and arbitrary political regulators (de Soto, 2000).

Insecure property rights over land are the root cause of many social problems in developing countries, both in farming areas and on the fringes of the rapidly growing urban areas (see Insert below). Governments often fail to set up cheap and citizen-friendly arrangements that allow squatters to register a title to their shacks and houses, to conduct their businesses under the protection of the law and to enforce simple rules that reduce the transaction costs of being an entrepreneur and trader. Officials and law courts in many countries do not side with enterprising poor citizens, but with the rich elites to whom they belong. The consequence of uncertain titles of property in land and enterprises is that the poor cannot use these assets to raise loans for growing their businesses and have to incur great costs in defending their uncertain possessions (e.g. by paying corrupt policemen, *mafia* bosses or local government controllers). Once property rights are secured and reliably protected, investments tend to burgeon spontaneously and entrepreneurs succeed in markets. Growth takes off, even without much foreign aid and foreign borrowing, as one East Asian country after the other has demonstrated. Poor Mexican immigrants began to grow affluent, once they were in the United States and could play by American property rules.

The lesson is not only that expropriation—for example of productive white farmers under the Mugabe regime in Zimbabwe—harms development, but that broad-based prosperity depends on the protection of private property of all citizens by governments and social *mores*. Secure and cheaply defended property rights are crucial to equitable economic development, starting at the local level in shanty towns and street markets.

Insert

Land Titles and Development

The transition from traditional village or regional economies to modern national and global economies nowhere requires more institutional innovation and enforcement than in the field of property rights in land. Alas, third-world governments often fail massively in this task.

In traditional agricultural settings around the world, people recognise property rights of sorts, often in the form of a connection between a more or less defined plot of land and a clan or family. Sometimes, the entire village owns the surrounding land in common; the village elders may allot specific plots to young couples so that they can build their houses or establish gardens, whereas the remainder of the village land is used as a 'commons'. The right of each family to graze cattle, to collect timber, or to fish in a stream tends to be regulated by traditional institutions. Conflicts are resolved by village elders or a traditional ruler. Frequently, different types of informal property rights overlap, with someone having the grazing rights, and someone else being able to collect wood in the same area, or enjoying a right of passage for his flocks.

When modern development takes off and people are motivated to make more intensive use of the land, frequent conflicts arise between different land uses. This was, for example, the case in Europe, when traditional landowners began to claim exclusive rights to their land and eliminated other, hitherto tolerated users. The traditional rights of weaker members of society are then frequently brushed aside. Thus, the 'Enclosures' in Britain and Spain in the 17th and 18th centuries permitted more intensive agriculture, but all of a sudden made the life of traditional herders impossible. In Scotland, the lairds reclaimed their traditional land to build up big sheep runs and evicted the crofters, who became homeless, although they had lived on the land for centuries. In many new colonies outside Europe, similar land seizures occurred and were protected by the colonial governments. The result of clearly enforced property titles was often not only a more productive agriculture, but also a landless under-class, many of whom drifted to the cities. In other jurisdictions, a more differentiated treatment of different property rights in the same land enabled different groups to co-exist and develop together, but such cases were more the exception than the rule.

To the present day, unclear land titles create serious development problems in many third world countries. Young villagers with motivation and ideas on how to modernise farming may be hampered by the fact that common village land cannot be appropriated or is not ceded to them by traditional village councils. Colonial and post-colonial governments have frequently implemented institutional arrangements that inhibit the allocation of land to individuals. Where schemes are implemented to encourage a more intensive communal use of the land and natural resources, we frequently observe a 'tragedy of the commons' (overgrazing, exhaustion of the ground water). No one invests in soil conservation and improvement. Population pressures aggravate the problem. Dividing up the land and allotting it to individuals or small families on the basis of a clear, long-term title is then often the best solution, but one that may clash with powerful traditions. Governments can do much to establish mechanisms for well-defined and reliably enforced property titles, for example by instituting a conveyance service and land registries.

Particular problems arise where land is made inalienable by government decree to protect traditional inhabitants. Thus, Fijian clans and aboriginal Australians have formal land title, but cannot separate out parcels, which individuals can use or sell. Instead, the real land title is vested in a distant overweaning bureaucracy, and for all practical purposes the land has been socialised in perpetuity. This not only gives rise to the usual waste of resources, when the asset belongs to no-one in particular, but also angers many young people who have no control over their families' most valuable assets and see their life opportunities artificially diminished (Kasper, 2000a).

Property titles in natural assets can—as we saw—frequently assist in their preservation. One much-reported example was the awarding of property rights in wild elephants to local villages in East Africa. The elephants are a menace to fruit gardens and hence the livelihood of villagers. They were hunted and poached, despite formal prohibitions. In the end, some governments and wildlife authorities allotted property titles in elephant herds to villagers and encouraged them to exploit the herds by showing them off to foreign tourists. All of a sudden, the occasional garden raid of the elephants became tolerable, because the elephants were the basis of lucrative eco tourism. What had been a socialised liability, became a privately owned asset. The communal purpose of nature conservation was served by private property (Kasper-Streit, 1998, 209–10; also Anderson-Leal, 1997).

Property titles are also a major problem in third-world cities. Many poor people come to the cities for a better life, but cannot gain control of the land on which they squat. Insecurity about land tenure mitigate against investment in improving shanties and often encourage criminal protection rackets. While many of these migrants are able to create wealth and capital with their own labour, they cannot mortgage what they own even to raise micro credits, because governments fail to ensure property titles (de Soto, 2000; Kasper, 2000a). Much can be done by governments to eradicate poverty in the big cities of the third world: They can set up cheap and reliably enforced land title offices, so that the poor are able to raise some money towards educating their children, improving their livelihood or their dwellings. However, powerful interests—for example, absentee land lords or big landowners, who fear they will not be properly compensated—often lobby governments against such a low-level and effective ‘social policy’.

Leaders, who understand the importance of property rights and institutions, will make land acquisition easy—as was, for example, the case in 19th century America or Australia, when millions of poor people could get land titles and lift themselves out of poverty.

Markets: The Right and The Responsibility To Compete

" . . . 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 (1948).

"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 and labour 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 systems of markets work. 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 the present essay, we note in passing that coordination by market and by organisation are often interchangeable. 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.

The Market Process

A market is a meeting place. Intending buyers and sellers, each with limited knowledge, seek and find information about what uses of their property might be mutually advantageous to them. 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 explored and discovered, 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"[1] (Hayek, 1945, 1948, 1978; Mises, 1949, see Catallaxy in the "Glossary"). The market is a dynamic phenomenon—a "discovery procedure", as Hayek used to call it. Markets fulfil their function in tackling the economic problem well if they

- facilitate entrepreneurial exploration and discovery,
- spread useful knowledge around,
- bring about spontaneous correction of errors, and
- control concentration of economic power (monopoly).

All four functions add to economic growth.

How effective market competition is in advancing 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 local vegetable market in Delhi, but the entire system of interdependent markets, the incredibly complex, evolving network of interrelated processes which constitute the web of economic life.

The Costs of Using Property

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, a fact that may possibly 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, the share of transaction services in GDP has probably doubled since the start of the 20th century, and it is rising rapidly in the developing countries. This is an inevitable consequence of the ever-more sophisticated division of labour

[1] 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.

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 information, as well as where and how to sell goods and services;
- *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 in Chapter 2 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. Before one has incurred sufficient exploration costs, one cannot know or evaluate whether or not it is worth one’s while to incur these costs (Streit-Wegner, 1992). There is simply no way of assessing rationally whether the exploration effort will yield a return in terms of useful knowledge before the exploration has been done and the costs have been expended! 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. The general institutions surrounding markets therefore must inspire a degree of confidence. Exploration costs are the major reason why there are limits to finding new knowledge, why the division of labour has limits, and why scarcity persists.

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 wish to explore a new area, cannot trust that they will be able to keep the benefits of new knowledge, they will desist from incurring the costs of new ventures. And where political favouritism offers easy profits, entrepreneurs concentrate on lobbying rather than searching for productive knowledge and cost saving. It is therefore essential to provide trustworthy institutions that guarantee pioneers rewards for finding useful knowledge and for restraining political favouritism. In other words, the institutions must guarantee universal property rights. Failure to do so is the main reason why different societies vary greatly in their innovative dynamism and why economic growth rates differ.

One good example to show that this is a realistic way of looking at knowledge exploration and risk-taking is the oil industry: oil companies 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. This is a costly exercise. Millions of dollars may have to be spent on successive drillings until the oil explorer knows whether he has struck a bonanza—or found nothing. Entrepreneurial guesses drive prospectors to incur enormous fixed costs for uncertain returns. Once a petroleum 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 oil well to commence production. This is solely determined by expected future costs and sales 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. In short, a dynamic market economy is a continuous invitation to buyers and sellers to incur knowledge-exploration costs for uncertain gains. The more market participants act in an entrepreneurial spirit, the more useful knowledge is likely to be discovered and used to advance living standards and life opportunities.

To be precise, entrepreneurship implies 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 visualised before (Kirzner, 1984, 1997; Gilder, 1984; Blandy, Kasper *et al.*, 1985; Berger, 1987), and
b) the willingness to incur the necessary transaction costs by pioneering new activities and products, which is always a risky business (Streit-Wegner, 1992; Streit-Kasper, 1998).

If the entrepreneur has guessed correctly, he or she will reap a profit. If not, a loss will be incurred; the business may even go bankrupt. Profit 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 tend to believe. Although luck does play 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, profits are highly taxed, invoke social opprobrium or are poorly protected by prevailing institutions, there will be less "creative curiosity" and less innovation (Maley *et al.*, 1983). Growth 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 their property to invest in search costs. Once entrepreneurs have a feeling that they are sufficiently informed, they will make a decision to buy or sell (Streit-Wegner, 1992). With hindsight, they may find either that they have spent too little or too much on the search. In the process, errors may have to be corrected and aspirations may have to be adjusted (bounded rationality). New information searches will be started in the never-ending process of knowledge-generating market activity, an open-ended, evolutionary process of discovery of new wants and new resources.

An example of what is involved is the Xerox company, a small office-products supplier at the time. After they discovered in the technical literature 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 convince sceptical bankers to finance the effort?
- Where to build the factory?
- How to train all necessary skills?
- How to find customers? There was no ready-made market for photocopiers at the time!
- How to distribute the machines and where? How to handle possible breakdowns in this, as yet untested, new technology?

Such practical information problems require an entrepreneurial attitude and the backing by people with property to shoulder the exploration costs.

In a competitive system, people have a profit incentive to search for and test useful knowledge that their fellows welcome. Market competition therefore creates conditions in which people are most likely to learn how to improve their 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; Kasper, 2001–02). 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 use 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 dominated by dictators, but not citizens of property.

Private entrepreneurship is absolutely essential for economic development, which is nothing but the discovery of new resources, wants, knowledge and means of production to meet human wants. Centralised government entrepreneurship—the model of statist development—has rarely been very successful in development and has left many developing countries with a legacy of white elephants and depressing foreign debts. Politicians and civil servants lack the knowledge and the incentive to discover the right knowledge. Instead of meeting the demands of the people and informing them of what is possible, they tend to employ their energies to finding opportunities to line their own pockets or support their political power. By contrast, profit-chasing, competing private entrepreneurs tend to do what the market demands and adjust to evolving circumstances in the course of economic change (Kilby, 1971; Gilder, 1984; Blandy, Kasper *et al.*, 1985; Baumol, 1990). In this context, it is also worth thinking about foreign aid and easy revenues from resource exploitation, for example oil. Aid and oil revenues have often contributed to stifling independent entrepreneurship and have encouraged political regimes to curb economic freedom, whereas resource-poor countries, such as Switzerland and Scotland had to concentrate on developing human resources and institutional capital. Where economic freedom is given, economic growth normally occurs spontaneously and capital and knowledge are mobilised. The difference in the development performance between East Asia on the one hand, and South Asia on the other is explained primarily by the difference in reliance on private entrepreneurs on the one hand and on statist control on the other.

The mainstream of Indian literature on the economics of development has shown little understanding of the spontaneous forces of development in a free economy, and trust has been put since 1948 in development plans, import substitution, statist, socialised industry and heavy administration. Yet, there have been clear-sighted exceptions, most notably Professor B.R. Shenoy who saw the errors of planners long before others and who understood that free markets and secure property rights for all was the path to a prosperous and just India (Shah, 2001).

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 by government 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 and other fees. In addition, there are compliance costs which have to be borne by those 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 statistical data, conduct business in disadvantageous ways and desist from certain, probably lucrative actions. If governments are careless in imposing such compliance costs, they create a major hindrance to the active use of assets and talents.

Some jurisdictions try consciously 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 or the environment, but draw on the art of administration to cause the least cost and inconvenience on complying citizens. Interested foreign investors who want to set up shop in Singapore or Taiwan can turn to a "one-stop shop" to learn what is required to start business and to obtain all necessary permits. Often, the "one-stop shop" even goes around to obtain all necessary permits on behalf of the applicant, possibly within a fixed period (as is the case in Taiwan, for example). With 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 compliance costs, regulatory inconsistencies and obstacles to business.

In other countries, it is not uncommon for a new business to run the bureaucratic gauntlet of obtaining some 20 or more permits from local, State and federal authorities. Often it is very difficult to find out how many permits are needed. Administrators sometimes seem to believe that industry and commerce are necessary evils, which have to be "domesticated" by strict and virtuous administrative supervision. In other places, officials consider permits to create jobs as items that have to be kept scarce, so it can be sold for their own private gain. Such conditions prevail in many developing and developed countries, so that small firms often operate illegally, and big enterprises stay away (de Soto, 1990, 2000).

While a user-friendly approach is fairly alien to many administrative traditions, a switch in the style of administration can do much to enhance growth and job creation. A first step in this direction is to depart from the model of perfect knowledge and to recognise the central fact that top-down coordination imposes considerable costs on business and citizens and that bureaucrats have no right whatsoever to extract bribes for expediting business applications. Where a corrupt administrative culture is deeply entrenched, it may even make sense to delegate approvals (within stipulated government guidelines) to private agencies who are then paid according to the number of jobs that are created or the number of successful approvals.

The costs of using property vary greatly from one community to another.

Where the internal and external institutions make sure there are few thieves, the costs of protecting property are low. Property is worth more. Where the government's enforcement of property titles is lax and haphazard, private exclusion costs sky-rocket and property loses some of its value. This has, for example, become evident in areas where crime against property has gone up.

Governments who set or alter the external institutions frequently disregard the transaction and compliance costs, which they impose. Indeed, many in the judiciary or politics (especially in countries with a British administrative tradition) scorn the thought that they should take these compliance costs into account when they pursue justice or similar goals, however defined.

Communities enjoy low transaction costs also when the internal institutions of society favour spontaneous honesty, punctuality and readiness to compromise in solving conflicts, and when the laws are universal and the courts operate expediently. More opportunities can then be explored and tested, and more 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—flourished because the coordination costs of merchants and innovators were kept low by the conscious cultivation of market-friendly institutions. And many locations remain economically and culturally underdeveloped, because the attitudes of the people and the heavy, visible hand of government hinder commercial creativity and confident competition.

Market Participants Compete by Incurring Transaction Costs

The uncomfortable business of competing 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 perennial 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, to advertise, and to offer better or cheaper new models. This rivalry drives ceaseless product innovation—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 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). By contrast, one only has to look at countries where suppliers were protected from incurring knowledge-exploration costs by their government. In India, for example, the heavily protected 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 miserable *Trabant* car year-in, year-out!

Rivalry in the market always creates uncertainties. You never know what your rivals might do next and whether their initiatives will eat into your market share. As long as suppliers cannot be sure how secure their market niche is, they will strive to control their costs. As long as their market position and profitability are perceived as temporary, producers will invest resources in knowledge search to find out cost-saving production processes (cost control by process innovation, see *Insert* below). The rivalry between suppliers is therefore essential not only to make firms bear the costs of product innovation, but also for them to incur the costs of process innovation. Private cartels and government-sponsored protection from their rivals (such as tariffs and industry licensing) automatically reduce the intensity of an industry's rivalry and hence the willingness to incur innovation costs. As a result of government intervention, the economy displays less of what economists call "catallactic or dynamic efficiency". In other words, entrepreneurs generate and utilise few useful new ideas.

It is not surprising that long-protected manufacturers, who enjoy government-made certainties, are poor innovators and tolerate high cost levels. They do not have to live with "creative unease". The flip-side of such "welfare policies for big business" is always an industrial malaise, poor economic growth and limited competitiveness. Once government-made protection gives way to limited, partial trade liberalisation and globalisation, as was the case in many countries from the late 1970s into the 1990s, the adjustment pains are great. Like someone rising from a sick bed, manufacturers have to relearn how to incur search costs and to compete. To the extent that they do, they begin to offer the buyers more advantageous products, often at lower prices. Where import protection is removed, locally made cars, for example, have without exception, become more reliable, and are better designed and cheaper. But industry has to face the discomfort of those insidious information-search costs. This induces many suppliers (firms and their previously featherbedded workers) to become politically active to regain a degree of political protection in exchange for offering government their political and material support. In many countries this has given rise to a certain backlash against the regulatory reforms of the 1980s and 1990s.

It needs to be mentioned here that not all people consider competition—incurring transaction costs to discover new things—a burden. For many people, discovery is a worthwhile pursuit in its own right. Especially the young and the curious experiment and explore; they derive satisfaction from venturing into the unknown and from solving problems, which others have found overwhelming. This exploratory curiosity is an integral feature of human nature. Where it is suppressed by too much regiementation and control, it seeks forbidden outlets: The young experiment with drugs or engage in street demonstrations, thrilling criminal or gang activities and "dares" that appear foolhardy. In Africa, Indonesia and Latin America, many young, who lack better opportunities to explore the world, join militias to exploit and monopolise precious natural resources. Traders go into black market activities. Repressed minorities emigrate or take on the oppressors. Overtaxed producers pursue tax evasion and go into the underground economy.

Although the transaction costs of entrepreneurial discovery are real and substantial, it would be one-sided to assume that they are a mere burden, which everyone tries to shirk. The energies and the entrepreneurship of many people could probably be channelled into economically creative pursuits, if the institutions guarantee them other, more constructive outlets. Rule systems that ensure a high degree of economic freedom and that avoid being excessively prescriptive promote economic development because the creative energy of entrepreneurial people is mobilised and because rent-seeking, unenterprising people are encouraged to risk their assets in discovery ventures in the market place.

What has been said so far about rivalry by 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 in the market place for the best deal. Sometimes their cost of exploration is even compensated by the pleasure of shopping around. Consumers read magazines and make inquiries. The market for computer software, for example, would not have flourished with such breath-taking innovative vigour without the young computer buffs perusing the computer magazines and the internet for product reviews, and their readiness to try out new software packages. By acting entrepreneurially, consumers thus enhance the intensity and quality of the competition. We get the best deals where we mix with discerning and critical buyers. This is why one can buy elegant men's suits in Italy and eat excellent restaurant meals in France. Discerning buyers are indeed crucial. Customers, who are too lazy to complain about poor products and who tolerate bad service, deserve no better!

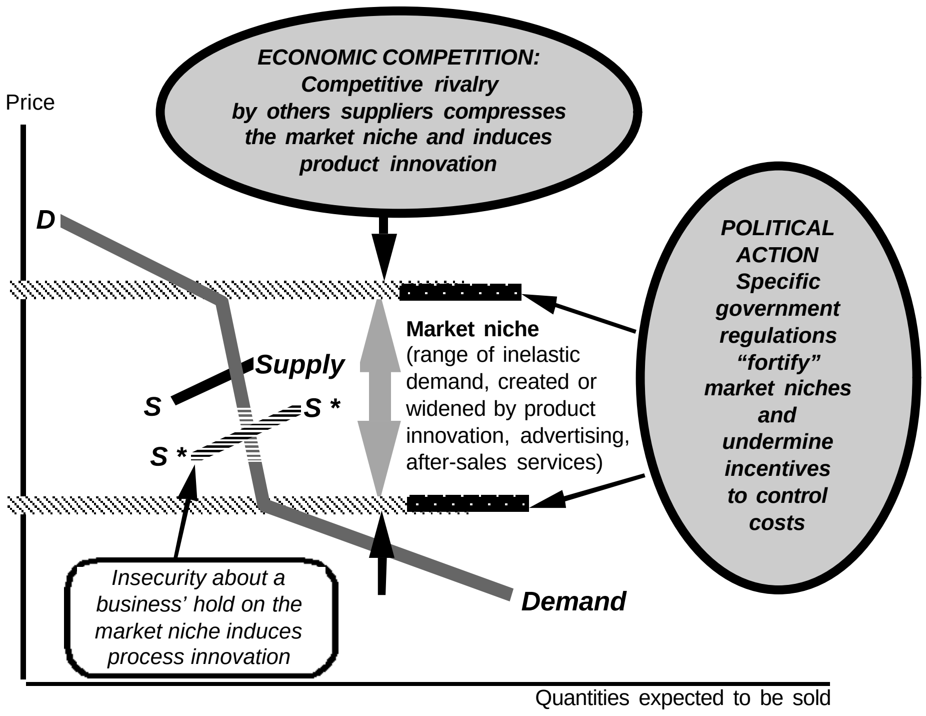
The fact that buyers rival with each other may not always be evident at first sight in markets with shelves full of stock. It is, however, evident when buyers rival for particular pieces of real estate or art. There, one's alertness and readiness to incur search costs may decide whether one is a successful 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 in R&D, as well as in information and contracting expenses into obtaining the most advantageous car components, and supermarket chains rival with each other to obtain fresh 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 take a snapshot from the dynamic competitive process. Let us take a car producer, for example. The producer will know 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—inelastic. This range of inelastic demand is called “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 three-year warranties, or free 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 compress his market niche and gain a bigger part of the action (Graph 7).

Graph 7: A Producer's Market Niche
A Snapshot from a Dynamic Process



The market niche is thus subject to a continuing tug of war; it is 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 laurels. It also impels them to control their costs or even bring costs down by process innovation (which is reflected in a lower supply schedule S* in Graph 7). Innovations cause expenses and often force producers to scrap old equipment to upgrade their production methods (“creative destruction” of old, but serviceable capital stock). Managers are forced by competition for market share to streamline their procedures, take risks, control their subordinates, and eradicate avoidable costs and on-the-job consumption. All this is good for the wealth of nations. 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 intervention to protect their market niches. Thus, car producers will invest effort and resources in lobbying politicians, bureaucrats and the public for protection from foreign competitors. The car producers will tell the industry minister and the bureaucrats that their duty is to provide 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 protection featherbeds, with the nation-wide employment and investment level, which is undermined by industry-specific measures, such as tariffs.

Often, it is of advantage for rivals on one side of the market to reduce the transaction costs of 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. Social critics of advertising tacitly assume "perfect knowledge" and conclude that advertising is a waste. In reality, potential buyers frequently 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 trial runs (for example, with new cars or nightclubs, where guests are invited to enter for a few minutes before they have to pay the entrance fee). 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 method is to offer warranties or money-back guarantees.

Another method of reducing information costs is to network or enter open-ended, more or less permanent contractual relationships. Dealing with the same stockbroker or the same tax accountant affords me cost-saving knowledge. 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 faceless and anonymous. Frequently it takes place amongst long-term friends and business partners who stick to shared rules of honesty, courtesy and reliability as a transaction-cost-saving strategy to beat the competition (see also Desai, 1998).

The Role of Middlemen

When community-wide institutions are ineffective and transaction costs high, as is typical of underdeveloped countries, there is often a place 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 with stockbrokers. In other instances, they become intermediary contract partners, as is the case in wholesale trade and with banks who contract separately with savers and borrowers. 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 solve numerous information problems.

Intermediaries are often unpopular, not only with people who assume that transaction costs do not, or should not, exist. The Jews, the Chinese and the Indian traders of East Africa form groups of middlemen who are of great service to their host communities. They convey knowledge and open new opportunities. Yet, they suffer persecution (Sowell, 1990). One possible explanation—not an excuse—is that these groups make themselves exclusive, engaging in monopolistic behaviour that gives the primary buyers and sellers the feeling that they are at the mercy of the middlemen. However, the problem is not solved by persecuting the middlemen. Then, the trade breaks down altogether, and buyers and sellers are worse off. In some South Asian agricultural industries, middlemen in agricultural produce have been replaced by government agencies, frequently to the detriment of the farmers. The solution is to create and enforce better general institutions which facilitate information search and equal market access for everyone so that middlemen have to compete or become redundant.

How Knowledge is Signalled to Others

Only after intending buyers and sellers have incurred sufficient search costs, will they strike a deal with someone on 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 (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 key signalling device in the market is the price. It conveys complex knowledge in condensed, coded form. If prices rise, this makes it profitable for suppliers to offer more of a certain product. The high valuation of that product by the buyers is signalled to other potential suppliers. As long as suppliers are allowed to appropriate the gains, they will have an incentive to provide more of what the buyers want. If suppliers discover an idea that is particularly highly valued by buyers, they will reap a "pioneer profit". At least initially, the return will be high. But a profitable price will also induce imitators to offer more of what is highly valued, or at least to offer close substitutes. This will bring the price down again and spread the advantage of the new idea to customers and the public.

Earlier, we considered what it took to launch the 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's commercial success, despite technical obstacles and patent protections. 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 of the use of photocopiers. The talents and knowledge of thousands of people were drawn upon in the effort to expand human knowledge. This was a true contribution to economic growth.

Profit thus has an important dual function: to signal knowledge and to serve as an incentive to improve valued human knowledge.

Alas, entrepreneurs frequently have to discover that their new product is not appreciated by sufficient "rupee 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 also 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 spontaneously. Products which citizens 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, which we might call "the rupee democracy of the market".

Price changes (as well as corresponding profits and losses) constitute the "radio signals" that 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 or by allowing the "static" of inflation to overlay the price signals, they pave the way for inefficiencies. 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.

To illustrate the practical relevance of the competitive system and its marvellous effectiveness in communicating knowledge, we may look at the famous "oil crisis" of 30 years ago: In 1973–74, the OPEC oil cartel quadrupled the price of crude. This raised the income of the oil producers in the short run, but reduced it over the long term. People around the world began to drive less, and—in the longer run—replaced their 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 and solar energy). Exploration for new oil, new technologies to crack petroleum and many other costly knowledge-search processes to cope with the problem were set in motion. The efforts of millions of people in all corners of the world were triggered by one signal—the higher oil price. The price increase also served an important motivational role. With time lags, 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 tried to protect the American people from foreign-made petrol price increases. He caused unexpected shortages and queues at gas stations, and was thrown out of office by the voters. The economists who had counselled the public to trust the power of the market were again proven right!

This episode 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, or whatever? The simple-to-interpret price signal did the trick! The market thus economised on everyone's knowledge problem.

Let us sum up this part of the argument. Intense competition in the market economy has 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 success 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 (signalling function).
c) It signals failures through "red ink" and induces the spontaneous, automatic abandonment of those property uses which are not sufficiently highly valued (control function).

The Responsibility to Compete

We saw that most people are naturally reluctant to compete, ie. to incur those insidious knowledge-exploration costs and that the mental obstacles to intense rivalry and knowledge search on both sides of the market are considerable.

Yet, it is important that these obstacles are overcome. Otherwise, there would be little prosperity and freedom of choice. Owners of property are of course free not to compete. But those who refuse to compete must anticipate that their property will lose value, as rivals capture market share. Owners who refuse to accept the challenge of competition thus have to accept the consequences in the form of possible losses of their property values and a possible reduction in their socio-economic position.

In the interest of well-functioning markets, such people must not be allowed to run to the government or conspire among themselves to avoid such losses. In a dynamic economy, positions must be revalidated by competing, time and again. It is absolutely essential for prosperity and the functioning of the capitalist system that the stimulus of competition is 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 destroy an essential mechanism of coordination. If opportunistic parliamentary parties, ministers, civil servants and judges protect or compensate unwilling competitors, they directly undermine the constitution of capitalism and detract from our freedom, security, prosperity and justice (Berger, 1987).

Property owners, including the owners of labour, who shirk the costs of knowledge search, will of course resent their losses. 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, culturally and militarily. Economic nationalism—by means of trade protection, control of foreign investment, "Buy National" campaigns, 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 well-organised trade unions to face open competition, defending the closed shop and privileges that could not be maintained in a competitive labour market. The third world is full of examples where protected unions have de facto taken over an industry and exploit the rest of the citizens, often sharing their ill-gotten advantages with political leaders.

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 interferes! In competitive open economies, such as the American economy, few of the top 500 richest stay on top for generations. Innovators challenge them ceaselessly.

No one's creative ideas flow ceaselessly. Established property owners will therefore often 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. Many observed "social injustices" are the consequence of such political interventions and their unintended side effects. Thus, the tariff protection of privileged industrial jobs by governments goes always inordinately at the expense of the poor. Most monopolies survive only because of government support (Friedman, 1962).

Of course, one can find numerous intellectual and administrative critics of a system of secure 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 unjust and inequitable outcomes. 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 in the developed world nowadays belong to a middle class and that there is constant turnover amongst the rich.

There can of course be no doubt that any economy is at any one moment typified by rich and poor people (inequality of outcomes), as well as by great differences in opportunities (iniquity of opportunity). Not all suppliers of products, ideas, capital and labour are "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 incur 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 Naomi Campbell in the modelling market . . .).

However, such inequalities are normally temporary, unless artificial obstacles to competition are set up by corrupt governments. Inexperienced, low-skilled or handicapped people cannot easily compete in the labour market because of minimum wage laws. The minimum wage, closed shops, import controls, a Byzantine structure of industrial relations, labour cartels and administrative practices are the source of much inequality of incomes. In the welfare states of the West, 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. Numerous interventions in product markets—from building codes and industrial regulations to tariffs—are adding to the inequalities of outcomes. Governments thus often deny citizens more equal opportunities. Those who are well organised tend to obtain political protection from open competition at the expense of the unorganised. Positions of relative economic power are translated into artificial political protection from the responsibility to compete at the expense of newcomers and outsiders. As we shall see in the following chapter, public choice has often displaced private competition, and political discrimination replaces the equality of opportunity.

One can, therefore, not criticise the competitive property rights system as discussed here with examples of iniquities in a highly distorted economic system. A glance at more competitive market systems overseas may suffice to demonstrate that genuine, open competition and the protection of private property can yield a high degree of income 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! And the liberalisation of the New Zealand economy has opened many new opportunities to previously disadvantaged groups, as is shown by disproportionately large drops in the unemployment rates of Maoris, women and the long-term unemployed. It is also worth looking at the evidence about economic growth, poverty eradication and inequality, which we reported in Chapter 1.

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 everyone in the community over a redistribution of a given economic cake.

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 1: Do we deal with the rationing of scarcity (economising), or are we involved in the enterprise of discovering new wants and new resources (catallaxy)?

The genius of competition facilitates innovation, freedom and self-realisation, as well as making for a cooperative rather than politically divisive social climate. A climate of competition and enterprise in all parts of the economy is a public good. The benefits of competition spread far beyond those directly involved in competing in a market. The institutions that make for genuine, open competition therefore deserve protection by government. This means that collective action should protect the universal institutions of private property and freedom of contract for *all* citizens and desist from discriminating between citizens by licensing, subsidies, specific taxes and other such corrupting interventions in market processes.

The Limits of Public Choice

"The statesmen who should attempt to direct private people in what manner they ought to employ their capitals, would .... assume an authority which . . . would nowhere be so dangerous as in the hands of a man who had folly and presumption enough to fancy himself to exercise it."

F.A. Hayek, Road to Serfdom, *ch. 5.*

"[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.

"Democracy is a way to rule the state, not a way to rule society."

J. Norberg (2001), p. 257.

The Shortcomings of Collective Choices

So far, we have discussed private choices to coordinate individual decisions about property uses. However, it is not always possible to attach private property rights to assets, as we saw in Chapter 4 when discussing public goods, externalities and common goods. When either the supply or the demand for an asset cannot be made exclusive, it becomes necessary to make collective choices about asset uses. Then, matters become much more complicated, as public policy is not subject to the same disciplines of market competition. This is so for the following reasons:

a) Instead of two 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 less welfare and complicated trade-offs.
b) Whereas individual contracts can be tailored to suit the two parties, collective solutions normally have to obey the maxim "one size fits all". Most people's diverse aspirations are then less well satisfied. In other words, the market can serve you à la carte, whereas collective provision

offers only one set canteen menu. Where there is less variety, there is also less potential for discovery and progress.

c) Collectives, such as governments, have to aggregate individual preferences, often relying on appointed or elected agents. They proceed on the basis of more or less agreed voting procedures, many of which inflict considerable political coordination costs.

d) Government agents are often elected or appointed on the basis of political patronage and owe little allegiance to those whose preferences they are supposed to represent. The principal-agent problem often leads to collective decision makers acting corruptly in their own self-interest and the population remaining ignorant of what their agents really do. A free press may make government more transparent, but the rulers are frequently capable of capturing the press. Governments buy newspapers, radio and TV stations and make the government-owned and private media part of the ruling elite. Principal-agent opportunism tends to be controlled effectively by market competition, but it is hard to recreate a similar discipline where matters are decided by government, ie. a power monopoly or a cartel among elite groups of the society. This is an eternal problem even in long-established democracies.

e) In bilateral market contracts, the give and the take are clearly defined. Both contracting parties believe that they gain from an exchange because what they trade is at least equivalent in their eyes. By contrast, 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 (moral hazard). Consequently, considerable monitoring and compulsion are required. Tax contributions to collective activities require compulsion, inflicting high agency costs. This often causes feelings of powerlessness 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. Because it is costly for the citizen-principals to keep themselves informed of complicated government actions, political agents are often inherently beyond proper control. This reinforces the danger of major and intractable principal-agent problems in politics.

f) In democracies, the re-election motive dominates collective action. It is therefore likely that time horizons in political choice are shorter than in private choices. Whereas private citizens often look beyond their lifetime to the well-being of their children and grandchildren, elected politicians, from the day of gaining office, think mainly about their re-election in two to four years' time.

g) In modern democracies, the free will and the responsibility of elected people's representatives are limited by the demands that political parties impose on parliamentarians. As a consequence, most political decisions are in reality made by small, powerful backroom committees, and not the elected majorities of the representatives who are directly responsible to the citizens. It is quite common in political decision making, that a few keenly interested persons dominate a committee that 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 exploitation of the majority by avid, self-seeking minorities.

h) This problem is aggravated by the combination of

- small, organised interest groups who have much to gain from political preferment,
- an electorate which faces high information costs and therefore remains "rationally ignorant" about the business of government, and
- organised political parties of parliamentarians who will do almost anything to obtain the support and financial donations to get re-elected.

Rent-seeking, rent-creating, opportunistic crooks who neglect the will of the citizen-principals are therefore endemic in all political choices.

For these reasons, collective action is very much a second best to private action in coordinating human activity, except in a limited number of circumstances. This leads one to conclude that government should constitutionally be limited to a few areas, and that as much of economic activity as is possible should remain private (Graph 8). One also has to conclude that the agents of government have to be controlled so that they do what the people desire rather than seek their own ends.

Before we can discuss these important concerns any further, let us look at the functions of government.

The Functions of Government

At various points we touched upon two roles of 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. This is the protective function of government. And when discussing the various forms of property in Chapter 4, we saw that not all assets can be assigned to exclusive private ownership. There is a case for government getting involved in providing, even producing some public goods (productive function). In other words, government has protective and productive functions. In addition, elected parliaments in mature democracies have greatly expanded an additional government function: redistribution by confiscating the property rights of some and allocating them to others[1]. Indeed,

[1] 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 (protecting holders of monetary assets from 'cold expropriation by

Graph 8: Private and Public Choice

	Private Choice	Public Choice Collective Action
Exchange:	reciprocal direct given and take	multilateral indirect
Shrinking:	monitored, curbed by institutions (contract)	shrink 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- petitiors economises on need to know (division of knowledge)	control by authorities, rent-seeking prevails; "rational ignorance",
Monitoring/ enforcement:	often spontenous	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 right can be attached to assets and the benefits/costs of their uses).

this has been the biggest cause for the relentless expansion of government in the 20th century (Buchanan, 1975).

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 the application of a rule has sometimes unwelcome or politically unpopular specific outcomes. Placing time-tested, non-discriminatory institutions above the pursuit of specific outcomes requires genuine, far-sighted leadership and strong constraints on political opportunism. In present-day democracies, elected politicians, as well as

---

inflation'). Beyond this, experience has taught us to doubt the capacity of governments to stabilise aggregate demand, let alone demand in particular markets. Price stabilisation in particular markets may serve particular interests, but it tends to undermine the overall coordinative efficacy of the market economy.

unelected judges and bureaucrats, are under pressure from well-organised lobby and advocacy groups, who pursue particular outcomes ruthlessly. They do so irrespective of whether this violates the time-tested rules of society or not. In their pursuit of votes and financial contributions, many politicians become the captives of such interest groups. They may even abandon the core values of their professed political creed and betray the core function of government, namely to ensure the non-discriminatory protection of universal rules (Downs, 1957; Olson, 1965; Tollison, 1982; Sowell, 1990).

In some instances, governments of course have to prescribe certain outcomes, for example setting health, environmental and other standards (Chapter 3). This is widely accepted in the community as legitimate because such government activities help citizens in economising on information costs and in feeling secure. When government agencies, for example, license certain pharmaceuticals, they save the citizens high, if not fatal costs of finding out whether or not a certain drug is effective in controlling a given medical problem. However, the proliferation of specific, prescriptive protection can easily undermine private initiative and the spontaneous order. As Ludwig von Mises demonstrated as long as half a century ago, proliferating and supposedly well-meaning protections pervert the spontaneous market order and make it as ineffectual as a centrally controlled economy (Mises, 1949).

Caution with the political supply of specific institutions seems advisable also because outcome-specific prescriptions tend to have unforeseen side effects. They tend to cumulate so that competitors become insecure and people shirk knowledge-exploration costs. Another side effect of pervasive, prescriptive regulation is 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). Then, the question arises whether the resources absorbed in complying with and enforcing such regulations, which cost tens of millions of dollars, could not be employed more effectively to save human lives. When certain risks are accepted and the “insurance” costs are saved, it may be possible to buy more dialysis machines and save many more lives. In any event, one has to approach this issue with the realisation that collective regulation cannot protect all citizens from all risks!

The second function of government—the productive function—is often justified by writers who discuss public goods. When not all benefits and all costs of certain activities can be privately appropriated, the incentives of private property do sometimes not work well in allocating resources, or not at all. But this does not automatically justify the production of such goods and services by government-owned and -managed monopolies, as we saw. In reality, public production has of course been extended far beyond cases of pure public goods. Governments often set up public production—or entire nationalised industries—to control markets and resources and to raise revenue without having to incur the political opprobrium of taxing. This is why many governments nationalised the telegraph, power and rail systems in the 19th and 20th centuries; why governments run salt mines, oil companies and cigarette factories; and why many toll roads are collectivised.

In this context, one has to beware of a confusion within the language: "public good" means "public access good" (or "public domain good"), not "publicly produced good". What is often required of the government is to ensure that all members of the public have access to certain facilities. For example, schools and public transport, need to be accessible to all members of the public because of network and information advantages. But that means neither public ownership nor the management of power, communications, schools and transport under the unwieldy rules and disincentives which are prevalent in public administration.

It is now widely accepted that (a) there is general advantage in the competitive production of goods and services (cost control, innovative benefits of competing suppliers), and (b) access to such goods and services can be provided even for poor people by government-provided vouchers and similar public funding mechanisms, if that is desired. Thus, transport, 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 the community decides to do so on equity grounds.

This insight has given rise since the late 1970s, to an accelerating worldwide wave of privatisation. Between 1985 and 1995, privatisation amounted to an estimated $535 billion worldwide (O'Leary, 1995), and in 1997 alone $ 157 worth of socialised assets and publicly-owned trading enterprises were privatised. The countries with large socialised sectors, such as Italy and Australia, have been among the most avid privatisers. In some countries, such as the Peoples Republic of China, the inefficient public sector is allowed to whither away, with new dynamic privately owned firms taking over markets and carrying the burden of economic modernisation. The governments of many developing countries have successfully withdrawn from running hospitals, refineries, railroads, ports, agricultural trading networks and white-elephant airlines, freeing scarce resources for more important priorities and relieving politicians of the blame for poor service.

The benefits of private ownership and competition in controlling costs, enhancing product quality, and innovating products—as compared to public monopolies—are evident around the world[2]. Privatisation has also often

---

[2] Throughout history, shifts have occurred away from a big public sector to competing, private operators. The results have always led to rising prosperity. For example, when trading shifted from state temples in the competing city states in ancient Mesopotamia to private entrepreneurs, trading networks expanded, innovations flourished and wealth grew (Moore-Lewis, 2000, ch.3). When the new Han Emperors of China reduced the taxation of crop yields from 50% under the preceding Qin Dynasty to 3 per cent, they laid the foundation of a long-lasting prosperity and a Dynasty that lasted four hundred years.

Cultivating the Constitution of Capitalism

"Political power, then, I take to be a right of making laws with penalties of death, and consequently all less penalties, for the regulating and preserving of property, and employing the force of the community, in the execution of such laws, and in the defence of the common-wealth from foreign injury; and all this only for the public good"

John Locke, *Second Treatise on Civil Government (1690).*

"It is not the amount of physical resources that a country has within its borders that determines the wealth of its people. It is how the resources are employed, and the institutional environment within which they are employed that counts."

G.P. O'Driscoll, K.R. Holmes, Jr., M. A. O'Grady, *2002 Index of Economic Freedom (Heritage Foundation, 2002), p. 43*

Coming to Terms with Globalisation

Everywhere, both in rich and in poor countries, the tug of war continues between

a) a vision of simple, universal institutions that coordinate autonomous individual behaviour and facilitate spontaneous economic growth, job creation, social peace and confidence, in short a vision of economic freedom, and

b) the reality of interest-group politics, party finance and parliamentary, bureaucratic and judicial *ad hoc* interventionism.

Many aspire to live under simple institutions which they can understand. They hope to arrange their lives and businesses free from confusing, selfish political activism and unpredictable interventions. They want the institutional framework of their lives to remain predictable. They want public policy and political leadership to back a rule system, which inspires trust. When politicians, judges or bureaucrats initiate yet another convulsive change or the military seize power, citizens deeply resent it. Changes from above produce unforeseen side effects and yet more confusing corrections!

Ordinary citizens often seem to understand instinctively how little the masters of public policy really know and can know. When political changes annoy or confuse them, some may try to exercise the exit option, at least with some of their capital. When this is not feasible, they voice protests and show their disaffection. When that also fails, they withdraw their loyalty, as Albert Hirschman predicted in his well-known book *Exit, Voice and Loyalty* (Hirschman, 1980). In many states, the majority of citizens seems to have reached a state of mind where they feel little loyalty to collective action and the wider community. In many developing countries, very little sense of collective loyalty has developed, and politicians are not trusted because they do not protect the rights of the individual.

Citizens also want specific, government-guaranteed outcomes. Sometimes, people do not even see the contradiction between confidence, order and a spontaneously effective community on the one hand and demands for “outcome engineering” and government hand-outs on the other. The fundamental conflict between a competitive market economy, which opens fair chances for most and distributive political interventionism is not widely perceived as such. Pressure-group spokesmen in parliament, in the bureaucracy and in single-issue advocacy groups do little to clarify this contradiction. It is therefore not easy to obtain political support for reforms that simplify the rule system, restore stability, confidence and pave the way for self-responsibility.

Because citizens often harbour such contradictory attitudes, politicians, bureaucrats and judges are able to circumscribe private property rights and restrict individual liberties in the market. The agents of government—whatever their professed ideology—are loath to make themselves superfluous by ceding ground to more coordination by markets. A minimal state is simply not in their interest. It is the citizens who will have to fight for it, but the citizens remain “rationally ignorant”. The fundamental conflict between private and collective action thus persists in many areas.

At the start of the new millennium, most developing countries have reached a critical crossroads in their political and economic development:

a) whether to embrace the cosmopolitan spirit whole-heartedly in order to complete the liberalisation agenda—still a major reform task for many nations—and to create the conditions that enable residents to compete freely, confidently and successfully for the rapidly growing number of jobs in the world; or
b) whether to fall back on the instincts bred in the long era of discretionary politics and protectionism, hoping that they do not need to rival all that hard with others and do not have to incur too many knowledge search costs in discovering modernity.

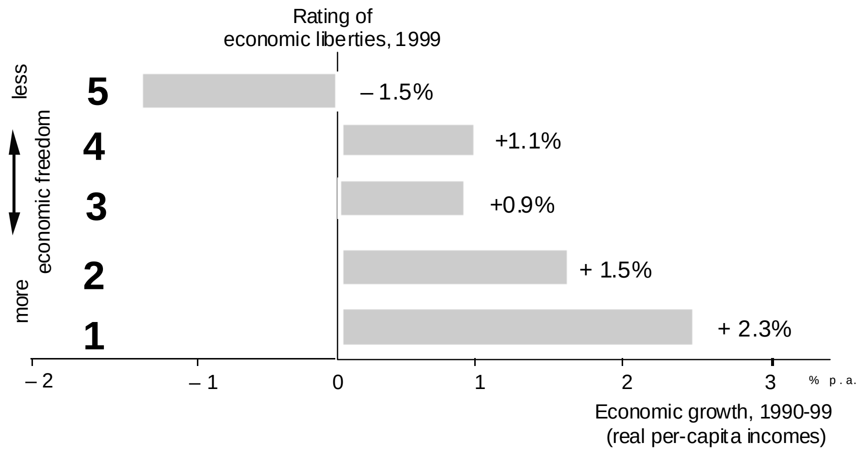
As of the beginning of the new millennium, policy makers and their advisors have certainly understood that openness and globalisation affect all nations in profound ways. Producers in developing countries, despite government-made handicaps, are now turning into spontaneous winners in global markets, most notably those in East Asia, but now also increasingly in India and Latin America. Among them are many service exporters. Globalisation also benefits those who win domestic market share using newly imported capital and knowhow, and also those who can benefit from better, cheaper imports. But of course there are also some losers, in particular people who believed in assurances of protection by previous, corrupt governments, and committed their capital, skills and careers to industries that were viable only with political protection. The losers from globalisation-driven reforms can also be found among politicians, military elites, unions, and community organisers. They are losing their customary grip on power as they are confronted with the "exit threat" of some of their constituents and are forced to abandon corrupt old ways, or are swept from power altogether. In countries where traditional tribal rules are still the dominant model of thinking about community life, the new challenges of equal liberty for all is in direct contradiction to the old hierarchical order. This 'clash of cultures' causes considerable frictions in everyday life. To overcome this clash of the modern and the traditional institutions requires time and a clear commitment to simple, universal institutions on the part of the ruling elites.

In many developing countries, pervasive interventionism since independence has created a *privilegentsia* of regulators, monitors, arbitrators, activists, industrialists and camp followers, who have a well-defined interest in perpetuating the interventionist culture (Chakravarti 2000). When the rules are simplified and streamlined, those used to organising individuals by command (such as military men who understand only command and control) naturally feel a sense of deprivation. Many who are still subjected to a government-made, top-down order feel a sense of comfort in this and may feel threatened by the uncertainties of a competitive, open world. Many have not yet discovered that continuing the government-provided certainties is an impossibility. The open society, with all its uncertainties, as well as its great promises, is here to stay for all citizens on earth.

Indians, too, have to realise that any modern rule system has to work with spontaneous self-organisation and competition. The rules and prescriptions must be simple and universal to allow individuals to cope constructively and expediently with the rapid and pervasive changes of modernisation. The insight that society and economy are complex evolving systems—where clumsy and frequent interventions are as perilous as in ecological systems or human medicine—must become part of the political culture. The know-all delusion of economic interventionism, which was able to develop in the closed economy of a simpler earlier era, will be overcome only when this fundamental fact is widely understood.

Much valuable and clear evidence has been accumulated in recent years which underpins the new institutional economics (see Insert below). The key message is that free markets and secure property rights, which are protected and administered without favoritism and under the rule of law, are more important than this or that government action programme or new development scheme. Graph 9 shows important and weighty evidence: It shows the economic freedom ratings, based on a thoroughly researched index of economic freedom for 123 countries, in relation to economic growth during the 1990s. Countries were grouped into five groups, ranging from economically most free to least free, and their average economic growth rate was calculated. It can be seen that economic freedom has a direct and powerful influence on economic growth. The "Economic Freedom of the World" reports also document that economic freedom goes along with high living standards, high job creation, low incidence of poverty and a long life for the average citizen (Gwartney-Lawson, 2001, chapter 1). We note in passing that India has always had a rather poor rating, being graded amongst the least free countries a notch wave "economically repressed".

Graph 9: Economic Freedom and Prosperity



Every year, the Fraser Institute, a Canadian think tank, surveys information for a systematic index of economic freedom in 123 countries. The Centre for Civil Society is a copublisher of this report. These countries are then grouped into quintiles, ranging from most free to unfree. The average economic growth rate for each quintile is depicted above. It can be seen that the countries with the most regulations and poorest protection of private property rights experienced economic decline, whereas the citizens in the freest economies managed an average annual growth of 2.3 per cent during the 1990s. The freest 20 per cent of economies enjoyed living standards of nearly US-$ 20, 000, on an average 18 times more than the 20 per cent of countries with the least free economies.

Source: Gwartney-Lawson, 2001, p. 9–12.

Tried and True Way to Economic Growth

The Heritage Foundation in Washington has just published its economic freedom ratings for 2002 [with India in a poor 125th position out of 155 countries, being rated as "mostly unfree"].

But the Heritage report, as well as work done by the Fraser Institute in Canada, does something much more important than publishing league tables on the quality of property rights and non-interventionism. It adds convincing evidence to a new theory of economic growth, namely that 'it is the traffic rules, the institutions, stupid, that make for poverty or prosperity!'

The same conclusion emerges from a weighty new empirical research by two American researchers, Richard Roll of the University of California and John Talbot. Their research has shown that 85 per cent of all differences between the poorest and richest societies—ranging from US-$ 440 in Sierra Leone to over $ 41 000 in Luxembourg—is explained by differences in the protection of private property, civil liberties, political and press freedom, as well as the absence of black markets, discriminatory regulations, inflation and barriers to free trade. This observation holds true between countries and over a period of time. Liberal economic reforms and the assertion of basic economic freedom have invariably boosted economic growth, as well as high employment, the reduction in poverty and improvements on many other social fronts.

Post-war economic reforms in Germany and Japan, subsequent improvements in economic freedom in East Asia, even the Peoples Republic of China, and more recent reforms in countries such as Australia have been rewarded by economic prosperity. Only analysts who disregard institutions could call these episodes 'economic miracles', i.e. outcomes that cannot be rationally explained. Interest groups which seek and extract political favours, parliaments and judges that grant them, and politicians that distribute opportunistic hand-outs have to be seen as the main enemies of broad-based and sustained prosperity.

The research confirms what common sense and some economic theories have asserted all along. Prosperity, and all its benefits, depend on the division of labour and the effectiveness of coordinating millions of specialised producers. If these are made to compete, time and again, and can do so with trust in simple, reliably enforced 'traffic rules', they will be a genuine knowledge nation and offer bountiful economic opportunity will growth and high employment for most.

The good news to emerge from these insights is that the institutions—the rules of human coordination—are man-made and therefore can be altered by us.

The new growth theory has powerful policy implications, which are now being absorbed in Washington and some other capitals, though not yet in the traditional policy establishments of industry departments, international organisations and many parts of the third world.

One policy consequence of the insight that poverty is the result of insecure institutions and discrimination, now contributes to the decline in foreign aid. Countries that have implemented competitive markets and protected private property cannot remain their mismanaged brothers' keepers forever. Aid is being concentrated on short-term emergencies after catastrophes and is channelled away from avid aid claimants, who keep violating the most basic economic and other liberties. With rampant cronyism, foreign trade restrictions, expropriation and wide-spread market distortions, even copious aid will have no effect on alleviating poverty and extending life spans. The implication for national policy makers and the World Bank is to make foreign aid conditional on institutional reform. With economic reforms that implement high standards of economic freedom, a good investment climate will be ensured and "the investment dollars will magically appear", as Roll and Talbot put it, so that most aid becomes superfluous.

Another policy implication of the new growth theory has to do with the fact that prosperity is not driven by what many economists have asserted, for example a high investment rate, high R&D spending or a big share of foreign trade. These are proximate causes of growth. They beg the immediate question: Why are investment, R&D or international trade high in some countries, but not in others? The real and deeper reasons lie with secure property rights, the freedom of contract and the equality of all before the law. Government policies that promote investment or research and development by artificial means, target superficial symptoms and induce a waste of resources on lousy projects. What is worse, they introduce favouritism and detract from the equality of all before the law. Over time, governments thus erode genuine economic freedom and weaken the economy's spontaneous growth potential.

The New Constitutional Economics

The dilemma in which we now find ourselves can be clarified and promising solutions can be found, if a new discipline of economic analysis—Constitutional Economics—is taken seriously. It is based on two premises, namely that institutions matter and that the institutional system can and needs to be enhanced by conscious reform. In particular, the simple rules of protected, respected private property rights and private autonomy require fostering. These rules do not only matter for the rich and big business, they determine everybody's opportunities in life: what work we can do, whether employment is a matter of free, private choice, what life opportunities there will be for the young, how we can employ our skills and whether we have opportunities to be creative and entrepreneurial and lastly how much of the proceeds we will be allowed to use for ourselves.

Constitutional economics is becoming popular around the world because institutional systems have come under scrutiny everywhere (Scobie-Lim, 1992). Growing numbers of economic analysts now recognise—again—that the dynamic efficiency of different national economies depends on their institutions (see, e.g. Buchanan, 1991; Scully, 1991; Porter-Scully, 1995; Kasper-Streit, 1998). The socialist rule system in the formerly centrally planned economies has imploded after causing so much pain. It is now realised, just how ineffectual the alternatives to the capitalist market economy were. This has given further impetus to the new approach which takes institutional economics, as outlined in previous chapters, one step further, namely to the insight that disappointing institutions can be redesigned, not only by piecemeal repairs after mishaps, but through comprehensive, forward-looking reforms (McKenzie, 1984; Brennan-Buchanan, 1985; Gwartney-Wagner, 1988; Voigt, 1996, 1997; Kasper-Streit, 1998)). Constitutional Economics—the analysis of the socio-economic performance of alternative rule systems—often deals with normative aspects, namely the desirability or otherwise of alternative institutional systems. But, more recently, overseas researchers have begun to measure and analyse the positive-economics aspect of Constitutional Economics:

- What are the objective outcomes of alternative rule systems? What, for example, are the effects of differing voting procedures?
- What can be said about the merits of openness to trade and finance and its effect on economic performance? (for an overview, see Voigt, 1997).

Once one adopts a Constitutional Economics frame of mind, one begins to ask important new political questions, for example:

- Do the higher economic growth rates in the United States and East Asia, as compared to india, have something to do with Indian rule systems, in particular lack of economic freedom, rampart discrimination and lean governance?
- Is the poor economic performance of India due to poor economic institutions, as suggested above, and whose fault is this? More importantly, what institutional reforms can be implemented to liberate Indian citizens and give them the life opportunities that people in freer economies are enjoying?
- What institutional deficiencies have evolved in the years since political independence? Need they be rectified? What rule changes will be needed to allow Indians to re-accelerate economic growth in a sustained way, so that they can, in 2030, live as well as East Asians now or Americans a hundred years ago? Such achievements are feasible.
- How can rules be devised to ensure a clean relationship between business and government? And how can a competitive economy contribute to racial and religious harmony?
- What features of India's present political constitution are harmful to the chances of Indians succeeding in the global competition? How can the unbridled political opportunism of leaders be constrained?
- How can one devise fundamental, high-order institutions that prevent governments from intervening on behalf of specific industries, groups or regions in economic processes, when this is likely to undermine private autonomy, property rights and equality before the law?
- How can the judicial system be used to cultivate binding rules that hinder rent-seekers from going against the interests of the electorate?

An explicit awareness of *Institutional Economics* (that effective institutions matter) and of *Constitutional Economics* (that the systematic, comprehensive reform of the rule system will enhance prosperity, freedom and confidence) can do much to promote prosperity and social harmony. To this end, existing arrangements and rules must not be taken for granted. One should ask how good rules can be developed and turned into productive social assets—and how bad rules can be effectively suppressed.

India's Institutions

Table 1 shows the quality of institutions from the standpoint of economic freedom and norms of good corporate governance for a range of developed and developing countries in Asia and the Pacific, so as to cast India's present institutions in an international comparative setting. It shows that India's institutions that influence the climate of doing business in the country are rated at best mediocre: equals 41st out of 59 countries. This index is compiled on the basis of numerous judgements by internationally experienced business leaders, which the respected World Economic Forum in Geneva, Switzerland, publisher annually. The same insight is offered by the renowned Index of Economic Freedom, which the Fraser Institute in Canada publishes annually and which assesses how well a nation's regime complies with the maxims of secure property rights, free contracts and equality before the law India is ranked a poor 74th out of 123 countries (Gwartney-Lawson, 2002), well short of truly successful competitors in global markets, such as Singapore and Hong Kong, which are of course trading cities where the commercial benefits of reliable rules are well understood. It is also worth noting that India is still a rather closed economy, still rated 80th out of 91 countries in 1999, and way behind the East Asian growth economies.

Producers in other South Asian countries have to cope with similar handicaps of restricted economic freedom (Table 1).

Table 1 gives an indication to those readers who have accepted the logic of the argument in this essay, just how much reform work needs to be done until one can be confident that the institutional underpinnings for sustained growth and success in the global division of labour are in place. The reform work will require not only energetic and inspired legal and economic reform on the part of the various levels of government, but also changes in social psychology and the internal institutions of Indian society. This will be neither easy nor fast, and the drive must come from Indian political entrepreneurs, not outsiders. Once the political will is there (as it now is in China), Table 1 can, in my view, point Indian reformers to countries that have been successful and that are now magnets for internationally mobile knowhow, capital and enterprise.

This essay has been an attempt to alert readers to the big gains that can be made by cultivating the right institutions and giving a competitive, capitalist market economy a simple and solid underpinning (Chakraverti, 2002). We

Table: 1
The Quality of Institutions in Asian and Pacific Countries

Country	Per-cap. inc. US-$, PPP 1999	Growth rate (% p.a.) 1990s	Institutional Quality (out of 10) [av. rank out of 59 countries]		Fraser Index of Ec. Freedom 2000 [rank*]		Fraser Index of Openness 1999 [rank**]	
USA	28 698	2.1	7.2	[17]	8.6	[2]	7.8	[10]
Australia	20 696	2.4	7.3	[16]	8.1	[10]	7.2	[19]
New Zealand	15 222	1.1	7.5	[15]	8.2	[6]	7.4	[15]
Singapore	23 582	5.8	8.6	[10]	8.6	[3]	9.8	[2]
Hong Kong	20 352	1.7	7.7	[14]	8.8	[1]	9.9	[1]
Japan	20 431	0.9	6.2	[=24]	7.5	[20]	6.5	[28]
Taiwan	15 720	3.6	6.2	[=24]	7.2	[33]	7.2	[19]
South Korea	13 317	4.8	4.6	[35]	7.0	[43]	6.6	[26]
Malaysia	7 328	4.0	5.1	[33]	6.6	[57]	7.8	[10]
Thailand	6 398	3.6	4.1	[38]	6.6	[56]	6.4	[30]
Philippines	2 291	2.0	3.3	[45]	7.0	[44]	6.3	[31]
China	3 259	6.4	3.8	[40]	5.3	[102]	5.2	[50]
India	1 818	3.4	3.8	[=41]	6.1	[74]	3.5	[80]
Indonesia	3 031	2.1	3.1	[46]	6.3	[69]	6.1	[36]
Vietnam	1 677	5.1	3.7	[=41]	n.a.	n.a.		
*Bangladesh****	*835*	*3.0*			*5.1*	*[107]*		
Burma (alias Myanmar)	*1 050*	*3.8*			*3.6*	*[122]*		
Fiji	*2 634*	*n a*			*6.1*	*[73]*		
Mauritius	*4120*	*n a*			*7.3*	*[30]*		
Nepal	*954*	*1.9*			*5.9*	*[81]*		
Pakistan	*1 952*	*2.3*			*5.1*	*[108]*		
Papua New Guinea	*n a*	*n a*			*5.7*	*[88]*		
Sri Lanka	*3 451*	*3.9*			*6.0*	*[78]*		

* Gwartney Lawson, 2002
– Ranks out of 123 countries.
** Gwartney-Lawson, 2001, 91-98. Ranks out of 91 countries.
*** Most of the countries below were graded by the Fraser team on the basis of a reduced number of indicators.

have tried to outline the underlying concepts and ideas that need to be grasped before a country's institutional handicaps are undone, and before the rules are made more business- and citizen-friendly.

Reformers in India will be assisted by the fact that the tide of opinion on these matters has begun to change in advanced and developing countries alike.

Far-sighted Indian reformers might be inspired by what James Buchanan, the 1986 winner of the Economics Nobel Prize, wrote a decade ago: “Without the glitter of romantic delusion and with a hard-nosed understanding of the limits and the potential of ordinary politics, we may be able for the first time in more than a century to reinterpret our Constitution and/or redesign and reform it to exploit the full potential of a free people” (Buchanan, 1988, pp. 262–63).

lessened the rents reaped by the workforce and the management of socialised firms. It is therefore not surprising that organised labour, public-service lobbies and some managers of government-owned enterprises 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 the 20th century. In the mature welfare states of the west, a very large part of public budgets does not go to protection and service provision, but is expended for the purpose of hand-outs by subsidy, and most of the publicly-owned production serves in reality the government's redistribution and patronage function. 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. If food prices are fixed at low levels, this is a political transfer to the urban population, which disadvantages the farmers and generates food deficits. And if petrol prices are fixed below world market levels, this deprives everyone of export income and burdens the budget. Of course, all such redistributive policies divert resources and taxpayers' money into bribes that serve politicians to get re-elected. To better understand the enormous expansion of the redistributive function in most countries, one has to turn to the phenomenon of rent-seeking in politics.

The Game of Rent Creation and Rent Seeking

Citizens, who face high information costs about what happens in politics and who know that they have little influence over collective decisions, are rational in choosing to remain ignorant about parliamentary and bureaucratic games of income and wealth redistribution. This increases the likelihood that their elected politicians and unelected bureaucrats will be tempted to act in their own interest to get re-elected or wealthy. They will not faithfully represent the—often poorly articulated—will of the people. Political choice therefore gives rise to corruption and massive principal-agent problems (Downs, 1957; Stigler, 1971; Buchanan, 1987; Buchanan *et al.* (eds.), 1991).

Rent-seeking by corrupt public servants can be illustrated with the example of tariff making. Parliamentarians, ministers and bureaucrats have much to gain when they respond to organised industry interest groups by intervening in market processes. They do so typically to discriminate against the many buyers of imported goods and in favour of the few local producers. A car tariff interferes with the freedom of citizens to buy cars from the best source by restricting the public's access to foreign suppliers. This allows the local (normally foreign-owned) vehicle producers to charge higher prices and to save themselves many of the troublesome search costs involved in new models and cost cutting (compare Chapter 5). If, for argument's sake, a country's market is 400,000 passenger vehicles per annum and the average car can be sold, thanks to the tariff, for $2,500 more, then each of four domestic car producers (and their workers) gain on an average $250 million annually—a massive, politically allotted windfall. For such a prize, it is certainly worth lobbying and bribing cabinet ministers and brow-beating the public! By contrast, the average household may buy a car every seven years, in particular when cars are overpriced and of the uninspiring quality, which is typical of the products of "tariff factories". Each household then bears an average, politically imposed loss of some $360 per year—not worth the effort to inform oneself of the harm done by the politicians and to lobby them against the tariff, which is 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. In heavily protectionist India, for example, the motor industry was still producing 1940s models in the early 1980s and selling them at inflated prices to the public. This is why protective, selective industry policies have been a worldwide disaster.

After visiting India in 1955, Miltan Friedman observed: "The sensible way for India to get automobile transportation is to import second-hand cars and trucks. But India in effect says," 'we are too poor to buy second-hand motor vechicles from abroad, we must produce new ones at home' (Shah, 2000).

Politicians produce and supply interventions, which redistribute income and wealth. In other words, they allocate rents not earned in the market. They trust that those whom they surreptitiously deprive of wealth and life opportunities will not notice or will soon forget. Those to whom they distribute privileges will often share the windfall with them or their parties and associates. Such redistributional interventionism goes far beyond tariff making and pervades every walk of life. Sometimes, organised unions extract political preferment (for example, political exemptions from the normal rules of contract law) in exchange for electoral support. At other times, organised professions and industries obtain political favours, for example in the form of subsidies for export or research.

Insert

Picking Winners: Can Anyone in Government Know?

The knowledge problem and consequent principal-agent problems in government are starkly highlighted in "industry policy". In particular, many developing countries have attempted to identify industrial winners by collective action instead of relying on competing private investors to find profitable activities. Governments are involved in interfering in market processes and industrial structures with the aim of advancing overall growth. The political fashion has long been to identify and subsidise supposed growth industries. However, this is now widely recognised as a costly way "to pick losers".

Can policy makers know any better than competing entrepreneurs where the future growth industries will lie, given the complexity and rapid evolution of the modern world economy? And are they more motivated than capitalists who risk their own wealth? These questions might perhaps be answered in the affirmative in new industrial countries where bureaucrats may be able to identify what has been successful in countries higher up the income ladder (e.g. post-war Japan, or South Korea after 1960). But even there, gross errors were frequent, e.g. the Japanese government telling Sony that transistors had no future, Honda that the car market was 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 been that political parties get corrupted and that industrialists shift their entrepreneurial energies from innovation to lobbying. The rent-seeking also leads to social tensions. It is instructive for example that in South Korea, the 20 largest and preferred *chaebol* have greatly under-performed when compared to the S&P 500 companies in the USA (average 1990-96: 4.7 per cent net profits as against 1.1 per cent in Korea, *The Economist*, 22 November 1997, p. 88). Many of them were the first to 'melt down' in the Asian financial crisis of the late 1990s. It is also worth noting that Korea has one of the most acrimonious industrial relations records, similar to formerly interventionist Australia. This is not surprising because industry policy is ultimately not about earning a rate of return, but about the good life for the managers and how to distribute ill-gotten rents.

Among most economists and international economic organisations, selective industry policies have therefore long been in disrepute as an instrument of economic growth (Burton, 1983). Governments simply cannot know. And political interests tend to outweigh the economic rationale and the citizens' interests.

Industry policy problems are lessened when governments confine themselves to generic supply-side policies, mobilising resources through education, research, savings promotion, opening up land and providing hard infrastructures. This is increasingly the style of industry policy in East Asia. Recent experiences with specific industry policies have taught costly lessons. For example in South Korea, government-sponsored *chaebol* conglomerates accumulated huge bad debts, in Malaysia firms close to the ruling political party made huge losses in government-sponsored projects, and in Indonesia a small circle of favoured cronies have caused what is wrongly termed a "monetary crisis"—it is an institutional crisis. The same might be said of the efforts of the Indian government constantly bail out PSUs wherever they fall in the red.

Political attempts to gain influence through rent-creation of course militate even against such general or generic supply-side policies. General industry promotion, for example by subsidising R&D or exports, have a habit of turning into subsidies for well-connected big firms, and they do nothing for small operators who do not have the time to fill in forms and visit ministries. Judging by copious international experience, there is a real danger that industry policy always becomes selective and will contaminate the probity of policy processes. 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 always violate the equality of all citizens before the law and hence the institutional principle of universality.

As selective interventions proliferate, the constitution of competitive markets is 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. Economic development slows down. The opponents of capitalism then find a reasonable amount of evidence to castigate capitalism. Those who favour capitalism are therefore well advised to also favour untrammelled competition and not to side with big producers who seek rents.

The Failures of the Welfare State

Nowhere has political opportunism by parliamentarians, bureaucrats and judges in interaction with single-issue groups had a bigger impact than in the expansion of cradle-to-grave public welfare in the mature Western democracies. But even massive redistribution policies have not worked to eradicate inequality and poverty. Many welfare programmes in reality 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.

The long-term availability of public welfare and the disincentive effects of progressive taxation have induced many citizens to cease making their own private, self-responsible welfare provisions by saving and acquiring work and life skills. The shift from self-responsibility to reliance on government agencies has led to much public posturing and lobbying and a loss of social harmony. The growing welfare burden of gradually ageing populations is frustrating the young generation, who feel disenfranchised and expropriated. In Western Europe, disaffection with public-sector inefficiencies and compulsory redistribution is growing and people discover that they do not simply want to be passive recipients of government hand-outs, but want to take responsibility for their own lives.

On a more fundamental level, government cannot logically fulfil its 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.

The increasingly obvious failures of the welfare state pose serious problems for most advanced democratic societies, many of whom still profess a commitment to redistribution and egalitarian outcomes. By contrast, none of the fast-growing economies of East Asia has developed a welfare state. Welfare is a private affair, a matter of personal saving and family solidarity. When this fails, private and religious associations may step in, and the government then becomes a rare welfare provider of last resort. In China, where government-owned firms were expected to provide housing, health and old-age support and have been failing to deliver, there are now moves afoot to set up private, portable savings schemes. In Latin America, where many governments used to promise welfare support and routinely failed to deliver, provision of old-age and health care is also increasingly a matter of private saving and professional, state-monitored investment. It appears that many developing countries will not repeat the failures of the welfare states of Europe.

How to Control the Opportunism of Political Agents?

The opportunism of the agents of government is an age-old problem. Throughout history, it has exercised the minds of many great thinkers and reformers, though with limited success. The need for checks and balances on those who shape and implement public policy is no less urgent in present-day developing countries. The extent to which well-designed and enforced institutions are adopted will determine whether corruption is controlled and economic growth unfolds. This requires not one-off action, but an eternal pursuit of economic freedom. Principal-agent problems in government can only be contained by eternal vigilance and concentric, multi-pronged controls (Olson, 1965).

a) Ancient philosophers, such as Plato and Confucius, saw great merit in relying on the moral education of future leaders. Nowadays many are rather cynical about this. Yet, public vigilance and intolerance of selfish, short-sighted opportunism in high political office are important bed-rock conditions for good government. This requires high moral standards in the community and the public censure of those who excuse breaches of the rules of law or ethical standards by corrupt office holders. The ultimate line of defence against the opportunism of office holders and their cronies is an innate probity of the public and a readiness of citizens of property to stand up for economic freedom. In poor developing countries, most citizens do not have the means to fight for high standards in courts and they have to rely on the weapon of public agitation and the democratic vote.

b) Another control device of agent opportunism in government is of course the periodic check of democratic parliamentary elections. One can also popularly elect heads of state, government leaders and other officials, such as judges, police chiefs and auditors, as is done in many walks of life in the US. It is also important to prohibit the sale of offices and commissions. If you or your father have bought your job, you do not have to work hard to keep it. Indeed you will try to extract as many bribes as possible to get a return on the investment. All this makes some public offices contestable. But how effective elections are in controlling agent opportunism in public office, depends ultimately on informed citizens and their fundamental values—and on the degree of their personal security. If legitimate opposition to corrupt practices leads to government sanctioned bullying or violence, the citizens' readiness to stand up for themselves is understandably reduced.

The democratic vote and other political freedoms have typically only been obtained *after* economic liberties were asserted. Once a European middle class arose on the basis of economic freedom, democratic constitutions followed in the 18th and 19th centuries. Likewise, the East Asian tiger economies of the 1960s and 1970s became electoral democracies with lively political debate in the 1990s, once the children of the new middle class realised that continued prosperity required more direct controls of erstwhile autocrats, who had started the economic reforms a generation earlier. There are cases such as colonial Hong Kong where a high degree of economic freedom and a competitive capitalist system long existed without political freedom. But such cases are exception. It is revealing, that of the 25 freest economies in the world, all but Hong Kong are democracies of long standing, and that the poorest and least free economies have no democratic control of government (Gwartney–Lawson, 2001, p. 9). In Africa and other parts, democracy and political freedom have often been introduced *before* economic liberalisation, and these democracies have often failed or worked less well.

Democracy functions much better when people have a certain amount of economic wealth (and are literate), so that they can defend their rights in courts, by public campaigns or electoral promotion of suitable and untainted candidates. This is not to say that democracy has no merits in poor countries, but there it appears to have a harder time of delivering appropriate and just controls of the wealthy and powerful.

In turn, democratic government tends to deliver a better protection of private property and the freedom of contract.

c) 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 implementors (administration) and the rule adjudicators (judiciary). Bi-cameral parliaments have a similar function of distributing power (Upper and Lower House).

The merits of the division of political powers are now widely recognised. In Westminster-style systems of government, the separation of powers is rather weak. Here, the parliamentary majority party or parties—or the leadership group—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 Supreme Court. Only when the Upper House majority is not matched by a Lower House majority, is there a parliamentary check on executive power. Even then, of course, political deals are done. As a result, parliament and executive in Westminster-style parliaments can get away relatively easily with discriminatory political interventions.

d) 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* made responsible for raising all requisite taxes to fulfil them, there is scope for effective mutual control. Competing States or provinces also have a considerable incentive to foster prosperity and a growing revenue base. Competing jurisdictions tend to offer attractive and citizen-friendly administrative solutions to collective problems. Competitive federalism induces governments to incur knowledge-search costs and to mobilise much valuable political-administrative creativity (Kasper, 1995). A lot can be gained from devolving certain tasks from the centre to the States or provinces. Yet, it must also be recognised that certain tasks of government are best left to a central agency, namely where there are distinct scale economies, such as defence, where there is great interaction, such as standardised traffic rules, and where competition amongst jurisdictions may have harmful consequences. Ensuring the same living conditions throughout the territory, irrespective of location, resource endowment and political behaviour must, however, not be an objective of policy if one wants an effective federal system. This objective only leads to income redistribution and stifles self-reliance and competition among provincial governments.

e) 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 fundamental framework rules, which constrain what elected politicians can do. This Legislative Assembly would be elected comparatively by age cohorts and for a long period, so as to ensure a degree of independence from the party system (Hayek, 1979, pp. 147–65). Hayek proposed that a traditional parliament, which he called the 'Governing Assembly' should be party-based and normally elected to pass enabling legislation, which compels citizens to act in certain ways and which appoints the administration. Hayek's hope was that the combination of a Governing and a Legislative Assembly would turn at least some parliamentarians into protectors of the citizens' liberties, a role British parliamentarians had fulfilled in the 18th century. To some extent, Hayek's Legislative Assembly could play the role of an independent Supreme Court (roughly as it does in the US). In large countries, the Legislative Assembly could also be constituted of members elected or appointed by regional entities.

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

g) Transparent information is needed about the conduct of collective action so that the electorate can judge whether office holders properly represent them. Such information is contained in annual budgets, public audits of the budget accounts, and the scrutiny of the conduct of office holders by a free press, academics, independent think tanks and other outside observers. Frequently, government officials manage to disguise relevant information to avoid scrutiny. Parliamentary privileges, limits on the freedom of information, defamation laws and other such devices are used to limit access to information about the collective actions of government. Care must therefore be taken that administrations do not erect such barriers to being scrutinised.

One way to promote transparency has been the recent proposal for governments to report not only flows of receipts and expenditures (the budget), but also its balance sheet of all independently assessed assets and liabilities. In other words, government has to reveal the same information that it demands of big corporations. This was successfully done in New Zealand with its *Fiscal Responsibility Act of 1994* (Kasper, 1996) and subsequently in Australia.

h) Agent opportunism in high office may 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, 1988; Brennan-Buchanan, 1985; McKenzie, 1984). Such rules may take the form of procedural constraints, for example prescribing a two-thirds majority to raise taxes or authorise deficit finance. Strict limits can also be imposed on the government's claim on resources, for example by sunset clauses on specific government programmes and formal limits on the size of the budget (as a percentage of the national product) or rates of taxation. Another result-oriented limitation is to oblige the government to adjust income tax rates automatically by the rate of inflation (so as to prevent the insidious method of tax creep, which pushes many ordinary wage earners in Western countries into high-tax brackets).

Politicians of course reject formal limitations of parliaments on the basis of the doctrine that Westminster-style parliaments must remain 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 parliaments absolutely!"

i) Another institutional control 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. There is much to be said for stimulating direct, democratic citizen involvement in political decisions at the local level, even in developing countries. In today's world, as schools and libraries obtain computers, it seems possible—at least in middle income countries—to allow citizens to initiate referenda by electronic means and to express their preferences by computer.

j) Given the increasingly political role of some Supreme Courts, 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, for example before a high-level gremium representing the people. 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 concentrated on procedural justice and on keeping the legal system coherent and universal, such checks were not necessary. But many Supreme Courts and their equivalents have been shifting to reformist activism and have become subservient to elected or unelected governments.

k) Arguably the most powerful control of political and bureaucratic opportunism is openness: free trade, free capital mobility and migration. When citizens disagree with how the government taxes, regulates them 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 often more effective "exit option" (Hirschman, 1980). 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 1). Now, similar international strictures are constraining the power brokers of East Asia. These strictures are resented, but, ultimately, they are effective in controlling political power. When the power instincts of rulers are constrained by the exit option, they will sooner or later learn to offer rule-bound, limited government as a way to attract resources (foreign investment), often despite themselves (Kasper, 1999).

  When international markets 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. Cases such as Burma, post-1975 Vietnam and many closed economies in Africa demonstrate the point.

Many newly independent nations were driven by tribal instincts of political power and economic nationalism. They have cultivated inward-looking attitudes by tariff barriers, investment controls and animosity towards multinational companies. This has empowered government agents and organised interests. However, the commercial necessities of the new age of globalisation began to tip the balance to openness and constrained government. Institutional reform has quite often followed an inconsistent, erratic course over the past two decades. Instead of embracing openness pro-actively and shaping highly competitive institutions to improve international competitiveness, as was done in many East Asian countries, reformers often act only under duress and hope to stave off the "affront of globalisation" wherever possible. They relapse into politically opportune interventionism when they think they can get away with it.

l) Development aid has normally been proferred to a established priviligentsia of the top-down rulers; and conditions of aid through which foreign aid-givers insist on changing harmful institutions have rarely been obeyed or enforced. This is why an increasing number of observers see development aid as an enemy of institutional reform and a support of harmful statism, and consequently an obstacle to economic development (Bauer, 1972; Bauer, Kasper, Siwatibau, 1991). Attacking and refusing foreign aid therefore may well be a means of facilitating pro-market reforms and replacing discredited political elites by new political entrepreneurs.

Not all of these reforms are equally applicable to developing countries, such as India. Other kinds of reform may be necessary to overcome age-old discrimination according to religion, caste or regional origin, which originate not in external institutions, but in internal rules of society. Modernity and development will automatically help to overcome some of these private discriminations, because in a market economy, discrimination is costly and competition punishes discriminators. Others will require external rules and their consistent enforcement. We have nevertheless listed some of the methods now being discussed around the world because some of these methods may one day be useful to defend a free economy and democracy.

Like a mother's job, the fight for citizen-serving government is never quite done! No single device will ever suffice to control inherent agent opportunism in government. The problem can of course be contained at its root by leaving as little coordination as necessary in the hands of collective action (minimal government). The linchpin to all the controls of agent opportunism in public office listed above is openness to trade, travel, the flow of ideas, investment and enterprise. It is the rock on which good governance, reliable property rights and individual autonomy rest in the face of ever-present political temptations of rent seeking and rent creation. Openness invariably goes together with high incomes and income growth induces the control of opportunism in government and promotes the provision of good, citizen-friendly institutions (Kasper-Streit, 1998, ch. 12). The top 12 countries according to an Index of Trade Openness were compared in a recent study with the bottom 12 out of 123 countries. The average income in the former group was an astounding 7.2 times that of the latter, and the economic growth rate in the 1980s and 1990s was 2.55 among the most open, as compared to only 0.3% among the least open (Gwartney-Lawson, 2001, ch. 3).

A country's own chosen trade and investment policy is much more decisive to the living standards of the people than foreign aid or initial factor endowment. This verity has not yet sunk in fully in many developing countries. Once the people wake up to the challenges of the age of globalisation, they will have to think hard how to create attractive institutions, which empower them to beat the global competition. Then, they will have to consider reshaping and universalising the fundamental rules of economic cooperation. In other words, the constitution of capitalism will be high on the agenda.

Centre Knows Best—A Satire

"Centre always knows better. Centre has the overview, at least the belief in their overview, and the card index. Men of limitless zeal busy themselves against each other at the Centre; yet, they tap you on the shoulder and say: 'Dear friend, you cannot judge this properly from your position out there! We at Centre….'

Centre has one main concern: how to remain central. Heaven help a subordinate body that might dare to make a decision of its own! Whether the decision was reasonable or not, whether it was necessary or not, whether things were afire or not: Centre has to be consulted first! This is why it is the Centre! Otherwise it would not be the Centre, always remember that! Those on the outer can fend for themselves.

Centre is staffed not by the intelligent ones, but the clever ones. For those who work away at their own little tasks may well be intelligent—but they are not clever. If they were clever, they would shirk work, and to this end there is only one means: a proposal for reform. Reform proposals lead to the creation of new departments which Centre of course subordinates, coordinates and associates. . . . One fellow cuts the timber and 33 others stand around: they are the Centre!

Centre is an institution whose role it is to subvert signs of energy and initiative among the subordinates. Centre never has an idea, and the others are delegated to implement it. Centre is a trifle less infallible than the Pope, but looks a lot less splendid.

Ordinary, practical people therefore do not have an easy life. They grumble about the Centre, rip up all the directives and wipe their eyes with the bits. Afterwards, they may marry the daughter of the head honcho to advance and be coopted into the Centre. They advance and get into the card index. Once there, they clear their throats, straighten their ties and cufflinks and begin to rule: members of the anointed elite, filled with deep contempt for the ordinary, practical people, and in profound conflict with their colleagues at the Centre. They sit like spiders in their nets which others have built, hinder intelligent work, pass unintelligent directives and know everything best.

(My diagnosis applies also for kindergardens, newspapers, Union governments, Departments of Local Government, Industry Ministries and company headquarters. It is of course a jocular exaggeration, which does not at all apply to one organisation, namely yours!)

Kurt Tucholsky (1925).
German writer and social commentator (1890-1935)
[my translation]

Glossary

CAPITALISM is a system of coordination of human economic activity that is based on institutions that guarantee private property and give individuals (or small groups) autonomy to use their property rights, as long as that does not infringe the rights of others. It facilitates decentralised, spontaneous and creative responses to changes and emerging problems.

CATALLAXY refers to the process of market exchange which 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", ie. rationing scarcity and using *given* resources to maximise predetermined ends.

Economic **COMPETITION** takes place in the **MARKET**, (a) between rivalling suppliers who incur the transaction costs of knowledge search and presenting themselves, so that they are positioned as attractive contract partners for potential buyers, and (b) between rivalling 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 knowledge exploration costs, competitive rivalry is often unpopular. But the incurring of such 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 rather permanent and that constrain 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 changes are needed to obtain certain economic results (positive constitutional economics).

CORRUPTION is defined as a systematic and intentional breach of accepted rules for material gain, treating different people differently and using deception, fraud or guile to disguise the act. Corruption can be seen as a market for political interventions in free markets and the rule of law, where political favours and preferments are traded in exchange for material and political gain of those with the power to award favours.

ECONOMIC GROWTH is the sustained rise in productivity and real per-capita living standards, let us say over a decade or more. It is normally measured in terms of real output per inhabitant or worker. Economic growth is a supply-side phenomenon, which means that it is tied to the steady increase of a society's capacity to supply goods and services by mobilising labour and skills, capital and technology, and natural resources. This requires a growing division of labour (specialisation) based on confidence-inspiring rule systems.

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 this intellectual tradition (whereas neoclassical economists closed the model to new, unpredictable developments and reduced the analysis 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 deliberate, 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 do not bear the full costs they impose on humanity and the environment (external costs). Other activities cause benefits which cannot be captured cost-effectively (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. For example, we are now able to measure road usage with transponders and charge road users accordingly. In other cases, collective action will remain the best way to compensate for externalities, taxing the creators of external costs ("polluter pays") and subsidising the originators of external benefits. Cases with 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, such as freedom, justice, security, prosperity and peace. These values tend to inform human action in invisible but dominant ways, similar to DNA information influencing an individual's characteristics. 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 whose violations incur sanctions of some kind. 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 to society, ie. they emerge from experience and are adopted in a community because they have been found useful. But some institutions are external, ie. 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**). Numerous institutions are obeyed by communities without being embodied in organisations.

Institutions define what is the framework for social interaction. They are essential for cultural and social cohesion. Institutions reduce uncertainty and thereby facilitate human interaction, for example in allocating resources and 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 conflicts and to settle remaining conflicts in predictable and constructive ways. Thereby, they advance social peace and confidence. This is also 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.

Institutions are essentially man-made. They represent a community consensus and therefore evolve over time. By the same token they can also be examined and consciously adapted and reformed.

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 only in settings which are not very complex.

Economic **LIBERALISM** is a philosophy and programme 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 as a means to coordinate autonomous human actions. While not denying a role for the state, liberalism 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 British, French and German writers, such as John Locke, David Hume, Adam Smith and Immanuel Kant, who argued for a minimal state and against political power to discriminate among the economic interests of different citizens. The concept of liberalism, as defined here, aims at enhancing negative liberties from coercion (in contradistinction to the modern American meaning of "liberalism", which stands for "generous with the taxpayers' resources to promote the material ends of organised groups by coercive redistribution and intervention" and in contradistinction to European "Big-L Liberalism" which has often been a political programme of intervention and support for well-organised interest groups).

ORDER is defined as the existence of recognisable patterns in nature or society. Order is useful because people with inherently limited cognitive capacities can interact more confidently and effectively when things are orderly. 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. However, the more complex and changeable the phenomenon is, which 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 the centrally planned economies in communist countries and the continued prosperity of the free market economies.

Human conduct is more likely to be ordered effectively, if the rules themselves are ordered, ie. that there are no contradictions among different rules. Such an **ORDER OF RULES** is more easily achieved if the rules are predominantly proscriptive, ruling out harmful actions, and not prescriptive, commanding people to act in certain ways. **ORGANISATIONS** are more or less permanent combinations of production factors under some form of leadership, which imposes a hierarchical order. This does not mean that organisations, such as business firms, clubs, or government agencies, do not also have to rely in part on coordination by spontaneous rule compliance. Indeed, many organisations embody institutions, such as work practices, which do not 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 ACTIONS**) 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.

PRINCIPLE-AGENT (P-A) PROBLEM easily arises when someone (an agent) acts on behalf of another (the principal). The agent typically 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 P-A problem has been diagnosed in business corporations. There, it is constrained by competitive markets that surround the business. Managers (the agents) cannot easily 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. The citizen (and at the same time the principal) can be less sure that the agents (parliamentarians, bureaucrats, judges) will not act in self-serving ways at his expense, for example by corrupt practices or rent-creation which assist with re-election or gives the agents political clout.

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 be divisible and transferable.

Pure **PUBLIC GOODS** are goods and services in whose provision costs and 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: enjoyment of these services by some does not detract from the enjoyment by others. It is also impossible to provide protection from external aggression exclusively to some, but not to other citizens. Once security is provided for some members of a nation, the others can free-ride. Hence, national defence is a pubic good.

It does not necessarily follow that public goods have to be provided by socialised means of production, only that government secures access for all. 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. Hence, national defence is provided by a government-run military force, rather than by reliance on hired competing mercenary forces, whose competition might inflict 'collateral damage'.

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 rational 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 all 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 too costly to inform themselves about such interventions and to organise themselves against such selective preferment. Rent seeking tends to undermine genuine competition among suppliers and hence prevents them from incurring the transaction costs, which are 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. This signals that the institutions have an effect similar to physical or skill capital on the productivity of 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 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 productive knowledge, negotiating and concluding contracts, monitoring contract fulfilment, as well as obtaining redress and compensation for non-fulfilment 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 occurs within organisations, we speak of **ORGANISATION COSTS**).

References

T.L. Anderson—D.R. Leal (1997), *Enviro-Capitalists—Doing Good by Doing Well* (Lanham, MD: Rowman–Littlefield).

W. B. Arthur (1995), “Complexity in Economic and Financial Markets”, *Complexity*, vol. 1:1, pp. 20–25.

Y. Barzel (1989), *Economic Analysis of Property Rights* (Cambridge, UK: Cambridge University Press).

(Lord) P. Bauer (1972), *Dissent on Development* (Cambridge, MA: Harvard University Press).

P. Bauer, S. Siwatibau, W. Kasper (1991), *Aid and Development in the South Pacific* (Sydney: Centre for Independent Studies).

B.L. Benson (1995), “The Evolution of Values and Institutions in a Free Society: Underpinnings of a Market Economy”, in Radnitzky-Bouillon, volume 1 (1995), *op. cit.*, pp. 87–126.

B.L. Benson (1997), “Institutions and the Spontaneous Evolution of Morality”, in G. Radnitzky—H. Bouillon, vol. 3 (1997), *op. cit.*, pp. 245–88.

W.J. Baumol (1990), “Entrepreneurship: Productive, Unproductive and Destructive”, *Journal of Political Economy*, vol. 98 (Oct.), pp. 893–921.

P.L. Berger (1987), *The Capitalist Revolution* (New York: Basic Books).

A.A. Berle—G.C. Means (1932), *The Modern Corporation and Private Property* (New York: Macmillan).

M.P. Bhatt—S.B. Mehta (eds.) (1996), *Planned Progress or Planned Chaos? Selected Prophetic Writings of Prof. B.R. Shenoy* (Madras: East West Books).

R. Blandy, W. Kasper *et al.* (1985), *Structured Chaos—The Process of Productivity Advance* (Oxford–New York: Oxford University Press).

P. Boettke (ed.) (1994), *Elgar Companion to Austrian Economics* (Aldershot: Edgar)

H. Bouillon (ed.), *Libertarians and Liberalism, Essays in Honour of Gerard Radnitzky* (Aldershot: Avebury Publ.).

G. Brennan—J.M. Buchanan (1985), *The Reason of Rules: Constitutional Political Economy* (New York: Cambridge University Press).

J.M. Buchanan (1975), *The Limits of Liberty—Between Anarchy and Leviathan* (Chicago: Chicago University Press).

J.M. Buchanan (1987), “The Constitution of Economic Policy”, *American Economic Review* , vol. 77, pp. 243–50.

J.M. Buchanan *et al.* (eds.) (1980), *Toward a Theory of the Rent-Seeking Society* (College Station, Texas: Texas A&M University Press).

J. Burton (1983), *Picking Losers. . . ?* Hobart Paper no. 99 (London: Institute of Economics Affairs).

S. Chakraverti (2000), *Antidote: Essays Against the Socialist Indian State* (New Delhi: Macmillan).

S. Chakraverti (2002), *Free Your Mind: A Beginner's Guide to Political Economy* (New Delhi: Centre for Civil Society).

R.H. Coase (1937/1952), “The Nature of the Firm”, in G.J. Stigler and K.E. Boulding (eds.), *Readings in Price Theory* (Homewood, Ill.: Irwin), pp. 331–52.

R.H. Coase (1960), “The Problem of Social Cost”, *Journal of Law and Economics* , vol. 3, pp. 1–44.

J. S. Coleman (1990), *Foundations of Social Theory* (Cambridge, Mass.: Harvard University Press).

J. Court (2001), “Bureaucracy and Perceptions of Corruption: Survey Evidence in Africa”, *2001 Transparency Report* [www.transparency.org], 74–77.

S. Courtois *et al.* (1999), *The Black Book of Communism, Crimes, Terror, Repression* (Cambridge, Mass.: Harvard University Press).

H. Demsetz (1967), “Toward a Theory of Property Rights”, *American Economic Review*, vol. 57, pp. 347–59.

H. Demsetz (1970), “The Private Production of Public Goods”, *Journal of Law and Economics*, vol. 13, pp. 293–306.

A. Desai (1998) *Self-Regulation in the Civil Society* (New Delhi: Centre for Civil Society)

J. Doti—D.R. Lee (1989), *The Market Economy, A Reader* (Los Angeles: Roxbury Publications)

A. Downs (1957), *An Economic Theory of Democracy* (New York: Harper and Row)

J. N. Drobak—. V.C. Nye (eds.) (1997), *The Frontiers of the New Institutional Economics* (San Diego: Academic Press).

R. Epstein (1988), “Covenants and Constitutions”, *Cornell Law Review*, vol. 73, no. 5, pp. 906–27

R. Epstein (1995), *Simple Rules for a Complex World* (Cambridge, Mass.: Harvard University Press).

R. Findlay (1992), “The Roots of Divergence: Western Economic History in Comparative Perspective”, *American Economic Review*, vol. 82 (May), pp. 158–61.

A. Flew (1989), *Equality in Liberty and Justice* (London: Routledge).

M. Friedman (1962), *Capitalism and Freedom* (Chicago and London: Chicago University Press).

M. & R. Friedman (1980), *Free to Choose* (Harmondsworth: Pelican Books).

H. Giersch (1989), *The Ethics of Economic Freedom* (Sydney: Centre for Independent Studies).

H. Giersch (1996), "Economic Morality as a Competitive Asset", in A. Hamlin *et al.* (1996), *Markets, Morals and Community* (Sydney: Centre for Independent Studies), pp. 19–42.

G. Gilder (1984), *The Spirit of Enterprise* (New York: Simon & Schuster).

J.D. Gwartney (1991), "Private Property, Freedom and the West", in J. L. Doti and D. R. Lee, *op. cit.*, pp. 62–76.

J.D. Gwartney—R. E. Wagner (eds.) (1988), *Public Choice and Constitutional Economics* (Greenwich, Conn.: JAI Press).

J.D. Gwartney—R.L. Stroup (1993), *What Everyone Should Know about Economics and Prosperity* (Tallahassee, FL: James Madison Institute).

J.D. Gwartney, J. Lawson, W. Block (1996), *Economic Freedom of the World, 1975–1995* (Vancouver: Fraser Institute).

J.D. Gwartney—R. Lawson (2001), *Economic Freedom of the World, Annual Report 2001* (Vancouver: Fraser Institute).

J. de Haan—J.-E. Sturm (2000), "On the Relationship between Economic Freedom and Economic Growth", *European Journal of Political Economy*, vol. 16, pp. 215–41.

G. Hardin (1993), "The Tragedy of the Commons", in D. Henderson (ed.), *op. cit.*, p. 88–91.

D.A. Harper (1996), *Entrepreneurship and the Market Process* (London: Routledge),

F.A. Hayek (1935/1948), "The Nature and History of the Problem", in F. A. Hayek, *Individualism and Economic Order*, 2 vols. (Chicago: Chicago University Press), pp. 1–40.

F.A. Hayek (1945), "The Use of Knowledge in Society", *American Economic Review*, No. 35: pp. 519–30.

F.A. Hayek (1948), "The Meaning of Competition", in F. A. Hayek, *Individualism and Economic Order* (Chicago: Chicago University Press), pp. 1–40.

F.A. Hayek (1960/1992), *Why I am Not a Conservative* (Sydney: Centre for Independent Studies)

F.A. Hayek (1967a), "Notes on the Evolution of Systems of Rules of Conduct", in F. A. Hayek, *Studies in Philosophy, Politics and Economics* (London: Routledge Kegan Paul), pp. 66–81.

F.A. Hayek (1967b), "Kinds of Rationalism", in F. A. Hayek, *Studies in Philosophy, Politics and Economics* (London: Routledge Kegan Paul), pp. 82–95.

F.A. Hayek (1973), *Law, Legislation and Liberty, Volume I: Rules and Order* (Chicago: Chicago University Press).

F.A. Hayek (1974/1984), "The Pretence of Knowledge" (Nobel Prize Lecture), in C. Nishiyama—K. R. Leube (eds.), *The Essence of Hayek* (Stanford: Hoover Institution), pp. 266–80.

F.A. Hayek (1978), "Competition as a Discovery Procedure", in *New Studies in Philosophy, Politics, Economics and the History of Ideas* (London: Routledge Kegan Paul), pp. 179–90.

F.A. Hayek (1979), *Law, Legislation and Liberty, Volume III: The Political Order of a Free People* (Chicago: Chicago University Press).

F.A. Hayek (1988), *The Fatal Conceit* (Chicago: Chicago University Press).

D.R. Henderson (1993), *The Fortune Encyclopedia of Economics* (New York: Warner Books).

A.O. Hirschman (1980), *Exit, Voice and Loyalty* (Cambridge, Mass.: Harvard University Press).

G.M. Hodgson, W. J. Samuels and M.R. Tool (eds.) (1994), *The Elgar Companion to Institutional and Evolutionary Economics*, 2 volumes (Aldershot, UK: E. Elgar).

D. Hume (1786/1965), "A Treatise of Human Nature", in D. Hume, *The Philosophical Works of David Hume*, edited by T. H. Green—T. H. Grose (Oxford: Clarendon, 1965)

J. Jacobs (1992), *Systems of Survival, A Dialogue on the Moral Foundations of Commerce and Politics* (New York: Vintage Books).

C. James, C. Jones, A. Norton (eds.) (1994), *A Defence of Economic Rationalism* (Sydney: Allen & Unwin).

M. James (ed.), (1989), *The Welfare State: Foundations and Alternatives* (Sydney: Centre for Independent Studies).

M.C. Jensen (1983), "Organization Theory and Methodology", *Accounting Review*, vol. 58, pp. 319–39.

M.C. Jensen—W. Meckling (1976), "Theory of the Firm: Managerial Behavior, Agency Costs, and Capital Structure", *Journal of Financial Economics*, vol. 3, pp. 305–60.

E.L. Jones (1982/87), *The European Miracle,* 2nd ed. (Cambridge, UK: Cambridge University Press).

W. Kasper (1983), "The Market Approach to Social Welfare", in: R. Mendelsohn (ed.), *Australian Social Welfare Finance* (Sydney: Allen & Unwin), pp. 80-93.

W. Kasper (1994a), *Global Competition, Institutions, and the East Asian Ascendancy* (San Francisco: International Center for Economic Growth).

W. Kasper (1994b), "The East Asian Challenge", in H. Hughes, W. Kasper *et al.*, *Australia's Asian Challenge* (Sydney: Centre for Independent Studies), pp. 19–33.

W. Kasper (1995), *Competitive Federalism, Promoting Freedom and Prosperity* (Perth: IPA States' Policy Unit).

W. Kasper (1996), "Responsibility and Reform—A Conversation with Ruth Richardson", *Policy*, vol. 12:3 (Spring), pp. 25–31.

W. Kasper (1997a), "Transitions and Institutional Innovation: Reflections on the Current Setback", *Malaysian Journal of Economic Studies*, vol. xxxiv, nos. 1&2, (June-Dec.), pp. 5–14.

W. Kasper (1997b), "Ignorance, Discovery and Choice: A Critique of Economic Rationalism", *Australian Journal of Legal Philosophy*, volume 22, pp. 1–14

W. Kasper (1998), *Property Rights and Competition, An Essay on the Constitution of Capitalism* (Sydney: Centre for Independent Studies).

W. Kasper (1999), "Regional Competition and Institutional Innovation", *Malaysian Journal of Economic Studies*, vol. xxxivi, no. 1, (June), pp. 1–15.

W. Kasper (2001a), 'How to Learn Racial Harmony? Fiji Would Benefit from Rules for a New Game', *Pacific Economic Bulletin* (National Centre for Development Studies, Australian National University, vol. 16, no. 1, pp. 136–41.

W. Kasper (2001b), The Liberal Idea and Populist Statism in Economic Policy: A Personal Perspective', H. Bouillon (ed.), *Do Ideas Matter?* (Brussels: Centre for the New Europe, 2001), pp. 103–37.

W. Kasper (2001–02), 'Economic Freedom Watch', *Policy*, vol. 17:4, 37–43.

W. Kasper–M.E. Streit (1998), *Institutional Economics: Social Order and Public Policy* , John Locke Series (Cheltenham: Edward Elgar).

P. Kilby (ed.) (1971), *Entrepreneurship and Economic Development* (New York: Free Press).

I.M. Kirzner (1984), *The Role of the Entrepreneur in the Economic System* (Sydney: Centre for Independent Studies).

I.M. Kirzner (1997), "Entrepreneurial Discovery and the Competitive Market Process: An Austrian Approach", *Journal of Economic Literature*, vol. xxxv:1 (March), pp. 60–85.

I.M. Kirzner (1998) *How Markets Work: Disequilibrium, Entrepreneurship and Discovery* (New Delhi: Centre for Civil Society).

L. Lachmann (1943/1977), "The Role of Expectations in Economics as a Social Science", in L. Lachmann, *Capital, Expectations, and the Market Process—Essays on the Theory of the Market Economy*, edited with an introduction by W. E. Grinder (Kansas City: Shed Andrews), pp. 655–80.

J. Graf Lambsdorff (2001), "Transparency International, 2001 Corruption Perceptions Index", *2001 Transparency Report* [www.transparency.org], 10–14.

B. Leoni (1991/1961), *Freedom and the Law* (Princeton: Van Norstrand).

B. Lomborg (2001), *The Skeptical Environmentalist: Measuring the Real State of the World* (Cambridge: Cambridge University Press).

A. Maddison (2001), *The World Economy, A Milennial Perspective* (Paris: OECD Development Centre).

B. Maley *et al*. (1983) *The Entrepreneur in Society* (Sydney: Centre for Independent Studies).

R.B. McKenzie (ed.) (1984), *Constitutional Economics—Containing the Economic Powers of Government* (Lexington: Lexington Books).

L. von Mises (1920/1994), "Economic Calculation in the Socialist Commonwealth", in M. Kirzner (ed.), (1994), *Classics in Austrian*

Economics, A Sampling in the History of a Tradition, 3 vols. (London: W. Pickering); vol. 3, pp. 3–30.

L. von Mises (1949), *Human Action* (Edinburgh: W. Hodge).

L. von Mises (1978), *Liberalism* (Kansas City: Sheed and Ward).

K. Moore—D. Lewis (2000), Foundations of Corporate Empire. Is History Repeating Itself? (London-Harlow: Pearson Education/Prentice Hall).

R. Nelson (1970), "Information and Behaviour", *Journal of Political Economy*, vol. 78:2, pp. 311–29.

C. Nishiyama—K. Leube (eds.) (1984), *The Essence of Hayek* (Stanford: Hoover Institution Press).

J. Norberg (2001), *In Defence of Global Capitalism* (Stockholm: Timbro).

D.C. North (1990), *Institutions, Institutional Change and Economic Performance* (Cambridge: Cambridge, University Press).

D.C. North—R. P. Thomas (1973), *The Rise of the Western World* (Cambridge, UK: Cambridge University Press).

G.P. O'Driscoll (1977), *Economics as a Coordination Problem* (Kansas City: Sheed Andrews-McMeel).

G.P. O'Driscoll Jr.—M. J. Rizzo (1985), *The Economics of Time and Ignorance* (New York: Columbia University Press).

G.P. O'Driscoll, K. Holmes and M. Kirkpatrick (2002), *2002 Index of Economic Freedom* (Washington-New York: Heritage Foundation-Wall Street Journal).

M. Olson (1965), *The Logic of Collective Action. Public Goods and the Theory of Groups* (Cambridge, Mass. reprinted 1971).

M. Olson (1982), *The Rise and Decline of Nations* (New Haven-London: Yale University Press).

M. Olson (1996), "Big Bills Left on the Sidewalk: Why Some Nations are Rich, and Others Poor", *Journal of Economic Perspectives*, vol. 10, no. 2 (Spring), pp. 2–24.

E. Ostrom (1990), *Governing the Commons: The Evolution of Institutions for Collective Action* (Cambridge, UK: Cambridge University Press)

D. Parker—R. Stacey (1995), *Chaos, Management and Economics: The Implications of Non-Linear Thinking* (Sydney: Centre for Independent Studies).

P. Porter–G. Scully (1995), "Institutional Technology and Economic Growth", *Public Choice*, vol. 82, pp. 17–36.

J.P. Powelson (1994), *Centuries of Economic Endeavour* (Ann Arnor: University of Michigan Press).

A. Rabushka (1974), *The Theory of Racial Harmony* (Columbia, SC: University of South Carolina).

G. Radnitzky—H. Bouillon (eds.) (1995–1997), *Values and the Social Order*, 3 volumes (Aldershot: Avebury Publ.)

S. Ratnapala (1990), *Welfare State or Constitutional State?* (Sydney: Centre for Independent Studies).

L.H. Rockwell (ed.) (1988), *The Free Market Reader* (Burlingname, CA: von Mises Institute)

N. Rosenberg—L.E. Birdzell (1986), *How the West Grew Rich* (New York: Basic Books).

J.A. Schumpeter (1961), *The Theory of Economic Development* (New York: Oxford University Press; first [German] edition, 1908)

G. Scobie—S. Lim (1992), "Economic Reform: A Global Revolution", *Policy*, vol. 8:3, pp. 2–7.

G.W. Scully (1991), "Rights, Equity and Economic Efficiency", *Public Choice*, vol. 68, pp. 195–215.

G.W. Scully (1992), *Constitutional Environments and Economic Growth* (Princeton: Princeton University Press).

P.J. Shah (ed.) (2000), *Friedman on India* (New Delhi: Centre for Civil Society).

P.J. Shah (ed.) (2001), *Profiles in Courage: Dissent on Indian Socialism* (New Delhi: Centre for Civil Society).

B.R. Shenoy (1968), *Indian Economic Policy* (Bombay: Popular Prakashan).

H.A. Simon (1982), *Models of Bounded Rationality and Other Topics in Economic Theory,* 2 vols (Cambridge, Mass.: MIT Press).

J.L. Simon (ed.) (1995), *The State of Humanity* (Oxford: Blackwell).

A. Smith (1776/1970-71], *An Inquiry into the Wealth of Nations*, 2 volumes (London: Dent).

B.H. de Soto (2000), *The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else* (New York: Basic Books).

T. Sowell (1983), *The Economics and Politics of Race* (New York: W. Morrow & Co.)

T. Sowell (1990), *Preferential Policies: An International Perspective* (New York: William Morrow).

T. Sowell (1991), "Cultural Diversity, A World View", *The American Enterprise* (May/June), vol. 5; pp. 44–55.

T. Sowell (1998), *Conquests and Cultures, An International Perspective* (New York: Basic Books).

T. Sowell (2000), *Basic Economics, A Citizen's Guide to the Economy* (New York: Basic Books).

G.J. Stigler (1971), "The Theory of Economic Regulation", *Bell Journal of Economics and Management Science* , vol. 2:1, pp. 3–21.

M.E. Streit—G. Wegner (1992), "Information, Transaction and Catallaxy. Reflections on Some Key Concepts of Evolutionary Market Theory", in U. Witt, *op. cit.,* pp. 125–49.

R.D. Tollison (1982), "Rent Seeking: A Survey", *Kyklos*, vol. 35, pp. 575–602.

R. Vaubel (1980), "Repairing Capitalism", *Regulation* (July-August), pp. 12–16.

S. Voigt (1996), "Pure Ecclecticism—The Tool Kit of the Constitutional Economist", *Constitutional Political Economy*, vol. 7, pp. 177–196.

S. Voigt (1997), "Positive Constitutional Economics: A Survey", *Public Choice* (Special issue on constitutional political economy), vol. 90, pp. 11–53.

G. de Q. Walker (1987), *Initiative and Referendum: The People's Law* (Sydney: Centre for Independent Studies).

G. de Q. Walker (1988), *The Rule of Law: Foundation of Constitutional Democracy* (Melbourne: Melbourne University Press).

M. Weber (1927/1995), *General Economic History*, 6th ed. (New Brunswick: Transaction Books).

E. Weede (1996), *Economic Development, Social Order, and World Politics* (Boulder, Co.: Lynne Rienner).

S.-J. Wei (2001), "Why is Fighting Corruption so Crucial for Embracing Globalisation?", *2001 Transparency Report* [www.transparency.org], 67–73.

Centre for Civil Society

The Centre for Civil Society is an independent, nonprofit, research and educational organisation devoted to improving the quality of life for all people of India by reviving and reinvigorating civil society. The motivation behind the Centre is the poignant paradox of intelligent and industrious people of India living in the state of destitution and despondency. But we don't run primary schools, or health clinics, or garbage collection programs. We do it differently: we try to change people's ideas, opinions, mode of thinking, the mindset by research, seminars, and publications.

We champion limited government, rule of law, free trade, and competitive markets. These principles promote civil society—peace, harmony, and prosperity.

The Centre was inaugurated on August 15, 1997, signifying the necessity for achieving economic, social, and cultural independence from the Indian state after attaining political independence from an alien state.

What is Civil Society

Civil society is an evolving network of associations and institutions of family and community, of production and trade, and of piety and compassion. Individuals enter into these relationships as much by consent as by obligation but never under coercion. Civil society is premised on individual freedom and responsibility, and on limited and accountable government. It protects the individual from the intrusive state, and connects the individual to the larger social and economic order. Civil society is what keeps individualism from becoming atomistic and communitarianism from becoming collectivist. Political society, on the other hand, is distinguished by its legalised power of coercion. Its primary purpose should be to protect, and not to undermine, civil society by upholding individual rights and the rule of law.

Relationship Between Civil & Political Society

The "principle of subsidiarity" demarcates the proper arenas for civil and political society, and for local, state, and central government within the political society. The principle suggests that the state should undertake those tasks that people cannot undertake for themselves through voluntary associations of civil society. The functions thus assigned to the state must be entrusted first to local governments. The functions that local governments cannot perform should be given to state governments and only those that state governments are unable to undertake should be delegated to the central government. The rampant growth of the political society—the institutions of government—since independence has hindered the flourishing of civil society in India. It is only by rethinking and reconfiguring the political society that India will be able to achieve economic prosperity, social peace and cohesion, and genuine political democracy. The focus on civil society enables one to work from both directions; it provides a 'mortar' program of building or rebuilding the institutions of civil society and a 'hammer' program of readjusting the size and scope of the political society. Both programs are equally critical and must be pursued simultaneously. Weeds of the political society must be uprooted and seeds of a civil society must be sown.

Support

In accordance with its purpose, the Centre accepts support only from individuals and institutions of civil society.

Research Agenda

- Law, Liberty, and Livelihood
- Provision of Social Services: The Role of Civil Society
- Assuring Quality and Safety: Self Regulation or State Regulation?
- Birth to Death Certification
- Radio Privatisation
- Market-based Initiatives for Environmental Concerns
- Role of the Private Sector in Provision of Infrastructure
- Farmers and Consumers: Is the State or the Market a Better Intermediary?
- Protecting and Creating Jobs: De-regulation of Labour Markets
- Government as Manager or Supervisor of Financial Markets?
- India in the Global Market: Liberalisation of Trade
- Corporatisation and Privatisation of Public Sector Units

Publications

- *Free Your Mind: A Beginners Guide to Political Economy* by Sauvik Chakraverti. Rs. 100
- *Profiles in Courage: Dissent on Indian Socialism edited by Parth J Shah. Rs. 350*
- *Money, Market, and Marketwallahs* by R K Amin. Rs 125
- *Research Internship Papers 2001* edited by H B Soumya. Rs 150
- *Friedman on India* edited by Parth J Shah. Rs 75

- *Kissan Bole Chhe* (Gujarati) by R K Amin. Rs 200
- *How Markets Work: Disequilibrium, Entrepreneurship and Discovery* by Israel Kirzner. Rs 50
- *Agenda for Change* edited by Bibek Debroy & Parth J Shah. (out of print)
- *Self-Regulation in the Civil Society* edited by Ashok V Desai. (out of print)

ViewPoint Series:
- *Peter Bauer: A True Friend of the World's Poor* by Sauvik Chakraverti. Rs. 30
- *Do Corporates Have Social Responsibility?* edited by Parth J Shah. Rs. 30
- *Population Causes Prosperity* by Sauvik Chakraverti. Rs. 30
- *Indian Financial Sector after a Decade of Reforms* by Jayanth R Varma. Rs. 50

Forthcoming Publications:
- *Swaminomics* by Swaminathan S. Anklesaria Aiyar
- *Terracotta Reader* edited by Parth J Shah
- *New Public Management: A Primer* by Sauvik Chakraverti and Parth J Shah

Education Programs
- Liberty & Society Seminar
- Economics in One Lesson Seminar
- Annual B R Shenoy Memorial Essay Competition
- Summer Research Internship Program
- School Lecture Series
- Business Journalism Workshop
- Workshops for IAS Officers

Dialogues & Panel Discussions
- The Centre holds regular Dialogues to provide a discussion forum for topical issues. Some Dialogues held:
- Fighting Poverty Diseases
- Indian Financial Sector After a Decade of Reforms
- Corporate Social Responsibility?
- Should We Ban Quacks?
- Liberalisation and Livelihood
- Economics Curriculum in Schools
- Education Policy: Choice and Competition

Friends of Freedom

To provide a platform for self-development and deeper understanding of the principles and policies of liberalism, Liberty & Society Seminar graduates come together to form Friends of Freedom (FoF). Young professionals and others interested in liberal values also become members.

Public Interest Litigations

- BALCO: With the help of advocates Parag Tripathi and Suranya Aiyar, the Centre filed an intervention PIL in the Bharat Aluminium Company (BALCO) privatisation case to support that the privatisation of public sector companies is in the public interest; its opposition serves only parochial interests.
- VIP Security: To stop the harassment and inconvenience under the guise of VIP Security to ordinary citizens of Delhi in using roads.

Legislative Alert

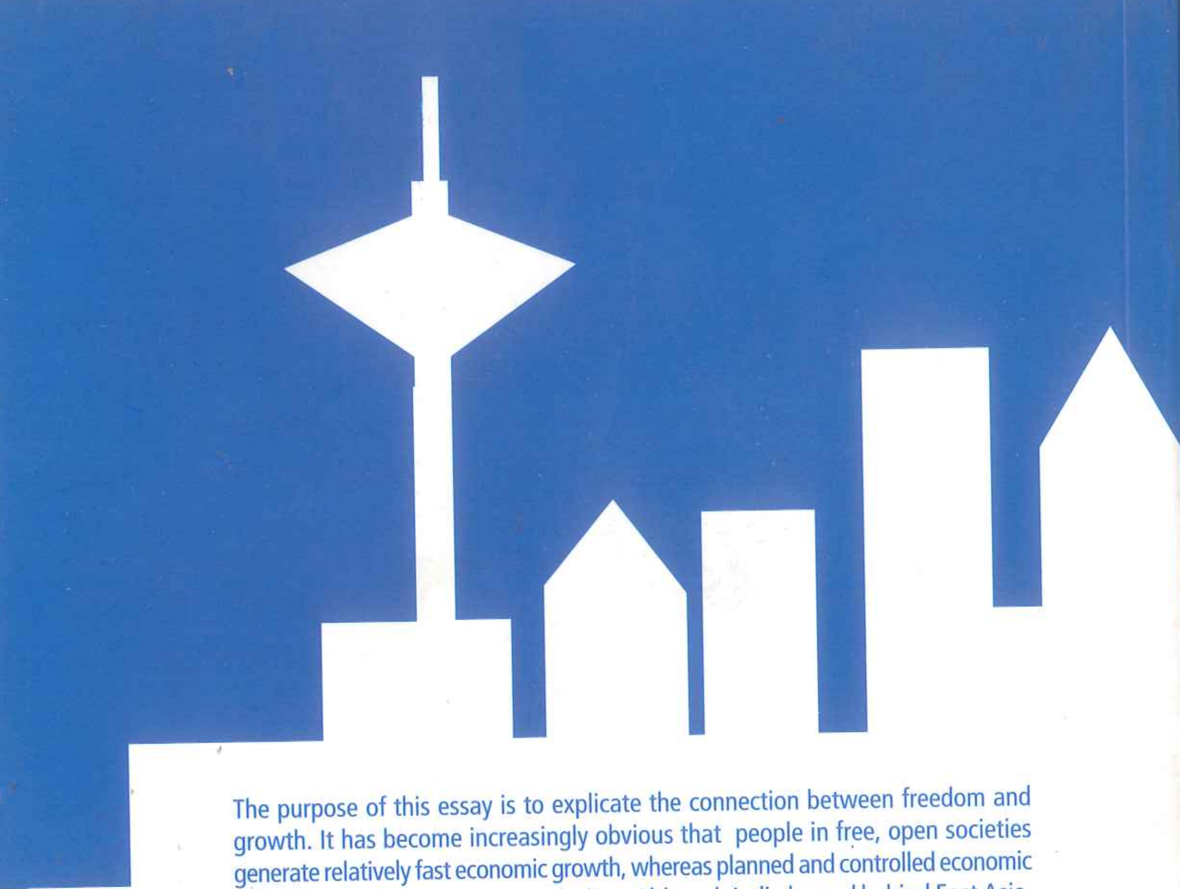
A bill pending in the Parliament is analysed, clause by clause and an alternate bill is drafted. The changes are then discussed with interested Members of Parliament, formally and informally.

Swaminomics

The Centre has created www.swaminomics.org and www.swaminomics.com to house the popular Sunday column "Swaminomics" in *Times of India* by Swaminathan S Anklesaria Aiyar.

Resource Centre

The Centre maintains a library of several thousand books, publications of a large number of public policy research institutes and computers with internet access. It is open to the public for use but borrowing privileges require membership. The Centre plans to open similar resource centres throughout India.



The purpose of this essay is to explicate the connection between freedom and growth. It has become increasingly obvious that people in free, open societies generate relatively fast economic growth, whereas planned and controlled economic systems make for stagnation or decline. Although India lagged behind East Asia, the easing of bureaucratic controls and central planning in recent years has allowed the spontaneous forces of growth to emerge in India too. Much remains to be done. The essay provides the ideas to build that road to prosperity.

What causes economic growth: Is it investment, learning, innovation, resource development, or something else? Focussing on these factors begs the question why people invest, learn, innovate in some and not in other societies! The reason for such differences in behaviour lies in different sets of rules of coordination, which we call 'institutions.' The institutions have to evolve if economic and social development is not to stall in its tracks. What might have been good 'traffic rules' to coordinate a tribal society are not necessarily the institutions that help a nation's prosperity in the era of globalisation. This essay therefore restates the fundamental insights of the new and rapidly spreading discipline of Institutional Economics. It explains in particular what has come to be known as the 'constitution of capitalism,' which has been widely recognised as essential for general material progress, as well as for a free, peaceful, and just society.

Wolfgang Kasper is emeritus Professor of Economics at the University of New South Wales in Australia and a Senior Fellow at the Centre for Independent Studies, Sydney. While working with international agencies, he gained first-hand knowledge of virtually all East Asian economies and has visited India and Latin America repeatedly.

Centre for Civil Society B-12, Kailash Colony, New Delhi 110 048
Tel.: 6468282 Fax: 6462453 Website: www.ccsindia.org

ISBN 81-87984-05-8