PROPERTY RIGHTS AND COMPETITION

An Essay on the Constitution of Capitalism

WOLFGANG KASPER

Policy Monograph 41

THE CENTRE FOR INDEPENDENT STUDIES

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AND
COMPETITION

An Essay on the Constitution of Capitalism

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This essay is dedicated to
the Fabians in all political parties
and academies of Australia

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Key Points

- Australia's economic growth and job creation have fallen well short of what is possible and desirable.
- This combines with spreading insecurity among Australians, which can be related to systematic deficiencies in present-day institutions by which individual conduct is coordinated.
- There is far too much reliance on a multiplicity of top-down directives and too little institutional security to encourage the spontaneous self-coordination of individual initiatives.
- This essay therefore restates the fundamentals of the new and rapidly spreading discipline of Institutional Economics and explains the essentials of what has come to be known as the 'constitution of capitalism.'
- The modern economy is a complex system that evolves in ways similar to an ecological system, where one intervenes at one's peril.
- The spontaneous search for new wants and new resources by enterprising people will depend 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 accumulate, make the entire economic system dysfunctional.
- The most successful set of ground rules for coordinating economic activities is the system of private property rights and private autonomy in using one's property through voluntary contracts, protected by the rule of law (the capitalist system).
- Under such an institutional system, propertied people have an incentive to compete by incurring the costs of searching for useful knowledge and testing whether such knowledge is sufficiently valued by others (reflected in a profit).
- Genuine competition thus stimulates innovation and economic growth. It also spreads useful knowledge and induces people to abandon errors when they make losses.
- Those property owners who shirk the shouldering of the costs of knowledge exploration will probably incur losses in the value of their assets. Given socio-economic positions should therefore not be protected by government from the challenge of competition.

- A genuine competitive system, free of governmental favouritism, tends to go along with a high degree of equity of opportunity.
- Public policy and collective action, normally second-rate mechanisms of coordinating human conduct, are nevertheless sometimes needed to back up the institutions of civil society and to control power.
- But many collective pursuits can nowadays be satisfied more effectively by private provision and competitive coordination.
- This holds particularly true of the redistribution of income and wealth by the failing welfare state, which now often dominates public policy to the detriment of protecting fundamental institutions.
- Government cannot effectively protect property rights, private autonomy and the rule of law while continuing to confiscate private property rights and favouring well-organised groups.
- Rampant redistribution white-ants the spontaneous creativity of a free society.
- The domain of collective action has been relentlessly expanded this century by self-serving parliamentarians, an activist judiciary and bureaucratic influence-seeking, in combination with the group egotism of ruthless pressure and advocacy groups.
- The unbridled power of party and lobby politics has not served Australians well and will have to be constrained by rules of a high-level, constitutional quality, if the new challenges of the open economy and the communications revolution are not to inflict painful, traumatic experiences on us.

Foreword

In this timely monograph Professor Kasper examines the pathology of the legal and institutional framework of the economy and makes recommendations for remedial action to ensure a higher standard of living for all Australians.

In recent decades many Australian legislators and judges have lost sight of the link between a stable, predictable legal system and economic opportunity. The jurisprudence of ad hoc social engineering such as that formerly taught by Julius Stone at the University of Sydney law school has encouraged a generation of judges to believe that they can alter the rules so as to contrive a perfect result in the 1 per cent of transactions that reach the judicial system, disregarding the impact on the other 99 per cent that do not.The continual falsification of people's legitimate expectations by this legal instability increases transaction costs, resulting in fewer transactions and a smaller national income.This translates in practice into reduced employment opportunities and a lower standard of living for all, including the poorest members of our society.

As the Nobel laureate James Buchanan has pointed out, higher transaction costs also increase the optimal size of firms, thereby making smaller and medium businesses less viable and leading to a market dominated by the large corporations that can afford to absorb the greater uncertainty premiums. This has visibly happened in the natural resources industry, especially since the High Court's revolutionary policy statement in the *Mabo* case.

Judge Richard Posner and others have shown that the economic burdens created by legal uncertainty can partly be offset by what economists call 'corrective transactions.' It is now common for Australians contracting with overseas partners to designate the courts of New Zealand as the forum for the settling of any disputes.They do this not because they admire the New Zealand Supreme Court, but because of the right of appeal from that court to the Privy Council, which has a reputation for upholding bona fide, lawful contracts. In this way business people can escape, at a cost, the lottery-like operation of our contract review laws and the sentimental oscillations of certain of our courts.

The British are in fact doing well today out of the defective jurisprudence of other countries. Even New York is steadily losing ground to London as a corporate and financial centre, partly because of the greater certainty of English contract law. Most American judges, like their Australian counterparts, were trained at law school in the social engineering theories of 'legal realism'.

As Professor Kasper emphasizes, these are not just matters of high finance or macroeconomic theory. They carry concrete answers to questions such as what awaits the young when they leave school or university, whether the family business will succeed or fail, and whether in the future we will have more freedom or less. As he demonstrates, all Australian stand to gain from closer adherence to the rule of law.

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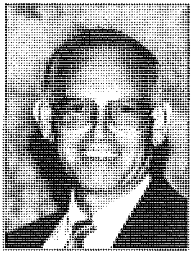

Wolfgang Kasper has been the Professor of Economics in the School of Economics and Management which the University of New South Wales maintains in the Australian Defence Force Academy since 1977.

After school and university in post-war Germany, Switzerland, Paris and London, Kasper worked with the German Council of Economic Advisors, the Kiel Institute of World Economics, and as an Adviser to the Malaysian Minister of Finance under the auspices of Harvard University. He came to Australia in 1973 to join the Australian National University. He also worked at the Reserve Bank of Australia, the Naval Postgraduate School in Monterrey, California, the Federal Reserve of San Francisco and OECD in Paris.

His puzzlement with Australia's disappointing economic performance led him to conduct research into Australia's defective political and competitive arrangements. This led to the study *Australia at the Crossroads* (1980) which foreshadowed the subsequent deregulation policies in Australia and New Zealand. He has also gained first-hand working knowledge of virtually all East Asian economies.

Professor Kasper has had a long association with the Centre for Independent Studies. He serves on the Advisory Council and has published regularly through the CIS, amongst others *Capital Xenophobia* (1984), *Restoring the True Republic* (with G. Walker and S. Ratnapala, 1993) and *Lessons from the Freiburg School, The Institutional Foundations of Freedom and Prosperity* (with M.E. Streit, 1993). He is the Director of the Centre's new *Constitutions and Markets* project.

Acknowledgments

An essay such as this could not have been put together without drawing on the wisdom of many, only some of whom are explicitly cited in the references and many of whose contributions the author is probably not even aware of. This essay has benefited in particular from the joint effort of writing a book on Institutional Economics with Professor Manfred Streit, the Director of the *Max-Planck-Institute for Research into Economic Systems* at Jena, Germany (Kasper and Streit, *Institutional Economics - Social Order and Public Policy*, to be published later in 1998 by Edward Elgar in the *John Locke series*).

I also acknowledge the helpful, critical feedback I received from my students at ADFA and participants in the 'Liberty and Society' seminars of the Centre for Independent Studies, where I was able to test run some of the ideas in this volume. I extend a particular 'thank you' to two young colleagues, Jason Soon of Sydney and Daniel Clode of Canberra, and to Dr Charles Richardson of the Centre for Independent Studies, who were enthusiastic and generous in giving me critical feedback. Finally, I wish to thank two anonymous referees. All helped me to sharpen the argument and to avoid blunders. However, the usual exclusive responsibility for judgements and errors must remain with the author, who, in some instances, insisted on being recalcitrant.

Wolfgang Kasper
Canberra, May 1998

INTRODUCTION

As of the late 1990s, the Australian community appears to be gripped by a widespread sense of insecurity if not anxiety – a far cry from the youthful can-do confidence so typical of Australians in an earlier era. One also observes a spreading cynicism about government being the solution to many of the problems besetting us. The sober 1990s are certainly a far cry from what US economist and Nobel laureate James Buchanan once called the 'romantic folly' of belief in collective solutions.

Is there something that can be done about the lack of confidence and these new doubts? If so, what should be changed?

Since the end of the 1970s at the latest, it has been clear that the ground rules on which the Australian community, economy and polity had previously been run, have become untenable. If not reshaped, the institutional system promised insecurity, social conflict and economic slippage (Kasper, Blandy, Freebairn, Hocking, O'Neill, 1980; Kelly, 1992, Introduction and Ch. 2). During the 1980s this insight led to some economic and social reforms, but these remained half-hearted and piecemeal. They have produced an inconsistent, ineffectual rule system. Eventually, the attempts to improve the institutions subsided in 'reform fatigue.' Powerful interest groups rallied to resist further reforms when they discovered that they, too, were no longer sheltered and could no longer seek preferment in the face of global change and continuing liberalisation.

Under the Howard government, comprehensive liberalisation and reform have been de-emphasised, although some piecemeal reforms, such as taxes, have been discussed belatedly in 1997 and 1998. The opposition parties have relapsed into populism. Many politicians are resurrecting the pretence that government can provide certainties.

In recent decades, the judiciary switched from the cultivation of procedural justice to the activist social engineering of outcomes which they believe will promote social justice. This has changed the law and greatly added to the spreading disorientation and uncertainty. The number of rulings and regulations keeps multiplying and politicians and judges try to engineer specific outcomes at the expense of cultivating general, stable rules. This approach not only affects formal rules, such as laws, but also the informal covenants of society, such as when ordinary Australians are told that the time-tested model of their society is to be deconstructed into a loose multicultural community, rather than integrating immigrants with a view to a shared future. Citizens and job creators are now gaining the impression that many rules are made on the run and that they can no longer be comprehended, let alone obeyed.

The more collective action tries to create specific certainties, the less do average Australians feel confident that they can build their own lives and businesses. They sense that security and confidence in a community have to grow from the inside out. Specific top-down government initiatives, which are often amended or reversed, are no substitute for simple and stable rules which are obeyed spontaneously. Governments often cannot know on what objective criteria to determine their priorities - other than by yielding to the loudest pressure group and the most promising contributors to the next election campaign! Ordinary Australians understand only too well that government interventions are the result of self-seeking parliamentary groups and ruthless, sometimes vocal interest groups. This game hardly ever advantages the average battling citizen or the new entrepreneur. We have to conclude that the Australian economy suffers from a weak economic constitution whose symptoms are deficient job creation, little spontaneous initiative and precious little cheer.

This has much to do with the fact that, in a complex, changing world, the certainty of politically ensured outcomes for some tends to increase the uncertainties for all others. To the extent that public policy makes sure that some client groups obtain specific outcomes, it paradoxically increases the burdens of adjustment for all others. It is therefore generally more conducive to certainty and trust throughout society to subject all to the same reasonably stable rules of conduct. This insight lies behind the classical concept of the rule of law.

The main purpose of this essay is to highlight the importance of simple, stable and universal institutions (i.e. rules with sanctions for violations) in coordinating human conduct in the economy and in establishing trust.[1] It will be argued that certain simple rules of an overriding, constitutional quality could constrain self-seeking political groups and their allies. Appropriate rules can create better predictability, which allows enterprising people to concentrate on their own aspirations and capabilities - without having to glance all the time over their shoulders to see whether the next tax change, the next subsidy scheme, the next prescriptive regulation or the next convulsive High Court ruling imper-

[1] See 'Institution' in the Glossary at the end of this essay. 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 spelled out in the Glossary.

ils their venture. If Australia's basic economic institutions could again be made credible and universal, this would reduce the costs of transacting business in Australia. It would also limit social conflict and de-emotionalise political life. It is simply not constructive to have matters of daily life - such as workplace relations - constantly embroiled in legal and political conflict and in the headlines!

Predictability based on general and reliable ground rules is of particular importance when circumstances change. Then, one cannot simply extrapolate the past. Reliable rules will then give people confidence that they can succeed in discovering new ways of coping and can turn the new circumstances to their advantage. Since the early 1980s, Australians, who had been told for most of this century to rely on the steady state and government-provided certainties, have been confronted with major and bewildering changes. The economy was opened up and many parts were liberalised. This coincided with the ongoing process of globalisation and the advent on the global scene of hundreds of millions of new, competitively managed industrial workers. The computer and communications revolution began to have its long-predicted impact. And superpower rivalry, which - oddly enough - used to provide a measure of certainty, came to an end.

In such a period of pervasive, interconnected changes, governments are unable to provide certainties from the top down, because no policy maker can understand all the many, often interdependent changes and foresee all the consequences. What is needed at such a time is a simple institutional framework that allows everyone to respond flexibly and spontaneously, to experiment, discover new opportunities, copy successes and ditch emerging failures. Such institutions (rules) will be outlined in the following chapters.

The present essay will make the case for simple, non-discriminatory and stable institutions that underpin reliable private property rights and their free, autonomous use through voluntary contracts - what one might call 'the constitution of capitalism.' This requires the enforcement of rules against private opportunism (forgetfulness, negligence, fraud, abuses of power, violence), as well as collective, political opportunism (rent-seeking, preference creation, abuse of political information and power).

The following chapters also contain a restatement of the argument for the market economy for those who have been (wrongly) taught that the market is an intersection of known and fairly stable demand and supply curves, and for those who have never been alerted to the creative power of markets. Many Australians have a mistaken conception of the invisible hand that guides the actions of market participants. However, an understanding of how private property and market competition really work is essential to protect us from unwittingly falling back into a simplistic and dangerous dependence on the clumsy, visible hand of government.

The proposed line of inquiry leads us to the analysis of institutions, which order human conduct. Institutions include both the customs, ethics and other internal rules of civil society, and externally made rules, such as legislation and regulations. Then, the reader will be invited to go one step further, from the analysis of the *given* rule system to thinking in terms of *alternative* rule systems and *alternative* outcomes. After all, the constitution and the other rules are only instruments to help us attain our diverse aspirations. Upholding the rules is not an aim in itself.

This is the province of the new 'Constitutional Economics,' which has a normative branch - looking at more desirable outcomes - and a positive branch - analysing the consequences of different rules.[2] All too often, Australians prevent themselves from even asking what first-best solutions they should really aspire to with the argument: 'But that would require a change in the Constitution!' A hundred years after Federation, it seems appropriate for public discourse to cast this all-too-easy conservative limitation aside and to ask instead: 'What is the first-best rule system for the community that we want to leave behind to future generations? What do we really want to achieve on this continent, if we free our minds from the constraints of our haphazardly grown institutional systems?' It is possible that such a re-evaluation will not lead to a dramatically different conception of the fundamental institutions, but it may lead to more streamlined and more effective ones. Above all, it may be a way of reviving a shared understanding of what this community is all about.

Finally, one word is required in this Introduction 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 preference for a free, prosperous, secure and peaceful society. Some readers will be more

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[2] It is revealing that the key journals in this important new discipline can hardly be found in Australian public libraries. To the best of my knowledge, no major Australian library subscribes to the *Journal of Constitutional Economics*, the *Ordo* yearbook or the *Journal des Economistes et des Etudes Humaines*, which - together with the more widely known journal *Public Choice* - are the central marketplaces for the new Constitutional Economics and the ideas discussed here!

comfortable with 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 life and guiding public policy. We can analyse objectively what outcomes result from certain institutions, for example whether poverty or wealth result from the suppression of theft (Olson, 1996). But the choice and reform of institutions also requires a subjective preference for wealth or poverty. The luxury of value-free analysis is therefore not available to those who discuss institutions and constitutions, because these rules invariably affect freedom, prosperity, security and peace in a community.

I hope to show that the competitive efforts of the many in discovering and testing what serves us best normally offer better solutions than the centralised top-down approach of government. The reason is that government agents often simply do not know. They act instead on a dangerous pretence of knowledge – to cite the title of Friedrich Hayek's famed Nobel Prize lecture (Hayek, 1974/84). In reality, policy makers are typically driven to activism by their own political interests. They care little what uncertainties, disadvantages, compulsions and conflicts they impose on ordinary citizens. We need to acknowledge this basic fact and to foster a system of Australian rules that empowers the citizens to freely pursue their own purposes, as long as this is compatible with the aspirations of others.

CHAPTER ONE

THE EMERGENCE AND THE DEBASEMENT OF THE INSTITUTIONS OF CAPITALISM

The present trend of opinion makes it seem quite possible that men, because they do not like it, will destroy the moral order that keeps them alive.

F.A. Hayek, 'The Origins and Effects of Our Morals,'
reprinted in Nishiyama and Leube, 1984: 330

The Importance of Institutions

Whenever individuals interact with others they have to trust that their counterparts will behave in predictable ways, fulfilling the promises they made. This fact is so fundamental that we frequently lose sight of it. 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 their 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 give 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 often deal with complete strangers in other countries whom they must trust.

Only by trusting one another, can we achieve the division of labour and draw on the specialised knowledge and knowhow that is held in the minds of many diverse people. Only then can we produce all the many goods and services that allow us to enjoy our high living standards. High living standards and our very survival depend on a gossamer web of rules that establish trust and help us coordinate our manifold, diverse activities with the plans of others. 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 entail sanctions if violated. Such rules are called 'institutions'. Their quality and content give structure to social interaction. They form, so to speak, the cement that binds us together and allows us to conduct ourselves as members of communities (Elster, 1989). Indeed, shared institutions define our culture and our society. The institutions people obey also contribute much to how they define themselves. Institutions matter because people are not isolationist individuals, but rely on company to bring out the best in them and to be creative and confident. They can interact with others productively only if their behaviour is by and large predictable, and institutions serve to make human behaviour reasonably predictable.[3]

People who are guided by appropriate institutions will find that they are not lonely. When many Australians nowadays suffer from loneliness, this seems the consequence of the same institutional deficiency that has caused our widely decried lack of confidence. To a large extent, loneliness – the involuntary lack of personal contact with others – seems the consequence of inappropriate rules of social conduct. Much institutional coordination has been shifted from the interpersonal to the collective level, from civil society and voluntary associations to state coordination by coercive, top-down rules (Norton et al., 1997: esp. 1-6). Australian rules have shifted from the internal institutions that give scope for individual spontaneity and diversity to imposed institutional arrangements which are tailored for 'the masses' and which breed uniformity. Civil society offers, so to say, an à la carte service for individuals, whereas the collective service of government only offers a set canteen menu.

Economic wellbeing and human productivity depend crucially on the right kind of institutional system because, 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 Australia and 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 print-

[3] 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.

ing ink, the writer, the independent referees and the editor, the international traders who brought some of the inputs to Australia, 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. All this is made possible only because people's efforts are ordered by effective institutions.

A society's institutional foundation sometimes consists of formal laws, enforced by courts and government. 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 reliance on a good reputation. People who continually break conventions and customs will be shunned and become lonely. Those who disregard professional standards lose their reputations, and soon their business. The aforementioned international currency markets operate without written contracts or reliance on the courts of any one nation. They function smoothly and often with surprisingly small trading margins because opportunistic cheats are soon excluded from the trade. These society-internal institutions are anchored in fundamental values that most of us share, such as high preferences for freedom, justice and equity.

Yet, the institutions and fundamental values are normally taken for granted. Economists, for example, frequently do not even mention the underlying ground rules when they explain how productive activity and exchanges are coordinated, or why one country manages fast economic growth and another fails. They tacitly assume the right institutions to be given. However, if not cultivated with care and defended against the assault of opportunistic operators, a society's institutional infrastructure can decay or remain stunted. 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 debased in dramatic ways, for example in present-day Russia, Cuba, Algeria and North Korea. Interestingly enough, observers often blame freak weather or foreign boycotts for the ensuing economic failures, rather than a lack of shared, credible institutions and shared values.

A Historical Perspective

A long-term historical perspective will help us to fully appreciate the importance of institutions. The lead-up to the industrial revolution, which ushered in the extraordinary, sustained rise of living standards and its spread to a growing number of people on earth, can teach us an important lesson about institutions. Early this century, German sociologist-economist Max Weber drew attention to the institutions that made capital accumulation, innovation and industrial enterprise possible in post-Medieval Europe (Weber 1927/1995). More recently, American, Australian and European economic historians have again highlighted how appropriate institutions and enforcement mechanisms had to be established before confident, enterprising and innovative capitalists could start the industrial revolution in Europe and usher in the modern era of continuing economic growth (North and Thomas, 1973; North, 1990, 1997; Jones, 1982/87, 1988; Rosenberg and Birdzell, 1986; Weede, 1996).

The technical preconditions had certainly been excellent for an industrial revolution in Tang and Sung dynasty China between the seventh and twelfth centuries AD. The artisans and thinkers of India had long had skills and knowledge superior to the Europeans. Why did the industrial revolution nonetheless occur in Europe? The explanation points to the central role of institutions. European and Asian rulers were probably equally arbitrary and opportunistic in their inclinations, with little interest in the material welfare of their ordinary subjects. Different from the large Asian empires, however, the European fiefdoms were small and open. Enterprising bankers, merchants and artisans were 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 power by binding themselves through 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.

In the Middle Ages, feudal law gave each class of citizen specific privileges and obligations. However, merchants who traded between different jurisdictions had found this system too uncertain and cumbersome. Often they discovered that corrupt, arbitrary rulers and judges were simply bad for their business. So they avoided relying on the rule of men or going to court. Instead, they agreed to operate on the principle of equality before the law and began to enforce their own rules. This became known as the medieval *lex mercatoria* (Custom of Merchants). It inspired princes who were eager to attract trade and talented people in order to enhance their tax revenues, to support simple and reliable rules. They began to guarantee economic, religious and civil liberties. Laws and law courts were set up to protect the fundamental institutions of capitalism. They secured private property and a high degree of private autonomy in using those property rights. Fraud and the 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, most notably with the Glorious Revolution (1688), which entrenched the rule of law in Britain (Walker, 1988, ch. 3). Only then 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 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 eighteenth century onward, when Europe opened out and underwent an industrial revolution, China closed and went into economic decline. This inward turn is amazing since China had benefited 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 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). Merchants could therefore be treated arbitrarily. Bureaucrats were able to discriminate with impunity. Court cases could be run without due process or obeisance to any notions of procedural justice. Private fortunes could be confiscated by opportunistic officials. Hence, there was much less incentive to accumulate and use wealth in productive, but visible ways. Much 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 fifteenth century the Chinese eunuch admiral Cheng Ho had sailed as far as Java, India and East Africa and brought home wondrous tales, goods and animals. But one word from a new Ming Emperor sufficed to stop further exploration. By contrast, Christopher Columbus, whose plans for a voyage westward on the Atlantic were rejected by several potential backers, was able to shop around until he obtained the support of the Spanish kings - the rest is history.

In a way, the beneficial impact of open and competing jurisdictions was replicated more recently in East Asia, where it has led to the evolution of institutions that constrain political power and empower the private citizens. In the first instance, the Japanese economy was opened up by American intervention in the mid-nineteenth century. This triggered a great internal constitutional and institutional change, the Meiji revolution. Many of the institutions that facilitated modern economic growth probably existed already, but were adapted to support technical and economic development (Powelson, 1994: 25-39). After the Second World War, the dominant centre of the East Asian world went into seclusion to become the People's Republic of China. As a consequence, several small jurisdictions in East Asia had to cope in the 1950s and 1960s with the experience of openness and external threat - Hong Kong, Taiwan, Korea, Singapore, Malaysia and others. Political entrepreneurs and innovators, such as 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.

The reformist political entrepreneurs who laid the foundations of East Asian development did not act out of deep philosophical insights or their love of capitalism. They had to develop 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 internal institutions after the Second World War 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 need for rules that facilitate spontaneous adjustment grew as the economies opened up. In particular, since the onset of the monetary and banking crisis in 1997, many East Asians have been reminded of the importance of an open, non-discriminatory rule system. Some are now trying to enhance the rules. As their economies mature and the cost of land and labour is rising, institutional evolution and reform will indeed become crucial for further fast growth, confidence, and social harmony. And those political leaders who debase the rules in order to retain or exploit power will discover that capital outflows, currency depreciation and slower growth are a high price for lacking cultivation of the institutions on which the smooth functioning of the capitalist system depends.

The Australian Experience

These experiences contrast with the way Australians have treated their institutions, if they paid any attention to them at all.

In the course of the nineteenth century, the vast Australian continent was developed extraordinarily fast thanks to the inherited British institutions and the imported skills and knowledge which the new immigrants brought to Australia. This enabled the colonies to tap Australia's natural resources, often against the odds and with innovative technical and institutional solutions. Some remarkable institutional innovations, for example on land tenure and organising democratic government, were put in place. In a climate of overall political and social stability, massive immigration and investment from Britain combined with local resources to generate high and rapidly rising living standards (for most of the white population). By the late nineteenth century, average Australian incomes were amongst the highest in the world, and 'Marvellous Melbourne' offered amenities far ahead of most other centres of western civilisation. This was achieved by relatively few people - the population of the entire continent was estimated at a mere $2^1/_4$ million in 1881 (Caldwell, 1987: 26). It would not have been possible without the imported and adapted 'capital stock' of British institutions.

After Federation, the fundamental institutions on which Australians had relied during the preceding century were deftly re-engineered partly in reaction to changes in the global *zeitgeist*, which favoured a new collectivism, partly in response to the insecurities of the land crash of the late 1880s and the attempt by new federal politicians to gain re-election. Increasingly, voters lent support to parliamentarians, such as Alfred Deakin, who promised them new, government-created certainties. The new federal government tried to gain influence over the States by offering a social contract that promised to ensure not a Bill of Rights (guaranteeing freedom from repression, thuggery and arbitrary rule), but a set of guaranteed outcomes: white, subsidy-assisted immigration, protection of certain industries from international competition, the central fixing of adequate wages, state paternalism and international protection under the umbrella of the British Empire.This went along with a sustained process of centralisation that had not been anticipated by the 'founding fathers' (Craven, 1997). Paul Kelly has described how this 'Australian Settlement' became entrenched as the vision of a decent society and how bureaucratic, political and institutional changes provided substance to the 'Settlement' (Kelly, 1992: 1-12).The basic rule system, which coordinated Australians and guided them in their lives, was changed from self-reliance and initiative to reliance on government, and increasingly complex top-down directives and regulations crowding out the spontaneity of civil society.

The community adjusted to the new legal, economic and political institutions. Many Australians may have felt secure and comfortable, but they became inward-looking, non-innovative, uncosmopolitan, unsophisticated and tolerant of proliferating limitations of their freedom. Compared to the boisterous nineteenth century, Australia became a fairly rigid and ordered society, focused on egalitarian outcomes, collective responsibility, and mediocrity. Most importantly, individual entrepreneurship, diversity and experimentation remained underdeveloped, as the new incentives militated against the practice of these qualities. Instead, entrepreneurial energies were directed into political lobbying. Ruthless group egotism became quite acceptable in political life, although it went against the personal liberties, economic dynamism and individual life opportunities of the citizens.

All this began to matter greatly when unforeseen developments led to the disintegration of the 'Australian Settlement' (Kasper et al., 1980: 1-94; Kelly, 1992: 12-16). From the late 1960s, governments could no longer provide the certainties to which most citizens had become accustomed. Per-capita incomes began to lag behind many other OECD countries. Australians had been lulled into false security, and many had lost the alertness and the will to exploit new opportunities on the horizon. In the 1950s and 1960s, Australians coped poorly and slowly with the realisation that Imperial benevolence was no more and that the US substitute for the British Big Brother was not as reliable as had been assumed.The rapid rise of new industries in East Asia, burgeoning international trade and investment flows as the driving forces of fast global economic growth, and the shrinkage of economic distances in the age of the jet and containership were initially not widely diagnosed as the harbingers of the inevitable end to the 'Australian Settlement.'

Although the Whitlam government made some spasmodic attempts in the 1970s to open the economy and look outwards, they soon felt it was all too much and fell back on new, selective protection measures. Across-the-board tariff cuts were soon undone by selective import quotas. But it was clear that Australia was at a crossroads between continued reliance on collectivist, politically-engineered solutions, on the one hand, and a swing to cosmopolitan openness and reliance on individual enterprise on the other (Kasper et al., 1980). It became increasingly obvious that the policy focus on specific outcomes had undermined entrepreneurial capacities to experiment and respond constructively to new circumstances.

As the Information Age impacted and investors and enterprises increasingly shopped around for favourable locations, pervasive rule changes to liberalise product, capital and labour markets were required (free trade, floating exchange rate, free capital flow, free wage negotiation, etc.). For the Australian location to be internationally competitive, it also seemed necessary to move to small, modest government and to enhance the trade-off between tax and compliance costs and government services, including the provision of business-friendly institutions. And it became increasingly apparent that the welfare state was a burden on internationally competing Australian jobs.

The Debasement of Australia's Institutional Infrastructure

Coming to grips with the new circumstances of the late twentieth century and exploiting them to our best advantage requires simple and certain rules of individual and collective conduct. The rules must facilitate discovery, spontaneous experimentation and the expedient correction of errors. This requires an approach to government that abstains from interventions to fix or correct specific outcomes. Last century's effective rule system was destroyed by the many decades of reliance on increasingly detailed, prescriptive and politically-motivated policies. Lobbying for discriminatory rules came to be considered normal. As a result, spontaneous individual responses to emerging opportunities have become harder. The individualistic institutions of the nineteenth century have been replaced, or have even come into disrepute. Where their great-grandparents had been guided by simple-to-understand 'traffic signs,' Australians are now guided by selective outcome engineering, arbitration, political power play and growing uncertainties, often succumbing to moral relativism.

The simple, basic institutions of the capitalist system were often abandoned without a second thought. Australia's 'constitution of capitalism' and the simple rule of the common law, which is relatively easy to understand, fell victim to the onslaught of parliamentary, judicial, bureaucratic and interest-group activism. Government responded to particular interest and advocacy groups and paid little heed to the universal liberties and the life opportunities of individual, diverse citizens. Governance aimed to ensure a predetermined income distribution, a stipulated rate of industrialisation, or particular regional developments. Organised interest groups interacted habitually with vote-seeking political parties and a self-seeking bureaucracy to replace the inherited simple rule system.

How far unbridled Australian parliamentarians are prepared to go in bending universal rules in favour of their political preference-seeking and in dishing out political preferments to their client groups, was revealed yet again in late 1997 when the Senate rejected the government's *Budget Honesty Charter.* This was to subject Australian federal parliamentarians to the same basic rules of accountability as incorporated businesses and executive government, and to reveal independently assessed estimates of the government's assets and liabilities.[4] The Charter was also intended to put independent valuations on the costs of political proposals, making it harder for politicians to fudge the fiscal position. Only in March 1998 did Australia's democratically elected Senate accept the need for quality information and transparency in managing the Commonwealth's collective fiscal affairs.

Following in the wake of those political developments, Australia's judiciary shifted from the traditional focus on cultivating procedural justice to engineering what they perceive to be social justice often with little understanding of the economic consequences of their interventions. The changes to the law often debased Australia's institutional system further. Thus, the principle of protecting private property rights has been overruled in the interest of social justice, for example in the judicial re-interpretation of work contracts or land titles. In addition, quasi-judicial bodies have proliferated and made new rules (Ratnapala, 1990). Most of these interventions have had unforeseen side effects that needed correction by further interventions. As the rules become

4 The incoming Howard administration appointed a high-level National Commission of Audit to report on the government's net wealth position (National Commission of Audit, 1996). To a resounding lack of enthusiasm from politicians, it recommended that the Commonwealth government adopt new standards of transparency and accountability (1996: 276-277) and estimated the Australian government's assets and liabilities. As of 1994-95, the Australian government's accumulated results and reserves are *minus* \$73 395 million (1996: xxii, 273-300) – in other words, successive governments have been in the business of value-destroying, rather than value-adding, to the tune of \$73 billion! Australia's corporate affairs watchdogs would doubtlessly close down a business with such a dicey balance sheet, and international creditors would run away.

more complex and specific, they also become less certain and less comprehensible. And people begin to realise that they have been losing control over their own lives.

Many ordinary citizens now feel disenfranchised, helpless and listless. They feel increasingly like football players whose rules are continually and unpredictably rewritten. As well, the promise of government to provide certainties to client groups could not be fulfilled either as circumstances kept changing. The process led to less predictability for ordinary citizens, as the supposed government-made certainties for some had to be bought for the price of the unpredictable discrimination against others. Fundamental values and modes of behaviour changed, as more and more people operated on the maxim 'let's rip off, and let us all be ripped off!' Where this is not possible, shirking and cynicism often take over.[5]

As a result, Australia's economic growth was poor from the 1960s onwards - not necessarily compared with the past record, but with other countries and with Australia's splendid opportunities. After the Second World War, Australian per-capita incomes had been markedly above those of Western Europe; from the 1960s they fell increasingly behind. Many East Asian neighbours, who had started from a very low base, began to catch up with unexpected speed.

Policies that had been developed when two-thirds of the world's manufactures had been made in the UK, the US and Germany were evidently inappropriate for a time when numerous new industrial countries were pushing into world markets. Since the 1960s, the global industrial workforce with direct access to modern methods of production and international distribution has jumped from somewhere around 250 million to well over a billion. The revolution in transport, communications, computing and management is thus making external challenges to the jobs and the competitiveness of numerous Australians more and more immediate. When Australian governments belatedly began to change the entrenched institutions and partially liberalised the economy from the 1970s onward, this coincided with globalisation. International competition has intensified also because a growing share of international trade and investment is no longer between different firms in different countries, but among different branches of the multinationals.

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5 One aspect of the decay of the institutions, which we cannot pursue further here, is a rise in criminality. Violent crime per inhabitant rose sixfold from the early 1960s to the early 1990s, and crimes against property recorded by police in the same period rose more than tenfold (Sullivan, 1997: 8-21). These are telling statistics which show the extent to which our rule system has been debased.

They now manage about one fifth of the world's gross product and a third of all international trade.

Australian jobs now have to compete with this rapidly growing number of competitors, and no government or union will be able to protect them. In the 1980s and 1990s, many Australians were confronted with the need to make major adjustments. Most perceived this as a threat, and not an opportunity. This is not surprising as people had to discover that their institutional infrastructure constituted a distinct handicap in global competition. No wonder they now lack confidence and feel confused. Whenever parliamentarians and bureaucrats respond with the familiar knee-jerk mechanism of promising certainty and providing new preferences to well-organised groups, they unwittingly erode the fundamental institutional infrastructure further. Activist 'social engineers,' who respond to organised groups, go on handicapping those citizens who are less well-connected and well-established, such as the young. Rising foreign and public debts have added to the uncertainty.

As of the late 1990s, the conceptless industrial policy activism of the early Howard government, its complicated, confusing industrial-relations legislation, its promises that no-one will be worse off in a period of turbulent change and its timidity in reforming a number out-of-kilter areas have only added to the confusion. There was a promise to reform the politicised and unnecessarily complicated institutions of the Australian labour market. But instead of replacing the complicated industrial-relations system by simple, easy-to-comprehend rules such as the freedoms of contract and association, as New Zealand had done on twenty pages of legislation (Kasper, 1996), the Howard government promulgated a confusing two-track system with numerous *dirigiste* stipulations that were too clever by half. No employer, who might create extra jobs if assured by simple rules, could understand the over 550 pages of new legislation. Consequently, Australian labour markets remain captured by politico-bureaucratic and quasi-judicial interests and therefore dysfunction. The lack of simple, reliable rules keeps unemployment high. It is not surprising that this institutionally deficient reform attempt failed to provide the basis for an expedient dissolution of the costly labour monopoly and the stevedoring duopoly on the waterfront. When put to the test in early 1998, these complicated, fuzzy rules failed the test, because Australian lawmakers had - yet again - failed to understand the basic principles of effective institutions.

Interest-group representatives were invited by the incoming Howard government to write reports on how to promote this industry or that in isolation and to submit plans for selective government schemes, some of which were implemented (Hughes, 1997-98). The same spirit of *dirigisme* lives on in the decision to grant exclusive access to the new medium of High Definition Television to the big established players and the two government-owned networks. How do they know that new outsiders would not exploit the new technology to the greater advantage of Australians and discover entirely new applications?

Average citizens, who had originally lent overwhelming electoral support to the change in government, soon came away with a feeling of betrayal, if not cynicism. This is so despite the fact that economic growth has been fairly steady and inflation-free in recent years, that Australian standards of living, amenity and personal safety are ahead of most other countries. Paradoxically, Australians feel insecure, although they experience no major threats to internal and external peace and weathered the impact of the Asian crisis well. Those who fail to understand the central importance of institutions will find this a puzzle!

What Has Gone Wrong?

Continuing prosperity depends on the discovery, testing and use of new knowledge (innovation) and the coordination of increasing numbers of people with specialised knowledge, skills and other assets. Two sets of rules of economic coordination are critical:

— institutions that protect private property rights in most of the means of production, including one's labour and knowledge ('self-ownership'), and

— institutions that create predictability in our interactions with others, namely that safeguard the principle of private autonomy to enter into voluntary contracts and that establish full responsibility for all possible consequences of deals made or efforts not made (law of torts and responsibility for one's own actions).

These fundamental ground rules constitute the pillars of the capitalist system. They need to be embedded in the rule of law, in particular the equality of all before the law (principle of non-discrimination).

In Australia, the straightforward rule of law has been replaced in many spheres of economic interaction by the rule of men - or rather committees, unelected officials and influential, organised interests. Thus, the freedom of contracting one's labour and associating has been replaced by industrial relations and the rule of quasi-judges; international trade and foreign investment have long been the subject of detailed government intervention and ever-changing regulations; and property-rights protection has been prejudiced by burgeoning rules on land-rights, health, safety, income distribution and business management. Many land titles have become uncertain and conditional on future political and judicial decisions. Australians are not free to enter many trades and professions, or to start businesses without a wad of government licenses. As a result, Australian rules are now complicated, and enterprise is hampered because the outcomes of private ventures are often impossible to assess.

The rules have been undermined by a growing avalanche of parliamentary, judicial and bureaucratic activism, often to please particular interest groups:

— Prescriptive rules and regulations have been allowed to proliferate with little regard for negative long-term side effects. For example, specific industries are singled out for preferment under industry plans, without any regard to the costs that this imposes on all other industries or on the consumer. Some jobs are subsidised each year by more than the annual pay to workers.
— Clever outcome engineering by activist politicians has made the rules less universal and less understandable. Property rights are increasingly eroded by burgeoning restrictions, and in New South Wales they even vary the traffic fines between holiday and non-holiday periods. As the rules become less certain, they lose much of their normative and coordinative power, so that people can feel less confident when acting spontaneously. People want to be law-abiding, but often the law can no longer be known.
— Proliferating public redistribution policies are clashing with the protection of private property rights. There is increasing confiscation of the very private property that governments once were charged to protect. Detailed, discriminatory regulations further erode private property rights and private autonomy.
— It is now widely accepted as normal that public policy serves the interests of deeply entrenched, well-organised particular interests, political parties, and self-interested bureaucracies, rather than the interests of individual citizens. Parliamentary parties primarily seek their own political re-election, and tribunals shelter vocal groups from having to defend the value of their assets in competition. The political protection enables industries to engage in political activism and to lobby for further protections. Thus, in 1998 the Australian Parliament decided for a third time in three years to prohibit the free importation of CDs in favour of a few well-organised record producers.
— Rules and the law are often violated with impunity. To cite but two

recent examples: the secondary boycotts of coal transports in the Hunter Valley were tolerated in 1997, although new federal law explicitly bans such boycotts, and the waterside workers union continues to hinder the creation of non-union jobs on the waterfront.

Many Australians instinctively resent the confusing complication of the rules. They prefer simple and certain rules. This was evident in the passion of popular reaction to the proposed legalisation of heroin or euthanasia in specific circumstances. The more specific the circumstances and conditions they have to diagnose to know what is right or wrong, the more confused they get!

It is not surprising that Australia's inherited and unwritten political and economic rules of constitutional quality are now perceived as weak and that confidence and trust are declining. In the 1990s, when complicated and necessary adjustments have to be made, clear and simple rules would help ordinary Australians and business investors to cope. Instead, institutional insecurity adds to the adjustment problem. This is often leading to the outflow of capital, enterprise and knowhow to countries with better institutions (see Insert below). The result of deficient institutions therefore is the disemployment of Australian labour and an erosion of the tax base.

In today's world, governments have to compete among each other as suppliers not only of physical infrastructures but also of institutional infrastructures. They have to become support organisations for capital, enterprise and knowhow.[6] Where the rules are complex, arbitrary and fuzzy, business transaction costs are high. The returns on capital and other mobile resources are compressed. Fewer economic opportunities are then open to workers who cannot easily relocate to more promising locations overseas.

In short, Australia has not done very well in preserving the simple, non-discriminatory constitution of capitalism, so essential for attracting and retaining mobile resources. In particular, the labour-market constitution is weak by international comparison (see Insert). It is safe to predict that continuing failure to come to grips with this problem will lead to further de-industrialisation, slow economic growth and, ultimately, a loss of national security.

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6 American economist Paul Krugman (correctly) said that governments do not compete the way business corporations do (Krugman, 1994). However, in a way typical of neoclassical economists who are blind to institutions (see following chapter), he overlooked the crucial role of governments as suppliers of institutional arrangements in globalised competition.

Australia's Institutions in International Comparison

Since the quality of 'institutional capital' matters greatly to the future attractiveness and competitiveness of the Australian location and hence future prosperity and security, a glance at a few international comparisons is useful. Table 1 compares per-capita income levels and recent growth data with what internationally comparable indicators of institutional quality are available as of the mid- to late 1990s:

- The Economic Freedom Index is prepared by a group of think-tanks around the world, led by Canada's Fraser Institute and including the Melbourne-based Institute of Public Affairs. This index looks at the protection of economic liberties in areas such as freedom from intrusive price regulation, freedom from inflation and freedom of international trade and investment. (It does not cover the freedom to work and associate.)
- The *Index of Institutional Quality* is based on assessments by internationally experienced business executives who responded to the questionnaires of the reputed World Economic Forum in Geneva, published in the *Global Competitiveness Reports 1997*. The respondents rated the various locations according to what they saw as supportive of the profitability of big international businesses. To obtain the data in Table 1, I have aggregated responses to questions such as 'is there a risk of outright nationalisation of property?', 'is the legal system effective?', 'are irregular payments common in business and government?', 'do citizens accept legal dispute settlement?', as well as assessments of labour-market institutions, for example 'do labour regulations facilitate flexible adjustment of working hours?' or 'are labour-employer relations generally cooperative?'

Australia is compared with those countries in the Pacific region with which Australians increasingly have to compete for mobile capital and enterprise, as well as a few selected European countries. It can be seen that, on economic freedom, Australia is ranked equal tenth out of 115 countries. This is not disastrous, but markedly behind New Zealand and the US. Many East Asian countries – though not the city states – are competing with economic institutions of poorer quality. But then, Asians are not yet trying to earn the top per-capita incomes that Australians aspire to.

Australia's general economic institutions are not top-rated, though not dramatically below leaders in institutional quality, such as New Zealand and the USA. However, when one turns to labour-market institutions, Australia occupies a poor position, despite the Coalition government's attempts to reform industrial relations. We rank far behind the US and New Zealand, let alone the Asian 'tigers'. Overall, Australia's institutions are ranked a mediocre 31st out of 53 countries covered in the *1997 Global Competitiveness Report*. This means that Australia's institutional infrastructure is a distinct drag on international competitiveness. This constitutes a handicap when justifying the relatively high Australian incomes in increasingly open world markets.

The data in Table 1 certainly does not mean that Australia will descend to the level of institutionally dysfunctional societies such as those of Russia, Latin America or Africa. But Australians remain in the neighbourhood of the ageing, institutionally deficient and stagnant welfare democracies, such as Sweden, France or Germany. The data – limited as it may be – indicates clearly that Australians have failed to reform their economic institutions sufficiently to reap income growth commensurate to our good location, comparative youth and virtually unparalleled per-capita resource endowment. This failure destines us to be among the 'slow-coaches' in the Asia Pacific region.

Table 1 raises the question why certain Asian countries with moderate economic freedom and mediocre institutional quality have enjoyed high growth in the past. The answer is that they started out from low income (and wage-cost) levels and engaged in considerable, though partial, institutional innovation (Kasper and Streit, forthcoming 1998, ch. 14). The 1997-98 economic crisis has, however, demonstrated that institutional innovation was insufficient to cope with rising national cost levels – not to mention institutional backsliding into corrupt practices. Indications are that the crisis is now triggering renewed efforts to enhance institutions, at least in some countries. It is likely that this will put new competitive pressures on Australians to cultivate business-friendly institutions.

To properly appreciate the central role of clear and simple institutions in achieving sustained growth, a few basic, but realistic assumptions about human behaviour will need to be explicated to give substance to the hypothesis that evolving knowledge is the major source of economic prosperity (Chapter 2). Institutions will be defined, so that we can understand how individual actions and institutions are ordered. We shall also explore the qualities that institutions need to have if they are to be effective and business-friendly (Chapter 3). Chapter 4

Table 1: Measures of Income and Economic Freedom

- rank numbers in [ ] -

Country	Per-capita income (1995, US$ at PPP(1))	Growth rate (% p.a.) Real GNP/cap 1985 - 95	Ec. Freedom Index (1995, out of 115 countries (2))	Quality of General Institutions	Labour Market Institutions	Overall Institutional Quality
				— own calculations, based on the Globol Compet'ness Report 1997 (3) —		
Australia	18 940 [18]	1.4	7.0 [10=]	5.5	3.4	4.4 [31]
United States	26 980 [2]	1.4	7.9 [4]	5.6	4.7	5.1 [8]
New Zealand	16 360 [22]	0.6	8.0 [3]	5.8	4.7	5.3 [5]
Japan	22 110 [6]	2.9	6.7 [18]	5.4	4.9	5.2 [=6]
Hong Kong	22 950 [4]	4.8	9.3 [1]	5.6	5.7	5.6 [2]
Singapore	22 770 [5]	6.2	8.2 [2]	6.0	5.8	5.9 [1]
Taiwan	15 701 [23]	6.2 (e)	6.8 [16]	5.0	5.0	4.7 [16]
South Korea	11 450 [28]	7.6	6.7 [18=]	4.6	3.7	4.2 [=35]
Thailand	7 540 [34]	8.4	7.2 [7]	4.5	4.4	4.4 [=26]
Malaysia	9 020 [31]	5.7	7.0 [10=]	5.3	4.7	5.0 [11]
Indonesia	3 800 [45]	6.0	6.3 [29=]	4.5	4.8	4.7 [=8]
China	2 920 [48]	8.0	4.3 [81]	4.9	4.2	4.5 [22]
UK	19 260 [17]	1.4	7.3 [7]	5.8	4.9	5.4 [4]
Germany	20 070 [14]	1.9 (e)	6.4 [25=]	5.9	3.2	4.5 [22]
France	21 030 [12]	1.5	6.1 [36=]	5.6	2.7	4.2 [=35]

(e) Own estimate.

(1) Per-capita incomes expressed in purchasing power parities, i.e. taking into account what an average income can buy in terms of a basket of goods and services. Source: World Bank, *World Development Report* 1997.

(2) An index of 17 criteria measuring ECONOMIC autonomy to use and dispose of one's material property, running from 10 [top rating on freedom] to 0. Ranking out of 115 countries in [ ]. – Source: Fraser Institute, *Economic Freedom of the World 1997.*

(3) 16 criteria from the survey of international business leaders in the World Economic Forum's *Global Competitiveness Report 1997* were weighed into an index running from 10 [top rating on freedom] to 0 to assess the quality of general institutions. Six criteria from the same source were weighted into an index of labour market institutions. Both together form the Index of Institutional Quality. Ranking out of 53 countries in [ ].

contains a discussion of the institutions that guarantee private property, and Chapter 5 proceeds to show that the competitive use of private property is essential to progress. This requires that the manifold private and public limitations of competition are tackled in the knowledge that active competition is a public good. In some (few) cases, such limitations are justified and political action is needed to decide economic allocation, but this is always problematic (Chapter 6). Chapter 7 will return to making the case for a comprehensive effort to clean up Australia's constitution of capitalism and to impose institutional constraints on the conduct of policy makers. Democracy will only be compatible with long-term, sustained prosperity and freedom if the power of parliamentarians, judges and administrators is tethered by institutions that constrain opportunistic behaviour.

CHAPTER TWO

THE ECONOMIC PROBLEM: COORDINATION, KNOWLEDGE AND MOTIVATION

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

Adam Smith, 1776/1970-71: 10

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

F.A. Hayek, 1978: 183-190.

To understand the importance of institutions in economic life, one has, in the first place, to understand what an economy is. It is an extremely complex, evolving system – not an organisation where top-down commands can be relied on to produce all wanted results. It is a living organism with an unimaginable multiplicity of complex interactions that evolve over time. We face the economic problem of scarcity because we do not know where to find sufficient resources and how to match them with our diverse and changing wants.

In the venture of matching wants and resources, which is at the core of economics, the pervasive knowledge problem is compounded by a frequent problem of motivation. We have only limited solidarity with complete strangers, on whom we frequently depend. Others often fail to make sufficient efforts to satisfy our wants. Frequently, we 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 have to know to be effective. They also assist with 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

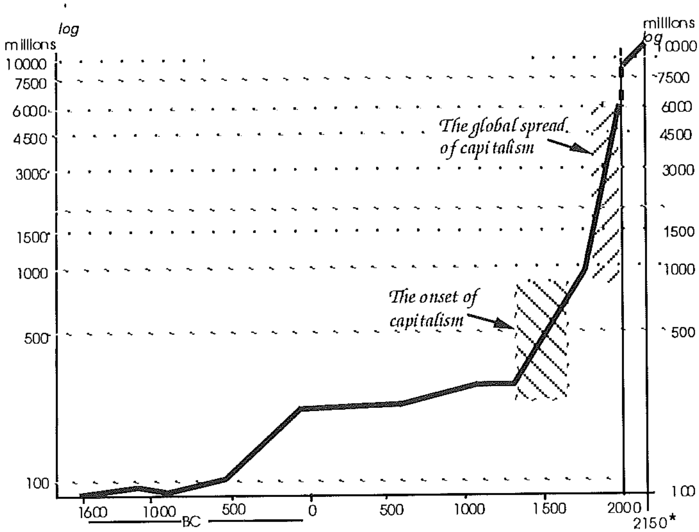
Every beginners' text on economics starts by making the point that the essence of economics is scarcity - human wants having the tendency to exceed the resources needed to satisfy them. The human ability to discover more wants than resources to meet those wants has been an eternal obstacle to human contentment.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

Scarcity forces people to make choices between alternatives. The choice of one use of resources means that other opportunities have to be foregone, for example your purchase of a new car may mean that you cannot afford an overseas holiday. Economists speak of 'opportunity costs' to describe this concept. It is clear that everyone's opportunity costs vary subjectively. For you, the opportunity costs for reading this chapter may be that you cannot attend a rock concert, for someone else that she cannot flirt with her boyfriend.

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

Material progress has had enormous non-material benefits in terms of security, peace, justice and cultural achievements. Growth is not only a matter of better food, shelter and other basic needs, but more access to knowledge, to shared artistic experiences, mobility, conflict resolution, a healthier, longer life and absence of fear. Economic growth has gone along with a dramatic rise in education, health and cultural amenities. Economic progress is about more choice. As a matter of fact, the twentieth century is extraordinary because the unprecedented rise in living standards has gone along with truly extraordinary population growth. This is so because the onset of economic development tends to reduce death rates quickly, but birth rates slowly. As a result, the world population has soared after the onset of widespread economic development. Population will ease again in the twenty-first century (Graph 1), as birth rates in affluent societies drop. We therefore speak of 'demographic transition.' The fact that some who survive are still desperately poor – in earlier eras they would simply have died young – should not detract from a generally cheerful view of humanity's economic achievement.

Graph 1
World Population
The Most Recent 3600 Years



* Medium-fertility forecast by United Nations

Source: J.Simon (1995), p.35

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

All this does not mean that economic growth can be taken for granted. Local catastrophes and episodes of economic decline - such as the decay of the Roman empire into the Dark Ages, the Chinese economic decline in the nineteenth and early twentieth centuries, the disintegration of the world trading system in the 1930s, or the economic collapse of the Soviet empire - are stark reminders that economic growth has to be nurtured carefully. Economists are agreed that growth is a complex process in which numerous, interacting conditions have to be met. The main source of economic growth is human knowledge; not only the wisdom, knowledge, knowhow and aptitudes that reside in the individual, but equally importantly the shared human capital that allows individuals to make the best of their assets. These are the institutions that guide human interaction. Periods of material and cultural advance have normally been ushered in by periods of institutional development. Periods of material decline have typically been preceded by periods of institutional decay.

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 interdependent and complex. It never stands still or simply reproduces what was done before. Much of economic life is about innovative resource uses, new technologies, better ways of organising factories, commerce and service delivery, and testing new goods and services. In that sense, the economic system is open-ended (O'Driscoll, 1977). It evolves in unknown and unpredictable ways.

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

We speak of a 'system' when various elements interact 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 such constellations of systematically interacting elements. A system is simple if the parts interact only with regard to one characteristic. Thus, the battery in my watch drives the clockworks. We speak of complexity when elements interact with regard to more than one characteristic. Thus, my university department is a web of social interdependencies and feedbacks. So are world currency markets, where numerous hard-to-comprehend interactions take place among millions of decision makers.

Some systems are static, repeating the same interactions in each period (for example, my watch until the battery is flat). The economy is an example of an evolving system: we learn new knowledge and apply it, others may select or reject the results, so that some concepts and elements gain critical mass and become widely accepted, others vanish. Economic evolution follows a path, 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 mind. With hindsight, the evolution of a system is evident. But its direction and detail cannot be easily predicted, as no-one knows beforehand what selections the many individuals will make when faced with changed circumstances (see 'Evolution' in the Glossary at the end of this volume).

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 is 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.

We speak of an evolving system if successive states of the system follow a path of change. 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 change at random all the time, cognition breaks down and we can make no sense of what we see. Similarly, overwhelming changes in economic life lead to massive mal-coordination because people are confused. This was, for example, the case after the Soviet revolution in 1917 when markets and private property were abolished. Economic chaos resulted, and Lenin had to backtrack by re-introducing markets in some areas. Likewise, there are indications that many Australians have been overwhelmed by the many changes in the 1980s and 1990s. We have lacked guiding institutions that would have made our task of cognition more manageable. It is in our interest that systems change gradually and with a pattern that we can understand.

Even when complex systems evolve in a broadly predictable pattern, specific outcomes may not be predictable and cannot be easily achieved. If an 'ordering hand' intervenes in such complex, evolving systems, this is likely to produce unforeseen and often detrimental consequences (Hayek, for example 1974/1984 and 1988; Parker and Stacey, 1995).

In recent decades, complex, evolving systems have come to be better understood by scientists (Anderson et al., 1988; Arthur, 1995; Parker and Stacey, 1995). We have, for example, learnt that ecological systems are complex and evolve, so that interventions often lead to unexpected, deleterious side effects. 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 we often 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 we turn to the complex, evolving system of a national economy. Here, millions of individuals interact in complex ways. They do so as producers and suppliers or buyers of goods and services, and as owners and users of assets. What happens in a distant part of the global economy may have untold effects in a factory or a field near you. For example, when oil supplies were curbed in the early 1970s and then again in the early 1980s, this affected virtually everyone on all six continents. The price rises sent a coded signal to millions of people to drive less, to buy energy-saving cars, to save energy in home heating, industry and transport, to replace petroleum products by other sources of energy, to 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. At the time, some observers went as far as almost predicting the end of modern civilisation. Yet, numerous decentralised, spontaneous, flexible, creative adjustments overcame the crisis - admittedly costing effort and sacrifices. Humankind went on prospering. Where an ordering hand intervened in this complex system, for example by fixing gas prices, chaos and unforeseen complications resulted.

Is it not paradoxical that people who preach caution when intervening in complex ecosystems, are still advocating interventions in equally complex and evolving economic life? They pretend such interventions are feasible and their effects can be fully predicted and controlled. Indeed, they often demand such interventions in economic processes on the assumption that one can intervene without unforeseen, hurtful side effects. Many Australian policy commentators and academics still have a fundamental belief in the visible, coordinating hand of government - as if governance was as simple as pushing a few policy buttons! A long record of disappointments with simple-minded interventions in the past does not seem to teach most of us that such a style of economic policy is not feasible. Academic and media commentators have persisted with a preference for what has long been castigated as 'social engineering' (Popper, 1945: 22-25), 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 evolutionary - so to say 'ecological' - view of economic life has not yet been widely absorbed into popular culture.

Ignorance, Discovery and Knowledge

In complex, evolving systems, knowledge becomes a central focus. Who can master what knowledge? How can various people's limited knowledge be coordinated? How do people discover new information and 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? These are some of the questions that are explored by philosophers under the rubric of 'epistemology' (from Greek *episteme* = knowledge).

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

Because of this pervasive knowledge problem, it makes no sense at all to build models of human action and public policy assuming that people, or committees of policy makers, have 'perfect knowledge.' One cannot legitimately assume the vexatious knowledge problem away and still hope to explicate economic issues. The knowledge problem is *constitutional* to the economic problem. Were we all-knowing, scarcity would not exist! As Hayek has pointed out, models that begin by assuming perfect knowledge 'for simplicity's sake' lead to nonsensical answers (Hayek, 1948: 94; also see O'Driscoll and 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. Gravity is a first-order (or constitutional) element of the subject matter. But one may of course begin by assuming second-order elements away, such as humidity, air temperature, and wind, when analysing ballistic trajectories.

Likewise, economists who assume perfect knowledge have unwittingly assumed the essential economic problem away - how to find and use evolving, complex knowledge. They have reduced economics to the petty issues of allocation of *given*, *known* resources to *given* wants with the aid of *known* technologies (the reader may wish to refer to the 'Postscript' on neoclassical economics at the end of this chapter). In such a closed, anaemic world, there is no need for profit, search-cost saving, entrepreneurs, and business management. Businesspeople and other practitioners - rightly - switch off when economists make the assumption that all relevant knowledge is available, 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. They cannot possibly be concentrated in any one place or human mind. 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 to some or many people, and new ideas are selected and accepted. In ways similar to biological evolution, the body of human knowledge thus evolves under the influence of millions of decentralised human choices.[7]

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

We have to distinguish in this context between genuine discoveries and new supplementary information (Kirzner, 1997). We should speak of a discovery when something becomes known of which a person or a community was previously totally ignorant. With hindsight, discovered facts will be quite obvious. For example, we speak of the discovery of America, as Europeans were unaware of the existence of that continent, and of Matthew Flinders's discovery that Tasmania was not part of the Australian mainland. A second-order type of ignorance exists where the big, general outlines of human knowledge are vaguely known, but the details have to be filled in by supplementary information. Here, we speak of 'information search.' Thus, the explorers who traced the coastline, the engineers who got nuclear power to work in power stations, the software developer who tests serial combinations to get new computer programs, and the market researcher who establishes where sales outlets should be placed – all search for information. They are not after 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 discoveries because the object is totally unknown. Thus, Christopher Columbus cannot be called an 'efficient discoverer' because he chanced upon America. All we can say is that he had attributes of curiosity and tenacity that made him more likely than others to discover some genuinely new knowledge and that he was prepared to marshal resources for exploration. (Economists should refer to the 'Postscript' at the end of this chapter, and 'Knowledge Problem' in the Glossary.)

The knowledge problem in economics is further increased by the fact that everyone has different knowledge and that diverse people pursue their own, differing, subjective purposes. Everyone values options in her or his personal manner. People will not necessarily chose what others have chosen. Since one's opportunity costs depend on one's subjective and changing preferences, they cannot be readily known to others. This adds to the knowledge problem in economic life. It also means that collective choices affect everyone's well-being in different ways. 'One size fits all' may suit you, but be hopelessly inadequate for me. Summary collective purposes can therefore not be imposed on entire communities without great losses to individual satisfaction. This is at the heart of what has been called 'subjectivism', a concept that has profound implications for one's world view and for how one wants public policy to be run (see 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. We therefore have 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 us to be wary of collectives as pseudo actors. It forces us to focus always on the real actors. Once presumed collective motivations are brushed aside (example: 'the government wants to maintain tariffs in the national interest'), we come to a much better understanding of public policy, for example: 'The minister of industrial affairs 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 look-out for statements that imply phony collective actors (such as 'the world community,' 'the Australian public,' 'the national will') and to translate these statements into subjective, individual terms. Consider such exercises as truth-finding devices!

Three Kinds of Rationality

When they act in complex, evolving environments, individuals typically adjust their aspirations in the light of 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 (means-end rationality: refer to 'Rational Behaviour' in the Glossary).

When faced with incomplete knowledge, decision makers do not go on indefinitely chasing additional knowledge. After all, knowledge acquisition costs resources, time and effort – it causes what economists call 'transaction costs.' And the world changes anyway. Instead, experience tells decision makers when they should probably end the information search and make a decision based on what they have been able to learn so far, rather than remaining moored in 'paralysis by analysis.' When past experience shows people that they consistently under- (or over-) fulfil their aspirations, they will adjust their aspirations downward (or upward) (Simon, 1982; Streit and Wegner, 1992).

Such pragmatic behaviour is a far cry from the means-end rationality that underlies most contemporary economic analysis. *Homo oeconomicus* is assumed to know all the ends and all the means and will then maximise 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, a self-contained household in Antiquity could, after the harvest, plan survival to the spring by 'economising' (this effort of rationing scarce resources was called 'oikos' by the ancient Greeks). Engineers may 'maximise' the performance of a given machine. We may aspire to maximise the distance we can jog within 30 minutes.

However, in more complex constellations, we do normally not know enough and cannot control what is going on to engage in such a 'rational' pursuit of a given end. Then, narrow, means-end rationality has to give way to bounded rationality. This important point can probably be best understood by discussing an everyday example: I can make a rational choice as to which of my shirts 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. The narrow rationality of neoclassical economics would be totally inappropriate for such a locational choice. Means-end rationality is therefore an inappropriate guide to analysing evolving complex constellations, which are typically the content in which economic policy operates.

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

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 and Streit, forthcoming 1998). Entrepreneurial behaviour is fairly prevalent when peo-

About Economic Rationalism

The term 'economic rationalism' has been given many and contradictory meanings in Australia, so that it has become meaningless other than being an all-purpose invective against those who advocate less collectivist economic policies and the re-privatisation of the responsibility for personal economic welfare. Those who argued this line of policy in the 1980s (see, for example, Kasper et al.,1980; James, Jones and Norton, 1993) never shared a common methodological base. Some, including this author, came from classical liberal philosophy and Austrian economics, i.e. held economic life to be an open-ended complex and evolutionary phenomenon; others - in particular in pro-market government agencies and consultancy firms - worked with models that had been closed off to unforeseeable future events in line with the assumptions of neoclassical economics. These methodological inconsistencies weakened the case for less government and more market. They also contributed to the current setback of a 'retro fashion' in economic policy making, namely extending tariffs and other interventions, picking winners to receive government subsidies, and obstructing the liberalisation of markets.

ple have confidence, even if they can never be absolutely sure of the results. Entrepreneurship is at variance with the means-end rationality of *homo oeconomicus*. As we shall see, discovery and the use of knowledge, which are so important to prosperity and job creation, depend greatly on the prevalence of the entrepreneurial spirit to break away both from means-end and adaptive kinds of rational behaviour.

When we allow for adaptive and creative behaviour - rather than just the maximisation of given ends by known means - we begin to appreciate the importance of devices that economise on the need to know, namely institutions that create confidence.

Economists who approach what is an open, ongoing process of economic life on the familiar assumption of *ceteris paribus* (all other things being known and remaining the same) and who operate with the 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 they deserve the criticism that this concept has been subjected to in Australian public debate (see the above Insert and the 'Postscript' at the end of this chapter).

What Motivates Us?

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

Most of us have experienced motivation first on the plane of altruism, solidarity, and love. In the small setting of our family we know the others fairly intimately. We can also influence their reactions. Altruism is a highly effective way of cooperation in such small communities (Hayek, 1976: 133-152; Boulding, 1962; Giersch, 1989; Norton et al., 1997). Yet, even in small communities - though kind souls may regret this - love and solidarity frequently have to be backed by authority and coercion. The parents - or tribal elders - at times have to coerce others in the group. This tends to be tempered by empathy and intimate knowledge of the others. In modern macro societies, we interact with millions of strangers and depend on their motivation to fulfil their promises to us. We cannot depend on love alone because we do not even know many of those people with whom we interact. Solidarity and benevolence decline quite naturally with social distance. Therefore, other motivating mechanisms are needed, either compulsion and fear, or self-interest.

The latter is the main motive that drives human cooperation in the capitalist market economy. People pursue their own ends, generating by-products which are welcomed by others. Shocking as it may appear to some readers, the baker who provides you with your daily bread, the doctor who makes a house call in the middle of the night and the employer who provides you with a job, do so because they are after an income. Your bread, health care, and jobs are mere by-products of their selfishness! Whether such a system works well, depends - as writers from David Hume (1786/1965) and Adam Smith (1776/1965) to Friedrich Hayek (1989: 6-47) have pointed out - on an institutional system, an extended order that coordinates spontaneous human actions as if by an invisible hand.

Those who reject self-interest as a valid motivation - for example Fabian socialists and church leaders - have to rely on 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 discovery procedures by coercion. These conditions are rarely fulfilled, as we know from events like the demise of coercive socialism in the Soviet bloc and the malfunctioning of guided systems like Australian industrial relations.

The voluntary coordination of self-interested people and organisations requires shared, respected rules. People can only interact effectively, given their cognitive limitations, if recognisable, predictable patterns of behaviour exist. They depend on an 'order of human conduct,' which normally requires that arbitrary and opportunistic behaviour incurs punishments (sanctions). In other words, the division of labour and knowledge 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.

Human interaction in macro societies, such as a nation or a national economy, can therefore – on the whole – be coordinated only by relying on spontaneous actions that respond to individual incentives through voluntary cooperation (contracts). Individual actions then are ordered by shared, enforced rules of conduct (institutions). This is normally preferable to a coercive, collective, top-down approach to the economy, because the leaders, too, suffer from limited cognition and motivation. Besides, the coercive approach imposes high costs of supervision, monitoring and enforcement if it is to work at all. It was, for example, found that slavery was very inefficient and costly, and that free, paid workers had much higher productivity and needed less monitoring when slavery was abolished in the Americas.

Principal-Agent Problems

What has been said about knowledge and motivation is at the root of another pervasive problem of human interaction, which has become known as the 'principal-agent problem' (see Glossary). Whenever someone (the principal) draws on the services of someone else (an agent), there is a possibility that the agent will be better informed than the principal about the task at hand, about what can be achieved and whether the best is made of opportunities. But the agent will frequently be motivated to pursue his or her own purposes, not necessarily those of the (ignorant) principal. The 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. They were inclined to shirk risks, prefer high on-the-job consumption, and pay themselves high salaries at the expense of the principals' profit (Berle and Means, 1932).

In the meantime, it has been found that share companies outperform other types of business organisations - such as mutual societies and family firms - because competitive markets, which surround the share company, produce information for the share-owning principals. Competitive markets exert control of agent opportunism because the principals, once informed, can act to assert their interests. The competitive discipline that matters here derives not only from the market for the products of those companies, but from agile, competitive share markets, takeovers (reflecting a market for corporate control), and markets for managerial skills (Jensen and Meckling, 1976; Jensen, 1983; Jensen and Ruback, 1983; Bishop, Dodd and Officer, 1987; Dodd et al., 1987).

The principal-agent problem has proved to be a much more serious handicap to motivating agents in areas not subject to competition, such as government administrations. Serious motivational deficiencies could be observed in centrally-planned economies where most resources are socialised. This can get to the point where lacking 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 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 able to run government to suit their own purposes, even when this is at the expense of the citizens. A classic contemporary example is the behaviour of the ATSIC bureaucracy, whose capacity to absorb funds without delivering much improvement in Aboriginal health and welfare seems limitless.

We shall return to this important problem in Chapter 6 below.

Conclusions So Far

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

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

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

The Knowledge Problem 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, peering into the 'fogs of ignorance.' This is an essential and constitutional condition from which one cannot abstract without getting nonsense answers.

If one takes the knowledge problem seriously, as Austrian economists have done (Hayek, 1945; Boettke, 1994), 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, cannot, in reality, be upheld; for example:

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

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

(c) Another consequence of human ignorance is that all human interaction requires information search, which is often costly and risky. Markets do not function without cost. They require buyers and sellers to incur what economists call 'transaction costs', most of which are information search costs or costs to cope with the risks of imperfect knowledge (contracting, supervision, enforcement). Much real-world economic activity deals with this problem. Over half of all costs of producing and distributing the national product in modern economies are transaction costs (North, 1992). Indeed, the fastest-growing part of our economy is the transactions and communications services sector: communications, advice-giving, accounting, finance, business services and the like. Traditional mainstream economics has little to say about the service sector because it assumes that all is known, and that market transactions are cost-free.

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

There are similarities in the underlying philosophical context between the open-ended evolutionary model of classical liberalism, Austrian economics and the Darwinian probabilistic world view. Likewise the closed-off neoclassical model of twentieth century modellers and econometricians has a family resemblence to a Cartesian, deterministic world view. The differences between these two world views are as old as philosophy. Plato, the idealistic inventor of utopian solutions, could be seen as the forebear of deterministic neoclassical economics, whereas Aristotle, that 'practitioner of common sense,' preached a philosophy that fits open-ended, diverse evolutionary economics. The evolutionary and the deterministic approaches are mutually exclusive and may lead to policy conclusions which differ diametrically.
No amount of mathematical or econometric escapism can disguise the fact that the neoclassical assumption of perfect knowledge limits the usefulness of what economists and econometricians have to contribute. Economic models are therefore now less in demand and economists have less credibility. The public and policymakers are increasingly aware of the evolutionary, unpredictable nature of economic life. Instead, attention turns to studying how people can improve the knowledge that neoclassical economists so glibly assume as given.

CHAPTER THREE

INSTITUTIONS AND ORDER

Intelligent beings may have laws of their own making; but they have also some which they have never made.
Charles de Montesquieu, 1689-1755

As every individual endeavours ... as much as he can both to employ his capital in support of domestic industry, and so to direct industry that its produce may be of greatest value; every individual necessarily labours to render the annual revenue of the society as great as he can ... he intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which has no part of his intention. Nor is it always the worse for the society that it was no part of it.
Adam Smith, 1776/1971, vol. 1: 400

Order and the Knowledge Problem

Since the knowledge problem is a constitutional ingredient to scarcity and the economic problem, it is essential for the effective coordination of people that they economise on the information that 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 convey complex patterns of information. And people must be in a position to 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 'Order' in the Glossary). Order means that elements in a system remain in a recognisable and predictable interrelationship, though not necessarily a totally static one. When the system changes, change should, however, 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 of how hard it is to go down a staircase with steps of varying height and width, and how easily you can skip down regular stairs.

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

— Order can be imposed. A pattern that someone has designed in her or his mind can be implemented. Thus, architects design orderly steps. Or to give another example, I order the books on my shelves in a certain way so that I can readily find them. After I moved office, chaos reigned and life was hell, because I had not yet imposed order and could not find much-needed reference books and files; I suffered from cognitive overload and a poor use of my resources. It is often also effective to coordinate people by a plan and by top-down command, for example in a firm or work team where leaders lay down an action plan and exercise some degree of control over collaborators.

  Order thus frequently depends on the visible, ordering hand of someone in the know and in control.

— Order can also arise spontaneously. 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 is rare. The Scottish philosopher Adam Smith wrote in 1776 that human beings produce, sell and buy what others want as if ordered by an 'invisible hand'(see quote at the top of this chapter). Recognisable patterns emerge in these instances because all participants obey shared rules. Then, participants find it easy to interact constructively with others because they can rely on those patterns.

The spontaneous order depends on clear rules. 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 must now take a closer look at rules or institutions - their precise definition, the various types of institutions, the properties that make for an effective, spontaneous order, and the benefits of appropriate institutions.

Institutions Defined

Institutions are rules of human conduct whose violations carry sanctions.[8] They serve to make repetitive actions and reactions more predictable. Rules without sanctions have little normative influence, in the sense of making the behaviour of others more predictable. They are therefore useless. Effective institutions confine the range of the outcomes

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

one can normally expect, but often without making specific outcomes certain. And often it is sufficient for us to depend on broad patterns of behaviour, which save us knowledge-search and other transaction costs. Without institutions, the transaction costs are, in many cases, so high that no production and exchange comes about.

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, and order and mutual trust are safeguarded. Nevertheless, we are frequently totally unaware of the institutions that order our behaviour and that of our partners. This is amazing because different institutional set-ups can profoundly affect our prosperity and the extent to which we achieve our own purposes. The importance of institutions often becomes evident only when 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. The results have been much suffering, material decline, disease, crime and a steep drop in the population. Observers now recognise the importance of reliable laws and rules of communal conduct.

In a similar vein, the gradual debasement of the time-tested institutions of Australian social life during the twentieth century has detracted from economic performance, identity with the community and hence stability of social life, as well as social harmony and civility. What in reality was behind the microeconomic reforms of the 1980s was an attempt to redefine the basic rules of economic conduct of Australians. Much of the yearning for the certainties of an earlier era is the wish to enjoy again a rule system that inspires confidence. An explicit analysis and understanding of the relevant institutions therefore seems fundamental to analysing public policy and socio-economic reform in Australia.

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 in an organised way by an appointed group, such as a law court (formal institutions, see Graph 2).

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

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

When we speak of 'the law,' we refer not only to formal legislation and regulations that emanate from parliaments, administrations and court rulings, but also the body of norms that are the result of tradition and the internal evolution of society. In the common law tradition of Britain and Australia, evolved rules have had a relatively high status. Internal rules and unwritten laws form an important part of the system of insti-

Graph 2

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

tutions under which we live. Indeed, the natural law, a body of internal institutions, has a very high status and may even override constitutional and statute law.

Internal Institutions Evolve in the Community

Institutions can be distinguished according to their genesis and the method by which sanctions for rule violations are applied (Graph 2). 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' has gained widespread 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 German, because I want to be widely understood in Australia);

— 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: we listen politely to opponents; traders offer reliable service so they do not lose their good reputation; workers in teams follow certain work practices - if they do not they are shunned by their fellows); and

— rules that have proven useful to group interaction and have sanctions applied formally, i.e. in organised ways, by selected senior members of the group (example: professional standards, violations of which are sanctioned by appointed professional bodies).

The first three categories of internal rules are informal in the sense that violations incur sanctions in the form of spontaneous, self-enforcing responses. Thus, we control our whims often out of self-interest, as 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. In decent societies, informal, spontaneous enforcement works in most cases. It is the cement that holds civil society together.

Self-enforcing mechanisms can be extremely effective. People with poor manners are lonely and the damage to a firm's reputation may cost it much business. A stunning example that shows to what extent self-enforcement works can be found in global currency markets. Traders, who daily transact billions of dollars, do not write and sign formal contracts, 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 is that they would otherwise have to fear for their reputation. Opportunistic currency traders who lose their reputation in the trade will not find contract partners and will soon be out of 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. Initially, internal rules may have been tried out by chance or on the initiative of a few. When the rule was considered a help, others imitated it, and the rule gained wider acceptance and sufficient critical mass to become a community institution. At times, established internal rules are rejected by people whose circumstances they no longer fit. Some may begin to accept the sanctions for rule violations or hope that they can explain why sanctions should not apply to them in their particular circumstances. Such variations may be seen as successful and may gain critical mass to become a new institution, or people may reject them. The body of internal rules is thus the result of mutation, selection and evolutionary adaptation over which no one in particular has control. The rules are the result of the interplay of numerous people. Their origins or rationale are often not even understood (Hayek, 1967a and 1979).

In immigrant societies such as Australia, 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 it may also trigger innovative changes of the shared rules which cause adaptation costs, even if they are welcomed by sufficient numbers of incumbent residents (Sowell, 1998). Thus, a poor 'payments morale' (lack of reliability in paying debts) and low honesty standards of certain immigrants may force everyone to incur higher monitoring and enforcement costs. On the other hand, the work practices of certain immigrants may be seen to yield better productivity and income results than traditional Anglo-Irish ways of running the workplace. This may eventually induce more and more Australians to adopt a different work ethic.

As we said some internal, evolved institutions carry formal sanctions. Thus, a community of legal, journalistic or medical professionals may have organised an internal, formal mechanism to deal with professional misconduct, for example by expelling violators from their community. They do so either to facilitate interaction within the profession or to ensure that the group's reputation does not suffer from the opportunistic behaviour of some members of the group. Chosen members of the group apply the internal rules 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 where this harms their community and their collective reputation. There are costs in such self-regulation, but they tend to be moderate, as long as the adjudicators are not driven by self-interest in extracting high adjudication costs.

External Institutions Depend on Political Action

The second major category of institutions is external (Graph 2). They are designed, imposed and administered by authorities who are above and outside the community. 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 the grace of God, spontaneous acclaim, usurpation of power, or democratic election. Examples of external institutions are legislation, regulations and administrative practices. Virtually 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 records or to conduct themselves in specific ways. External institutions are normally much more costly to implement than internal ones. A well-run community will need strong checks on the costs of external institutions and on the behaviour of the agents of government.

Specialist agents normally derive their livelihood from designing and implementing the external institutions. Often, there is an understandable bureaucratic self-interest in having complex and costly-to-administer external rule systems (just think of Australian tax rules and the industrial relations system!). This provides jobs, income and influence to the agents. It is a case of the principal-agent problem that we mentioned in the preceding chapter.

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 only serve as a back up to internal institutions. The attempt by socialist revolutionaries in the USSR early this century 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, the institutions could not even be known and implemented, after the spontaneous incentives and the traditional internal rules had been suppressed.

Thus, newly collectivised farmers in China after 1957 and in southern Vietnam after 1975 failed to produce food sufficient to feed the population, whereas they had grown export surpluses before. Indeed, socialist plans and draconian coercion could not even stop newly 'liberated' peasants from destroying rice which they did not want to yield to the government. Only when the rule set was changed again with the economic reforms of the 1980s, did China and Vietnam solve the food problem. Vietnam even became a surplus producer and major exporter of rice! This experience is replicated by numerous other cases where 'scientifically designed' and enforced institutions have led to major famines, which were then invariably blamed on the weather (for example, in the Soviet Union in the 1920s, in Ethiopia under Colonel Mengistu, in North Korea in the 1990s - as if South Korea did not have the same climate!).

The methods by which to coordinate modern mass society, and in particular economic life, have arguably been the most fought-over social issue this century. The imposition of a top-down socialist order in the communist countries has cost about 100 million lives this century, among them some 20 million to enforce the new order in the Soviet Union, 65 million in the Peoples' Republic of China, two million each in North Korea and Cambodia, and one million in Vietnam (Courtois, 1997). The events in Indonesia in May 1998 were in essence also conflicts about institutions and rule enforcement.

The Qualities of Effective Institutions

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

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

— Universal rules should be *general* and *abstract*, rather than case-specific. In the words of Friedrich Hayek, abstract rules are 'applicable to an unknown and indeterminable number of persons and circumstances'(Hayek, 1973: 50). This criterion was not fulfilled, for example, when the Indonesian president ruled that his son's car assembly plant should have preferential access to the local market, or when Australian governments hand out tariff preferments to the car industry. Rules that discriminate between citizens fail the test of universality.

— 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, where a voluminous and inconsistent stream of decrees is promulgated in present-day Russia, when numerous mullahs give binding, but conflicting interpretations of Islamic law, or when the Australian Parliament and Tax Commissioner continually rejig the tax rules. In the course of this century, the volume of Australian laws and regulations 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 that must be part and parcel of any effective institution. This aspect of universality is violated when - as was the case in 1997 - striking NSW and Queensland coal miners relied with impunity on secondary boycotts by railway workers, despite the fact that the *Workplace Relations Act* explicitly bans such secondary boycotts. These boycotts were the object of time-consuming negotiation and formal industrial-relations arbitration. This caused much industrial uncertainty, because participants did not feel that they could rely on the law. Just imagine how the traffic would move if every give-way sign were subject to similar 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 innovative actions. In other words, the rules must be designed in ways that guide people in responding to new circumstances. Openness is absent when legislation is prescriptive and case-specific, so that private agents are bound to particular outcomes even when circumstances change. The criterion is met when the rules offer guidance to actors engaged in new experiments. Thus, universal property rights and tort law offered guidance when people began to market their services on the Internet. By contrast, intricate and specific rules offer little normative guidance. Thus, the legalisation of heroin use in some circumstances, its toleration in others and its prohibition in yet others is institutionally deficient and will have only limited influence on potential heroin users.

Universality can be safeguarded relatively easily when the institutions are prohibitive, that is, when they rule out classes of actions that are widely seen as harmful. Moses promulgated prohibitive rules, such as 'thou shalt not steal or lie.' This left everyone great scope for their own initiatives as long as they obeyed these rules. Likewise, the rule that no-one is above the law is a good example of an easy-to-understand universal rule. By contrast, prescriptive rules, which aim at attaining specific outcomes, are much less likely to offer certainty and openness. 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 due to their lack of knowledge and resources. This is why an effective rule system to be effective cannot prescribe very many specific outcomes.

Good institutions should also remain reasonably stable over time, because rule changes impose adjustment costs on citizens and risk malcoordination. The conservative dictum that 'old rules are good rules' certainly has much to recommend it in the face of our cognitive limitations. But from this 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) that we always have to ask what serves our purposes best and that new rules will sometimes be preferable.

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

— when the institutional system consists of a hierarchy of rules, ranging from more specific institutions that are changed within a stable framework of more general, overriding rules, and
— when there are so-called *meta* rules that lay down predictable methods of rule change, for example the constitutional rule that new legislation must be passed by a majority in parliament, or that only elected parliaments are entitled to change legislation, but not a High Court or individual ministers.

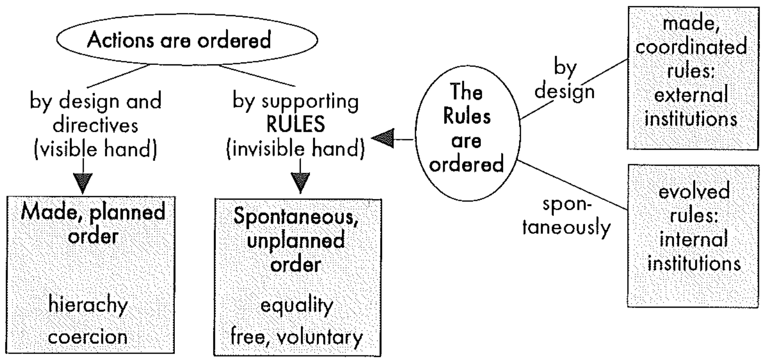
These higher-level rules are often formally enshrined in written constitutions. Effective constitutions give cohesion and predictability to the rule system. They are so fundamental to the economic and general well-being of a community that one may rightly say that 'this country has a healthy economic constitution, whereas that country'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 rule system (Graph 3). 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 federal Constitution and procedures of judicial review. New legislation has to be compatible with the Constitution. If necessary, this can be tested before the High Court. Legislative and judicial activism is likely to destroy the stable order of rules and introduce inconsistencies among rules and over time. People then resent the chaos of rules. This seems increasingly to creep into Australian public life, for example when the simple and convenient figment of *terra nullius* was replaced by the construct of native title in the High Court or when, in 1997, the rules on nursing-home admittance were changed twice within a fortnight.

People also resent incompatibilities between the made rules and the internal institutions - legislation is widely resented when it clashes with the grown standards of the community. Certain regulations and formal laws which are on the statute books in Australia are for this reason widely disregarded or even completely forgotten. In a society where the citizens are the ultimate arbiters of institutions, laws should be

Graph 3

Order of Actions and Order of Rules



abandoned if a critical mass of rule violations occurs and it becomes obvious that 'the emperor has no clothes.'

The tendency of opportunistic political parties and judges to create specific, outcome-focused rules to please vocal single-issue groups and organised lobbies gradually leads to chaos in the rule system. The consequences are disorder, loss of confidence and systemic weaknesses in the community's institutional infrastructure. Then, one poor rule often generates unforeseen side effects, which need to be corrected by further, specific rulings. This triggers a slide into a disorder of rules. The evolution of socialised welfare in Australia and elsewhere offers numerous examples for such incompatibilities and resulting ineffectiveness across the system (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 cause of widespread prosperity and growth.

Human interaction always causes transaction costs, and universal institutions help to economise on these costs. Particular problems arise when people want to make discoveries and search for knowledge. They simply cannot make rational choices as to the extent to which 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.

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

(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 the freedom of others. Without appropriate institutional constraints, liberty would be license and freedom would collapse, as the Roman orator and jurist Cicero made clear when he said: 'We are servants of the law, so that we can be free!' Freedom is essential for motivating people to be enterprising and creative. This in turn contributes to material progress.

(d) Effective institutions also serve 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 delays and accidents.

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

(e) Finally, appropriate institutions can 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 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 and trust that they will, in due course, reap the returns. Deficient institutional systems are, by contrast, characterised by short-termism, ripping out the resources with little commitment to long-term skill and capital formation (Anderson and 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 Australians now inevitably operate, appropriate institutions - as well as the order they help to create - can serve as an important source of confidence. The growing lack of confidence in the Australian community (Introduction) suggests that the search for more effective institutions and better underlying political and economic constitutions should be a priority, so that the community can return to the experience of trust and confidence which were the hallmarks of an earlier era.

Shared Values Underpin the Ordering of Rules and Conduct

The cohesion and effectiveness of a community's rule system are underpinned by shared fundamental values: very high priorities that inform the daily actions of individuals, such as freedom, justice, security and prosperity.[9]

[9] When we use the word 'justice' here, this is intended 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 uncoerced choices. Security and justice when combined with the adjective 'social' have, however, often been given totally different meanings, namely referring to outcomes being equal, irrespective of effort or luck. As we shall elaborate later, these concepts of justice and security tend to undermine freedom, peace and security as defined here (Hayek, 1989: 112-119).

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 to attain them. They 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, in contrast to their biological analogue, fundamental values can be shaped by intelligent and wilful efforts.

One consequence of a shared value system in a community is that it facilitates the shaping of an order of rules and an order of actions. Value relativism and a post-modernist denial of absolute standards of good and evil can make a community's rule system inoperative. The high costs of a lack of shared values are then demonstrated by anarchic, chaotic and dysfunctional societies, for example by post-socialist Russia. 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 (refer to 'Institutional Capital' in the Glossary).

Order is also furthered among institutions by certain procedural *meta* rules. As already noted, written constitutions often stipulate certain procedural rules that avert conflict among norms and enhance the effectiveness of the institutional order, for example by laying down certain voting procedures to determine political action. Similarly, most Australians obey in their daily lives certain informal *meta* rules. For example, we let common sense prevail, and we attach a high value to a degree of tolerance of the ideas and aspirations of others, to a sense of humour, and to frank debate and listening to opponents. In Australian society, people who violate these procedural *meta* rules will soon find themselves ostracised, sidelined or reprimanded. Tolerance is a procedural *meta* rule that normally promotes internal peace and freedom. But it is not a goal in itself, such as freedom or justice.

The anchoring of institutions in fundamental values drives home an important point about institutions: they are not value free! We can objectively analyse what the effects of certain rules and rule systems are, but when we apply these insights to shape concrete rules, we cannot - and should not! - avoid value judgements (normative institutional economics). To dismiss a preference, for example, for freedom as 'unscientific' would mean the suppression of an important element of economic and social analysis. What scientific analysts should, however, do when they make normative judgements, is to make it explicit where their own preferences lie and to acknowledge that others may rate the various fundamental values quite differently.[10]

Some Consequences for Public Policy

Australian parliamentarians, politicians and industry representatives tend to rely on case-specific interventions to obtain predetermined economic outcomes, 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, new management styles nowadays rely on 'participative management,' a style of spontaneous cooperation in teams that follow shared rules. Less and less, business organisations are run on the command-and-control approach so typical of an earlier, simpler and less dynamic industrial era (Parker and Stacey, 1995).[11]

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 Australian public, parliamentarians, ministers, bureaucrats and judges wish to rely on specific, instrumentalist designs that order economic life from above. Few observers ask, when confronted with clever new government schemes, to save this industry or that, and to subsidise one industry location or another: 'How do politicians and their advisers know? Indeed, do they have any relevant knowledge at all?'

We now possess ample evidence that 'know-all interventionism' often overtaxes human knowledge and the capacity to control social processes by political and administrative means. In microeconomic policy, we have learnt that intervention in markets invariably leads to unforeseen, deleterious side effects, as circumstances change constantly. For example, the scheme to shore up the wool price in the early 1990s by stockpiling wool in Australia, not only cost considerable resources,

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

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

but led eventually to a protracted depression of the wool price. We know that schemes to control housing 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. Minimum wages hinder those less well-equipped with labour skills to get their foot on the training-and-income ladder. Indeed, Australia's persistent unemployment is a consequence of collective choices (the industrial relations system) based on assumptions that are not true.

Industry ministers may argue for the simple-minded means of tariff protection or bounties to favour certain producers, but they cannot control international developments, price and cost changes, exchange rate fluctuations and numerous other variables. Consequently, such specific interventions often fail and produce unintended side effects. State Premiers may promote specific new ventures, often with great fanfare and at great expense to the budget. But we hear little about subsequent failures. Thus, NSW once 'bought' itself the international booking agency of Cathay Pacific, and South Australia a Multifunction Polis. Available subsidies were harvested, and later these ventures were closed down again. Despite numerous such experiences, Australian politicians are habitually promising specific outcomes, and - in the end - still seem surprised their action so often disappoints. Ultimately, politicians of course earn themselves cynical disinterest.

Instead of coordinating economic activity by 'visible hand' interventions, governments should desist from interventions and protect the market order by enforcing universal rules, such as protection of private property and the enforcement of contracts. Governments should protect the institutions that promote spontaneous order (Kasper and Streit, 1993).

Australian 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.' Their pretence of knowledge has given them great but undue influence. 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 reappeared in OECD countries and governments tackled the problem by simply easing demand management as Keynes had recommended, it was discovered that - alas - this led to unexpectedly high inflation, indebtedness and instability. Unemployment also went up despite the expansion of aggregate demand. In the 1990s, Japan engaged in the biggest spending-and-stimulation policy anywhere ever, but attained little by way of a lasting economic turnaround. At least in this respect, most Australian policy makers have learnt to be more cautious about the feasibility of outcome-targeted policy.

A similar caution about relying on the visible, ordering hand of government is rare in microeconomic and social policies. The still rampant naive belief in the feasibility of ordering the economy from above should also have been dealt a massive blow by the collapse of central planning in the former Soviet orbit. There, 'scientific central planning' had been introduced to do away with the 'chaos of markets,' that is, the spontaneous coordination by buyers and sellers. The socialist governments' visible hand of command and control predictably led to malcoordination on a scale that is hard to imagine. Discoveries and new uses of knowledge were scarce and often misguided. Living standards, health, education, old-age care and the environment suffered as a consequence. Mortality rose, so that the population of Russia has been plummeting. Obviously, the made order delivered inferior results. This was realised by the leaders of the Peoples' Republic of China, who have gradually scaled back the sphere of central planning since the late 1970s. Now over 55% of China's national product is subject to the decisions of private producers and buyers. As the residual, planned state sector is mired in a deep and costly crisis, its share continues to contract.

The experience of the former command economies has underlined another crucial point. The spontaneous coordination by market processes does not take place in a vacuum. One cannot assume that markets function effectively 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 drops in Russian living standards. The old order lingers, as former bureaucrats pursue their interests as members of criminal gangs. Only gradually are new rules of economic conduct emerging, or are imposed, so that sufficient spontaneous private initiatives materialise to generate the re-emergence of economic growth. This minimum of institutional infrastructure is now in place in some east European countries, such as Poland, the Czech Republic, Hungary and Estonia, and the long-suppressed internal institutions of society are re-emerging. Consequently, these economies are now showing visible improvement, although the process of institutional reform is far from complete (Kasper and Streit, forthcoming 1998).

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

A simple, reliable order of rules, which foster the confidence that one can invest in physical and human capital, cannot emerge as long as arbitrary and industry- or product-specific interventions proliferate, triggering impossible-to-predict and often unsettling side effects. In Australia, where the inherited, time-tested British rules have long been implicitly taken for granted, little attention has been paid to the need of cultivating the underlying institutional system. The notion that order is a precious possession that requires nurturing is not dominant in this country, nor is the understanding of what institutional qualities are needed to facilitate order. Not much attention has been paid to the character and shape of the best possible rule system, although many of our old rules have become counterproductive to our aspirations (see Chapter 7).

Creating Institutional (or Social) Capital

Overseas, it has been increasingly realised that appropriate institutions are a central condition of freedom, security, prosperity and economic growth. A universal rule system constitutes a precious possession of a community, enhancing 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 therefore spoken of 'institutional capital'; others have used the term 'social capital' (Coleman, 1990; Weede, 1996; Norton et al., 1997).[12]

In many parts of the world, there is now a renewed awareness of the need for effective institutions and much systematic research to find out how to shape institutions that facilitate superior outcomes in terms of freedom, security, justice, peace and prosperity. The pursuit of piecemeal microeconomic reform has given way to new discussions of the

12 Some Australian observers, such as Eva Cox of the University of Technology in Sydney, have in recent years adopted Coleman's term, but erroneously infused it with a new meaning, that of 'socialised assets' and reliance on external, top-down institutions. Most of what constitutes social capital in Coleman's sense is made up of the voluntary, evolving institutions of civil society, in contradistinction to the coercive, collective controls of the state (see A. Norton, G. Sturgess and M. Stewart-Weeks, in Norton et al., 1997: 1-6, 49-70 and 85-89 respectively). Because of the frequent confusion caused by the term 'social capital,' this author prefers to go with Confucius in naming phenomena by their correct names and hence prefers to use the term 'institutional capital.'

overall design of economic and legal constitutions. Do they serve to constrain corruption, political whim, discrimination and power abuses, or not? New Zealand, for example, has engaged in a comprehensive venture to recast the rules of coordination to simplify them and advance justice, although that effort is incomplete (Kasper, 1996a, 1996b).

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

One standard conservative response to such a comprehensive and ambitious attempt is that changes are not feasible under the present Constitution of the Commonwealth. In a rapidly changing world, this conservative 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 of our aspirations. It should be based on the insight that enormous gains can be made by a streamlined, universal framework of underlying rules. They have been taken for granted and allowed to decay for too long. Potential gains promise to exceed the marginal improvements to the allocation of resources that can be had from piecemeal microeconomic reforms. It seems time that we focus on 'picking up the big bills'! (Refer to 'Institutional Capital' and 'Human Capital' in the Glossary.)

CHAPTER FOUR

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: 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.
David Hume, 1786/1965, Book II:2, para. 2.

The institutional system which has, to date, most effectively addressed the fundamental traits of human nature (as outlined in Chapter 2), has generated the most sustained rise in material living standards and human numbers, and has facilitated the most advanced - although far from perfect - degree of individual freedom, is capitalism. Capitalism, in its pure form, is a rule system which assigns most assets to specific owners - persons or private organisations, such as clubs or firms - and which fosters the autonomous, self-responsible use of private property (freedom of contract). It functions well only without discrimination, that is, 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. 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. In addition, property rights may be attached to one's intellectual creations (intellectual property rights).

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

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 users. The better the internal and external institutional protections of property in a community, the lower are the exclusion costs and, consequently, the higher is the value of property. Property owners therefore have a direct interest in effective institutions. One might turn the old saying around and say that 'law-abiding neighbours make for low fences.' When respect for private property is low, the private exclusion costs can be considerable. It then makes sense for property owners to pay some collective agent who helps with excluding unwanted property users. This may be a private protection agency, or a government organisation that sets up formal, external rules and enforces them through police, the judiciary, prisons and similar forms of legitimated force. Australian property owners rely on both, with private security services employing several times the number of people that the police do.

The active uses of property cause further costs. The owners of physical and intellectual property have to be coordinated. Firstly, they need to search for potential contract partners and to find out their characteristics, to engage in research and development so as to identify new, but needed intellectual property or resources, to negotiate and execute contracts, and to monitor and enforce contract fulfilment. We call these coordination costs 'transaction costs' when property is used through market contracts. When property is used within an organisation they are called 'organisation costs.' The level of these coordination costs depends greatly on the internal institutions of society – such as spontaneous honesty and strong spontaneous disapproval of rule violations – as well as on the external institutions, namely the universal quality of the law, the reliability of the judiciary and the quality of the regulations. Effective institutions, therefore, determine not only the value of property in a society, but also the ease or otherwise of its active use (see 'Transaction Costs' in the Glossary). 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 poor competitiveness and the flight (exit) of financial, physical and intellectual property.[13]

Historically, the state has long had an important role in protecting private property. Indeed, government probably came about soon after the emergence of property rights in the full, modern sense of the word in the 'Neolithic revolution' some 10,000 years ago. Humans then engaged in agriculture and the domestication of animals. This revolution occurred in a number of different locations, such as the Middle East, northern Thailand and the Americas. It is not imaginable without the discovery of respected property rights. Who would dig the soil and sow, capture and care for animals, if possession is constantly threatened and the fruit of these efforts cannot be appropriated? Without a respected property rights system the exclusion costs can be so high that agricultural production does not take place.

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

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

assets were not combined in a major way with human skills and knowledge to create valued goods and services and to supply them to others. Only when the tribal exploitative mentality gives way to cooperative, creative efforts, are a great variety of goods and services created for the enjoyment of others (see Insert below). Only then does xenophobia give way to exchange and curiosity about what outsiders have to offer (Jacobs, 1992). Although most of our forebears have lived with private property and creative enterprise for many generations, we are nonetheless still prone to fall back instinctively into the atavistic, tribal mentality of the Palaeolithic age (Hayek, 1988: 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 or organisation, and that others are excluded. When private property is used actively, all the benefits and costs should ideally impact on the owner (or should be 'internalised,' as economists would say). Only then

A Former Prime Minister on Land Rights and the Law

A lack of respected property rights, as defined here, could explain the historical puzzle of why (Paleolithic) Australian Aborigines never engaged in agriculture and animal husbandry despite long contact with (Neolithic) Torres Strait Islanders with whom they traded. Torres Strait Islanders had well-defined private property rights, but the same is not so clear for the Aborigines. The High Court of Australia and the Keating government have been criticised for confounding these two, radically differing institutional systems, for example by former Prime Minister Sir John Gorton who said in 1997: 'Mabo (a Torres Strait Islander) lived on an island where the concept of private property had long been accepted. The growing of crops was the common thing. The ... ownership of the lands and the ability to pass them on was also accepted ... The Mabo/Murray Island principle was seized upon by the former Labor government and Paul Keating, and applied to mainland Australia. It transferred those laws to a people who had no concept of private property; to a people who have never grown or farmed any crops ... By doing this, the Labor government and the High Court turned Australia's land system on its head. Land disputes will be tied up in courts for years, with the only sure winners being the legal practitioners.'

Canberra Times, 13 November 1997: 1-2.

will private people make the choices that lead to the best possible attainment of prosperity. Only then will profits and losses be a good guide to finding and using resources. Where it is not possible to attach private property rights to assets (i.e. where externalities exist), complicated interventions by political action have to be contemplated (see Glossary on 'Externalities').

Free Goods, Club Goods, and Public Goods

When early humans roamed in nature, property rights were not needed. Hunters and gatherers found free goods, goods that were not scarce because the few humans hardly rivalled with each other for resources. In the Garden of Eden, there was no need for private property. The spread of the human species across the globe was no doubt driven to a considerable extent by the search for new free goods. But as the number of humans rose, demand for certain assets became rivalrous. 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 rationing devices were invented (Graph 4).

Small groups that possessed such a '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, such informal institutional means work cheaply and effectively. The anthropological literature on different civilisations shows that informal policing of commonly owned resources such as fields, forests, fishing grounds and tennis courts works reasonably well in groups not exceeding five or six dozen participants. Once the group exceeds this limit, the informal institutional mechanisms break down and lead to over-exploitation and internal conflicts (Hardin, 1993). Therefore, when the group grows, internal institutions have to be enforced more formally. Probably, they have to be backed up by external institutions - a king or chief allocates land uses or hunting rights, and this is formally enforced. Thus, Australians are allowed to collect oysters, lobsters and abalone in coastal areas, 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. Garrett Hardin has cited a telling case of this 'tragedy of the commons.' When the first satellite images were made of the Sahel region in Africa during a major, catastrophic drought, patches

Graph 4

Private, Club and Common Property

<table>
<tr><th rowspan="2">Supply exclusive?</th><th></th><th colspan="2">Demand rivallous?</th></tr>
<tr><th></th><th>YES</th><th>NO</th></tr>
<tr><td rowspan="2"></td><td rowspan="2">Yes</td><td>Private goods:</td><td>Natural monopolies:</td></tr>
<tr><td colspan="2">Private Choice
e.g. bread, hair cuts, electricity uptake, passage on trains, congested toll road (YES)
e.g. fire protection, cable TV, access to elecricity grid, uncongrested e-mail access (NO)</td></tr>
<tr><td rowspan="2"></td><td rowspan="2">No for group, yes for out-siders</td><td>Rationed club goods:</td><td>Unrationed club goods:</td></tr>
<tr><td colspan="2">Group collective choice to supply
e.g. access to tennis courts on weekends, university library loans, access to local hospital, alotment of farm land in some Asian villages, shared knowhow (YES)
e.g. access to uncrowded commons, use of club house, tennis courts during the week, local environmental amentities (NO)</td></tr>
<tr><td rowspan="6"></td><td rowspan="6">No</td><td></td><td>Free goods:
Supply by nature
e.g. fish in ocean, food for hunter-gatherers</td></tr>
<tr><td>Common Goods</td><td>Pure Public Goods:</td></tr>
<tr><td colspan="2">Supply by collective choice
e.g. crowded public hospitals, busy public roads, some environmental amenities (YES)
e.g. street lighting, some information, uncongested public roads, shared institutions, law and order, national defence (NO)</td></tr>
<tr><td colspan="2">Direct financial control required?</td></tr>
<tr><td>No</td><td>Yes</td></tr>
<tr><td>Contract out & quality control</td><td>Socialised property</td></tr>
</table>

of well-grassed land were discovered amid overgrazed, durably damaged land. Ground investigation revealed the consequences of good and bad institutions. The grassed areas belonged to 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 - illustrating the fundamental effect of universal institutions on resource conservation (Hardin, 1993). With the increasing numbers of people on earth, property rights can often be used to encourage careful stewardship of natural resources.

When common property uses cannot be properly policed, then one way to secure the most highly valued uses of the scarce assets is to introduce the rules that establish exclusive private property title to specific parts of the commons. These can then be exchanged in markets on the basis of voluntary, bilateral contracts (Graph 4). 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. This privatisation process still goes on, not only in the third world, but also in developed countries, for example when local councils introduce parking fees in the CBD or when previously free commercial fishing access is auctioned off to 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 that arise within large groups of joint owners and users can be expected to loom large in those 'ownership clubs' that are now being established for and by Australian 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 diversion of the benefits to influential insider groups who are in *de facto* control of the asset. The institutional arrangements necessary to police large 'club properties' may well be more complicated and require more administrative control than the alternative of assigning smaller properties to 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 of how to make use of newly reconfirmed property titles to their own best advantage, rather than to the advantage of some collective or distant agents. It would seem that the move from free goods and traditional, informal club ownership to private property is often inevitable in the modern world. This model seems easier to handle than the large, socialised blocs of property under ATSIC control, and it is likely to confer more direct gains to individuals and families.

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

We speak of 'external costs' when people other than the owners have to bear some of the costs of property uses. For example, the emission of noise or pollution from an industrial activity impacts on the community at large. We speak of 'external benefits' when others gain benefits from certain property uses, for which they do not or cannot compensate the owners. When I create a beautiful front garden or light the street, my neighbours enjoy the amenity (free riding). Such externalities are due to the fact that not all costs and benefits from property usage can be assigned, because they cannot be measured or the assignation would create inordinately high costs. 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 Sydney airport. 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 for measured road usage.

In instances where measurement is not possible or economical, the private production of goods and services may not be privately rewarding to individuals. As long as positive externalities impact in close proximity, neighbours can form an association to internalise all the benefits. Local government areas often capture such neighbourhood 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 reaping external benefits within self-administering associations. A similar case occurs in clubs when one individual cannot capture the full benefits of a sports field 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 between collective and private choices (Graph 4).

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

While many externalities of property uses impact on neighbours, there are externalities that even transcend the reach of national jurisdictions. For example, if an up-river country, such as Turkey, uses irrigation water, it 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 it is a trend – tends towards uniform, centrally planned and hard-to-enforce targets for the reduction of emissions. The alternative to this 'one size fits all' approach would be to take a page from institutional economics and to think of globally tradeable 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 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.

There are some cases where exclusion by the device of private property rights is not necessary because private users do not rival with each other. Economists call these 'pure public goods' (see Glossary). Demand is similar to free goods, but - different from free goods which are provided by Nature - the supply costs resources and effort. Provision has to be decided and made by collective choice (Graph 4). 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 practicable to collect fees from the passing traffic to compensate the provider for incurring the cost of the street lights. Instead, government should fund street lighting from taxes. More important cases of pure public goods are the provision of defence from external aggressors and of internal protection from thuggery by providing and enforcing agreed institutions (law and order).

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

When the conditions that make for pure public goods are not 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. Government provision is different from the case of clubs which people are free to join or leave; membership is compulsory. All residents have to fund the provision of these common goods, and all are subject to the collectively determined forms of rationing. Disaffected members have only a very costly exit option, therefore they have to rely mainly on the option to raise their 'voice' by voting, demonstrating, lobbying, etc. (Hirschman, 1980).

The Private Production of Public Goods

The terms 'public good' and 'common good' do not necessarily imply that the means of production of such goods should be publicly owned, nor that the production process has to be managed by government administrations (Demsetz, 1970). What matters is access - providing these goods and services in the public domain (Graph 4). Thus, a good case can be made for financing street lighting and roads from taxation, but to have these services produced by private and preferably competing producers. Many common goods, such as electric power, rail services, telephone connections or school education, can be made accessible to everyone without having to be produced by state-owned enterprises. Private trains can run on publicly-owned tracks. Telephone companies can be broken up and privatised. Access to private schools can be made possible by tax-financed vouchers. With competing providers, the community is better protected from monopoly abuses. The rivalry of contending producers is likely to empower the citizen, promote the better use of knowledge (innovation) and offer a richer variety of goods and services to choose from. This has been demonstrated since privatisation has become a worldwide phenomenon.

Government has two roles in the competitive, private provision of public-domain goods. One is to ensure that quality standards are kept. Another is to ensure that less affluent citizens have access, e.g. through vouchers (Kasper, 1996a). Thus, poor children in Puerto Rico were recently given the option to access private schools through government-endowed school vouchers. A similar proposal for Australian university students, which was contained in the original discussion paper of the West Review, was hastily turned down by the Howard government.

The case for direct public ownership of assets rests on a different consideration. Sometimes, there is a need for the complete control of certain asset uses because their competition might be too costly for the citizens or because producers cannot be trusted to do the citizens' bidding. Thus, military forces, police officers and other 'violence professionals' normally come under the direct financial control of government. The purse strings are part of an arrangement whereby they are controlled by non-violent means. The alternative might be private competition by the use of force. The competition between Sandline-style mercenaries and competitive police protection rackets would, however, be fairly unattractive forms of competition! In a similar vein, most law courts are run by the government 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. The administrative agents of government may exploit the knowledge problem of elected political supervisors and citizens, acting opportunistically. Police corruption, and judges who favour interest groups or who seek public acclaim for being 'ahead of their time,' come to mind as examples of the failure of political controls. A case can therefore be made for private policing and competing private adjudication.

In modern economies, certainly including Australia, there are massively more publicly owned ventures than are justified by externalities or the need for direct collective control. Governments have expanded socialised ownership as an easy way to raise revenues, to redistribute incomes, to expand political influence, and to respond to ideological criticisms of private property. Public ownership is more attractive to parliamentarians and bureaucrats, when publicly-owned firms can be turned into monopolies. Then, monopoly rents accrue to the government and those who work in it. However, economic theory teaches us that monopolies sell at a higher price, offer less quantity and poorer quality and innovate less than competing privately-owned producers. The state's gain is therefore typically the private citizen's loss and an impediment to long-term innovation. Therein lies the case for much privatisation.

Divisibility and Tradability of Property Rights

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

The property rights attached to a specific asset do not form a monolithic bloc. They are a potentially open-ended bundle of specific rights. The value of an asset can therefore often be greatly enhanced by making institutional provision for the separation of the various rights.

Thus, a land-owner may lease the land to someone for farming, to someone else for cutting timber or mining, to yet another for fishing the stream through the property, and yet others for recreational uses or various rights of way. Such divisibility of the property rights bundle means that different people with different knowledge and motivations can make use of the same asset, deriving much more highly valued outputs from it than a single owner-user ever could. Divisibility is based on institutions. The Romans, for example, refined existing property laws to allow loans and partial uses of assets, giving people who could not afford outright property ownership access to those parts of properties that they valued highly. Roman law secured contracts and reduced uncertainties and the 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 cannot acquire the asset in exchange for money or other assets. When assets can be traded, their potential value is enhanced, and discovery of new knowledge (innovation) is encouraged.

If a property is inalienable, for example by an inheritance clause or by custom, it loses much of its value. This is then often resented. We observe now a tendency to assign a growing share of Australia's land surface inalienably to national parks for purposes of nature conservation and to collective Aboriginal ownership. In an inevitably evolving world, new ideas and opportunities will arise as to how to conserve endangered species and how to open ways for Aborigines to advance themselves. The non-tradability of land will block 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 Aborigines would enhance their life opportunities. The lesson of human history certainly is that inalienability reduces the value of property and discourages its creative uses.

CHAPTER FIVE

MARKETS: THE RIGHT AND THE RESPONSIBILITY TO COMPETE

The market is the best garden.
George Herbert, *Outlandish Proverbs*, 1640.

... competition is important as a process of exploration in which prospectors search for unused opportunities that, when discovered, can also be used by others ...
F.A. Hayek, 1968: 188.

The modern business economy has as its basis human freedom exercised in the economic field ... We acknowledge the legitimate role of a profit, this means that the productive factors have been properly employed and corresponding human needs have been duly satisfied.
Pope John Paul II, *Centesimus annus*, 1991.

Owners normally use their private property rights in combination with the property of others. Property rights can be combined (a) within an organisation, 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 the working of individual markets, as well as entire interdependent systems of markets.[14]

The Market Process

A market is a meeting place. Intending buyers and sellers, each with limited knowledge, seek and find information about what property uses

[14] How property in capital, 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 should note in passing that coordination by market and by organisation are often interchangeable ways of combining production factors. For example, some firms produce an input in-house and others subcontract the same input in the market; your mother may have done the cooking in-house whereas you subcontract it to fast-food outlets (for more detail, see Kasper and Streit, forthcoming, 1998).

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 discovered and explored, new resources and resource uses are uncovered and tested, and unwanted resource uses, which are signalled by low profits or even losses, are discontinued. What happens in markets is therefore at the heart of the economic problem: discovering and satisfying changing wants with scarce resources, and discovering new resources. This process has been called 'catallaxy' (Hayek, 1945, 1948, 1978; von Mises, 1949; and see 'Catallaxy' in the Glossary).[15]

The market is a dynamic phenomenon - a 'discovery procedure,' as Hayek used to call it (Hayek, 1978). Markets fulfil their function in tackling the economic problem well if they

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

All three effects 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 obviously do this better than others. What matters here is not only what happens in one specific market, such as the potato market in Sydney, 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 (North, 1990: 27-28). This may possibly have surprised the reader. Much work effort

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

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 services). Entire service industries have sprung up to expedite such coordination (trade, communications, finance, advisory services, etc.). In mature economies, these transaction services are growing faster than most other sectors of the economy. The share of transaction services in Australian GDP has probably doubled since the start of the century. This is an inevitable consequence of the ever more sophisticated division of labour and knowledge. It is a natural concomitant of the process of economic growth.

Coordination costs in markets (which we call 'transaction costs' - see Glossary) fall into the following categories:

— *exploration and information costs*: finding out what one wants and is able to aspire to, what sources of supply there are, as well as where, at what prices and qualities goods and services may be available, whether potential contract partners are reliable and similar specific information, as well as where and how to sell 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 that the costs of exploring new concepts and finding information before a deal in the market can even be contemplated have a rather insidious quality (Chapter 2). Before we have incurred sufficient exploration costs, we cannot know or evaluate whether or not it is worth our while to incur these costs (Streit and Wegner, 1992). There is simply no way of assessing rationally the return from exploration before one has done it. It takes true entrepreneurial flair and a taste for risk taking to engage in this essential part of market activity. Many people feel intensely uncomfortable with the risks involved, in particular when knowledge search involves sizeable expenses. Most try to avoid the uncertain returns involved in exploration costs. The general conditions 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 the economic problem of 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 explore a new area cannot trust that they will keep the benefits of new knowledge, they will desist from incurring the costs of new ventures. It is therefore essential to provide trustworthy institutions that guarantee pioneers the rewards of having found useful knowledge and entice many of us to search for new knowledge. In other words, the institutions must guarantee universal property rights. Failures to do so are the main reason why different societies vary greatly in their innovative dynamism, indeed why rates of economic growth differ.

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

The Spirit of Enterprise

Entrepreneurship is needed to find new opportunities in all walks of life. Thus, the real-estate developer may see an opportunity in a new location; the industrialist may respond to new technical opportunities and explore the commercial feasibility (profitability) of a new product or process; the young woman or man may be alert to the need for new skills and incur high costs in acquiring these skills; and the consumer may be alert to new products and be prepared to explore whether or not they will be as useful as expected. Lively, innovative markets require not only entrepreneurship on the supply side, but also alert consumers on the demand side and both with a preparedness to shoulder knowledge-exploration costs.

A dynamic market economy is a continuous invitation to buyers and sellers to incur knowledge-exploration costs for uncertain gains.

The more participants act entrepreneurially, the more useful knowledge is likely to be discovered and used to advance living standards and life opportunities. This is both the attraction of competition and the reason for its lacking popularity.

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 seen before (Kirzner, 1983, 1997; Maley et al., 1983), and

(b) the willingness to incur the necessary transaction costs by pioneering new activities and products, always a risky business (Streit and Wegner, 1992; Kasper and Streit, 1998, forthcoming).

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 an 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. It is the result of constant alertness and preparedness to incur the transaction costs of knowledge exploration. When 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 and Wegner, 1992). With hindsight, they may find they have spent either too little or too much on knowledge search, and errors may have to be corrected. In the process, aspirations may have to be adjusted (bounded rationality). New information searches will be started in the never-ending 'film' of knowledge-generating market activity, an open-ended evolutionary process of discovering new wants and new resources.

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

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

Such practical information problems require an entrepreneurial attitude and proper backing for shouldering the exploration costs.

In a competitive system, people have an 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: 7-21). Free markets - as Joseph Schumpeter once said - provide 'many private fortresses' in which people are free and from which they can defend their domain against the use of power by others and by the state. It is no coincidence that the new middle class in nineteenth 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, but not citizens of property.

Tax and Compliance Costs

We have to mention two further types of cost in coordinating economic activities, namely tax and compliance costs. As we have seen, the internal institutions, which order most of our activities, sometimes require the back-up of government by legislation, regulation, monitoring, and enforcement by legitimated compulsion. This is a costly exercise, causing what economists call the 'agency costs of government.' These have to be financed by taxes 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 statistics, conduct business in disadvantageous ways and desist from certain, probably lucrative actions (compliance costs). If governments are careless in imposing such compliance costs, they create a major hindrance to the active use of assets and talents.

Some jurisdictions have learnt to keep citizens' compliance costs to a minimum, even if that inconveniences the administrators. They will impose certain policy requirements, for example to protect health or the environment, but draw on the art of administration to cause the least cost and inconvenience on complying citizens. Such an approach has, however, rarely been a priority in Australian public administration. For example, it is not uncommon for a new business in Australia to have to run the bureaucratic gauntlet of obtaining some 20 or more permits from local, state and federal authorities. These permits are often handed out by administrators who seem to believe that industry and production are necessary evils that have to be 'domesticated' by strict and virtuous administrative supervision.

This can be contrasted with the business-friendly concept of a 'one-stop shop,' where an intending business files a single application. The relevant government office then goes around to obtain all necessary permits on behalf of the applicant, possibly within a fixed period (as is the case in Taiwan, for example). In such an institutional arrangement, most compliance costs for setting up new industrial ventures are shifted to a government agency. This has the additional advantage that government agents become aware of the costs, regulatory inconsistencies and obstacles to business approvals. They can do something about it to attract more job-creating capital and knowhow. While such a user-friendly approach is alien to Australian administrative traditions, a switch in the style of administration can do much to enhance growth and job creation, as some State governments have found out. 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.

The cost of passive and active uses of property (the exclusion and coordination costs) vary greatly from one community to the next. Where the internal and external institutions make sure there are few thieves, exclusion costs are low. Property is worth more. Where the government's enforcement of property titles is lax and haphazard, private exclusion costs sky-rocket. Property loses some of its value. This has, for example, become evident in Australia in areas where crime against property has gone up because of drug addiction, and in rural areas where land values have been affected by the High Court removing the cost-saving fiction of *terra nullius*. Whether or not the *Mabo* and *Wik* rulings were justified, we should note that they greatly raised exclusion and coordination costs. Those who set or alter the external institutions frequently disregard the transaction and compliance costs which they impose. Indeed, many in politics or the judiciary in Australia 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 where people are honest, punctual and ready to compromise in solving conflicts, the laws are universal, and the courts operate expediently. More opportunities can then be explored and tested, and much valuable knowledge is discovered and utilised. Big trading centres - such as Florence, Venice and Amsterdam in earlier ages, and New York, Zurich, London, Hong Kong, and Singapore nowadays - have flourished because the coordination costs of merchants and innovators were kept low by the conscious cultivation of market-friendly institutions. Peripheral locations often remained backward and boorish because the heavy, visible hand of government and intrusive regulatory attitudes hindered commercial creativity.

Market Participants Rival by Incurring Transaction Costs

Why do market participants incur knowledge search costs?

This uncomfortable business is driven by the rivalry with others on the same side of the market place. Thus, the (typically few) suppliers in a market are in continual rivalry with each other. To position themselves favourably for deals with buyers, producers incur high costs of research and development to improve their product, and to offer better or cheaper new models. This rivalry has driven 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). One only has to look at countries where suppliers were protected from incurring knowledge-exploration costs by their government. In India, for example, the car industry produced the rachitic 1948 model of the Morris Minor into the 1970s; and in East Germany, the most industrially advanced country in the socialist bloc, they produced the laughable 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).The rivalry between suppliers is therefore essential not only to make propertied people and firms bear the costs of product innovation, but also for them to shoulder the costs of process innovation. Private cartels and government-sponsored releases from competition (such as tariffs and market regulations) automatically reduce the intensity of an industry's rivalry and hence the willingness of firms to incur search costs and risk innovation. As a result of government intervention, the economy displays less of what economists call 'catallactic' or 'dynamic' efficiency. In other words, it generates and utilises few useful new ideas (see 'Catallaxy' in the Glossary).

It is not surprising that Australia's long-protected manufacturers were poor innovators and tolerated high cost levels in the 1950s, 1960s and 1970s. They enjoyed government-made certainties (such as a guarantee of 85% of the Australian car market). Consequently, they did not have to live with 'creative unease.' The flip-side of such a 'welfare policy for big business' was an industrial malaise, poor economic growth and limited competitiveness. Once the government-made protections gave way to limited, partial trade liberalisation and globalisation in the 1980s, the adjustment pains were great. Like someone rising from a sick bed, manufacturers had to relearn how to incur search costs and to compete.

To the extent that they did, they began to offer the buyers more advantageous products, often at lower prices. Australian-made cars for example have become more reliable and are better designed and cheaper, despite continuing residual tariffs. But industry had to face the discomfort of those insidious information-search costs. This induced 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 (see Chapter 6, 'Rent Seeking' in the Glossary, and Insert below).

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 for a deal. Sometimes their cost of exploration is even compensated by the pleasure of 'the hunt.'

Consumers read magazines and make inquiries. The market for computer software, for example, would not have flourished with such breathtaking 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 enhance the intensity and quality of the competition. Discerning buyers are indeed crucial. When Australians learnt to discern good food and complained of bad restaurant service, the eating-out scene improved. Customers who tolerate bad service, deserve no better!

The fact that buyers rival with each other may not always be evident at first sight in 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 much R&D, as well as information and contracting expenses, into obtaining the most advantageous car components, and supermarket chains rival with each other to

How Producer Rivalry Drives the Innovation of Products and Processes

To understand how competitive rivalry motivates producers to take on the burdens of transaction costs, we can turn to a snapshot from the dynamic competitive process - a snapshot from a film depicting the market process, so to speak. 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. The range of inelastic demand is called a 'market niche.' To create such a niche, a car producer will develop new car models (product innovation), advertise the merits of his cars and offer better after-sales services (for example, guaranteed spare part supplies, free 100,000 km warranties, or roadside 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 of crowding in on his market niche (Graph 5).

The market niche is thus subject to a continuing tug of war; it is never certain, never reliable, always in need of fostering by the investment of new transaction costs.

> The uncertainty of the market niche keeps producers in 'creative unease.' This prevents them from driving up prices or resting on their oars with product innovation, advertising and improving the service. It also impels them to control costs or even bring costs down by process innovation (which is reflected in a lower supply schedule S* in Graph 5). Process innovations cause expenses, often forcing producers to scrap old equipment and upgrade their production methods ('creative destruction' of old, but serviceable, capital stock). Managers are forced by competition for market share to streamline procedures, risk innovations, control their subordinates, and eradicate avoidable costs and 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 (manifestations of the principal-agent problem).

obtain fresh supplies.

Saving the Other Side of the Market their Transaction Costs

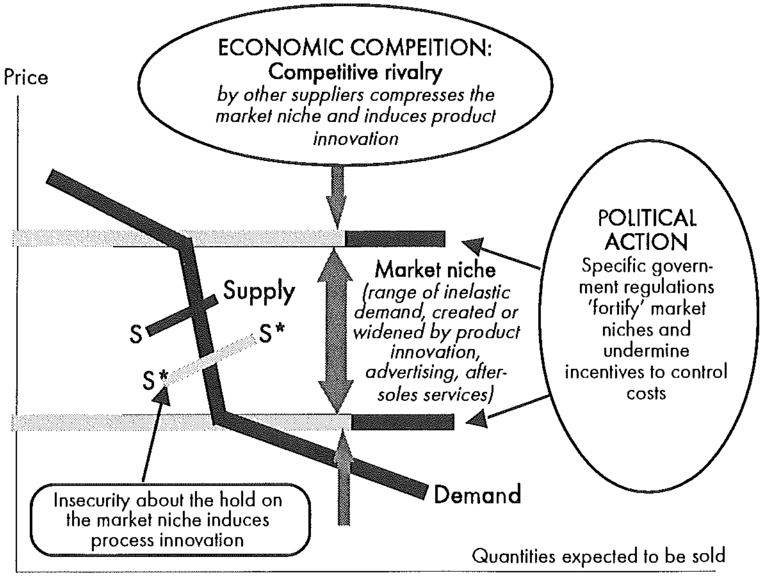
When one analyses the rivalry among potential suppliers and - parallel to it - potential buyers, the question often arises which side of the market should bear the unavoidable transaction costs. Often, it is of advantage for rivals on one side of the market to reduce the transaction costs of those on the other side. Thus, competing suppliers often incur advertising costs. This has the advantage for buyers that they are better and more cheaply informed.[16]

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

More and more modern consumer goods as well as most services are experience goods. New cars or holiday packages fall into this category. There, potential buyers face a costly information problem. To

[16] Critics of advertising, because they tacitly assume 'perfect knowledge,' conclude that advertising is a waste.

Graph 5
A Producer's Market Niche
A Snapshot from a Dynamic Process



The need to incur transaction costs to defend market positions explains why producers often demand political action to 'fortify' their market niche. Thus, car producers will invest effort and resources in lobbying politicians, bureaucrats and the public for protection from foreign competitors. The few car producers will tell the industry ministers and 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 a tariff featherbeds, with the nation-wide employment and investment level, which is undermined by industry-specific measures such as tariffs.

As protected industries in Australia and elsewhere have demonstrated time and again, competitors who receive government patronage tend to incur fewer costs to develop new technology. They will implement fewer innovations over the long run. The end result is an economic system that

> generates less growth and job security, operates with higher costs, and is full of firms with a habit of shirking search costs, and government patronage encourages them to do so!

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

Yet another method of reducing information costs is to network, or enter open-ended, more or less permanent contractual relationships. Thus, buyers subscribe to electricity and telephone services, instead of contracting anew for each week's supply, and firms hire labour on an open-ended contractual basis. Indeed, one reason for forming durable organisational ties is to save on transaction costs - as Ronald Coase 'discovered' when he asked himself why firms exist at all (Coase, 1937/1952). To cope with the information problem, buyers and sellers also often form preferential, though not exclusive relationships. Buying at the same shop saves my wife search costs. Dealing with the same stockbroker or the same tax accountant affords me cost-saving knowledge.

All these examples incidentally serve to demonstrate how important information and other transaction costs are in real life. As a result, the market is far from a faceless, anonymous abstract. Frequently it takes place amongst long-term friends and business partners who stick to shared institutions of honesty, courtesy and reliability as a transaction-cost-saving strategy to beat the competition.

The Role of Middlemen

When community-wide institutions are ineffective and transaction costs high, there is often a 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 in the real-estate market. At other times, they become intermediary contract partners, as is the case in retail trade and in financial markets between savers and borrowers. The banks offer borrowers, who wish to invest long term, credible loans (a knowledge-cost saving device). At the same time, they offer depositors short-term contracts and the possibility of early withdrawal. They also bundle small savings into big loans. In the process, financial intermediaries generate valuable knowledge and solve numerous information problems.

Intermediaries are often unpopular, and not only among 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 opened opportunities. Yet, they suffer persecution (Sowell, 1990, 1998). 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, this is not solved by persecuting the middlemen. Then, the trade breaks down altogether, and buyers and sellers are worse off. The solution is to create better general institutions which facilitate information search and equal market access for everyone, which may make middlemen redundant.

How Knowledge is Signalled to Others

How do rivalling buyers and sellers transact business?

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

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

Earlier, we considered what it took to launch the 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 in the use of photocopiers. The talents and knowledge of thousands of people were drawn upon in the effort, and human knowledge expanded. 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 enhance valued human knowledge. Alas, entrepreneurs frequently have to discover that their new product is not appreciated by sufficient 'dollar votes' to make a profit. Likewise, they may find that a process innovation - a new production technology or a reorganisation of the firm - does not produce sufficient cost savings. The resulting 'signal of red ink' makes the error obvious. As this reduces the value of someone's property, it creates at the same time 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 that 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 in which many place their 'dollar votes.' The market is a daily exercise in democracy, the will of the people.

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 signals by fixing prices or by allowing the 'static' of inflation to overlie the price signals, they pave the way for mal-coordination. Less knowledge is used, fewer wants are satisfied, and fewer choices are available. Market interventions may become even more disruptive when they trigger social upheaval, for example when increases in administered prices lead to street riots, such as in early 1998 in Indonesia.

To illustrate the practical relevance of the competitive system and its marvellous effectiveness in communicating knowledge, we may remind ourselves of what happened in the 'oil crisis' of 1973-74 when the price of crude quadrupled. As we saw in Chapter 2, this induced efforts by millions of people in all corners of the world, triggered by one signal – the higher price.

The price increase served an important motivational role. In the longer run, higher prices mobilised new supplies of oil and curbed demand. Eventually, the real petroleum price (adjusted for inflation) came down again. The Jeremiahs who had predicted the end of modern civilisation and the regulators who tried to stop the price increases by direct intervention were proven wrong. US President Jimmy Carter, who had tried to protect the American people from foreign-made petrol price increases during the second oil crisis in the late 1970s, but had instead caused unexpected shortages and queues, was thrown out of office by the voters. The economists who had counselled the public to trust the power of the market were proven right!

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.

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

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

The Responsibility to Compete

We saw that most people are naturally reluctant to incur those insidious knowledge-exploration costs, and that there are considerable mental obstacles to intense rivalry and knowledge-search processes on both sides of the market. Yet, in a market economy 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 engage in knowledge searches. But those who refuse to engage in knowledge search must anticipate that their property will lose value, as rivals capture market share. Owners who refuse to accept the challenge of competition have to accept the consequences in the form of possible losses of their property values and a possible reduction in their socio-economic position. And even those who incur knowledge-search costs must live with the constant insecurity that their search may be in vain.

In the interest of well-functioning markets, they must not be allowed to run to government or conspire among themselves to avoid possible losses. In a dynamic economy, positions must be re-validated again and again. It is absolutely essential for prosperity and the functioning of the capitalist system that the unwelcome stimulus of competition be kept alive. As was said in the previous chapter, property rights establish not only claims to benefits, but also responsibilities. Governments that 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 or unlucky competitors, they directly undermine the constitution of capitalism and detract from our freedom, security, prosperity and justice.

Property owners, including the owners of labour, who shirk the costs of knowledge search or are unsuccessful, will of course resent 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, socially and militarily. Economic nationalism - by means of trade protection, the control of foreign investment, 'Buy Australia' 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 Australian miners and waterfront workers to face open competition, defending the closed shop and privileges that could not be maintained in a competitive labour market. The fundamental freedom to associate - or not associate - and to compete is denied to Australians in many walks of life: ultimately because governments have been captured by powerful supplier lobbies.

Competition and Equity

The responsibility of asset owners to compete, if they wish to maintain the value of what they own, influences the distribution of incomes and wealth. Positions of relative income and wealth evolve continually. In a truly competitive economy, there is no such thing as a permanently rich and a permanently poor class of people – unless political power play prevents competition. In competitive open economies, such as the American economy, few of the top 500 richest stay on top for generations. Innovators challenge them ceaselessly. But their creative ideas may not flow ceaselessly. Established property owners will therefore often seek collective action to freeze their socio-economic positions.

If they are successful in obtaining favours and 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 textile and garment jobs by successive Australian governments has been inordinately at the expense of poor families with children. And most monopolies survive only because of government support (Friedman, 1962).

In Australia, one can find numerous critics of a system of property rights and free competition who admit that such a system is good for efficiency and economic growth. But they fear that it leads to 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 Australians belong to a middle class and there is constant turnover amongst the rich. How many of Australia's richest families in 1945 are still on that list now?

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

However, many observed differences in market outcomes are the result of artificial obstacles to competition in Australia. Inexperienced, low-skilled or handicapped people cannot easily compete in the labour market with their limited assets because of minimum wage laws. The minimum wage, closed shops, the Byzantine structure of industrial relations, labour cartels and administrative practices are the source of much inequality of incomes. 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 on children's clothing - are adding to the inequalities of outcomes. Governments thus are denying Australians more equal opportunities. Those who are well organised have obtained political protection from open competition at the expense of the unorganised. Positions of relative economic power in this electoral democracy are translated into artificial political protections from the responsibility to compete at the expense of newcomers. As we shall see in the following chapter, public choice has often displaced private competition and political discrimination replaces the equality of opportunity.

One cannot, therefore, criticise the competitive property rights system as discussed here with examples of inequities in Australia's current, 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 outcome equality and economic growth. Taiwan, for example, figures at or near the top of all international tables on equality of income and wealth despite - or because of - a near-total absence of public welfare and coercive income redistribution (Riedel, 1988: 18-21). And the liberalisation of the New Zealand economy has opened many new opportunities to previously disadvantaged groups, as disproportionately large drops in the unemployment rates of Maoris, women and the long-term unemployed show (Kasper, 1996b).

In this context, it is also worth noting that total income equality would not be a worthwhile goal to aspire to. First, when government engages in redistribution, the incentives of the discovery system by competition are distorted. It is simply counterproductive to expect market participants to invest in search costs, when a share of the returns is confiscated. The search-discovery-production face of the market system cannot be divorced from the distribution face of the same coin. Secondly, the market is an ongoing dynamic process, so that 'income distribution snapshots' at any one point in time tell a partial story only. Naturally, older citizens, close to retirement, are richer than youngsters. Today's glamour company is investing in a risky venture that may make it poor tomorrow. A high-income job today may be in tomorrow's sunset industry. And a battler may well discover tomorrow's highly rewarding opportunities.

Once one takes a dynamic, evolutionary view of the market process, one is likely to favour institutions and a style of governance that increase material opportunities for the community, rather than redistribution of a given 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, because the benefits of competition spread far beyond those who are directly involved 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, specific legislation, and other such interventions in market processes.

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

CHAPTER SIX

THE LIMITS OF PUBLIC CHOICES

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

M. and R. Friedman, 1980: 50.

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

Gwartney and Stroup, 1993: 79.

The Shortcomings of Collective Choices

So far we have discussed private choices to coordinate decisions about property uses. 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, collective choices have to be made to use the asset. However, matters become much more complicated when actions are coordinated by public policy instead of voluntary, bilateral contracts that are subject to the discipline of market competition:

(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 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 menu. Where there is less variety, there is also less potential for 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. The agents are often appointed on the basis of political patronage and owe little allegiance to those whose preferences they are supposed to take care of (the principal-agent problem).

(d) In bilateral market contracts, the give and the take are clearly defined and equivalent in the eyes of the contracting parties. 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, much monitoring and compulsion are required. Contributions to collective activities require compulsion, inflicting high agency costs. They often cause 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 evaluation. This reinforces the danger of major and intractable principal-agent problems in politics.

(e) Since the re-election motive dominates much collective action in democracies, it is 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 three years' time. Australia's short electoral cycle reinforces political myopia.

(f) In modern democracies, the free will and the responsibility of elected people's representatives are limited by the discipline that political parties impose on parliamentarians. As a consequence, most political decisions are in reality made by small backroom committees, rather than elected majorities of the representatives who are directly responsible to the citizens. It is quite common in political decision making for a few keenly interested persons to dominate a committee that fixes party policy on a particular matter and for parties to automatically and uncritically vote for committee recommendations. As a consequence, modern parliaments are frequently turned into an instrument of the exploitation of the majority by avid, self-seeking minorities.

(g) This problem is aggravated by the combination of (i) small, organised interest groups that have much to gain from political preferments, (ii) an electorate that faces high information costs and therefore remains 'rationally ignorant' about the business of government,

Graph 6
Private and Public Choice

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

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

and (iii) organised parties of parliamentarians who will do almost anything to obtain the support and financial donations necessary to get re-elected. Rent-seeking, rent-creation and opportunistic crooks who operate at the expense of the citizen-principals are therefore endemic in political choices (see 'Public Choice', 'Rent Seeking' and 'Rational Ignorance' in the Glossary).

For these reasons, coercive collective action is very much a second best to voluntary private action in coordinating human activity, except in a limited number of circumstances. This leads one to conclude that government should be constrained to a minimum of areas, and that as much of human economic activity as possible should be privatised (Graph 6). One also has to conclude that the agents of government have to be controlled so that they do the bidding of the citizen-principals as far as possible

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

The Functions of Government

At various points we touched upon two roles of collective action by government. When discussing institutions in Chapter 3, we saw a role for government in backing-up the internal institutions of society by imposing and formally enforcing external institutions (protective function of government). And when discussing the various forms of property in Chapter 4, we saw that not all assets can be assigned to exclusive private ownership. There may be a case for government getting involved in providing, even producing some public goods (productive function). Therefore, government has protective and productive functions. In addition, elected parliaments in countries such as Australia have greatly expanded an additional government function: redistribution by confiscating the property rights of some and allocating them to others.[17] Indeed, this has been the biggest cause of the relentless expansion of government this 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 specific outcomes of applying the rules are sometimes unwelcome or politically unpopular. Placing the time-tested, non-discriminatory institutions above the pursuit of specific outcomes requires either genuine, far-sighted leadership, or strong constraints on political opportunism. In present-day electoral democracies, elected politicians, as well as unelected judges and bureaucrats, are under pressure from well-organised lobby and advocacy groups. These groups pursue particular outcomes ruthlessly, irrespective of whether this violates the time-tested rules of society or not.

In their pursuit of votes and electoral finance, many politicians become the captives of such groups. They may even abandon the core

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[17] Some writers would assign government a further function: stabilising the economy. It seems, however, more appropriate to subsume the stability of the value of money under the protective function, and to doubt the capacity of governments to stabilise aggregate demand, let alone demand in particular markets. Admittedly, such stabilisation may serve particular interests, but it tends to undermine the coordinative efficacy of the market economy.

values of their professed political creed (Downs, 1957; Olson, 1965; Tollison, 1982; Sowell, 1990; for telling Australian evidence, see Warby, 1994). When they do, they betray the core function of government, namely to ensure the non-discriminatory protection of universal rules which allow a spontaneous order to evolve.

Governments of course also have to prescribe certain outcomes, for example in regard to health, environmental and other specific, prescribed 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 protections 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 (von Mises, 1949).

Caution with the political supply of specific protections seems advisable also because outcome-specific prescriptions tend to have unforeseen side effects. These tend to accumulate so that a competitive society becomes insecure and people shirk knowledge-exploration cost. Another side effect of prescriptive protections 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 could not be employed more effectively to save human lives through other methods, for example by accepting certain risks, saving the costs and buying more dialysis machines. In any event, this issue has to be approached 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 in connection with public goods. When not all benefits and costs of certain goods and services can be appropriated, the incentives of private property sometimes do not work well, or not at all, in allocating resources. But this does not automatically justify the production of those goods and services by government-owned and managed enterprises, as we saw.

In reality, public production has of course been extended far beyond cases of pure public goods. Governments often set up public monopoly producers - or entire nationalised industries - to control private monopoly powers which in the first instance flowed from prior political protections. Or governments wish to collect revenues without having to incur the political opprobrium of taxing. This is why many governments nationalised the telegraph, power and rail systems last century; why governments ran salt mines and cigarette factories; and why many toll roads are collectivised.

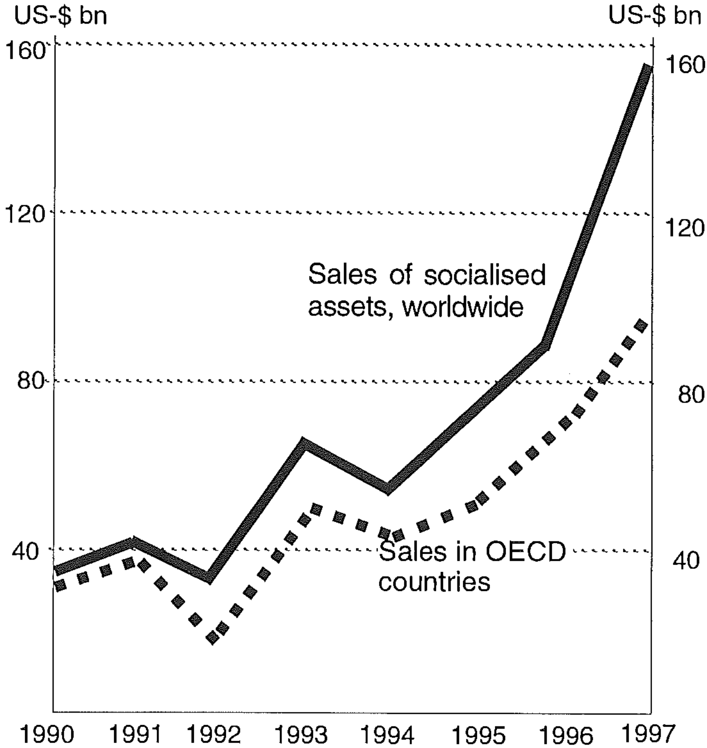
We have to beware of a confusion of the language - 'public good' means 'public access good' (or 'public domain good'), not 'publicly produced good.' All that is often required is for the government to ensure that the public have access and that certain quality standards are adhered to (see the views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

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

This realisation has given rise, since the 1970s, to an accelerating worldwide wave of privatisation (Graph 7). Between 1985 and 1995, privatisations amounted to an estimated US$535 billion worldwide (O'Leary, 1995), and in 1997 alone US$157 billion worth of socialised assets were privatised. Countries with large socialised sectors, such as Italy and Australia, have been among the most avid privatisers. Since 1990, about $60 000 million worth of publicly-owned trading enterprises have been sold, more than two-fifths by public floats to shareholders, many of whom gained a direct shareholding stake in the economy for the first time.

The benefits of private ownership and competition (for example, controlling costs and innovating products) are becoming increasingly evident. But privatisation has often lessened the rents reaped by the workforce and the management of socialised, political firms. It is there-

Graph 7
The Proceeds of Privatisation



NB. The share of privatisations by countries that previously had large socialised sectors, such as Italy and Australia, is high.

Source: OECD

fore 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 this century. In Australia, a very large part of federal and State budgets does not go to protection and service provision, but consists of tax-confiscation for the purpose of hand-outs by subsidy. Much publicly-owned production serves in reality the government's redistribution and patronage function. However, the redistributive role of government does not stop there; in addition, governments interfere directly in many market processes with redistributive aims to reallocate incomes, for example by fixing minimum prices, impeding CD and other imports, or licensing a limited number of competitors. To understand the enormous expansion of the redistributive function in Australia and other electoral parliamentary democracies, we have 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 agents will be tempted to act in their own interest to get re-elected or wealthy, rather than in faithfully representing the - often poorly articulated - will of the people. Political choice therefore gives rise to massive principal-agent problems (see Glossary; Downs, 1957; Stigler, 1971; Buchanan, 1987; Buchanan et al., 1991).

In the Australian case, this can best be illustrated with the example of tariff making. Parliamentarians, ministers and bureaucrats have much to gain when they respond to organised industry or social 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 tariff interferes with the freedom of Australians to buy cars or CDs, for example, from the best source, by excluding or handicapping the public's access to foreign suppliers. This allows the local (yet foreign-owned) vehicle producers to charge higher prices and to save themselves many of the troublesome search costs for new models and cost cutting (compare Chapter 5).

If, for argument's sake, the local market is 400,000 passenger vehicles per annum and the average car can be sold, thanks to the tariff privilege, for $2,500 more, then each of four domestic car producers (and their workers) gains on average $250 million annually - a massive, politically allotted windfall. This is certainly worth lobbying cabinet ministers and browbeating the public! By contrast, the average household may buy a car every seven years, particularly when cars are overpriced. Each household then bears an average, politically imposed, loss of some $360 per year - not worth the effort to inform themselves of the harm done by the politicians and to lobby them against this welfare policy for the car industry (see 'Rational Ignorance' in the Glossary).

Over the longer run, the loss of 'creative unease' in an industry leads to less innovation and poorer international competitiveness. This is why protective, selective industry policies have been a worldwide disaster (for more on this, Wood, 1997; Snape, 1997). A recent survey of recommendations to the Howard government by Helen Hughes (Hughes, 1997-98) and rampant political support for specific industries and ventures (such as supposedly private new rail lines, privately organised sports events, and an array of well-organised industries from cars to tourism) have shown that the costly game of rent-creation and rent-seeking is alive and well in Australia (see Insert).

Parliamentarians and other political agents opportunistically produce and supply interventions that redistribute income. 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 redistribute selective

Industry Policy: Can Government Know?

The knowledge problem and consequent principal-agent problems in government are starkly highlighted in 'industry policy,' in particular in attempts to identify industrial 'winners' by collective action instead of relying on competing private investors to find profitable industrial activities. Government agencies, including in Australia, have become involved in interfering in market processes and industrial structures with the aim of advancing overall growth. In Australia, the main instrument of industry policy has been the tariff. It is now widely recognised as a costly way to 'pick losers.' More recently, the political fashion has been for identifying and subsidising supposed growth industries (Hughes, 1997-98).

But 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? The question 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, Korea after the 1960s). But even there, gross errors have been frequent: the Japanese government telling Sony that solid-state technology 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 leads to social tensions. It is instructive for example that in South Korea, the 20 largest and preferred *chaebol* have greatly underperformed when compared to the S&P 500 companies in the USA (average 1990-96: 4·7% net profits as against 1·1% in South Korea; source: *The Economist*, 22 November 1997: 88). It is also worth noting that South Korea has one of the most acrimonious industrial relations records, similar to 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.

Among economists and international economic organisations, selective industry policies have therefore long been in disrepute as an instrument of economic growth (Burton, 1983; Kasper, 1985). Governments simply cannot know. And political rationale tends to outweigh the economic rationale in which the citizens are interested (see 'Knowledge Problem' in the Glossary).

The industry policy problem is lessened when governments promote generic supply-side policies, mobilising resources through education, research, savings promotion, opening up land and providing hard infrastructures. This is increasingly becoming the style of industry policy in East Asia. Recent experiences with specific industry policies have taught costly lessons, for example in South Korea, where government-sponsored *chaebol* conglomerates have accumulated huge bad debts, in Malaysia, where firms close to the ruling political party made huge losses in government-sponsored projects, and in Indonesia, where a small circle of favoured cronies have caused what is wrongly termed a 'monetary crisis' – it is an institutional crisis.

The political temptations to gain influence through rent-creation of course militate against such general supply-side policies, as well as against the free-market stance of treating industrial structures with benign neglect. This also applies to the Howard government, which has for example pretended to know that car assembly, tourism and certain research-intensive activities are more promising than all the other evolving uses of capital. Judging by copious international experience, there is a real danger that selective industry policy will contaminate the probity of policy processes in the future. The dividing line between corruption and probity is hard to discern when a government is committed to providing corporate welfare. In any event, such discriminatory policies violate the equality of all Australians before the law and hence the institutional principle of universality.

privileges will often share the windfall with them, maybe to supplement party budgets at election time. Such redistributive interventionism goes far beyond tariff making, and pervades every walk of life. Sometimes, organised suppliers of labour extract political preferments (for example, political exemptions from the normal rules of contract law) in exchange for electoral support. At other times, organised professions and industries obtain political favours; for example, in the form of subsidies for their research. The 1990s revival of selective import-substitution policies in Australia is amazing, because they are now widely understood as a worldwide disaster, and they have been correctly called 'the alter ego of protectionism' (by E. Jones, in *The Australian's Review of Books*, 10 December 1997: 12-13, 31). Australian policy makers still brush aside the inevitable fact that they too suffer from severe and endemic knowledge and motivational problems. They meddle regardless.

As selective interventions proliferate, the fundamental market rules are upset and the overall intensity of competition - the risky, troublesome commitment to finding and testing new knowledge - is eroded. Market signals become hard to read. The economic system loses some of its catallactic efficiency in uncovering growth opportunities. The opponents of capitalism then find much evidence with which to castigate capitalism. Those who favour capitalism are therefore well advised to also favour competition. If business leaders argue for private ownership but seek political protection from the consequences of competition, they are likely to find that capitalism is opposed by the population at large and that private property will, sooner or later, be interfered with by political action. The system of capitalism will only gain popular support if it is not deprived of open comeptition - of what Australian historian Geoffrey Blainey once aptly called the 'invigorating air and sunlight' of the economy.

The Failures of the Welfare State

Nowhere in the mature democracies 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. Increasing doubts are, however, now being voiced in the mature welfare states with mixed economies, such as Australia, as to whether the welfare state has not been a case of massive government failure. It may now constitute a costly road block on the path to high employment, growth, freedom and self-responsibility (Minogue, 1997):

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

(b) The long-term availability of public welfare has induced many citizens to act opportunistically (moral hazard). Many have ceased to make their private, self-responsible welfare provisions by bearing the costs of acquiring work and life skills, by adjusting their expectations to prevailing market conditions and by saving for a rainy day. This is exacerbated by the disincentive effects of progressive taxation. The result is a ballooning claims and dependency mentality (James, 1989; Maley et al., 1996; Green, 1996; Jones, 1997). Tax-funded welfare, heavy taxation and poor integration of tax and handout policies also reduce private charity, typical of well-functioning civil societies. Well-off people feel pushed aside by the public tax-handout mechanism, and most voluntary welfare organisations have become clients of the government welfare machinery. They lobby for tax money on behalf of welfare recipients rather than raising their own funds. Whereas the Good Samaritan gave the beggar his own cloak, most Australian charities nowadays are arguing for the coercive distribution of other peoples' wealth.

(c) Much public welfare is provided through public-sector monopolies. These have been captured by well-organised producer groups, for example unionised health and welfare workers. Consequently, public programs are often managed in the interest of organised labour, and not with a view to efficient welfare provision (Kasper, 1983; 'Public Goods' and 'Public Ownership' in the Glossary).

(d) The shift from self-responsibility to reliance on government agencies has induced much public posturing and lobbying. Social harmony is lost in growing political confrontation and recriminations, on the mistaken notion that inequality is automatically injustice (Flew, 1989). The need to ration demand for handouts by queuing, waiting lists, political interventionism and public admonition is another source of political acrimony. Worse still, a growing part of public welfare administration now escapes judicial and parliamentary scrutiny (Ratnapala, 1990: 8-18). This paves the way for what Hayek calls 'the miscarriage of the democratic ideal' (Hayek, 1979: 98-104). All this has led to the beginning of a widespread and divisive political backlash, which some astute observers have long been warning of (e.g. Sowell, 1990, especially p. 174).

(e) The growing welfare burden of the gradually ageing Australian population leads to the disgruntlement of the young generation. The 20- to 30-year olds expect high tax burdens and a gradual deterioration of public services, as has long been predicted (Kasper et al., 1981: 208-210; National Commission of Audit, 1996: 121-153). Indeed, the high and unsustainable claims of the ageing baby-boomer generation constitute political dynamite for the future. While initially there were political gains from redistribution policies in terms of political loyalty and support for government assistance to those less well off or less lucky, those political gains are now overshadowed by a growing disaffection with public-sector inefficiencies and compulsory redistribution.[18] People find that they do not simply want to be passive recipients of government handouts, but want to take responsibility for their own lives.

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

(g) 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 political fiat. The Coalition government has sold off public assets but simultaneously it has increased the taxation of private incomes and assets, for example by changing the basis for measuring tax obligations or by imposing a levy to buy back guns. Therefore, it has failed in its protection of private property rights. Like other welfare states (Sowell, 1990), Australia now witnesses the erosion of political legitimacy and authority, because the state has promised too much. Driven by a welfare commitment, it deprives people of life opportunities and freedom, and destroys their confidence by undermining the fundamentals of private property and autonomy.

[18] In the wake of the pervasive economic reforms in New Zealand, a pronounced generational conflict over welfare has been revealed. The under-40-year olds are strongly critical of statist policies, while the old display strong collectivist-socialist tendencies and favour big welfare budgets.

The increasingly obvious failures of the welfare state pose serious problems for Australians. Many in this country have a long and emotional commitment to redistribution and egalitarian outcomes. If they control that commitment, Australians will be able to rectify the consequences of the welfare blight and restore the economic institutions to a more competitive and promising shape. If Australians wish to persist with their traditional egalitarian instincts, they will have to think much harder about turning the government into a last line of defence against personal misfortunes, with government coming in only once private effort, family and voluntary community resources have been exhausted (Green, 1996). Only then will Australian governments be able to protect private property rights and individual autonomy and restore general confidence.[19]

How to Control the Opportunism of Political Agents?

The opportunism of the agents of government is an age-old problem. It has exercised the minds of many great thinkers and reformers, though with limited success. A number of institutions and control devices have been tried. They will have to be applied in combination, as 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. Australians are nowadays rather cynical about this. However, public vigilance and intolerance of selfish, short-sighted opportunism in high office are important bed-rock conditions for good government. This requires high community standards and the public censure of those who excuse breaches of the rule of law or of ethical standards by office holders. In cases such as WA Inc. and Victoria Inc. in the 1980s, the innate probity of the public was the ultimate line of defence against the opportunism of office holders and their camp followers.

(b) Political writers of an earlier age, such as Charles de Montesquieu (1689-1755) and the shapers of the US constitution, proposed and

[19] We should note in passing that none of the East Asian economies has committed more than marginal budget resources to the provision of public welfare. Welfare is a private family's or a firm's responsibility. At most, income earners in several Asian countries are compelled under the law to save for their retirement. This is the major reason why government burdens on East Asian producers are competitively low. In 1995, the new industrial countries there had a share of general government spending of only 27% of GDP, as compared to 35% in Australia (and 54% in western Europe). Because Australia is a front-line state vis-à-vis the new industrial countries of Asia, welfare burdens constitute a heavy public handicap to our international competitiveness.

implemented the separation of the powers of government between the rule-makers (parliament), the rule implementers (administration) and the rule adjudicators (judiciary). Bicameral parliaments have a similar function (House of Representatives and Senate).

The merits of the division of political powers are now widely recognised. However, in Australia's Westminster-style system of government, the separation of powers is rather weak. In practice, the parliamentary majority party or parties - or its leadership group - dominates not only the legislature, but also the executive. Over the long run, the elected political party also has great influence over who is appointed to the High Court. Only when the House of Representatives majority is not matched by a Senate majority is there a parliamentary check on executive power - unless, of course, political deals are done with Senators. In contrast to some other federations, both houses of the Australian parliament tend to decide along party lines, and Senators nowadays rarely act as the representatives of regional interests. As a result, the Australian parliament and executive are exposed to interest group lobbying and can get away relatively easily with discriminatory political interventions.

(c) Another method of controlling agent opportunism in politics is the separation of powers between local, state and central governments (federalism). If these three levels of government are assigned separate tasks and empowered to raise their own requisite taxes to fulfil them, there is not only much scope for effective mutual control, but also a considerable incentive to foster prosperity and a growing revenue base. Competing jurisdictions tend to offer competitive administrative solutions to collective problems. Competitive federalism induces governments to incur knowledge-search costs and to mobilise much valuable political-administrative creativity (Kasper, 1995).

It must be recognised that certain tasks of government are best left to a central agency (where there are distinct economies of scale, such as defence, where there is great interaction, such as standardised traffic rules, or where competition amongst jurisdictions may have harmful consequences). Ensuring the same living conditions throughout the country, irrespective of location, resource endowment and political behaviour, cannot, however, be an objective of policy if one wants administrative creativity and power control. This objective is the equivalent of income redistribution: it stifles self-reliance and competition.

Unfortunately, Australia's originally decentralised federal constitution has been increasingly centralised by Canberra politicians, High Court judges and State premiers. State governments now have very limited capacities to defend the citizens' rights against central opportunism (Craven, 1997). Moreover, most State constitutions leave little scope for truly independent and responsible local government. The centralisation of so much government business also means that the government is remote from the citizen. The fixed costs of influencing public affairs are extremely high for the individual citizen or firm. The influence of organised pressure groups and political parties is correspondingly greater. They can often concentrate their lobbying efforts on a single government, which is not seriously exposed to interjurisdictional competition.

(d) When discussing the failures to effectively check the concentrated power of political parties over central governments, Friedrich Hayek proposed a separate Third Chamber of Parliament (Legislative Assembly). It would set the fundamental framework rules which constrain what elected politicians can do. The Legislative Assembly would be elected for a comparatively long period by age cohorts, so as to ensure a degree of independence from the party system (Hayek, 1979: 147-65). He proposed that a party-based and normally-elected Governing Assembly should, by contrast, pass enabling legislation which compels citizens to act in certain ways and which appoints the administration. Hayek's hope was that this would turn at least some parliamentarians into protectors of the citizen's liberties, a role British parliamentarians had fulfilled in the eighteenth century. To some extent, Hayek's Legislative Assembly could play the role of an independent High Court in Australia. But it seems doubtful to this observer whether such an arrangement would escape the pervasive dominance of Australian political life by organised parties.

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

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

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

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

One way to promote transparency has recently been the Budget Honesty Charter and the proposal for governments to report not only flows of receipts and expenditures, but also their balance sheets of assets and liabilities. This was first mooted in 1996 by the National Commission of Audit (National Commission of Audit, 1996). In 1996 and 1997, Parliament discussed the Charter - a watered-down version of the successful New Zealand Fiscal Responsibility Act of 1994 (Kasper, 1996). It was most revealing that the non-government parties in the Senate blocked this move to increase transparency in public finances, until it was finally adopted on 25 March 1998.

(i) Agent opportunism in high office can 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 and Buchanan, 1985; McKenzie, 1984). Such rules may take the form of procedural constraints, for example requiring a two-thirds majority to raise taxes or authorise deficit finance. Strict limits could also be imposed on the government's claim on resources, for example by sunset clauses on specific government programs and formal limits on the size of the budget or rates of taxation. Another result-oriented limitation is to oblige government to adjust income tax rates automatically by the rate of inflation (so as to prevent the insidious method of tax creep which has pushed most ordinary Australians into high-tax brackets). This was tried for a while under the Fraser government, but soon conveniently dropped again.

Many Australians appear to reject such formal limitations of parliaments on the basis of the doctrine that Westminster-style parliaments must remain sovereign so that they cannot even bind themselves against future opportunism. However, a variation of Lord Acton's famous dictum applies: 'Power tends to corrupt, and absolute power corrupts parliament absolutely'.

(j) Another institutional device is the citizen-initiated referendum (CIR) which allows citizens, when they observe what they deem abuses of their will, to throw out government measures they do not like (Walker, 1987; Mack, 1995). The experience with the CIR device in Switzerland shows that citizens hardly ever initiate more government activity. Instead, they vote to reduce the ambit of collective action, defending their own autonomy. In Australia, there are only politician-initiated referenda, not citizen-initiated ones. An ACT proposal has been assiduously opposed by politicians who fear interference from citizens.

(k) Given the increasingly political role of the High Court, 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 the Senate or another high-level body 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 recall 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 the Court's shift to reformist activism and to 'colouring the law' with fashionable contemporary concerns would seem to require methods that allow the people to signal their will.

(l) Arguably the most powerful control of political and bureaucratic opportunism is openness. When citizens disagree with how the government taxes, treats 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 earlier (chapter 1). Now, new international strictures are constraining the power brokers of East Asia. These strictures are resented, but, ultimately, they are effective in controlling political powers. This explains the agitation of political and single-issue groups against globalisation, free trade and openness to foreign investment. But opennes empowers the citizens: when the power instincts of rulers are constrained by the exit option, they normally learn to offer rule-bound, limited government as a way to attract resources (foreign investment), often despite themselves (Kasper and Streit, forthcoming, 1998).

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 interjurisdictional competition, economic growth tends to be slow and unemployment high. Cases such as Burma and post-1975 Vietnam demonstrate the point.

Australians have been driven by tribal instincts of political power and economic nationalism. They have long cultivated inward-looking attitudes by tariff barriers and investment controls. This has empowered government agents and organised interests. However, the commercial necessities of the new age of globalisation have gone some way to tip the balance to openness and constrained government. Yet, instead of embracing openness pro-actively and shaping highly competitive institutions on the basis of Australia's traditional competitive assets, institutional reform has followed an inconsistent, erratic course over the past two decades. Reformers often acted only when forced, but hoped to stave off the 'affront of globalisation' wherever possible.

They even relapse into politically opportune interventionism when they think they can get away with it.

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

This truth has not yet sunk in fully in this country. Once Australians wake up to the challenges of the age of globalisation, they will have to think hard about how to create attractive institutions that empower Australians to beat the global competition. Then, they will above all have to consider reshaping and universalising the fundamental rules of economic cooperation. In other words, then the constitution of capitalism will be high on the agenda.

CHAPTER SEVEN

CULTIVATING THE CONSTITUTION OF CAPITALISM

> *... one thing is clear to me. We are at the end of the world as we know it. Our grandchildren will obtain their order by methods we cannot imagine; our legacy to them should be a virtual landscape open to all the possibilities they might try. Let's be ancestors for them as great as Jefferson and Madison were to us. - Let's leave them freedom.*
>
> John Perry Barlow, lyricist of the 'Grateful Dead' rock band (1995).

Coming to Terms with the New Openness

In Australia as elsewhere, 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, and

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

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

Ordinary Australians 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). Australians seem to have reached a state of mind where they feel little loyalty to collective action and the wider community.

Yet, they also want specific, government-guaranteed outcomes. Many do not appear to see the contradiction between confidence, order and a spontaneously effective community on the one hand and demands for 'outcome engineering' and government handouts on the other. The fundamental conflict between redistributive political interventionism and a competitive market economy that opens fair chances for most, including the 'battlers', is not widely perceived. Pressure-group spokesmen in parliament, in the bureaucracy and in single issue advocacy groups of course do little to clarify this contradiction. It is therefore not easy to obtain political support for reforms that simplify the rule system, restore stability and confidence and pave the way for self-responsibility. We therefore have to witness a progressive 'tragedy of the commons' in Australia - political preferments and exemptions from general rules debasing the shared stock of institutional capital.

Because citizens often harbour schizophrenic attitudes to the relationship between themselves and government, hard institutional constraints sometimes lack legitimacy in Australia. Politicians, bureaucrats and judges are able to exploit split public attitudes to circumscribe private property rights and liberties and to usurp the market. The fundamental conflict between private and collective action thus persists in many areas. The agents of government - whatever their professed ideology - are loath to making 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.'

How - despite the odds - can we obtain a truce in the discriminatory political activism and the selfish, organised supplier lobbying? From what has been said in the previous chapter, no single measure will be strong enough to control political opportunism. It is equally clear that the ultimate back-stop of the restraints on political rent-seekers is openness - the effrontery of free trade and investment flows. Openness often irritates politicians, lobbyists, and single-issue activists. With low tariffs and reduced foreign-investment controls, full currency convertibility and a growing awareness in Australia of the profit opportunities overseas, the essential conditions for the exit option are now in place. These conditions have to be defended against ministers and parliamentarians who have become the captives of special interests.

It has to be anticipated that partisans of particular groups and their followers in academia and the media will continue to oppose openness and individual autonomy and revile those who shift between different jurisdictions (e.g. the multinationals, the capitalists). They will promote Australian nationalism as a means of shoring up political control and cast aspersions on cosmopolitan influences. The power of collectivist action can, after all, only be properly exercised in closed economies. The advocacy of collectivism, which flatters the ego of leaders and intellectuals, will therefore remain the opiate of the elites.

On their tortuous journey to an open economy, Australians have now reached another critical crossroads:

(a) whether to embrace the cosmopolitan spirit whole-heartedly in order to complete the liberalisation agenda of the early 1980s - still a major reform job - and to create the conditions that enable Australians to compete confidently and successfully for some of 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 this lucky country does not need to rival all that hard with others and does not have to incur all that many knowledge search costs.

As of the 1990s, Australians certainly understand that openness and globalisation affect them in profound ways. They have also discovered that, after a long period of government-made certainty, they are not particularly well equipped to compete in the open world economy (just note the institutional deficiencies that were documented by international comparisons in Table 1). Despite the self-made handicaps, some Australians have turned out to be spontaneous winners in global markets. Among them are rapidly growing niche exporters, many service exporters, those who win domestic market share using newly imported capital and knowhow, and those who can benefit from better, cheaper imports.

But there have also been losers:

(i) People who believed government assurances of protection in the 1950s, 1960s and 1970s, and committed their capital, skills and careers to industries that were bound to decline in high-income locations such as Australia;

(ii) low-income citizens who pay the inflated costs of still-protected and regulated goods and who lack the knowledge and organisation to lobby against such discrimination;

(iii) regions and States weakened by intervention, many of whose inhabitants and leaders still believe that what is good for them must be good for Australia, and

(iv) politicians, unions, and community organisers who are losing their customary grip on power as they are confronted with the 'exit' threat of some of their constituents, and are reluctantly forced to reshape their old ways.

Australia's pervasive interventionism has created a coterie of regulators, monitors, arbitrators, activists and camp followers in parliament, academia, the courts and the media. They have a well-defined interest in perpetuating our interventionist culture. When the rules are simplified and streamlined, those used to organising individuals by command naturally feel a sense of deprivation.

For example, a free labour market would make the entire industrial relations industry redundant. The Howard government did not have the courage to do that. Instead, it introduced a confusing, byzantine two-track system that keeps the institutions of Australian labour markets dysfunctional. If the Howard government had adopted an equivalent of the New Zealand *Employment Contracts Act* and given Australians the right to contract freely and to associate or not associate, political confrontations such as in the coal industry or on the waterfront would no longer be possible. Numerous minders, including the entire industrial-relations industry, would, however, be out of a job. Many Australians - organisers of others and those who willingly let themselves be organised - still feel a sense of comfort with the artificial top-down order. Many have not yet discovered that Australia's half-reformed order - with its rigidities, contradictions and spasmodic adjustments to changed circumstances - is now the major source of widespread insecurity and social conflict, and that a return to the government-provided certainties of the 1960s is an impossibility.

Openness and globalisation put the post-Federation institutions to the test in the 1980s (Chapter 1). They have been found wanting. Indeed, we have witnessed many failures of Australia's political and economic constitutions. Ruthless, rule-less political redistribution battles have debilitated our economy and society. In the long term, the anarchy of 'rip off and let rip off' has deprived consumers and savers of life opportunities, and keeps preventing many from advancing themselves. Occasional knee-jerk remedies to redress this or that specific insecurity and to pacify this or that fear only compound the growing insecurity. In the process, the futility of discretionary interventions becomes more and more apparent.

Unfortunately there is little momentum, as of the late 1990s, towards a systematic and cosmopolitan solution to address the spreading unease. A conscious, intelligent and concentrated attack on the root cause of the current Australian malaise would lay the foundations for self-responsible individual choice by a conscious overhaul of the underlying institutional system. The alternative that leaders pronounce - an inspiring vision for a government-made order from the top down - is most unlikely to ever work again. Australia has become too complex and too open to the world and future evolution. This lesson has been learnt the hard way in Beijing, Moscow and Addis Ababa. But will the same lesson be accepted in Canberra, Melbourne and Adelaide?

We have to realise that Australia's fundamental rule system impedes spontaneous self-organisation. The Byzantine accumulation of rules and prescriptions has become too complex to allow us to cope constructively and expeditiously with rapid and pervasive change. The insight that society and economy are complex evolving systems - where clumsy and frequent intervention is as perilous as in ecological systems or human medicine - has not yet become part of the popular culture. The know-all delusion of economic interventionism, which was able to develop in the closed economy of a simpler era, will only be popularly rejected when this fundamental fact is widely understood.

The New Constitutional Economics

The dilemma in which we now find ourselves could be clarified, and promising solutions could be found, if a new discipline of economic analysis - constitutional economics - gained wider currency here. It is based on two premises, namely that institutions matter and that the institutional system can and needs to be enhanced by conscious action. In particular, the simple rules of protected property rights and private autonomy require fostering if prosperity, self-confidence and harmony are to return to the Australian community. These rules do not only matter for the rich and big business. They determine everybody's life opportunities: what work we can do, whether employment is a matter of free choice, how we can employ our skills and whether we have opportunities to be creative, entrepreneurial and successful in our daily lives.

Constitutional economics is becoming popular around the world because institutional systems have come under scrutiny everywhere (Scobie and Lim, 1992). Growing numbers of economic analysts are recognising - again - that the dynamic efficiency of different national economies depends on their internal and external institutions (see, e.g. Buchanan, 1991; Scully, 1991; Porter and Scully, 1995; Kasper and Streit, 1998). The implosion of the socialist rule system in the former centrally planned economies, and the realisation of just how ineffectual the alternatives to the capitalist market economy were, have given further impetus to the new approach. The New Constitutional Economics 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 in reaction to mishaps, but through comprehensive, forward-looking reforms (McKenzie, 1984; Brennan and Buchanan, 1985; Gwartney and Wagner, 1988; Voigt, 1996, 1997; Kasper and 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 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 new types of questions, for example:

— Do the higher economic growth and job creation rates in the United States and East Asia as compared to Western Europe and Australia have something to do with the rule system, in particular the ready provision of social welfare and muddled labour market constitutions?

— What institutional deficiencies have evolved and been overlooked in East Asian countries? What rule changes will be needed to return to high economic growth in East Asia?

— How can rules be devised to reverse the long-term increase in welfare dependency?

— What features of Australia's political constitution are harmful to the chances of fellow Australians succeeding in the globally competitive game? How can the unbridled political opportunism of parliamentary majorities be constrained?

— Is it wise to trigger inflation in the hope of short-run gains in demand and job creation (as Premier Olsen of South Australia advocated), when this at the same time erodes confidence in the stability of money and triggers long-term side effects that weaken job creation?

— How can one devise fundamental, high-order institutions that prevent governments from intervening on behalf of specific indus-

tries in economic processes when this is likely to undermine private autonomy, property rights and equality before the law?
— How can judicial activism be constrained by binding rules that hinder judges from going against the will of the electorate?

In Australia, there is little explicit awareness of Institutional Economics (that effective institutions matter) and of Constitutional Economics (that the systematic, comprehensive reform of the rule system can enhance prosperity, freedom and confidence). This owes much to the thought habits of neoclassical economics. Australian economic policies normally target specific ends, on the assumption that there will be no unforeseen, negative side effects in the long run. The fundamental rules are taken for granted and are not seen as something that has to be nurtured.

This essay is an attempt to alert Australians to the big gains that can be made by cultivating the right institutions and giving our market economy a simple and solid underpinning. I have tried to outline the underlying conceptions and ideas that need to be grasped before this country's institutional handicaps can be undone, and the rules made more expedient and citizen-friendly. One cannot simply assume that all political action is acceptable simply because it is based on democracy. However, the tide of opinion on these matters in advanced countries has begun to change. The climate will be right soon in Australia, too, for discussing strict constitutional constraints on the agents of collective action. One cannot but agree with James Buchanan, the 1986 winner of the Economics Nobel Prize, when he 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 to redesign and reform it to exploit the full potential of a free people' (Buchanan, 1988: 262-63).

What to Do?

Once the dangers of interventionism are better understood (maybe in the wake of some future crisis), there will be scope for new political entrepreneurs to initiate legal and regulatory reforms to streamline and simplify the rules.

Meantime, much could be gained by entrenching economic and civil liberties, in particular private property rights, in high-level rules of a constitutional character. Admittedly, these liberties have long been part of the unwritten constitutions of all countries with a British tradition. Yet, in practice, poorly constrained parliaments, bureaucracies and judiciaries have increasingly violated these traditional institutions. This has in part been possible because those with an interest in liberty and self-responsibility left the political game to the interventionists and political operators. In the judiciary, the emphasis has often drifted from procedural justice on the basis of clear, consistent rules to social justice, and from respect for individual property rights and individual autonomy to coercive and selective redistribution. In the process, the market economy and civil society have been undermined, and have lost much of their innate catallactic capacity.

Paradoxically, the undoing of Australia's creeping collectivism and the implementation of the lessons of constitutional economics will require collective action. Political entrepreneurs, who see a career opportunity by pushing institutional reform have to undo the pervasive collective activism of earlier generations. They would be well advised to consider the concept of rules of high constitutional quality that impose constraints on monetary and fiscal policy and put formal limits on the regulatory and redistributive powers of elected parliaments and law courts (Buchanan, 1988).

Political activism could, for example, be constrained to some extent by a separation of powers between federal, State and local governments. Frequently, the best way of testing alternative legal or administrative arrangements is to begin with competition among rival State and local jurisdictions. New administrative solutions to emerging problems can often be tested at a more limited scale by inter-State rivalry (competitive federalism). Other constitutional innovations that were canvassed in the previous chapter - such as term limits, citizen-initiated referenda, formal budget constraints and other limits on the unconstrained power of parliaments - also deserve serious consideration. The doctrine of an absolutely unbridled parliament has not served the Westminster-style Anglo-Saxon economies all that well, judging by their economic growth rates. Indeed, parliamentary sovereignty has often been a cloak for unconstrained rent-seeking.

Late last century, Australians (and New Zealanders) were great institutional entrepreneurs. They did much pioneering work to shape new institutions of electoral democracy, welfare provision and labour markets. Since that time, circumstances have changed thoroughly, and many of the institutional innovations of 100 years ago are now failing us. Blindly upholding the old rules is never the right response when the world changes. Rule systems are, after all, not ends in themselves, but means to higher ends, such as the attainment of individual freedom, security and justice. Instead of rigid constitutional conservatism, a confident and critical approach to evolution is needed, based on fundamental values - above all freedom (Hayek, 1960/1992). If Australians approached constitutional reform in that spirit, much could be gained.

When re-examining the underlying political, civil and economic rules by which we live from a Constitutional Economics perspective, we should focus on a few fundamental, time-tested principles: equality before the law and individual freedoms from undue coercion, including the protection of private property. Such an examination should be based on the realisation that, despite our diversity and daily controversies, we share a common destiny. Statutes and rules that do not measure up to the fundamental principles should be repealed. A plethora of confusing rules accumulated over many decades would have to be weeded out. Only a few universal, cohesive and simple rules can be readily understood by citizens and businessmen. Australia's economic and political constitutions could then be turned into internationally competitive assets in the open, dynamic age that we now have to master.

The much needed decollectivisation of responsibility cannot be achieved without the involvement of the judiciary in keeping the rule system simple and comprehensible. In recent years, the Australian judiciary has shown little commitment to defending the simple rules of the common law. What has been said from an international perspective also applies to contemporary Australia: 'Judges have destroyed the classical law of contract, eroded property rights, and imposed a socialist law of tort designed to bring [the] capitalist economy to a grinding halt. Law has become increasingly unpredictable, and at the same time the respect for all laws has been systematically undermined' (G. Radnitzky in Radnitzky, 1997: 29). The progressivist push by the Australian judiciary in recent years has been led by the High Court, which has altered long-standing and fundamental institutions and unwittingly created much insecurity. This progressivist activism has frequently undermined the normative power of Australia's popularly ratified Constitution and of the statute law adopted by elected parliaments (Craven, 1997).

The effectiveness of the overall rule system in coordinating spontaneous experiments, which was the purpose of old-fashioned procedural justice, may not be perceived as important by today's legal practitioners. After all, they are always involved in specific cases and have been educated in case-specific problem solving. They often embrace a mentality that favours intervention and overestimates what is feasible by top-down ordering. The members of the judiciary therefore need to be reminded, time and again, by public discourse and criticism of specific judgements to be modest in what they attempt. The best one can hope for is a simple, coherent system of procedural rules to guide us through complex changes (Epstein, 1995; 1996).

The drift from procedural justice to social justice in the courts of the land probably needs to be tackled by a two-pronged line of attack: the education of judges and the explicit legislative assertion of the simple, basic rules of capitalism. This will not be easy. Judicial activism to engineer certain outcomes may be satisfying to those who serve on tribunals. It is also fairly risk-free because, ultimately, judges are not materially responsible for the unforeseen side effects of their political activity.

A conscious effort could also be made to cultivate the internal, informal institutions of civil society - rather than formal law - in order to make gains in our spontaneous coordinative capacity. The time-tested civil and cultural structures inherited from Britain should give Australians an advantage over many other communities. It is an ongoing challenge for any society to shift conflict resolution out of costly courts. One way to go may be competitive private arbitration. Traders and partners in employment contracts might, for example, agree more frequently *ex ante* to select private arbitrators and refer to them when contract fulfilment becomes contentious. Commercial arbitrators would probably compete with each other by offering simple rules and expeditious conflict resolution, as is customary in international trade (Kasper and Streit, forthcoming, 1998). Much social capital would again be created.

An organised assault on the institutions of capitalism and the rule of the simple, common law has been carried by a large section of the churches. They habitually claim the moral high ground, even in areas where they lack expertise. Many Australian church activists - inspired by the ignorance of economic matters in overseas church groups - are broadcasting economically incorrect, new-age ideologies without any awareness of the long-term harm of what they are advocating. They often argue on the basis of simple, push-button models of society and in total ignorance of the evolutionary complexities of modern social and economic life. In a free, pluralist society this is permissible. But such an arrogant pretence of knowledge deserves to be shown up for what it is. Even if well-intentioned, populism will harm the materially less well off and those groups without power on whose behalf church leaders pretend to speak.

It also has to be mentioned in this context that most of the so-called voluntary organisations in Australia have in reality become clients of the redistributive state. They are financed predominantly by taxes and consequently are often acting as the disguised propaganda battalions of statism. It is not surprising that their spokesmen typically advocate bigger government. Few Australians are game to criticise social advocacy groups as incisively and memorably as Ludwig Erhard, the father of the post-war German economic miracle, once did when he said: 'Government is not a cow that is fed in Heaven and can be milked on Earth!'

On similar grounds, we cannot expect government-financed educators and media spokesmen to argue for reducing the domain of public choice by fostering private property and competition. After all, intellectuals have more influence in a large and expanding domain of collective choice. The democracy of the market disempowers them.

A more robust defence of Australia's shared institutions and of the rule of law against the rule of ignorant self-appointed busybodies will require a philosophical foundation in the theory of complex systems, as sketched in chapter 2, and in the principles that are developed overseas by the New Constitutional Economics.

Much is at stake here for future generations of Australians. The opportunities of the open, fast developing world of the twenty first century cannot be exploited if we are guided by constitutional rules that were developed in the horse-and-buggy era for a world of simple certainties. We would be much better equipped to face the ongoing, open-ended changes if we relied more on spontaneous decentralised responses to emerging challenges. Australians have sufficient civic resources not to be on a 'road to serfdom' whatever the circumstances. But by tinkering piecemeal we are on the road to mediocrity. Averting this requires a revived constitution of economic, civil and political liberties.

GLOSSARY OF IMPORTANT TERMS

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

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

COLLECTIVE CHOICES - see PRIVATE CHOICES

Economic COMPETITION takes place in the MARKET, (a) between suppliers who rival with each other by incurring transaction costs to position themselves as attractive contract partners for potential buyers, and (b) between rival buyers who shoulder transaction costs to position themselves favourably vis-a-vis sellers. Since one can never be sure what return one gets from incurring transaction costs, competitive rivalry is unpopular. But the incurring of transaction costs is essential for prosperity and the control of economic power.

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. abstract, overriding rules that are considered fairly permanent and that govern adjustments in lower level rules. 'Constitutional' in this sense does not necessarily relate to a nation's written or unwritten political constitution. Constitutional economists raise the question of what economic and political principles and *meta* rules are desirable (normative constitutional economics) and what constitutional redesigns are needed to obtain certain economic results.

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

The term EXTERNALITY is used by economists to denote costs and benefits that cannot or are too expensive to be sheeted home to the decision maker who causes them (they cannot be internalised). Thus, industries that burn fossil fuels cannot easily be burdened with the full costs they impose on humanity (external costs). Other activities cause benefits which they cannot (cost-effectively) capture (external benefits: for example when people vaccinate themselves and thus reduce the risk of contagion for all others in a community). Better measurement technology now often permits the conversion of externalities into internalisable costs and benefits. In other cases, collective action will be the best way to compensate for externalities, taxing the creators of external costs ('polluter pays') and subsidising the originators of external benefits. Extreme cases of 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 economic welfare if activities that cause external costs are not overextended (because they seem too profitable) and activities that cause external benefits are undertaken 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 the visible characteristics of a body. Fundamental values tend to remain fairly constant over time, but many social reformers have tried to influence them by education or propaganda. Thus, we witness current attempts to reshape basic values with regard to the environment.

HUMAN CAPITAL consists of the skills, aptitudes, knowhow and knowledge that are stored in the individual or in groups of individuals (communities). Human capital can be acquired by conscious learning, but also by unconscious emulation. Institutions, which are storehouses of knowledge and reflect the experiences of past generations, are part of human capital. The acquisition of human capital costs effort and raises the effectiveness of other production factors such as labour and physical capital. Indeed, the process of accumulating physical capital has, on the whole, raised the demand for human capital which is – in a way – the 'software' needed to operate the 'hardware' of physical capital.

IMPOSED ORDER – see ORDER

An INSTITUTION is defined here as a rule 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 a court. Most institutions are internal, i.e. they emerge from experience and are adopted in a community because they have been found useful. But some institutions are external, i.e. they are designed by authorities that have been empowered by a political process and are enforced by formal coercive means.

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

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

INSTITUTIONAL CAPITAL – see SOCIAL CAPITAL

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 COMPETI-

TION) force resourceful people on both sides of the market to tackle the insidious knowledge problem by spontaneous exploration and testing procedures. An alternative way to gain knowledge is for appointed analysts and planners to engage in systematic research and development. But this tends to work successfully only in settings which are not very complex.

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

MARKET– see COMPETITION

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

Human conduct is more likely to be ordered effectively, if the rules themselves are ordered, i.e. do not create contradictions. Such an

ORDER OF RULES is more easily achieved if the rules are predominantly proscriptive, ruling out harmful actions, and not prescriptive, commanding actors to do certain things.

ORGANISATION COSTS – see TRANSACTION COSTS

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

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

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

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

Public choices also tend to require more costly monitoring and adjudication procedures to ensure that the will of the principals is done.

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

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

PUBLIC CHOICES - see PRIVATE CHOICES

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

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

PUBLIC OWNERSHIP - see PUBLIC GOODS

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

RATIONAL IGNORANCE is a kind of behaviour that one observes frequently when collective choices are made at the level of large groups, such as nation states. The term refers to the choice by individual citizens to ignore the political business of collective choices because they have no influence over outcomes anyway. Widespread rational ignorance is a condition that favours principal-agent problems in politics and facilitates rent seeking. Rational ignorance tends to decline when the size of the group becomes smaller.

RENT SEEKING is an aspect of collective action based on the knowledge problem. It is frequently a manifestation of the principal-agent problem (see above). Organised suppliers typically seek material advantage and protection from having to compete by obtaining an intervention in 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 selective preferments that are to their detriment. Rent seeking tends to undermine genuine competition among suppliers and hence efforts their need to incur transaction costs (essential for innovation and growth). It also corrupts political life.

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

SPONTANEOUS ORDERING – see ORDER

TRANSACTION COSTS are the costs of coordinating people in markets. They arise because of the knowledge problem and have to be incurred to find and test knowledge; specifically by finding contract partners, materials and production knowledge, negotiating and concluding contracts, monitoring contract fulfilment, as well as obtaining redress and tort 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 is done within organisations, we speak of ORGANISATION COSTS.)

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