Institutions and Order

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

Charles de Montesquieu, 1689–1755

Order and the Knowledge Problem

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

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

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

> Order can be imposed. A pattern that someone has designed in her or his mind can be implemented from the top down. Thus, architects design orderly steps. Or to give you another example, I order the books on my shelves in a certain way so that I can readily find them. After I moved office, chaos reigned and life was hell, because I had not yet imposed order and could not find much-needed reference books and files. I suffered from cognitive overload, high search costs and a poor use of my resources. It is often also effective to coordinate people

by a plan and by top-down command, for example in a firm or a work team where leaders lay down an action plan and exercise some degree of control over collaborators. Such order depends on the visible, ordering hand of someone in the know and in control.

Order can also arise spontaneously: Flocks of birds fly in orderly patterns and do not collide in the air, although no 'boss bird' or flight controller directs them. The herds of animals that crowd around a waterhole drink in orderly succession without a bull being in command. The cars in the city move in predictable patterns, obeying traffic rules and signalling devices; disorder (accidents) is rare. The Scottish philosopher Adam Smith wrote in 1776 that human beings produce, sell and buy in markets as if ordered by an "invisible hand". Recognisable patterns emerge in these instances because all participants obey shared rules. If they know the rules, participants find it easy to interact constructively with others because they can rely on predictable patterns.

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

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

Institutions Defined

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

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

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

set-ups can profoundly affect our prosperity and the extent to which we achieve our own purposes. The importance of institutions often becomes evident only when institutions disappear. For example, the Soviet rule system collapsed and effective new rules of conduct did not emerge quickly enough in Russia over the past decade. Thus, there are few accepted rules in street markets and order is not enforced by impartial officials, but by hired thugs and the mafia. The result has been a lot of suffering, material decline, disease, crime and a steep drop in the population.

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

One can classify institutions according to various criteria:

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

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

Graph 4: A Classification of Institutions

<table>
<tr><td colspan="3" rowspan="3"></td><th colspan="2">Genesis</th></tr>
<tr><td>spontaneous, decentralised evolution within society</td><td>design and imposition by outside (political) authority</td></tr>
<tr><th>Internal Institutions</th><th>External Institutions</th></tr>
<tr><th rowspan="2">Enforcement</th><td>spontaneous decentralised feedback</td><th>Informal Institutions</th><td>Examples:
Customs and good manners which are enforced by social feedback, tit for tat, or exclusion</td><td>Examples are rare.
Sometimes breaches of top-down rules are penalised by moral suasion or public criticism (such as enforcement of “political correctness”)</td></tr>
<tr><td>family organised procedures of sanctioning</td><th>Formal Institutions</th><td>Examples:
A professional code ofconduct that is administered by a professional body; rules of a club</td><td>Examples:
A legal code which is enforced by court and police procedures</td></tr>
</table>

combinations of production factors which are marshalled by a leader in pursuit of certain purposes. Thus, a firm is an organisation that pools capital, technology, knowledge about markets and that is led to pursue certain goals, such as profit. Banks, universities and insane asylums are not institutions (as defined here), but organisations (see Glossary).

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

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

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

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

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

Internal Institutions Evolve in the Community

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

Examples of internal rules are

- rules that we follow in our own self-interest (example: I do not write this essay in Tamil, because I want to be widely understood throughout India);
- rules that we have internalised by education, acculturation, and practice (examples: ethical behaviour, civil virtues such as punctuality and honesty);
- customs and manners that are obeyed and enforced by spontaneous reactions to facilitate smooth human interaction (examples: traders offer

reliable service so they do not lose their good reputation; workers in teams follow certain work practices, if they do not they are shunned by their fellows); and

- rules that have proven useful to group interaction, where violations attract formal, i.e. organised sanctions, which are decided and imposed by selected senior members of the group (example: professional standards, sanctions which are handed down by boards of medical practitioners and similar appointed professional bodies).

The first three categories of internal rules are informal in the sense that violations incur sanctions in the form of spontaneous, self-enforcing responses. Thus, we control our whims often out of self-interest, simply because we would be fairly isolated if we did not. When we write by hand we try to form the letters according to certain agreed rules, simply because otherwise people will not take note of what we have to say. Violations of ethical rules often lead to the quasi-automatic sanctions of a bad conscience. Within decent societies, informal, spontaneous enforcement works in most cases. Self-enforcing mechanisms can be extremely effective. People with poor manners get reprimanded, ridiculed or shunned. And the damage to a firm's reputation may cost it much business. They are the cement that holds civil society together.

A stunning example that shows to what extent self-enforcement works can be found in global currency markets. Traders, who daily transact billions of dollars, do not write and sign formal contracts and may live in different cultures and jurisdictions and cannot rely readily on the judiciary of one country to sort out conflicts over contract fulfilment. Yet, they deliver on contracts, even when this means a loss to them. The reason for this is that they would otherwise have to fear for their loss of reputation. Opportunistic currency traders who lose their reputation in the trade, do not find contract partners and are soon out of the business.

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

In immigrant societies such as the US, Australia and a big city like Delhi, the internal rule system is subject to particular challenges from new arrivals. Immigrants may appreciate the results of ordered, secure community life, but nevertheless challenge specific rules, either wilfully or out of ignorance about the prevailing rules. This raises the costs of coordination and creates irritation among the incumbents who rely automatically on familiar institutions. But this may also trigger innovative changes of the shared rules, which cause adaptation costs, even if they are welcomed by sufficient numbers of old residents. Thus, a poor "payments morale" (lack of reliability in paying debts) and low honesty standards of certain members of society may force everyone to incur higher monitoring and enforcement costs. On the other hand, the work practices of new groups may be seen to yield better productivity and income than those of the existing groups. If members of both groups are free to compete in markets and to keep the rewards, this will gradually induce more and more people to adopt the visibly more successful work ethic.

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

External Institutions Depend on Political Action

The second major category of institutions is external (Graph 4). They are designed, imposed and administered by authorities who are above and outside the community as such. This always requires some collective action, a political process, and the appointment of agents who have interests of their own. The designers of external rules, as well as the administrators, are political agents, whether legitimised by inherited status, spontaneous acclaim, usurpation of power, or democratic election. Examples of external institutions are legislation, regulations and administrative practices. All external institutions are formal in the sense of carrying explicit sanctions which are applied in organised ways by outside authorities (e.g. the judiciary, the police, administrators).

The agents in charge of external institutions incur agency costs (costs of governance). These have to be financed, for example, by taxation. The costs of implementing external institutions include not only the agency costs, but also compliance costs that have to be borne by the citizen. Citizens are, for example, obliged to keep and submit accounts, or to conduct themselves in specific ways. External institutions are normally much more costly to implement than internal ones. A well-run community requires strong checks on the costs of external institutions and on the behaviour of the agents of government. Many external institutions require specialist agents, who normally derive their livelihood from designing and implementing them (tax agents, lawyers, etc.). Often, there is an understandable bureaucratic self-interest in having a complex and costly-to-administer external rule system (just think of India's import regulations, past and present!). This provides jobs, income and influence to the agents, but inflicts high costs on citizens. It is a case of the principal-agent problem, which we mentioned in the preceding chapter. Governments that are 'captured' by professional groups and shape the institutions to benefit themselves are a frequent cause of citizen discontent.

External institutions are, nevertheless, often necessary to obtain order. In modern mass societies, the rules are often better known when formally decreed, and are more uniformly obeyed when formally enforced. Given the monitoring and enforcement costs of external institutions, they should, however, only serve as a back up to internal institutions. In the last century, the attempt of socialist revolutionaries and third-world leaders to replace the traditional, grown institutions of societies completely by "scientifically designed" rules has been a resounding failure. The new, decreed rule systems imposed very high monitoring and enforcement costs. Frequently, ordinary people could not understand the new institutions and suffered from confusion, after the spontaneous incentives and the traditional internal rules had been suppressed. Thus, newly collectivised farmers in China after 1957 and in southern Vietnam after 1975 had little incentive to produce. Indeed, newly "liberated" peasants failed to produce food sufficient to feed the population. Only when the rule set was changed again with the economic reforms of the 1980s, did the food problem in China and Vietnam end. Vietnam even became a major exporter of rice! This experience is replicated by numerous other cases where "scientifically designed" and enforced institutions have led to major famines, which were then invariably blamed on the weather (for example, in the Soviet Union in the 1920s, in Ethiopia under Colonel Mengistu; in North Korea in the 1990s as if South Korea had not had the same climate!).

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

The Qualities of Effective Institutions

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

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

- Universal rules should be *general and abstract*, rather than case-specific. To put it in the words of Friedrich Hayek, abstract rules are "applicable to an unknown and indeterminable number of persons and circumstances" (Hayek, 1973, p. 50). This criterion is not fulfilled, for example, when a president rules that his son's brewery has preferential access to the local market, or when national governments hand out tariff preferments and import concessions to particular industries. Rules, which discriminate between citizens, fail the test of universality and open the door to burgeoning corruption.
- Universal rules should also be *certain*:. This means that everyone should have a reasonable chance of being able to know and understand the rule and the sanctions for infringements. This criterion is violated, for example, in present-day Russia where a voluminous and inconsistent stream of decrees is promulgated, when different mullahs give binding, but conflicting interpretations of Islamic law, or when the politicians and tax officials continually re-jig the tax rules. In the course of the 20th century, the volume of laws and regulations in most nation states has swollen to a level where no one is able to know and obey all these imposed institutions. Proliferating, detailed rules, which are often made on the run rather than by an orderly process, violate the maxim of certainty.

  Certainty also extends to the sanctions for rule violations, which are part and parcel of any effective institution. This aspect of universality is violated for example when trade unions or military groups are not subject to the law and get away with the exercise of undue force. Universality is also violated when certain exemptions to the general laws are negotiated with the government. Just imagine how the traffic would move if every give-way sign were subject to bargaining, arbitration and doubts about effective sanctions! When the law loses its teeth, coordination breaks down and the community's capacity to generate spontaneous growth wanes.
- Universal institutions should also be *open*, so as to allow actors to respond spontaneously to new circumstances by confident actions. In other words, the criterion of openness is met when the rules offer general

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

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

Good institutions should also remain reasonably stable over time, because rule changes impose adjustment costs on citizens. The conservative dictum that "old rules are good rules" certainly has much to recommend itself in the face of our cognitive limitations. But it does not follow that the conservation of existing rules is always desirable. After all, circumstances do change and social systems evolve, so that rule systems must evolve, too, if people are to make the best of the new circumstances. Hayek made the point in his famous essay "Why I am not a Conservative" (1960/1992). We always have to ask what serves our purposes best and accept that new rules will sometimes be preferable.

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

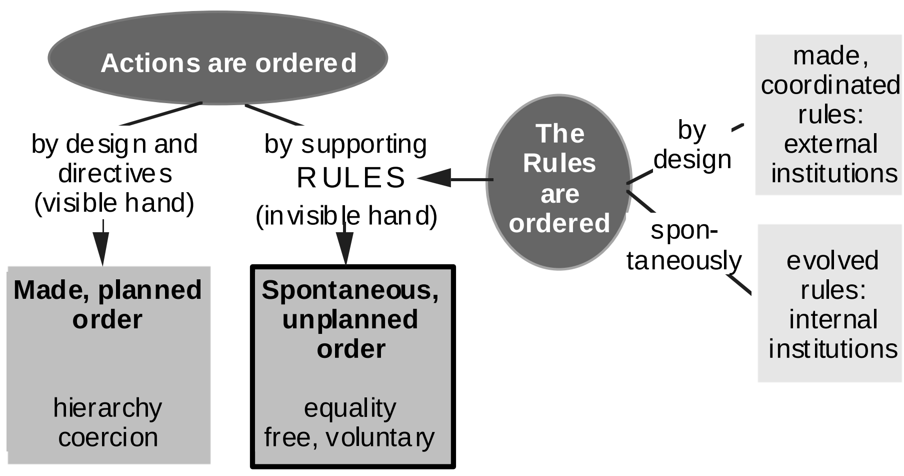
- when the institutional system consists of a hierarchy of rules, ranging from more specific institutions that are changed within a stable framework of more general, overriding rules, and
- when there are so-called *meta* rules that lay down predictable methods of rule change, for example the Constitutional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

These higher-level rules are often formally enshrined in written Constitutions. Effective Constitutions give cohesion and predictability to the rule system. They are so fundamental to the economic and general well-being of a community that one may rightly say that "Switzerland has a healthy economic constitution, whereasIndia's socio-economic constitution has deteriorated", referring both to the fundamental rules and the economic performance.

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

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

Graph 5: Order of Actions and Order Among Rules



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

The Benefits of Effective Institutions

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

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

   Human interaction always causes frictions (transaction costs), and universal institutions help to economise on these costs. Particular problems arise when people search for new knowledge. They simply cannot make rational choices as to the extent to which search costs should be incurred, because they can never know and evaluate the results of the search before the search process has yielded the necessary knowledge (information paradox). Given the risks and costs of knowledge search and the importance of such activities to a prosperous, free society, it is essential to foster institutions that encourage the widespread search and testing of knowledge. Proper institutions can make it cheaper to find out what people value most highly, whereas non-universal, complex, changing rule systems complicate knowledge search and hamper innovation.

   Saving transaction costs is an extremely important consideration for modern societies which unavoidably rely on a complex division of labour and continued innovation. Over half the costs of generating and distributing the national product of advanced countries, such as the United States, have been estimated to consist of the expenses of coordinating people (North, 1990). In recent decades, transaction-supporting services have outgrown most other sectors in the advanced economies (business advice, communications, finance, trade, logistics, research, development, information exchange etc.). Internationally, cost-saving institutions constitute an important source of a country's competitiveness.

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

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

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

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

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

This is not to say that universal, stable, consistent institutions are a panacea for all human problems. They are only an instrument that can help or hinder productive, peaceful interaction and the sense of satisfaction we derive from it. In the rapidly changing, globalised setting in which most people on earth now inevitably operate, appropriate institutions can serve as an important source of confidence. If there is a growing lack of confidence in the community, as is attested by sections of many developing societies, it is implied that the search for more effective institutions and better underlying political and economic constitutions should be a priority. The community needs the experience of trust and confidence, which often were the hallmarks of an earlier era.

Shared Values Underpin the Ordering of Rules and Conduct

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

Shared fundamental values tend to be fairly abstract. Yet, they are seen as desirable by the vast majority of the community, even if there is disagreement on the methods how to attain them. Shared values are the normative anchoring points of a rule system that we judge to be effective. They inform our daily actions in fundamental and pervasive ways, similar to the DNA information influencing biological characteristics and processes in invisible, but powerful ways (Arthur, 1995). However, different from its biological analogue, fundamental values can be shaped by intelligent and wilful efforts. Where fundamental values are not shared, this can be the source of continuing conflict, and secession and political separation of two conflicting communities may sometimes be the only solution.

One consequence of a shared value system in a community is that it facilitates the order of rules and the order of actions. Moral value relativism and a post-modernist denial of absolute standards of good and evil make a community's rule system inoperative. The fundamental values, as well as the institutions, therefore constitute a worthwhile and valuable possession of a community, even more important than its physical infrastructure.

The anchoring of institutions in fundamental values drives home an important point about institutions: They are not value free! We can objectively analyse what the effects of certain rules and rule systems are, but when we

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[2] When we use the word "justice" here, we intend this to mean formal or procedural justice, namely the application of the same rule to all equals. Security here refers to the future freedom to make free choices.

Security and justice, when combined with the adjective "social" have, however, often been given totally different meanings, namely referring to outcomes being equal, irrespective of effort or luck. As we shall elaborate later, social justice and social security tend to undermine freedom, peace and security as defined here (Hayek, 1988, pp. 112–119).

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

Some Consequences for Public Policy

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

Once one understands the fundamental traits of human nature and the complexity of a system of national and international economic and social relationships (Chapter 2), one is amazed that so many members of the educated public, parliamentarians, ministers, bureaucrats and judges presume to rely on ordering economic life from above by a visible hand. Few observers ask, when confronted with clever new government schemes: "How do politicians and their advisers know? Indeed, do they have any relevant knowledge at all?"

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

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

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

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

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

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

Most economists have done little to draw attention to the pervasive knowledge problem in policy making because their classroom models are based on the assumption of *ceteris paribus* and 'perfect knowledge' (see preceding chapter). Their pretense of knowledge has given them great but undeserved influence in economic policy. Everyone knows that other things never remain equal. At least in macroeconomics, the belief has now been largely abandoned that government can stabilise aggregate demand and restore full-employment by discretionary, fine-tuned policies (Keynesianism). By the mid-1970s at the latest, when mass unemployment again reappeared in OECD countries and governments tackled the problem by simply boosting demand management, it was discovered that—alas—this led to unexpectedly high inflation, indebtedness and instability. Unemployment went up despite the expansion of aggregate demand contrary to what Keynes had predicted, when he wrote his famous book in the 1930s. In the 1990s, Japan engaged in the biggest spending-and-stimulation drive in history, but attained little by way of a lasting economic turnaround. At least in this respect, most policy makers in OECD countries have learnt to be more cautious about the feasibility of this outcome-targeted policy.

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

Soviet orbit and the many failures of development planning in other countries. There, "scientific central planning" had been introduced to do away with the "chaos of markets", i.e. the spontaneous co-ordination by buyers and sellers. The socialist governments' visible hand of command and control predictably led to confusion on a hard-to-imagine scale. Discoveries and new uses of knowledge were rare and often misguided. Living standards, health, education, old-age care, and the environment suffered as a consequence. By the Brezhnev era, it was obvious that the 'scientifically designed order' delivered inferior results. This was realised by Gorbachev whose attempt to reform the system led to its demise. It was also realised from the late 1970s by the leaders of the Peoples' Republic of China, who have gradually scaled back the sphere of central planning since then. Now over 55 per cent of China's national product is subject to the decisions of private producers and buyers. The residual, planned state sector is mired in a deep and costly crisis, and its share continues to contract.

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

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

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

Creating Institutional (or Social) Capital

In the Anglo-Saxon and many East Asian countries, it has been increasingly realised that appropriate institutions are a central condition of freedom, security, prosperity and economic growth. A universal rule system is considered by at least some as a precious possession of a community, which enhances the productivity of labour in ways similar to the availability of good tools and other capital goods (Olson, 1996). To underline this, some authors have spoken of "institutional capital"; others have used the term "social capital" (Coleman, 1990; Weede, 1996).

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

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

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