Other articles

Laissez-faire and the institutions of the free market

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The absence of an adequate institutional structure explains why entrepreneurial capitalism did not automatically follow the collapse of central planning in the 1990s. It is a necessary function of a liberal state to provide a framework for the enforcement of private contractual terms. Beyond that basic need, other regulatory structures tend to emerge spontaneously through the force of mutual advantage and the test of social competence. In particular, institutions such as banking, the law, accountancy, insurance etc. exist to minimise the transactions costs which are inherent in a market economy.

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The apotheosis of the Bolshevik revolution was the division of Europe in 1945 into market and centrally planned economies. Its last vestige was covered by the debris of the Berlin Wall in 1989. In between times, the comparative economic performance of East and West silenced the intellectual socialists, whose aspirations had been sharpened by the Marxist phalanx in the 'calculation debate'[1] of the 1930s. Socialism was shown to be a failed creed, but credit was slow to accrue to the opposing Austrians. That intellectual case against socialism was forgotten in the era of a 'mixed economy,' 'social democracy,' Keynesian–Beveridge–Butskellite middle-of-the road welfare state. Thereafter, monetarism and the ascendancy of the New Right followed in the wake of general dissatisfaction with macroeconomic performance. In the West, the free-market and trade liberalisation gained an ascendancy.

However, the final collapse of central planning in the 1990s presented new food for thought. Many were surprised when *laissez-faire* did not follow *laissez-aller*: the emergence of free market entrepreneurial capitalism was not automatic. With hindsight, it was always likely that those who had been taught to equate private property with theft would be troubled by the notion of property rights. Although thriving black markets in the Eastern bloc had replicated some aspects of the market economy, they had drawn no support from the rule of law, nor could they provide any basis for taxation. So, apart from the currency printing-presses, the state had few public revenue sources to draw upon after the sell-off of state-owned firms.

The institutional infrastructure of a market economy

Although the need for positive action is now apparent, little thought has been given to the institutional infrastructure necessary to support a market economy. Stated differently, the long-neglected arguments of the Austrian School of Economics are increasingly relevant. Until recently, the most common – though incorrect – view of the calculation debate was that the thesis of central planning had been matched by the antithesis of complete *laissez-faire* to give a synthesis of market socialism.

Karl Marx had envisaged the self-destruction of capitalism: specialisation would force individuals into an ever greater division of labour and mutual interdependence, the intricacies of which no single individual would be able to grasp; nor would there be any control over its effects. But this would be a temporary phase. A growing concentration of industrial might would lead ultimately to central direction which would replace the market system and restore the bond between workers and their product.

The counter from Ludwig von Mises had been that *local* planning is vital. This would be undertaken under the impartial direction of the market process, which no level of sophistication in the instrumentation of a central plan could possibly emulate. Since every entrepreneurial decision affects the configuration of prices, co-ordination is achieved only through a constant feedback of new prices and re-adjustments to individuals' plans. With the further point, that a centrally directed economic plan cannot draw upon knowledge of particular circumstances of time and place, Friedrich Hayek had shown that intellectual aspirations for socialist planning are an epistemological impossibility. Indeed, the socialist calculation debate drew from Hayek three important arguments against socialism: 'in the real world goods are not easily specified ... costs were not objectively given ... [and] .... knowledge is uncentralizable.'[2]

Yet, the problem of socio-economic co-ordination is one which has received scant attention. In ignoring knowledge acquisition and co-ordination, Walrasian general equilibrium economic theory misrepresents the ease with which optimal resources allocation might be achieved. This allows a case to be made for socialism: given the same information set as is assumed to exist under *theoretical* general equilibrium, Oscar Lange demonstrated that an *actual* central planning board can replicate the competitive outcome. So, with this sleight of hand, it was made to appear that the mechanism of competitive market prices adjustment could be replaced by the precise *mathematical* calculation of a planning board.

Austrian versus neoclassical economics

Because the methodological gulf which exists between Austrian (disequilibrium) economics and neoclassical (equilibrium) economics was not acknowledged, much of the socialist calculation debate was conducted at cross-purposes. Whereas Austrian economics perceives the economy as a *mêlée* of competing and contradictory plans, and is conducted against the (dynamic) criterion of multi-plan co-ordination, neoclassical economic analysis centres upon the (static) criterion of Pareto efficiency. To Austrians, the incentives implicit in the margins that exist when trade is undertaken at disequilibrium prices are an integral part of the process by which markets move towards equilibrium.

The entrepreneurial function (which is assumed by neoclassical economics to have already taken place) is vital since, by that activity 'the price in one particular market is brought closer to equilibrium, and other people are better-informed about the opportunities available.'[3]

The fundamental lesson to be drawn from the socialist calculation debate of the 1930s – the lesson that was lost to advocates of the mixed economy – is that economically efficient methods of production and distribution become evident only as some producers succeed and others fail. Bankruptcies are important to processes of discovery in which efficiency and ingenuity are tested in open competition. To eliminate the possibility of failure is to eliminate initiative. Equally important is Hayek's message that economics is an integral part of an evolving social order in which cultural history and mores are vital to processes of knowledge acquisition and dispersion. The importance of a cultural infrastructure to support free-market processes is central to recent comments by the Chairman of the US Federal Reserve Bank:

> '[m]uch of what we took for granted in our free market system and assumed to be human nature was not nature at all, but culture. The dismantling of the central planning function in an economy does not, as some had supposed, automatically establish a free market entrepreneurial system. There is a vast amount of capitalist culture and infrastructure underpinning market economies that has evolved over generations: laws, conventions, behaviors, and a wide variety of business professions and practices that has no important functions in a centrally planned economy.'[4]

Among other requirements identified by Alan Greenspan are a free press, an impartial judiciary and a bill of rights to preclude arbitrary action by government. Although Greenspan is confident of the ultimate diffusion of free-market liberal principles – 'the face of the world economy continues to edge toward free-market-oriented societies' – a recent counter-argument has been presented by Professor John Gray of the London School of Economics, who cites Hayek, guru of Thatcherism-cum-Reaganomics, as the prime perpetrator of the falsehood that Western modernity is 'the ultimate fate of all humankind.'[5] In furtherance of his belief that the political sphere should have primacy over 'the delusive certainty of legal principles,' Gray asserts that no 'basic rights and liberties ... are immune from the vagaries of political conflict.'

Free markets: destroyers of traditions?

While Gray acknowledges the 'original political justification and historical rationale of Thatcherite policies,' which lay in the break-up of corporatist institutions and policies which created conflict rather than wealth, he sees the free market both as the engine of wealth creation and the destroyer of traditional institutions and cultural forms. Thus, 'the communitarian and paternalistic concerns' of post-1945 British conservatism, where there was a 'genuine understanding of enduring human needs,' were trampled by 'the Thatcherite march.' Even though market deregulation 'allowed somewhat lower levels of joblessness than our European partners,' the associated labour mobility brought pathologies which include marital breakdown and unprecedented levels of crime.[6]

Gray does not consider that many (if not all) of these trends pre-date Thatcherism. In Britain, the 1960s was the most notoriously liberating of recent decades; labour mobility and the decline of the family is more plausibly linked to state financial sponsorship of an ever-widening set of 'rights' – for example, to adolescent independence, to single-parent families, to further education, to medical provision – than to the notion that 'the free market works to transform or overturn all inherited and traditional social institutions.' Like many apologists for *dirigiste* state control, Gray fundamentally misunderstands (or conveniently forgets) the value of free-market exchange: it is because the culture, beliefs and motives of every participant are irrelevant to the functioning of the market that the greatest harmony can be achieved.

Competition, discovery and co-ordination

The tendency to achieve mutual compatibility across the decisions of countless economic agencies is a function of an institutional environment founded upon the principles of classical liberalism. Market competition allows knowledge to be discovered and it provides the mechanisms by which individuals' actions are co-ordinated; but the market is unpredictable, and state intervention cannot prevent, nor could it lessen, the costs arising from that unpredictability. Indeed, the very attempt would be undesirable, for it would retard necessary adjustments. Furthermore, it would be absurd to expect the market to reward merit: '[w]e allow the individual share to be determined partly by luck in order to make the total to be shared as large as possible.'[7] Instead, the free market serves prosperity and progress by rewarding those who are lucky enough to be able to satisfy particular demands arising from rapidly changing circumstances.

Under competition, it is inevitable that many lose out, and there are always claims for the protection of vested interests. While there is an undoubted need to counter such claims, there are no ready prescriptions: '[p]robably nothing has done so much harm to the liberal cause as the wooden insistence of some liberals on certain rules of thumb, above all the principle of *laissez-faire*.'[8] So, it is for economists to probe the issues which determine the legitimate scope for state intervention. 'Private property' and 'freedom of contract' do not, *in themselves*, provide for solutions:

> '[o]ur main problems begin when we ask what ought to be the contents of property rights, what contracts should be enforceable, and how contracts should be interpreted or, rather, what standard forms of contract should be read into the informal agreements of everyday transactions.'[9]

The free economy is not simply mechanistic market exchange. Rather, it is a system of local voluntary planning embodied in the nexus of property, consent and contract. It is this nexus which comprises the institutional structure: a coherent set of practices by which individuals are permitted to interact socially and by which they achieve mutual advantages. Business transactions themselves comprise a sub-set of this social interaction, whereby costs are determined within the evolving institutional structures which support an extensive division of labour and the realisation of ever greater mutual gains from trade.

The importance of transactions costs

Yet, even though the existence of most economic institutions can be explained as a response to the requirements of socio-economic transactions, the analysis of transactions costs is much neglected within economics. It is the existence of transactions costs which creates a role for the middleman – the entrepreneur – who simultaneously takes advantage of and reduces those costs. Thereby the advantages of free-market competition are spread as entrepreneurs 'buy cheap and sell dear': the 'law of one price' ensures that new demands raise prices where they are low and new supplies lower prices where they are high.

Instead of emphasising the importance of that entrepreneurial function, modern teaching of economics has tended towards a general criticism of the enterprise system. That criticism is founded upon the concept of 'market failure' and of a divergence between private benefits/costs and social benefits/costs. Yet, many of the phenomena so categorised are merely symptoms of the fact that there are instances where transactions costs are too high to allow a more appropriate allocation of benefits and costs. Transactions costs are just another cost of production and exchange. They are not 'special.' Where trade does not occur because of high transactions costs, this is only another case of costs exceeding benefits. High costs do not imply inefficiency. If raw materials costs suddenly increased, we would be poorer, but we would not be less efficient. The same applies to transactions costs and so to most examples of 'market failure.' Markets allocate resources most efficiently in that prices will reflect all the costs – including transactions costs – involved in producing and trading the outputs which derive from those resources.

As a truism, every institution whose function is to facilitate exchange would be superfluous if exchange were costless. Among those institutions which owe their existence to transactions costs are: money, banks, the law, accountancy, insurance, firms, distributors, stores and salesmen. In each case, the institution exists to reduce transactions costs. To illustrate. A bank acts as an intermediary between borrowers and lenders; if there were no transactions costs to arranging loans, lenders and borrowers would make their own arrangements. Financial reporting standards, accounting principles, insurance and the law generally are an integral part of the contracting process and exist to minimise transactions costs. As another example, firms become monopolies when their potential competitors face impediments to trade; i.e. when entry barriers create insurmountable transactions costs.

The state as enforcer of contracts

The state can also be viewed in these terms, since it provides a framework for the enforcement of contractual terms (including the provisions of the criminal law) which obviates the transactions costs that would be incurred in private enforcement. More generally, the involvement of the state is justified to safeguard an agreed basis of exchange

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between two or more parties at minimum cost.

The legal enforcement of individual property rights is essential both to encourage self-responsibility and to maintain the economic incentives for producers to meet consumers' needs. Moreover, there is a symmetry between property rights and the laws of liability where contracts between an injured and an injuring party are too costly to negotiate or to enforce. The role of the government is to lower those costs through the enforcement of law.

Social cohesion does not just happen. Without regulation there is anarchy and conflict; but regulatory structures tend to emerge spontaneously through the force of mutual advantage and the test of social competence. The intensive interdependence of an extended socio-economic order relies upon a common moral consciousness which supports rules of conduct. These rules fall into different categories: there are those which everybody follows because of the like manner in which the environment is perceived by individual minds; those which are followed spontaneously because they form part of a common cultural tradition; and those which must be enforced because, though individuals would gain through non-observance, they would damage the social order. The latter – the legitimate exercise of political power – underpins all such private arrangements.

So, what is legitimate in the exercise of political power? Although a democracy enables any majority to rid itself of a government, it is a dangerous belief that there is no need for any further institutional restraint. Even under democracy, the rule of law faces the threat of encroachment by government. The modern tendency of the state to merge the legislative and executive functions undermines the impartiality of the law and creates (potentially) an instrument of political repression. A democratically elected government can find itself bound, not by moral convictions, but by the obligation to satisfy a number of vested interests. It is for this reason that government should have no exemption from operating according to the fundamental liberal principles of impartiality and universality: 'people submit to authority not to enable it to do what it likes, but because they trust somebody to act in conformity with certain common perceptions of what is just.'[10] It is in this – rather than in 'communitarian and paternalistic concerns' for 'enduring human needs' – that an individual's freedom will remain secure.

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