ama-gi

The Journal of the Hayek Society at the London School of Economics

Note from the Editor

My decision to study in London this year has brought me considerable grief. Come June, I will have to leave.

My experience at the London School of Economics has been just as I imagined- herds of intelligent students constantly seeking and absorbing life and knowledge. They just don't know when to stop. Right at this very moment, the library is probably filled to the brim with them. And as cliché as that image is, there's more: the diversity is overwhelming. Half the students are from outside of the United Kingdom; students come from every imaginable place and bring with them every imaginable idea on politics, economics, philosophy, etc. Often times views merge and all is swell but the best times are when the ideas clash- when a spark of an idea provokes us to think. The Hayek Society strikes me as a particularly potent example of this creation process. It provides students with a forum to think aloud and figure themselves out. The concepts of capitalism, socialism, free markets and equality, as integral as they are to our studies, require such investigation. We are not here to pound libertarian ideals into heads or to disparage those who lean to the far left; we are just here to talk and to encourage others to talk. Without this freedom to be an individual the foundations of our society would mean nothing.

In this issue of *ama-gi*, articles reach backward to a scientific basis for economic philosophies and forward to policy proposals on land use and government, all in the spirit of Hayekian thought to provide our peers with a current look at classical liberalism. Enjoy.

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The logo and name of **ama-gi** is taken from a cuneiform inscription found in ancient Sumeria. It is the earliest written representation of the concept of "freedom."

Globalization Through Human Action or Human Design?

Bruce L. Benson

If globalization refers to the ever-expanding opportunities for voluntary interaction between individuals around the world, then the result has to be beneficial to most of the world's population. The exceptions are likely to be those individuals and groups who collect rents because of the protectionist policies of their governments (e.g., organized labor, agricultural sectors, state supported religions). Nonetheless, government officials around the world seem to believe that the process of globalization requires tremendous amounts of human design through alphabet-soup (e.g., UN, EU, WTO, NAFTA) organizations of and/or agreements between their governments. In fact, however, these organizations and agreements appear to be creating the same kind of constraints on voluntary interaction that nation states have implemented, as governments attempt to protect various domestic interests, thus raising the cost of globalization, if not preventing it altogether.

A frequently alleged justification for the heavy hand of government in the globalization process is that individuals from different countries and cultures will not enter into what could be mutually beneficial interactions without a common understanding generated by homogenous rules, and without contract enforcement by the coercive power of states. In fact, however, globalization does not require globally standardized law or state coercion. It is true that recognized rules and either trust or recourse are required for many voluntary interactions to occur, but there are several options beyond state-made and/or enforced law that are likely to be superior sources of incentives for beneficial globalization.

Must States be the Source of Rules?

Hayek explains that rational individuals are not able to use conscious reason to evaluate *every* particular option in the array of alternatives that are available, because there are significant limits on abilities to reason and to absorb knowledge. This means, among other things, that rational individuals often find it beneficial to voluntarily develop and conform to rules. In this context, "rules" should be seen as behavioral patterns that other individuals expect a person to adopt and follow in the context of various interdependent activities and actions: that is, rules specify obligations. The rules one individual is expected to follow influence the choices made by other individuals: like prices, rules coordinate and motivate interdependent behavior.

Some rules are designed and imposed by state rule-making authorities, but there are other rules too, that are actually much more important determinants of behavior in many aspects of human activity, including commercial activity. Indeed, a key distinguishing characteristic of such rules is that they are initiated by an individual's decision to behave in particular ways under particular circumstances. Hayek emphasizes that adopting a behavioral pattern creates expectations for others who observe it and thus creates an obligation to live up to those expectations. Furthermore, when individuals who interact with one another observe each other's behavioral patterns they often emulate those that appear desirable so that such behavior and accompanying obligations spread. In other words, customary norms evolve spontaneously from the bottom up rather than being intentionally imposed by a legislator, and they are voluntarily accepted rather than imposed, even though there may never have been an explicit statement declaring that they are relevant. For an obligation to achieve the status of a "customary law" it must be widely recognized and accepted by the individuals in the affected group or community.

Customary law tends to be quite conservative in the sense that it guards against mistakes, leading some to believe that customary law is very slow to change, and thus "inefficient" in a dynamic environment. Certainly, this process can be a very important mechanism for creating new custom, but there also are faster mechanisms for initiating change in customary law.

If conditions change and a set of individuals decide that, for their purposes, behavior that was attractive in the past has ceased to be useful, they can voluntarily devise a new contract (explicit or implicit) stipulating any behavior that they wish. Through negotiation and contracting, existing custom can be quickly replaced by a new rule of obligation toward certain other individuals without prior consent of or simultaneous recognition by everyone in the group. Individuals entering into contracts with these parties are informed of the contractual innovation, however, and/or others outside the contract observe the results of a new contractual stipulation, so if it provides a more desirable behavior rule than older customs do, it can be rapidly emulated. Contracting may actually be the most important source of new rules in a dynamic system of customary rules, but as conditions change, the inadequacy of existing customary rules also can be revealed when a dispute arises. If the parties to a dispute turn to a third party for arbitration, as they do in cases within modern international commercial communities, for instance, new customary rules can be and often are initiated by the arbitrator's resolution to the disputes. Unlike public court precedent, such resolutions only apply to the parties in the dispute, but if a rule is implied that appears to be more effective at facilitating interactions than previously existing customary rules have been, the rule can spread rapidly through the interacting community.

Does Enforcement of Law Require State-Backed Coercive Power?

When individuals specialize and trade, depersonalized exchange of simple goods may occur if the good's characteristics are easily observed and quality can be determined before a purchase (e.g., as in an informal urban market for fruits and vegetables), but for more complex difficult-to-measure goods, the seller often knows more about the product and its quality than the buyer. Under these circumstances, the cost of the exchange for the buyer will be relatively high if he cannot believe the claims or promises of the seller; the buyer will have to invest in obtaining more information, bear the risk of making an undesirable purchase or forgo what might be an advantageous exchange. Under such conditions people may make small risky purchases in hopes of getting something that improves their lives, but for large exchanges and/or exchanges that involve complicated products where quality can only be determined with use, *trust or recourse* generally must be available in order to make promises credible so that voluntary transactions can occur.

Repetitious dealings within small closeknit communities encourage the development of trust (a willingness to make oneself vulnerable to another even in the absence of external constraints), because incentives to live up to promises and make valid claims arise in such personalized exchange in order to continue benefiting over a long period. The scope of trust-based trade tends to be limited to small groups, however, and this limits the potential benefits of specialization and trade. Globalization might be thought of as the "extension of the market" from the trust-based arrangements in a local town or village to the region, nation, and ultimately to the far corners of the world. In order for such large scale depersonalized exchange to occur in extensive markets, however, individuals generally require recourse to some third party enforcement mechanism before they will accept the claims and promises made by unknown trading partners.

One way for extension of the market to occur is for traders to develop reputations for fair dealing, given that information about such reputations spread. After all, people have strong incentives to avoid dealing with someone they believe may not behave opportunitisticly, so if the spread of information about fraud or contractual breaches is sufficiently effective, a spontaneous boycott of opportunists can be anticipated (recourse is available as the spread of information will produce punishment for misbehavior: the third party is the trading community as a whole). Depersonalized business-to-business trade networks often form "contractual" groups that facilitate the spread of information. Potential contractual arrangements are numerous, including the implicit contracts of ethnic or religious networks, various corporate structures such as indirect equity ties through pyramidal ownership structures, direct equity ties, interlocking directorates, and various informal and formal commercial and trade associations. In order to maintain the potential for ongoing trade and protect reputations, mediation or arbitration services can be produced within the group, or external mediation and/or arbitration specialists (individuals with extensive knowledge of trade practices and usage within the disputants' area of commerce) can be employed.

Organizations to facilitate the flow of information about reputation and/or lower the cost of dispute resolution can be geographically extensive (e.g., international trade associations), although they often are functionally focused. Perhaps an institution that is both geographically and functionally extensive could economize on the spread of information and on dispute resolution? In particular, nation-states with coercive power certainly can provide strong sanctions against fraud, breach of contract, and other forms of non-cooperative behavior, creating incentives for people to live up to their promises and make valid claims. Indeed, a frequently made claim is that in order to induce compliance with contracts and/or acceptance of arbitration the other party must be willing and able to seek enforcement by a coercive power. For example, some observers see sanctions under the 1958 New York Convention on the Recognition and Enforcement of Arbitral Awards and other similar international agreements between states to recognize and enforce arbitration rulings (e.g., 1961 European Convention on International Commercial Arbitration) as the major reason for widespread acceptance of international arbitration. If this is the case, then why not simply substitute the state and its legal system for customary commercial law systems. After all, a state's legal system, or a multi-state organization's (e.g., the EU) legal arrangements can provide recourse for trades between people who are not members of informal or formal trading communities with internal arbitration or mediation services. Such potential benefits are likely to be outweighed by significant costs.

Globalization in the Face of Increasing Complexity: the Benefits of Specialization in Law

The wide variety of activities and relationships that exist mean that many rules that are effective for one type of transaction or one group may not be effective for another. The diamond traders in New York, Amsterdam and elsewhere may prefer a very different set of rules and institutions than those adopted by international oil traders, for instance. The products being traded are very different, of course, suggesting that very different contractual issues are likely to be relevant, and the trading communities are also very different. Many diamond merchants share common ethnic and religious backgrounds, creating an environment of mutual understanding (e.g., of common trade practices and usage) and trust, for instance, thus reducing the need for highly technical and specific contracts, while oil traders display much greater ethnic and religious diversity as well as differences in motivations (a number of oil producing states have nationalized production, for instance, so political considerations can have major impacts on decision-making), possibly reducing the level of common understanding and undermining trust relationships, thus dictating much more specific and complex contracts. Combining all of the rules from each group into a single legal system would create unnecessary costs for both groups.

The Opportunity costs of Legal Transfers through Designed Rules Backed by Coercion

Another potential (and probably inevitable) problem arises when states are heavily engaged in law creation and enforcement. Coercively imposed and enforced rules can facilitate voluntary interaction, but they also can influence the distribution of wealth, and the use of law to transfer wealth (e.g., taxes and subsidies, regulations that limit entry, raise prices, impose trade barriers) actually reduces wealth creation for several reasons. First, such transfers are often achieved by preventing or raising the costs of voluntary exchange, including limitations on entry and competition, thereby limiting the wealth that could be created through these activities. Second, the resources consumed in the political competition for wealth transfers (lobbyists, political organizers, etc.) could be employed to produce new wealth rather than to seek transfers of existing wealth. Third, potential victims of the transfer process have incentives to resist, so transfer-avoidance costs also arise. These costs can take the form of diverting some of their productive resources in order to invest in political information and influence in order to compete in the political process. Exit is another option, however, whether by moving to an alternative political jurisdiction, or by hiding economic activity and wealth (e.g., moving transactions "underground" into the informal sector). Therefore, in order to induce compliance with discriminatory transfer rules, the rule makers will generally have to rely on a large enforcement bureaucracy, both to limit exit and to execute the rules. The resources devoted to such enforcement also are diverted from potentially wealth increasing production activities- a fourth cost. Enforcement bureaucracies can develop their own agendas and extract wealth transfers (e.g., excessive budgets, bribes) for their own benefit, raising the cost of enforcement even further. The fifth consequence is likely to be even more significant than the other four, however. Faced with the probability of involuntary transfers, potentially productive individuals' property rights to their resources, products and income flow are perceived to be relatively insecure, so their incentives to invest in maintenance of and improvements to their assets, and their incentives to produce and innovate in order to earn more income are undermined. If transfers are expected to be large, frequent and arbitrary, production will be low and wealth expansion (economic growth) will be very slow if it occurs at all.

Perhaps state-made law will not produce biased rules for the purpose of transferring wealth (rules that will also undermine incentives to be productive), but it is clear that a necessary prerequisite for such law is strong barriers to exit for those who expect to lose wealth through transfers. Interjurisdictional competition can occur between legal systems attempting to monopolize law making and enforcement, and to the degree that wealth can escape one to move to another, the potential for using law as a transfer mechanism is limited. And importantly, when competition comes from customary law produced and supported by institutions which are not attempting to monopolize law or transfer wealth, but simply to substitute for trust in order to facilitate depersonalized voluntary interaction, individuals may be able to escape the jurisdictions of all of those who seek monopolies in law for transfer purposes. Furthermore, the relatively limited jurisdictions of some customary communities are not as constraining as they might appear to be. The membership of trading communities can differ, although considerable overlap may also occur, so individuals may deal with other individuals on some dimensions but not on all dimensions. Perhaps more to the point, however, it took privately produced and adjudicated medieval *lex mercatoria* to *overcome* the limitations of political boundaries and localized protectionism during the medieval period, thus paving the way for the commercial revolution and development of international trade. Indeed, there is absolutely no reason to believe that any particular national government or organization of governments is of the ideal size to take full advantage of the economies of standardization in law. However, since customary law can be geographically extensive and functionally decentralized (i.e., specialized), in contrast to the law of geographically defined states or organizations of states which tends to be functionally centralized and geographically constrained, customary law can have different sized jurisdictions for different functions. A customary system of polycentric law would appear to be much more likely to generate efficient sized "geographic market areas" (jurisdictions) for the various legal communities involved — perhaps many smaller than most nations, with others encompassing many of today's political jurisdictions (e.g., as international commercial law does today). Globalization is supported by such an overlapping system by allowing for specialization and encouraging voluntary interaction through spontaneously evolving institutional arrangements.

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Hayek's *Sensory Order*

Gerald R. Steele

FRIEDRICH HAYEK REGARDED *The Sensory Order* as one of his "more important contributions to knowledge" (Hayek, 1994, 138). Given the thirty years of its gestation, it is unsurprising that the exposition and conclusions are implicit in much of Hayek's other work. *The Sensory Order* is important for establishing the limitations of intellectual endeavour and explicit knowledge, and (thereby) the rationale for a dependency upon the tacit knowledge that is embodied in cultural and institutional forms.

Limits to Understanding

Mind is the black hole of human science: no empirical evidence emanates from within. Behaviourism has no access to cognitive functions, so it cannot reveal motivation. Introspection gains access to mental images, not mental processes. Empathy may disclose motivation, but gains no insight into relevant neurological structures.

When working in the laboratory of a brain anatomist during the winter of 1919-20, Friedrich Hayek lighted upon a crucial insight: a sensory fibre cannot carry, nor a nerve cell store, the characteristics of mental phenomena. Although Hayek believed that he held the answer to an important question, he was unable to explain precisely what the question was! Over thirty years later, Hayek's *Sensory Order* identified and addressed that question: 'What is mind?'

The Sensory Order provides the rationale for self-knowledge, social adaptation and social science generally. Without some degree of uniformity of minds, there can be no meaningful social interaction: a human is more sensitive to (the perceptions of) another human than to a rat or (less still) to a bat or (less still) to a gnat. Introspection reveals (hypothetically, and given genetic and cultural similarities) what is thought by other minds; and that same kind of conscious self-examination provides a basis for ameliorating purely instinctive (or emotional) responses. It thereby admits a social dimension that invites both conditioned and considered reactions.

Connectionism

Artificial intelligence research is directed by competing methods. With the orthodox 'symbol-processing' approach, a series of binary decisions is made against set rules, and memory is stored at specific locations. The alternative paradigm—of which *The Sensory Order* is an early statement—is that of 'connectionism,' where the whole brain (potentially) is engaged by the variable strength of inter-neural impulses. Memory and thought are indistinguishable neurological processes - particular configurations of an intricate neural network - that are constantly adapted to stimuli from the external world. The mind is not a store of data that reflect (or are correlated with) characteristics of elements in the physical world. Rather, organisms live in a sensory order that is created by the central nervous system.

For simple reflex action, higher centres receive simultaneous reports of both stimulus and response. At the highest levels of consciousness, responses to stimuli are modified by the influence of the widest range of current and past impulses. Between the extremes of reflex and conscious response, a continuous range of 'engaged' connections is hypothesized with no qualitative distinction afforded to the most abstract processes of thought. All experience is shaped by memory and understanding; and whenever a new experience is inconsistent with 'the classification based upon past linkages,' the classification must be revised: "[w]hile there can thus be nothing in our mind which is not the result of past linkages (even though, perhaps, acquired not by the individual but by the species), the experience that the classification based on past linkages does not always work, i.e., does not always lead to valid predictions, forces us to revise the classification" (TSO, 168).

The differentiating responses of the neurophysiological system are determined by linkages previously created within the organizational structure of the central nervous system: a system of connections "acquired in the course of development of the species and the individual by a kind of 'experience' or 'learning'" (TSO, 53). Pre-sensory linkages determine 'the order of the apparatus of classification'; that is, the framework that determines all our 'conscious experience of qualitative attributes of external events'. Pre-sensory linkages—"relations of which we are not consciously aware" (TSO, 142)—are that part of *a priori* knowledge that "is not learnt by sensory experience, but is rather implicit in the means through which we can obtain such experience" (TSO, 167).

What Mind *Is*

The irresolvable conundrum is that the neural order is a subsystem of the physical order, but that any understanding of the relationship between the sensory order (mind) and the physical order must derive from the neural order. Hayek's speculation was that a machine designed by the human mind might yet be capable of 'explaining' what the mind is incapable of explaining without its help: "such a machine would not differ in principle from ... a calculating machine which enables us to solve problems which have not been solved before, and the result of whose operations we cannot, strictly speaking, predict beyond saying that they will be in accord with the principles built into the machine" (TSO, 189).

This conundrum is a generalization of Gödel's theorem, that in no consistent axiomatized mathematical system can the proposition expressing its own consistency be proved: "Gödel's theorem is but a special case of a more general principle applying to all conscious and particularly all rational processes, namely the principle that among their determinants there must always be some rules which cannot be stated or even be conscious" (Hayek, 1967, 62).

Now, Gödel's theorem says nothing in respect of machines (or, rather, algorithms of artificial intelligence) that might exercise (non-computational) mathematical intuition as competently as the finest mathematicians; and so the human mind might be explained by means of some more elaborate artifact (though unlike a calculating machine). The argument is that, deep within the mind, there may lie some 'unconscious unknowable algorithm' that affords it an ability to judge logical consistency: "the Gödel argument demonstrates that whatever understanding is, it is not a computational thing. This allows that natural selection could operate for this general non-computational quality- a quality which could be applied to a whole range of problems and not simply to mathematics … If mentality is a function of brain action, and we accept that brain action is subject to the same laws of physics as everything else, those physical laws must allow for non-computational action" (Penrose, 1995, 26).

In regard to the perennial mind-body issues, Hayek describes dualism and the notion of "mind 'stuff'" as an 'old habit' that derives from humankind's "early study of nature'; and he delivers the conclusion that 'an account of mental phenomena which avoids the conception of a distinct mental substance is ... the opposite of materialistic, because it does not attribute to mind any property which we derive from our acquaintance with matter. In being content to regard mind as a peculiar order of events, different from the order of events which we encounter in the physical world, but determined by the same kind of forces as those that rule in that world, it is indeed the only theory which is not materialistic" (TSO, 177-8). From that description, *The Sensory Order* finds its place within the categorizations of dual-attribute or central-state theories that identify brain processes as wholly physical but with non-material properties that cannot be reduced to material ones.

The Adaptation of Mind

The brain is a biologically evolving instrument of an adaptive system: the sensory order of mind. The three key principles of Darwinian selection are *diversity* (of component elements), *interaction* (with the environment to test adaptive fitness) and *differential amplification* (successful variants are reproduced in relatively greater number). The potential fallibility of both the brain and the mind is a necessary characteristic to allow Darwinian selection process to operate.

Knowledge is not a unitary entity that exists to a greater or less extent in different species. Knowledge is domain-specific: different genes direct the selection process of intelligence to produce different adaptations (knowledge) in different species. So, it would be meaningless to ask how close perceptions are to the noumenal world: "[w]hich external events are recorded at all, and how they will be recorded, will ... depend on the given structure of the organism as it has been shaped by the process of evolution" (TSO, 108).

While no clear boundaries separate biological, psychological and social adaptation, there are obvious variations in the pace of evolutionary change. In a social context, it is by a process of relatively rapid adaptation that the "knowledge and intentions of different members of society are supposed to come more and more into agreement" (Hayek, 1937, cited from Hayek, 1949, 45). In attempting to model those patterns, a feasible task for social science is to seek empirically testable theories of expectation formation and learning.

Evolution cannot proceed without variations and it is impossible to anticipate more than their *immediate* impact upon organic function. Herein lies the argument for liberal social systems that have allowed experiment, adaptation and selection such that "practices which had first been adopted for other reasons, or even purely accidentally, were preserved because they enabled the group in which they had arisen to prevail over others" (Hayek, 1973, 9).

Scientific Knowledge

Individuals' behaviour is based upon the assumption that their sensory order is both safe and similar to that of organisms with which they associate. To remain safe, knowledge must be continuously revised at two levels: (i) 'we not only establish new relations between the data given within a fixed framework of reference' but (ii) 'we are led to adjust that framework itself' (TSO, 169). In this manner, *a priori* knowledge of one kind (pre-sensory linkages, which precede all conscious experience) becomes augmented by *a priori* knowledge of a second kind (i.e. objective knowledge or 'science'), as classifications based upon "immediately given sensory qualities' are replaced by those 'defined in terms of consciously experienced relations" (TSO, 170).

Science seeks ever-greater consistency in the account of events. There is a conscious search for new classes—defined in terms of interrelationships between events rather than in terms of their sensory properties—such that general propositions (about the behaviour of events) are universally true. Ultimately (and hypothetically), '[s]uch a complete system of explanation would necessarily be tautological, because all that could be predicted by it would necessarily follow from the definitions of the objects to which it referred' (TSO, 173). While this categorization of events, by characteristics that belong to the objective order, defines the (natural) scientific method, progress by this 'reductionist' approach must not be so rigidly applied as to inhibit understanding.

Complex Phenomena

Hayek distinguishes between 'the relatively simple phenomena with which the natural sciences deal' and 'the more complex phenomena of life, of mind, and of society' (Hayek, 1967, 25), that are less accessible than those of physical systems. Although classes of patterns identified by social science might allow for predictions, these must be predicated upon highly specific circumstances; that is, upon extensive empirical data. However, predictions are not the sole concern and, if the data are insufficient to allow predictions, the theory—the knowledge of the pattern—is still useful. Where a theory has little empirical content, "hypothetical predictions' may be possible; that is, 'predictions dependent on yet unknown events" (Hayek, 1967, 29). Beyond that, "[t]he very insight that theory provides ... that almost any event in the course of a man's life may have some effect on almost any of his future actions, makes it impossible that we translate our theoretical knowledge into predictions of specific events" (Hayek, 1967, 34).

So, Hayek warns of the 'pseudo-entities' that comprise the Keynesian approach: "the number of separate variables which in any particular social phenomenon will determine the result of a given change will *as a rule* be far too large for any human mind to master and manipulate them effectively. In consequence our knowledge of the principle by which these phenomena will be produced *will rarely if ever* enable us to predict the precise result of any concrete situation" (Hayek, 1952, 73-4, italics added).

Conclusion

In the years that followed publication of *The Sensory Order*, Hayek's work on the "far-reaching philosophical problems" that derive from "the distinction between what we can say 'within a system' and what we can say 'about a system'" (Hayek, 1994, 29) proved 'so excruciatingly difficult' that a long and unfinished paper was abandoned after he found that nobody he "tried it upon could understand" (Hayek, 1982, 290). Even so, the immutable constraints upon the understanding of mental processes have important philosophical and social implications: "[w]hile our theory leads us to deny any ultimate dualism of the forces governing the realms of mind and that of the physical world respectively ... we shall never be able to bridge the gap between physical and mental phenomena; and for practical purposes ... we shall permanently have to be content with a dualistic view of the world" (TSO, 179).

Hayek saw a way forward in drawing a distinction where none exists: between forces that govern the mind and forces that govern the physical world. The social relevance of that conclusion is that it removes the basis for mitigating circumstances that might excuse some particular action. There is no "metaphysical self which stands outside the chain of cause and effect" (Hayek, 1967, 232). In other words, an individual's action is *always* integrally linked to the circumstances of that action by our essential ignorance of the physical conditions that would have given rise to some different action. Such ignorance would be removed only by an understanding of the derivation of the sensory order from the physical order, but that is impossible. This explains the emphasis that Hayek places upon an individual's action and the responsibility of that individual for his or her action. If individuals were not held responsible for their action, nothing would be left for which an individual could be held responsible.

To hold an individual "responsible for the consequences of an action" is an assertion neither of causation nor of fact, but "is rather of the nature of a convention introduced to make people observe certain rules" (Hayek, 1960, 74-5). Such conventions are the representation of commonly held attitudes and relationships that, by their evolutionary adaptation, endure as one generation succeeds another. This is a genuinely social structure that is separated from any particular set of individuals. In accepting the discipline of those conventions, and despite personal ignorance, the individual is guided by a cultural inheritance that facilitates the achievement of the widest range of individual purposes.

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Philosophical Speculations
adapted from *Whither Socialism?*

Joseph E. Stiglitz

THE DREAM OF a better world here on earth has been a central theme in the development of Western civilization since the Reformation. The nineteenth century saw some of these utopian visions translated into experiments of rather limited success. But the nineteenth century also saw the development of ideologies, which replaced the religious doctrines that had so long held sway over humankind but were held with the same emotional fervor; indeed the fervor was reinforced by the false sense that the ideologies rested on scientific premises. The sway that the Marxist ideology had over the minds—and eventually the lives—of so many for more than a century should give us pause: It is surely a sign of the importance of human fallibility. It should make us cautious in the confidence with which we hold our views, and cautious in our appeal to "science" to justify our beliefs about the organization of society. But, beyond that, we need to seek the deep-seated reasons for the depth and persistence of the appeal of these doctrines.

Shaping Individuals

The popular success of the Marxist ideology was partly the hope of a more efficient economy, one that would bring more goods to more people. But the success among intellectuals went beyond that: It was partly based on the belief of the effect of the economic system on the nature of the individual. The concern was well-founded: One of the most damning criticisms of the socialist experiment has been what it did to the human spirit—the cynicism that developed among the young, the bureaucratic mentality, the lack of innovation.

Competition

Competition is important, not only because of its ability to promote economic efficiency but also because of the zest that it gives to life. Here we encounter one of the many ambivalences that characterizes our views about market economies: Competition is good, but we have our doubts about excessive competition. We encourage cooperation within teams but competition among them. We frown upon people who are excessively competitive. Yet the competitive market environment may encourage and bring out these aspects of individual's personalities. If ruthlessly competitive people are successful, such behavior may be imitated. At the same time those who are (excessively) cooperative may be taken advantage of, derogated as pansies. Accordingly such behavior will be discouraged.

Self-interested Behavior

One of the reasons that we frown upon people who are excessively competitive is our ambivalence toward self-interested behavior. Adam Smith may have been right that we can rely on self-interestedness to lead to the public interest being served more surely than we can rely on benevolence. There are some special conditions in which the reliance on self-interested behavior results in economic efficiency.

Yet trust is essential in the world in which we live; to be earned, trust often requires acting in a less than perfectly self-interested manner. Trust was essential for the early development of capital markets. In "imperfect" markets certain types of self-interested behavior impair economic efficiency. Indeed we know that we must provide incentives that are often quite costly to make self-interested individuals act in a trustworthy way (the wages of trust).[1]

There is, in this, a certain irony: Capitalism, as it promotes self-interested behavior, may create an environment less conducive to efficiency. Capitalism prospers best in an environment with a peculiar combination of self-interested behavior—enough to induce individuals to look for profitable activities—and non-self-interested behavior, where one's word is one's honor, where social rather than economic sanctions suffice to enforce contracts.

The critique of capitalism, that it promotes self-interested behavior, goes beyond, of course, the self-interest of capitalism in itself. A long-standing tenet of civilizations, both East and West, is that individuals must care about others. Capitalism may encourage self-interestedness, but is that really desirable?

We view charity as a virtue,[2] but does it remain a virtue when we compel charity upon others? There is something different, certainly for the giver, perhaps for the receiver, about giving money to a poor person voluntarily rather than being compelled to do so. By changing the locus of caring and responsibility from the individual to the government—not only for the needy, but for oneself, one's parents, one's children—we change society and we change ourselves. Here again we see a certain irony: Attempts to *improve* society by having the government undertake a greater role in redistribution, may ultimately—through their effects on individuals and the nature of the social contract—have more ambiguous consequences.

Endogeneity of Human Nature

I have spoken of how the design of the economic system may foster certain characteristics—self-interestedness and competitiveness. In modern vocabulary, we say that certain aspects of human nature are endogenous to the system. The concern about what the economic system does to the human spirit, while it has disappeared from modern economics, was present in Adam Smith's writing:[3]

The understandings of the greater part of men are necessarily formed by their ordinary employments. The man whose whole life is spent in performing a few simple operations... generally becomes as stupid and ignorant as it is possible for a human creature to become. The torpor of his mind renders him, not only incapable of relishing or bearing a part in any rational conversation, but of conceiving any generous, noble, or tender sentiment, and consequently of forming any just judgment concerning many even of the ordinary duties of private life... His dexterity at his own particular trade seems, in this manner, to be acquired at the expense of his intellectual, social, and martial virtues. But in every improved and civilized society this is the state into which the laboring poor, that is, the great body of the people, must necessarily fall, unless government takes some pains to prevent it.

Yet, while traditional economic theory is clearly wrong in treating individuals as immutable—"tastes" no less than technology were the primitives of the model—we have no scientific basis on which to judge one set of moral values, one set of personality types, as superior to others. Thus, while Hayek may have been right in stressing the moral dimension of markets—the kind of consequences in shaping human nature that I have just described—he fails to provide us with a systematic approach for addressing these issues (e.g., see his 1989 book).

The Evolutionary Approach[4]

Neoclassical economists have attempted to defend capitalism on the narrow ground of economic efficiency... There are other strands of thought in economics that argue for market processes, but decry the neoclassical defense as too narrow, and indeed even misguided. I have already noted Hayek's argument for the "moral" dimension. One long-standing tradition, which includes Hayek and his followers, and Alchian, has emphasized an evolutionary argument for markets.

There is a natural analogy between competition among species and competition among individuals in the marketplace. Spencer and others extended Darwin's ideas on natural selection and survival of the fittest to a social context. Terms like "fittest" have an essentially normative overtone: The term "survival of the fittest" is obviously meant to convey more than just the observation that those who survive are the ones who survive. In some essential respect the "fittest" who survive are better than the less fit who do not. There is a teleological aspect of evolutionary processes: Nineteenth-century views of progress were reflected in the motion of constant, albeit slow, "improvement" in species and societies resulting from evolutionary forces. Callous policies that entailed governments ignoring the suffering of the poor were justified in the name of social Darwinism.

Indeed it is only with hindsight that we may be able to tell whether a particular policy had survival value. Certainly the hypothesis that governments constitute a positive evolutionary step is supported by the observation that societies within governments have survived, and those without have not. By the same token, certain types of government intervention in the market may, from an evolutionary perspective, enable a society to survive better. While we might conclude from the demise of socialism that it did not have survival value, we cannot conclude that therefore market institutions are superior. By the same token, one can argue from the sucess of the East Asian countries, that "managed markets" and strong government intervention have survival value, in comparison with market institutions with much more limited government intervention.

More broadly, we now recognize that there is more than one form of capitalism , that the conduct, structure (organization) and performance of the Japanese economy—both the private sector, and the relationships between government and the private sector—differ, for instance, in important ways from those of the United States. Evolutionary theory does not give us much basis for choosing among these institutions.

By the same token, those who appeal to the evolutionary processes also claim too much: There is no reason to believe that evolutionary processes have any optimality properties. Indeed there are strong arguments suggesting that evolutionary processes are far from optimal. Biologists stress the randomness of the process, the seeming redundancies so frequently observed, the vestigial elements that often lead to problems (such as the human appendix).

Economists note that in the absence of a capital market, a species with strong long-run prospects simply cannot "borrow" to carry it through a temporary change in the environment. A species—or a firm—with greater long-run adaptability can be wiped out in the competitive struggle by one better-suited for the particular environment. Thus more competitive environments—environment in which competition is more ruthless so that any but the most efficient firms, in that environment, are weeded out—may in the long run actually be less productive...

The fundamental point is that there is no reason to believe that market economies "naturally" make the right trade-offs or that, in particular, market economies with more ruthless competition are more efficient than economies in which competition is more gentle. Moreover, since whether a particular trait (species) survives depends on the environment, which itself is endogenous, there is no reason to believe that the system as a whole has any optimality properties. The system simply ensures that those who have characteristics that are rewarded, in the particular environment which the system has created, survive. Thus one can imagine a world in which there are two types of individuals, bureaucrats and innovators. Bureaucrats make life difficult for innovators, and innovators make life difficult for bureaucrats. There are multiple equilibria to such a society. Bureaucrats may dominate; in that environment innovators do not prosper. The bureaucrats create an environment that is favorable to their own type. But, conversely, innovators might dominate. They create an environment that is favorable to their type. Though the economy, from different initial conditions, could evolve toward either equilibrium, one of these might be (under some welfare criterion, such as long-run economic growth) clearly superior to the other. (It is only when the two societies come in direct conflict or comparison with each other that the disadvantages of bureaucracy become revealed.)

Good mutations (new social institutions) may not survive on their own, for they require accompanying changes in other social institutions. There is a coordination failure. Many changes have to occur at the same time, and market processes may not be able to provide the necessary coordination. There is thus no presumption that evolutionary forces, left to themselves, have any desirable welfare properties. Moreover, if we take seriously the observations made in the first part of this chapter, concerning the endogeneity of preferences, we have fundamental problems even ascertaining what are appropriate criteria for judging evolutionary processes.

Of course, if evolutionary forces "naturally" led to desirable outcomes (whatever that might mean), then the economist's task would be a simple one: to observe and comment on the process. But as economists, we are called upon to analyze a variety of proposed changes in policies and institutions. As our tools of analysis have improved, we are in a better position to ask of any proposed change, what are its effects? In evolutionary terms we can ask, is it likely to survive? We are even in a position of engaging in social engineering, of asking can we design institutions or policy reforms that are likely to be welfare improving, or, again in evolutionary terms, that are likely to have survival value?

The great socialist experiment is coming to an end: We have learned a lot from these experiments, but because they were hardly controlled experiments, what we learned remains a subject of some dispute. While government ownership is clearly no panacea, there remains scope for further experimentation. For instance, we need to study forms of economic organization involving more worker participation and ownership. Not too much should be read into the failures of the worker-managed firms in the former Yugoslavia, for these involved peculiar (and obviously unsatisfactory) arrangements with respect to the transfer of property rights, as well as other institutional details which, both ex ante and in hindsight, were not conducive to success. To return to the theme with which

I began these speculations, the question is whether the insights of modern economic theory and the utopian ideals of the nineteenth century can be brought closer together?

Endnotes

[1] This notion was emphasized in the reputation models (including the efficiency wage theories) I discussed earlier.

[2] We should note the extensive literature arguing that certain forms of altruism have survival value in an evolutionary context. (The critical issue in that context is, What is the relevant unit of analysis?)

[3] Quoted by Heilbroner, in "Reflections: Economic Predictions," *New Yorker*, July 8, 1991.

[4] This section borrows heavily from Stiglitz, J. E. Notes on evolutionary economics: Imperfect capital markets, organizational design, and long-run efficiency. Paper presented at Osaka University International Symposium on "Economic Analysis of Japanese Firms and Markets: A New Microeconomic Paradigm." Osaka, Japan, November 9, 1992.

Whither Socialism? expands on the Wicksell lectures presented at the Stockholm School of Economics.

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Review of John Kay's *The Truth About Markets: Their Genius, Their Follies, Their Limitations*

David Henderson

John Kay's new book is a truly ambitious venture. It covers five related topics: the wealth of nations, and the factors that determine prosperity; the role of competitive businesses in furthering innovation and progress; recent developments in mainstream economics, and the light thrown by these on the uses and limitations of markets; some leading trends in economic events and policy over the past decade or so; and the lessons to be drawn, in the light of all the above, for the conduct and direction of economic policy today. Given this large agenda, it is not surprising that the book is a long one. But thanks to the author's gift for clear and readable presentation, laced with well-chosen and well-informed examples, it is not difficult to read. Kay has the ability to present arguments and evidence in a readily assimilable and often informal way, without oversimplifying or writing down. He has drawn to good effect on a wide range of pertinent sources, by no means confined to economics, as well as on his wide knowledge of economics and business history. Along the way, he makes many interesting and perceptive points to which a short review cannot do justice.

In relation to the first two of the five above topics, Kay's main thesis is not new, though he presents it in his own distinctive and often highly illuminating way. In the earlier parts of the book he outlines the positive role of markets and competitive businesses, and the ways in which they have contributed to economic progress. Here of course he is in good company. The case for what he terms 'disciplined pluralism,' and others might prefer to call economic freedom, is widely accepted; nor would most advocates of that case wish to quarrel with him when he stresses that "market economies are embedded in a social, political and cultural context." But the book is only partly concerned to restate the case for a market economy and the need for such an economy to go together with supporting institutions and behaviour. Its second purpose is to argue against excessive and uncritical reliance on markets and, more broadly, on forms of conduct which are based only on self-interest. Kay departs from current pro-market trends of thinking, in that he is preoccupied with the inadequacies and dangers of what he sees as 'market fundamentalism.' He believes that to state correctly 'the truth about markets' it is necessary to expose and discredit some currently accepted untruths. It is this second line of argument that constitutes the main distinctive contribution of the book.

In part, the argument is developed by outlining ways in which markets may perform badly or be subject to limitations. In this connection, Kay writes informatively about particular recent episodes of failure, excess or fraud, such as the dot.com bubble and the Enron affair. In a more systematic way, as the third of the above listed topics, he considers, in five successive chapters of the book, how far recent developments in economic theory support or undermine the case for reliance on competitive markets. Despite a few queries and reservations, I found these chapters clear and instructive.

Unfortunately, however, the various informed, discerning and well presented arguments that I have summarised up to now are linked in the book with an extended frontal attack on something which Kay terms 'the American business model' (or ABM for short). His preoccupation with this doubtful construct greatly reduces the interest and usefulness, and indeed the accuracy, of what he has to say about the world of today.

The main features of the ABM, as stated in the opening paragraph on the book's dust-jacket, are four: "the unrestrained pursuit of self-interest, market fundamentalism, the minimal state and low taxation." A number of questions arise concerning this allegedly influential and threatening way of thinking.

First, what is the history of the ABM, and when did it become a phenomenon that should be taken seriously? Although at one point Kay traces its growing influence back to the election victories of Ronald Reagan and Margaret Thatcher, and in what may be a throwaway line he refers to Commodore Perry as having brought it to Japan in 1853, he believes that the decisive event was the collapse of communism. In that connection, he takes the surprising positions that "The right won the cold war and the left lost… The profits of Goldman Sachs and Coca Cola are the fruits of victory" (281), and that the British Conservative Party lost its main *raison* *d'etre* with the collapse of the Berlin Wall (324). But in fact the collapse of communism made little difference to the profits of business enterprises, the terms on which controversies about the role of markets and the state are conducted in democratic countries, or the positions taken in those countries by non-communist political parties.

Second, who are the exponents of the ABM, the gurus whose ideas have supposedly carried weight in recent years? Although Kay refers to a number of American persons and sources, none of these is of any serious consequence. More fundamentally, he argues that the intellectual basis for the ABM is to be found in Robert Nozick's 1974 book, *Anarchy State and Utopia*, and in the first 'fundamental theorem of welfare economics' that was established in the 1950s for an economy that meets a number of highly restrictive assumptions. But it is not apparent that either of these lines of thought, if indeed they play the role he assigns to them, has come to the fore in recent years.

Third, who actually believes in the ABM? Clearly, no government is, or ever has been, committed to it. Kay maintains (8) that it "remains the working hypothesis of most business people and consultants." This is not so, however: most large businesses today, and the consultants who stand ready to advise them on the subject, are now committed to the questionable doctrine of 'Corporate Social Responsibility' (CSR). Contrary to what Kay believes (314), CSR is deeply collectivist in its assumptions and implications.

While the ABM is little more than a figment of the author's imagination, it is not just a harmless eccentricity. Because of his fixation on a largely non-existent threat, Kay's treatment of recent history and current issues of policy is flawed. In particular, there are two serious omissions. First, he does not refer to the ways in which collectivist ideas have maintained and attracted support, and influenced the course of economic policies, in recent years. The gains made by collectivism are a much more worrying phenomenon than the so-called ABM. Second, he does not give the consideration that his title promises, and the issues deserve, to arguments for extending the scope of competitive markets- for example, in the provision of health and education services, in tackling the various current manifestations of over-regulation, in further liberalisation of cross-border trade and investment flows, and in reversing the erosion of freedom of contract that has occurred in the name of 'equal opportunity,' 'anti-discrimination' and 'diversity.' In these respects especially, the book represents a missed opportunity; and taken as a whole, it does not offer a balanced treatment of its subject matter.

John Kay, *The Truth About Markets: Their Genius, Their Follies, Their Limitations*, London, Allen Lane (Penguin Books), 2003.

This review was prepared for, and has been published in, the Swedish journal, *Axess*. It will also appear, in the present English version, in *Economic Affairs.*

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The Risk of Paternalism

adapted from Philosophy, Policy and Social Value MSc thesis

Peter Rossi

The traditional case for liberal[1] risk-management via a market order relies on human nature enabling individuals to interact and better themselves within such an order. Although market-driven progress since the industrial revolution arguably supports this view, calls for regulation to "help" the market reach so-called socially optimal ends are ever-present. The latest come from the field of behavioral law and economics (BLE), which, by questioning the rationality of neoclassical economic man (NEM), attempt to show why paternalistic regulation is warranted. After a definitional detour, this essay will attempt to show why BLE may have unwittingly strengthened the liberal case by paving the way for a revival of Austrian market process theory, which explains the workings of markets without recourse to the unrealistic assumptions of NEM, and preceded BLE in incorporating psychological insights into economics.

The behavioral paradigm

"The task of [BLE]...is to explore the implications of actual (not hypothesized) human behavior for the law."[2] In particular, "Behavioral Economics is the combination of psychology and economics that investigates what happens in markets in which some of the agents display human limitations and complications."[3] Jolls *et al.*[4] group these limitations or biases into three categories: bounded rationality, bounded willpower and bounded self-interest.[5] An example of bounded rationality is the availability heuristic, where people confuse familiarity with probability.[6] The more memorable or notable an event, the more likely people assume it to be, in contrast to actual statistics.[7] It is these biases "that can justify the need for paternalistic policies to help people to make better decisions and come closer to behaving in their own self interest."[8] The policy recommendations have different names, but they amount to the same thing: paternalism.[9] A representative example is the proposal for mandatory cooling-off periods because hot-sales lead to poor decisions due to projection bias.[10] Thus, for our purposes, BLE should be seen as a challenge to liberal risk-management because it suggests that individuals cannot cope in market settings.

The next section will offer an alternative to the main target of BLE: NEM. This Vulcan-like figure is not the only economic actor, for there exists the older, more plausible Austrian account, which renders the BLE account of economics semi-otiose.

Austrian Economic man

For Hayek, the economic problem is not the neoclassical problem of optimally co-ordinating given resources among given ends. Instead, "It is rather a problem of how to secure the best use of resources known to any of the members of society, for ends whose relative importance only these individuals know. ...it is a problem of the utilization of knowledge not given to anyone in its totality."[11] Knowledge for Hayek was distinguished from information by temporal and spatial specificity, whereas on neoclassical and BLE accounts, knowledge is a commodity, indistinguishable from information.[12] For Austrian Economic man (AEM) then, the market, via specialisation, economises on the need for the excessive information and rationality demanded of NEM and encourages learning by doing. The Hayekian/Austrian market, co-ordinated by the (unhindered) price-mechanism, transmits knowledge far more efficiently than a central planner because the relevant knowledge cannot be represented statistically. Hayek's insight was eclipsed by the formalist revolution in economics,[13] and so we are in the ironic situation where BLE is criticising neoclassical economics for ignoring psychology, when Austrians were originally criticised by neoclassical economics for incorporating psychology. Since the Austrian market does not depend on the achievement of static equilibrium, "the deviations of real markets from the model do not constitute rebuttals to [Hayek]. Indeed, deviations from the model were Hayek's starting point."[14] The irony that perhaps lies ahead for BLE academics is that in comprehensively undermining NEM, they may be laying the groundwork for a Hayekian/Austrian revival.[15]

A brief note must be made here concerning the social aspect of Austrian theory. Scholars such as Beck and Habermas critique liberalism for its "atomism"– its supposed disregard for the role of the social in individuals' preferences. On this account, because preferences are socially constructed, public spheres are of fundamental import. Interestingly, Hayek recognised this critique,[16] but advocated markets precisely because they facilitated the transmission of social knowledge more effectively than alternatives. In Austrian theory, preferences are endogenous to institutions, and therefore, a liberal order is needed to foster creative development and effective transmission of such knowledge.[17] Central planning of social knowledge and preferences is as ineffective as its economic counterpart.[18] Furthermore, the patchwork quilt liberal order would allow deliberative democrats to live amongst their ilk, although one wonders if they would be content to leave non-deliberative others alone.

For paternalism...

Before discussing the further failings of BLE, a BLE development that ought to be embraced by liberals will be adumbrated. Liberals arguably need to defend some redistribution, however minimal, in order to provide for defence and security. Therefore, liberals should adopt any BLE proposals that make liberal laws more effective. For example, rules can be reframed to reflect cognitive biases,[19] and the replacement of probabilities with natural frequencies can eliminate many cognitive biases, such as over-confidence.[20] Furthermore, liberals welcome extensive private paternalism (such as Victorian philanthropy) and the liberal State can be defined as a paternalistic institution. This liberal acceptance holds only for as long as BLE does not recommend new, illiberal laws, although it cannot resist this temptation.

...and against paternalism.

The first of five distinct arguments against the policy recommendations of BLE is a familiar one: democratic political decision making tends to pervert the initial policy. Firstly, as Bastiat presciently recognised in *What Is Seen and What Is Not Seen*, politics relies on the availability heuristic. Rent-seekers are able to drive legislation anecdotally by pleading special circumstances.[21] Jolls *et al.* expect 'availability entrepreneurs' and behavioral bureaucrats to use behavioral knowledge to enact "good" legislation: "Thus, public choice accounts can work productively with behavioral accounts."[22] This is wishful thinking in the extreme.[23] Only specific forms of political reform can limit such legislation, and perhaps the most effective is to reduce the power available to lobbyists. The absence of such accessible power is a defining feature of the liberal State. Secondly, we need to ask the following: where are such biases likely to have worse consequences– in politics or in civil-society? Even if, counterfactually, power did *not* corrupt, the consequences of biases in the legislative process are far more serious than in normal, day-to-day market activity. The consequences of my suffering from the availability heuristic whilst betting on horses, for example, are insignificant compared to the consequences of politicians suffering from the same bias after the Love Canal incident. At the very least then, behavioral bias and power do not mix. Therefore, decision-making needs to be compartmentalised, by protection of several property, to limit the effects of biases.[24] Only reliance on omniscient politicians can avoid such a conclusion.

Secondly, it seems the market, even in its present regulatory straightjacket, functions *despite* behavioral biases. Such biases have not prevented the attainment of our uniquely high standard of living. Furthermore, there are three reasons why the market reduces the effects of biases. Firstly, most, if not all traders c*annot* suffer from the endowment effect without losing their jobs.[25] Good drives out bad, or bad hires good, which amounts to the same thing. Secondly, reputational non-public regulation is provided by organisations such as the Underwriters Laboratory and various consumer groups.[26] Such private regulation is based on the sound premise that firms make more money by *not* harming customers. Thirdly, BLE argues against private provision of behavioral consulting services to reduce the effects of biases in two ways.[27] One, firms offering cooling-off periods will be driven out of the market. Initially this may be true, but in the long-run it is impossible to rule out a feedback mechanism whereby consumers learn by their mistakes.[28] Furthermore, support for harm caused by hot-decisions in serious matters that result in destitution is properly the role of welfare. It is far easier and more efficient to leave the market alone and rely on PUW and PRW than intervene in the market with a view to reducing the need for welfare. Two, biases will prevent people realising their mistakes. Again, the market is a feedback process, so it is not clear why private firms cannot provide behavioral consulting to alleviate the impact of such biases. Perhaps only BLE academics and behavioral bureaucrats are qualified to provide such a service?

Thirdly, a crucial question to ask of society is not solely "who decides?" but in what type of institutional framework are decisions motivated and played out?

"Neither constitutional democracy nor a market economy relies on decision makers to have superior wisdom or morality. ... Historically, it was—and is—a revolutionary concept, rejecting theories going back thousands of years which insist that what matters is which persons and which doctrines rule, rather than the systematic incentives and constraints that control whoever rules under whatever doctrine. The American Constitution left little room for philosopher-kings."[29]

Similarly, Hayek describes the advantages of a liberal institutional framework as follows:

"Rules alone can unite an extended order...Neither all ends pursued, nor all means used, are known, or need to be known to anybody, in order for them to be taken account of within a spontaneous order. Such an order forms itself..."[30]

These accounts of liberal society are not compatible with NEM who needs to fully comprehend the system in which he acts. It is real-life deviation from this Godly standard that BLE is exposing and in this respect, it is questionable what relevance BLE has to reality. The constructivistic BLE approach falls to what Hayek called the fatal conceit: the belief that order must be designed. It assumes that actors must comprehend their institutions, and subsequently posits the "irrational" incomprehension of actors as sufficient cause to "rationalise" them through paternalism. Ecological rationality,[31] as opposed to constructivism, recognises that the human mind economises by relying on the subconscious and thus we are not always able to articulate the reasons for our actions. The Hayekian market, then, economises on cognitive computations.[32] Thus, information markets can supply more accurate information than articulated polls.[33]

Fourthly, BLE advocates reducing consumer options.[34] However, whilst liberals can accept the premise,[35] it is not clear *which* choices should be prohibited. If, out of choice-set A through D, John prefers A, B, and Mary C, D, whose preferences win? If individual preferences are subjective, and assuming A through D are lawful,[36] the choice will inevitably come down to politics, which is well described as choosing for others. The problem then is less reducing options, but *who* restricts *whose* options?[37] Does John choose to decrease his options by buying only branded goods because he acknowledges their reputation, or does the State prohibit non-branded goods to increase safety, or some such? If the latter, what happens to people who cannot afford branded goods? Similarly, competition, which lowers prices and increases efficiency, works by *increasing* choice. For BLE to say here that "less is more" contradicts economic history.[38] Furthermore, BLE actually stresses (unintentionally) the need for competition: "...cognitive biases offer but another illustration of the basic Hayekian insight regarding the importance of decentralization in social affairs: the partitioning of responsibility ... functions as an error-correction mechanism."[39]

Finally, in a sceptical mood, one could accuse BLE of being the latest manifestation in the historical association between intellectuals and socialism. Since Plato's philosopher king, many intellectuals have embraced the fatal conceit of constructivism.[40] Goodin's moral collectivism epitomizes this philosophy: "state officials are probably better informed as regards questions of what are the best means to people's chosen ends. It may also be true that they are better informed even as regards questions of what people's ends really are– or will be."[41] On the BLE account, there are two classes of people: the behaviorally irrational majority, and the rational minority (intellectuals and politicians). Hayek's explanation of this intellectual deceit needs no further comment:

...intelligent people will tend to overvalue intelligence, and to suppose that we must owe all the advantages and opportunities that our civilisation offers to deliberate design rather than to following traditional rules, and likewise to suppose that we can, by exercising our reason, eliminate any remaining undesired features by still more intelligent reflection, and still more appropriate design and 'rational coordination' of our undertakings.[42]

Therefore, although BLE poses a substantial and welcome challenge to liberal risk-management, it fails mainly because it succeeds only in toppling NEM. Since NEM was originally created as a modelling tool, BLE has ironically paved the way for Austrian economics, which deals with the real economic problem: how do knowledge-rich, information-poor individuals coordinate for mutual gain? The answer, through a free-market, has been available for hundreds of years. It is this conclusion that BLE ought to be drawn to: "The only practical implication of behavioral economics is to strengthen the case for private institutions".[43]

Endnotes

[1] Liberal here means classical liberalism, as distinct from Rawlsian or modern liberalism.

[2] Jolls *et al.,* p. 14.

[3] Mullainathan and Thaler, p. 1.

[4] A referenced list is provided on pp. 52 – 53.

[5] This paper will not deal with the self-interest critique. Generally, BLE expresses surprise when participants act "fairly" and hence irrationality (by NEM standards) in the ultimatum game (on experimental economics see Smith, 2003, pp. 36 - 52). However, it is a 'complete misrepresentation' to equate (classical) economics with self-interest - economics merely says that selflessness is not *necessary* for the market to work (Coleman, pp. 136 – 162).

[6] Tversky and Kahneman, pp. 1127 – 1128.

[7] A dramatic illustration of the far-reaching political consequences of this heuristic can be found in the Love Canal incident (Sunstein, 2002, pp. 79 – 82).

[8] Camerer *et al.*, p. 1218.

[9] 'Libertarian paternalism': absence of coercion (Thaler and Sunstein, p. 175); 'asymmetric paternalism': imposes little/no harm on NEM but helps others (Camerer *et al.*, p. 1212); 'anti-anti-paternalism': between paternalism and anti-paternalism (Jolls *et al.* pp. 46 - 47).

[10] Camerer *et al.*, pp. 1238 – 1247.

[11] Hayek, 1945, p. 520. Indeed, the Hayekian economic problem has to be solved *before* the neoclassical problem (Kirzner, p. 50).

[12] Boettke, 2002, p. 266. For example, Mullainathan and Thaler (p.5), believe market trades occur due to the overconfidence bias, "even in the absence of true information." Furthermore, neo-classical "search" theory is unrealistic, as Kirzner (p. 50) implies: "It assumes that those whose information is incomplete know how much information they lack, that they know the value to them of the missing information, and that they know precisely how (and at what cost) it is possible to obtain the missing information."

[13] Boettke, 1997.

[14] *Ibid.*, p. 51.

[15] Nobelist Vernon Smith's Hayekian experimental economics research programme is excluded from my critique of BLE.

[16] Hayek, 1967, pp. 313 – 317.

[17] Scientific progress shares the characteristics of an Austrian market process (Walstad, 2002). It would be absurd to argue that science progressed by the methods advocated by deliberative democrats for the socio-political sphere.

[18] Pennington, 2003.

[19] Camerer *et al.*, p. 1230.

[20] Gigerenzer, 2002; Cosmides and Tooby, 1996.

[21] Jolls *et al.*, p. 37. Sunstein, 2002, pp. 78 – 98.

[22] Jolls *et al.*, p. 37, 48.

[23] Johnston (p. 779) dissents: "Technocrats can do little or nothing to reduce political barriers to economically efficient or socially desirable regulation."

[24] Barnett, pp. 138 – 142.

[25] Epstein, 2003, pp. 210 – 227.

[26] Blundell and Robinson, 2000.

[27] Camerer *et al.*, pp. 1251 – 1254.

[28] A taste of the illiberal BLE tendency is found in Jolls *et al.* (p. 49), where State intervention is needed to prevent people falling asleep under sunlamps and burning themselves! BLE also suffers from economic illiteracy: Camerer *et al.* (pp. 1253/

4) believe extended warranties are profitable *because* they are costly to the consumer. However, consumers obviously value the piece of mind and convenience of warranties more than their cost. Also, if BLE regulations stymie feedback learning, *ceteris paribus,* more errors will occur, leading to further regulation, etc.

[29] Sowell, pp. 381 – 382.

[30] Cited in Smith, 2003, p. 23.

[31] There are two definitions of ecological rationality, neither of which support BLE recommendations. The first is the Hayekian, implied in 4.2. Smith (2003, pp. 7 - 8) defines an ecologically rational order as "an undesigned ecological system that emerges out of cultural and biological evolutionary processes" and which contains "rules, norms and institutions of our cultural and biological heritage that are created from human interactions but not by deliberate human design."

The second, as employed by Gigerenzer and Selten (p. 9) matches the structure of behavioral biases to the evolutionary environment in which they evolved, so that rationality is particular to time and place, not a universal rule of consistency or coherence. Gigerenzer and Selten (p. 6) criticise the BLE authors referenced in 4.1 for illustrating cognitive biases "without analyzing the structure of environments."

The work of Gigerenzer and Selten, Gigerenzer, and Cosmides and Tooby, show that many cognitive biases disappear if the environment is included in the analysis, so Cosmides and Tooby (p. 69) suggest we give millions of years of evolution the benefit of the doubt over a few hundred years of normative theorizing. Hayek (1988) came to a similar conclusion in his "two worlds" thesis, whereby different types of rationality are needed in formal (societal) versus informal (familial) orders. In sum, the Hayekian critique of constructivism is inseparable from the research of Gigerenzer and company.

[32] For experimental economics evidence see Smith, 2003, pp. 15 – 24. For example, in certain institutions, zero-intelligence actors achieve efficient gains. In sum, "What we learn from such experiments is that any group of people can walk into a room, be incentivized with a well-defined private economic environment, have the rules of the oral double auction explained to them for the first time, and they can make a market that usually converges to a competitive equilibrium, and is 100 percent efficient—they maximize the gains from exchange—within two or three repetitions of a trading period. Yet knowledge is dispersed, with no participant informed of market supply and demand, or even understanding what that means" (Smith, 1999, p. 198). Similarly, simple linear decision making models can outperform multiple regression versions (Gigerenzer, 2001, p. 45).

[33] Hanson. Smith, 2003, pp. 18 – 20.

[34] Camerer *et al.*, p. 1247. Beaulier and Caplan.

[35] The market works by reputation which reduces the need for individuals to evaluate all options.

[36] The liberal State cannot be neutral between all preferences (see Tomasi, 2001), but in minimising the need for the State to take sides, its relative amorality is everybody's second-best preference (Barnett, pp. 303 – 308).

[37] Jolls *et al.*, p. 49, argue that State paternalism can rely on information campaigns rather than coercion. They do not admit, however, that the State would have to raise the money for such campaigns through additional coercive taxation.

[38] Such rhetoric is succour to leftist media: "Regulation may help us make better choices" (Editorial, *The Observer* 17th August 2003). However, this potential absurdity is captured by Stephen Pollard (*The Times* 26th August 2003): "I bought some lavatory paper the other day. What a nightmare!...How is anyone supposed to cope with the chaos involved? Go into one shop and it's 27p for a roll. Go into another and it's 32p, but that's double strength. ...Something should be done. The Government should legislate."

[39] Epstein p. 232.

[40] Sowell (pp. 331 – 368) offers discussion and empirical support. See also Hayek, 1998.

[41] Quoted in Schmidtz and Goodin, p.74.

[42] Hayek, 1988, pp. 53 – 54.

[43] Epstein, p. 208.

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Capitalism Works

Sir Geoffery Owen

THE AMERICAN VERSION of capitalism has been knocked off its pedestal in the last three years. After the stock market crash and the corporate scandals which followed, the triumphalism inspired by the productivity surge in the second half of the 1990s has been silenced. What John Kay has called the American business model (Prospect, May 2003) is now widely condemned as both immoral and inefficient.

What happened at Enron, WorldCom, et al was indeed a shaming episode in the history of US capitalism. Yet the conclusion which some critics have drawn—that the shareholder-based model of corporate governance is flawed and that managers should be answerable, as they are in Germany and Japan, to a wider set of stakeholders, including employees—is wrong. The recent scandals have exposed failings in the way US companies are managed, failings which are now attracting a flurry of reforms. But the scandals have not negated the enormous strengths of the US system as it has evolved over the last 25 years.

The principal US advantage lies in the speed with which new industries and companies are created and old ones dismantled or shrunk. This advantage stems from four forces that first emerged in the 1970s and that became more powerful in the next two decades. The first was a new relationship between companies and their shareholders. The rise of investing institutions—principally pension funds and mutual funds—as the dominant owners of most publicly quoted companies brought to an end a long period in which managers had been largely free from active oversight by shareholders. These institutions, holding larger stakes in companies than the private shareholders they replaced, had the power and incentive to press poorly managed companies for better performance. At the same time, an array of financial innovations made new sources of funding available to ambitious entrepreneurs. The result was an increase in the number and size of hostile takeovers and in the supply of venture capital for start-up firms. The second force was international competition. With the entry into world markets of low-cost manufacturers from Japan and other East Asian countries, several US industries, especially those which had lived for years in a state of comfortable oligopoly, found themselves under pressure. Thirdly, deregulation transformed the structure of industries such as telecommunications, airlines and banking. As barriers to new entry came down, former monopolists such as American Telephone and Telegraph came under attack from start-ups. AT&T subsequently broke itself up into separate pieces, and each of these businesses is now operating in highly competitive markets. Finally, advances in information technology created huge opportunities for new companies. These changes also had a broader impact on the way older companies organised themselves. The general trend was for big companies to "deintegrate," relying on outside suppliers for products or services that used to be provided in-house.

The consequence of all this was to put a sharp brake on managerial empire-building. Companies which had paid little attention to shareholder value in earlier decades were forced to use their assets more efficiently. During the 1960s, businessmen such as Harold Geneen at ITT had created large, diversified groups, claiming that their superior managerial skills enabled them to run a variety of disparate activities—ranging, in ITT's case, from hotels and insurance to vehicle components and paper-making. By the end of the 1970s, it was clear that many of the businesses would be better off on their own, or under different ownership.

The number of mergers and acquisitions in the US reached a historic peak in the late 1980s; after a lull in the early 1990s, activity resumed at an even higher level in the second half of the decade. Many of the biggest mergers took place in industries which were going through a period of turbulence as a result of regulatory or technological change. Although some deals worked out badly, the resulting reallocation of resources almost certainly contributed to the strength of the US economy during those years. Recent research by two American economists, Gregor Andrade and Erik Stafford, suggests that, taken overall, the mergers of the 1980s and 1990s served to increase productivity. Mergers can be an efficient means of dealing with excess capacity in declining industries, while in rising industries they allow well-run companies to grow faster.

Despite the mega-mergers, the level of concentration in the US—the share of industrial output accounted for by the largest corporations—has been stable or declining over the last 15 years. This is due partly to spin-offs and divestments by large companies, and partly to the growth of new companies. In the chemical industry, for example, new entrants, sometimes created through management buyouts, have taken over activities that had previously been part of long-established groups such as DuPont and Dow. Much of the heavy end of the industry—the production of low-value commodities such as petrochemicals and plastics—is now in the hands of companies which did not exist ten or 15 years ago.

The shareholder value revolution, linked to innovation in financial markets, has made US industry more flexible and productive. To the extent that Britain moved in a US direction during this period—and it did so to a much greater extent than other European countries—the results were also beneficial. Unwieldy conglomerates were broken up, and companies were quicker to close loss-making businesses. Deregulation allowed new entrants to prosper, Vodafone being a spectacular example. And an expanding venture capital industry supported many business start-ups in new areas such as biotechnology.

Large-scale acquisitions are risky, but that does not mean they should never be undertaken. BP bought two large American companies, Amoco and Atlantic Richfield, in the late 1990s; the rationale for these deals seems to have been sound, and post-merger integration has been handled well.

Acquisitions can succeed or fail for a variety of reasons, most of which are hard to assess in advance. What the record shows, however, and here the critics of excessive deal-making are on stronger ground, is that the incidence of mistakes tends to be greater during a raging bull market. In the late 1990s, euphoria over new technology drove prices of internet and telecommunications companies—including some which had no early prospect of making a profit—to absurd levels. A mood of irrational exuberance took hold, affecting managers and shareholders.

In these circumstances, companies whose shares are riding high are tempted to use those shares to buy other companies—an apparently easy way of maintaining the momentum of growth and feeding the appetite of analysts and bankers, who are urging them to do more deals. Whether stock options contributed directly to unwise acquisitions is not certain, but there were, in any case, other reasons for questioning the effectiveness of this form of remuneration. When they were introduced in the 1980s, their purpose was to align the interests of managers with those of shareholders. The subsequent escalation in top managers' pay could be defended on the grounds that companies, operating in a more competitive environment than in the past, now depended to a greater degree on exceptionally talented managers, and those managers were in short supply. (Tenure of top executive posts was also becoming shorter and more precarious—hence the generous "golden parachutes" in the event of forced departure.) By the second half of the 1990s, however, it was clear that some companies had been far too lavish with their stock option awards. The stock market boom allowed them to cash in their options at very high prices, even though these prices might have owed little or nothing to their own efforts. More seriously, as Edward Chancellor has shown (Prospect, June 2002), poorly designed option schemes with short payout periods created an incentive for unscrupulous managers to inflate reported profits by dubious or illegal means.

A reappraisal of executive remuneration is now under way, in Britain as well as the US. There are moves to lengthen the period before options can be exercised, or to replace them, as Microsoft has done, with other ways of enabling managers to acquire and retain ordinary shares in the business. Companies may also be forced to disclose the cost of stock options when they are granted. One of the reasons why stock options were so popular in the US was their favourable tax and accounting treatment, which made them appear less expensive for the employer than straight salary or other forms of share-based remuneration; that now seems certain to change.

The need to rethink stock options, while retaining the link between rewards and shareholder value, is one of several lessons that have come out of the stock market boom and bust. Another is the need for auditing reform. While Enron was an extreme case, the practice of manipulating quarterly earnings statements in order to keep investors happy was by no means confined to "new economy" companies. To some extent these lapses may be self-correcting as investors and managers learn from their mistakes. But there is clearly a case for stronger regulation to ensure the integrity of financial reporting, and to prevent auditors from being "captured" by their clients, as Andersen was by Enron.

It is probably healthy, too, that institutional investors are taking a stronger line over practices, such as over-generous executive rewards, which they regard as damaging to the interests of shareholders. In Britain this greater activism may be partly due to pressure from the government: New Labour is now more interested in making the shareholder-based system work well than in shifting to the stakeholder model. There will always be room for argument, as in the recent ousting of Michael Green from the chairmanship of the Carlton/Granada group, over whether institutional investors or boards of directors know best- and it is a mistake to put too much faith in shareholder activism as a cure for underperformance. Nevertheless, as owners, the big institutions have a responsibility to be vigilant and to intervene when things are going wrong.

A regulatory response to Enron was necessary, but it would be wrong to overreact. The benefits of stricter rules on corporate governance need to be set against the potential costs, not least in deterring companies from going public. After all, the US economy has come through the stock market crash and its recession in decent shape, with business productivity growing at 3.5 per cent a year since 2000, much faster than in the eurozone. The events of the last three years do not undermine the case for well-developed and demanding financial markets, nor do they cancel out the gains that stem from the shareholder value revolution. Indeed, the bursting of the bubble should strengthen the US system if, as seems likely, it helps to re-establish what shareholder value really means.

The definition has to start from the purpose of the corporation, which is to create wealth. Its success in doing so is shown by its profitability—its ability to provide goods and services at a price which more than covers the costs it has incurred. If the corporation achieves this in a competitive market, there is a reasonable presumption that it is using its resources efficiently, and thus contributing to social welfare.

Shareholders are interested in expected as well as current profitability, and share prices should reflect the market's estimate of what future earnings will be; it is a signal to managers of how well they are doing. But from time to time the stock market can fall out of line with reality, and, as Harvard business professor Michael Jensen has remarked, an overvalued share price can be as dangerous to a company as an undervalued one: it can tempt managers to do foolish things to keep it up. Recent experience (not just at Enron) has shown that a focus on boosting the share price in the short term can lead to the long-term destruction of value on a massive scale. The proper task for managers is to create wealth over the long term; it is for them to decide what the appropriate time frame should be and to explain to investors how their decisions contribute to that objective.

This is a different goal from that of promoting the survival and growth of the company. Most senior managers are loyal to their company and want it to prosper. But it may happen that the sector in which they are competing enters a period of maturity or decline. The appropriate response is to get smaller, to demerge or sell off parts of the business and to return cash to shareholders. In that sense the interests of shareholders—and by extension those of society as a whole—take precedence over those of other stakeholders, including senior managers, in the enterprise.

This does not imply a lack of concern for employees and local communities. A loyal workforce and a reputation for fair dealing are assets which should contribute to long-term value creation. But to give these other constituencies equal weight with shareholders, as urged by some advocates of stakeholder or "Rhineland" capitalism, is a recipe for confused accountability—in effect, giving managers the freedom to set and pursue their own objectives.

These disadvantages are less serious as long as the market in which stakeholder-based companies are operating is competitive. The post-war success of Germany and Japan owed more to the vigour of internal competition than to those countries' distinctive corporate governance arrangements. It would also be wrong to exaggerate the link between the creation of shareholder value and the threat of hostile takeover; after all, Toyota has done far better for its shareholders in recent years than any US carmaker and Hoechst transformed itself without the threat of takeover. Nevertheless, financial markets of the sort which have taken shape in the US over the past two decades are a powerful instrument for constraining the power of incumbent management and promoting the growth of new enterprises. The absence of such markets provides greater stability for employees and a cosier life for managers, but it makes adjustment to change more difficult. Those concerned about the productivity gap between Britain and the US, such as Gordon Brown, should embrace the pursuit of shareholder value as part of the solution.

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Steel Not Getting it Right

Vladimir L. Andonov

Although free trade has been a contentious issue ever since its inception as a theoretical proposition in the late eighteenth century, it "remain[s] one of the most durable and robust propositions that economic analysis has to offer for the conduct of economic policy."[1] Unfortunately, adopting free trade policies is far from a straightforward decision-making act, as the multidimensionality of interest groups involved inevitably complicates the process. This realization is precisely what US President George W. Bush has painfully come to himself during the course of the past nearly two years. Rescinding on December 4, 2003 the safeguard tariffs he had imposed on steel imports 21 months earlier did successfully break the deadlock of an impending $2.2 billion worth of retaliatory sanctions by the European Union but Bush's determination to make this move was not motivated by sound economic argumentation. Neither was this the case in March 2002, when he made the decision to unilaterally introduce higher steel tariffs. In both cases, the US president failed to get the calculus of free trade right. Even though Bush made the correct choice in the end, his faulty underlying justification for doing so does not bode well for the future of trade liberalisation.

Needless to say, disentangling the complex argumentation surrounding the steel case can be a daunting endeavour. For analytical purposes, therefore, the process can be decomposed into two 'stages,' which I designate as consecutive *decision nodes*. The first one involves the run up to President Bush's decision to impose the steel safeguards. What were the President's main objectives in making his choice, and were they subsequently met? Similarly, the second decision node relates to the rationale that drove Bush to his December 4 announcement. It should be rather obvious that the latter decision-making process strongly hinges upon what the outcome of the preceding node is. What is perhaps somewhat more nuanced to discern, however, is that an erroneous interpretation of the intra-stage environment can easily engender misleading conclusions regarding the rationalization of the final outcome. I will argue that precisely this qualification is what explains why the Bush administration presented the case for termination of the steel tariffs in the light it did.

At the outset, what was the motivation for imposing the steel safeguards in March 2002? According to Gary Hufbauer and Ben Goodrich from the Institute for International Economics (IIE) in Washington, DC, "President Bush's decision to protect the US steel industry with Section 201 tariffs had no economic justification."[2] Before relief was granted, they had calculated that safeguard tariffs would cost over $400,000 annually per job saved in the steel industry. Moreover, they would result in net job losses in the economy due to downstream layoffs. Instead, a more likely explanation for the tariffs is that they "were driven not by an economic match between problems and solutions but by two political motivations"[3]: passing Trade Promotion Authority in Congress, and buying the steel industry's support in congressional and presidential elections.

In fact, trade was not so much the problem as the administration was led to believe, and trade protection, therefore, hardly constituted the correct move at the first decision node. Most observers at that time failed to recognize that minimills were – and continue to represent – the main force crowding out steel firms.[4] The US steel industry consists of high-cost integrated mills and minimills, almost evenly splitting the market amongst themselves. Over half the decline in traditional integrated steel production is attributable to the rise of the domestic minimills due to their superior productivity. Each employee in Nucor's minimills, for instance, makes three times as many tons of steel as each employee at US Steel, the largest integrated steel producer in the United States. To be sure, "both input and output mixes differ between the two firms, but the differences do not cancel out the crude comparison of annual tons per worker."[5]

The two primary problems that the US steel industry faces are *legacy costs* and *persistent overcapacity*. Legacy costs, which include pension and health care benefits, represent a much greater burden for integrated mills because of the massive pool of retired workers these companies have. Persistent overcapacity reflects the proclivity of the government to slow down the closure of high-cost steel mills; it is not just a cyclical phenomenon. The result is too many firms, operating on too small a scale.[6] To alleviate both burdens, the industry should emphasize measures that reduce capacity permanently, through consolidation, and import tariffs are certainly not the right instrument to achieve this. In fact, additional safeguards would only further exacerbate the problem. The logic is straightforward: steel tariffs raise the domestic price of steel, which in turn allows inefficient steel producers to make profits more easily and, hence, stay in the market. From this process, known as *market distortion*, follows that least efficient firms are not necessarily the first to close their doors.[7]

The President's stated rationale for the tariffs was to give the industry breathing space in which to restructure.[8] Steel lobbyists point out that the industry has consolidated in the past year. Yet, they never adequately explain *how* the safeguards hastened the pace of consolidation, and instead simply assert a relationship between the safeguards and consolidation. Consolidation in the steel industry only occurs when a steel-producing firm is performing very badly and sells itself to a stronger firm. In contrast, by raising the profitability of ailing firms, the tariffs may have raised the price the stronger firms had to pay to acquire them.[9] "All of the consolidation that occurred in the steel industry since 1997 happened in the context of bankruptcy, mostly before the tariffs were introduced in March 2002. In this sense, bankruptcy is a prerequisite to consolidation."[10] By increasing steel prices moderately, the Bush administration may actually have propped up weak steel firms for a longer period, delaying consolidation.

Thus, we arrive at the second decision node. I take the December 4, 2003 White House Press Briefing to stand for the official position of the Bush administration on why steel tariffs needed termination. Based on that, I derive that the rationale behind rescinding the tariffs related neither directly nor genuinely to the existing steel industry context. Indeed, some of the justifications seem outright misconstrued. This is exactly what I cautioned against: that perceptions of realities are of critical weight when forming policy preferences and making decisions. President Bush was right about repealing the tariffs; yet, his particular motivation for doing so appears greatly unfounded for four reasons, each of which requires elaboration.

First, US officials sought to play down the significance of the EU retaliation threat, arguing that the move was merely a response to the recovery in the market for steel.[11] Robert Zoellick, US trade representative, fittingly captured the standpoint of the administration: "This decision was independent of that [the EU threat]."[12] Instead, Zoellick maintained that the conclusion had been based on a straightforward cost-benefit analysis. However, it is hard to comprehend how not taking a possible economic and political impact of sanctions of an amount of $2.2 billion can be presented as legitimate cost-benefit analysis. Ian Rodgers, director of UK Steel, seems to have discerned much better what underlay Bush's move: "I have no doubt that the president has been forced into this decision by the knowledge that if the tariffs had remained in place he would have faced EU sanctions on •2.4 billion of US exports."[13]

Next, the Bush administration argued that "the tariffs […] clearly had worked;"[14] that jobs had been saved, and that steel businesses had been given another chance to compete. Admittedly, there are signs that "inefficient capacity has been cut, productivity has risen sharply, and prices are now 15 percent to 30 percent higher than in February 2002."[15] Nevertheless, tariffs "are not painless for America."[16] While higher steel prices benefit steel producers, they hurt steel users, of which many are manufacturing companies also struggling against foreign competition. For this reason, the administration "has not reaped the benefits it expected from the introduction of tariffs in March 2002."[17] The IIE calculates that the cost to steel users so far has been about $600 million in lost profits from higher prices and 26,000 lost jobs. That dwarfs the benefit to American steel firms, which the IIE reckons has been only $240 million, mostly from a 3.3% rise in average steel prices, with some 5,000 jobs saved.[18] If the tariffs 'clearly had worked,' one would expect their welfare impact to be somewhat more supportive of such an argument, which clearly is not the case. In short, "the conclusion is that the safeguards are *unambiguously* a drag on the US economy."[19]

Third, the White house briefing seems to suggest that administration officials played down the likelihood that they would face a strong backlash in the steel states because they had lifted the tariffs early. However, Zoellick's claim that "…this is an industry that wanted help for a number of years. It got help."[20] is not supported by the evidence. For one, the fact that Bush promised to continue a monitoring and licensing scheme to guard against the risk of future surges in steel imports demonstrates that the President has made only a small concession to his domestic industry.[21] For two, the union representing US steelworkers promptly demonstrated its discontent by calling the termination of tariffs "clear evidence of capitulating to European blackmail."[22] The union's reaction lends further support to the proposition that "in some sectors of the steel industry demands for protection have become virtually institutionalized, a part of the industry's ongoing business strategy."[23]

Finally, the administration's perspective on the existing environment of the steel safeguards could additionally have been refracted through the lens of the latest economic recovery. Arguably, the decision to lift the tariffs was aided by the recent strong growth in the US economy and declines in the dollar, both of which have bolstered the steel industry.[24] Moreover, there appear to be healthy signs that job creation is picking up. However, this can hardly conceal the fact that the decision is sure to draw sharp criticism from labour unions and several of the Democratic presidential candidates, who say the incipient recovery is largely bypassing manufacturing workers in the industrial states where steel remains a force.[25] In addition, even the relief provided by currently higher world steel prices due to China's insatiable appetite for raw materials cannot represent a permanent shift in the dynamics of the industry.[26]

All things considered, one could conceivably suggest that President Bush never really had a chance of getting the tariff thing right. Yet, to maintain such a deduction is to miss the central argument developed here. Bush could have much more easily 'gotten it right,' if he had admitted having seriously taken the EU threat into consideration; if he had revealed a more realistic picture of the US steel industry by agreeing that there is still a lot more consolidation left to be done; and if he had demonstrated that he had downplayed electoral considerations when weighing the pros and cons of trade liberalization. In this respect, EU trade commissioner Pascal Lamy is misguided to assert that "Whatever the reasons were, we got the results we wanted."[27] Getting the causal relationship of the process of free trade decision-making right is just as critical as arriving at the decisions themselves, if not even more so. If we get *that* right, there could be a brighter future for the world trading community, especially in light of the current post-Cancún stalemate in the WTO Doha Round. It is high time that we realize that the contemporary case for free trade is "not the old argument that free trade is optimal because markets are efficient." Rather, "it is a sadder but wiser argument for free trade as a rule of thumb in a world whose politicians are as imperfect as its markets."[28]

Endnotes

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28 Paul Krugman (1987). Quoted in Douglas, Irving (1996) Against the Tide: an Intellectual History of Free Trade. Princeton. p. 227.

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Reforming Governments

Philip E. Graves

WHAT IS WRONG with politics today? Why are voters so *turned off*? Voters know that, despite campaign promises, politicians have incentives to incur deficits since increasing spending is politically desirable while increasing taxes is not. Additionally, politicians promote inefficient expenditures that benefit *them*, notably special interest abuse.

The preceding has led to growth in government. Considering the US, the percent of GDP spent by all levels of government was 22.8 (1950s), 25.1 (1960s), 28.2 (1970s), 30.6 (1980s), and 30.5 (1990-1998).

Large US deficits caused some to advocate a Balanced Budget Amendment (hereafter BBA) amendment. BBAs require annually balanced federal budgets, except in times of war or national emergency. Deficits may then be run if both the House and Senate vote to do so with a super-majority, details differing among BBA proposals. The presumption underlying the BBA is that it would reduce the growth of government.

Many economists are concerned that a BBA would worsen recessions. In a recession, some expenditure *automatically* increases (e.g. food stamps, unemployment insurance), while tax revenue automatically falls. Balanced budgets necessitate either spending cuts or increases in taxes, possibly deepening a recession.

Another objection to BBA proposals stems from variation in voter desires about the size of government: any BBA would have the practical result of cutting spending growth. Some voters argue that large levels of government spending are necessary to reflect the diversity of opinion about what should be funded. While a voting majority is likely to support smaller government, some feel that a large government doing many things reduces the tyranny of the majority over the minority.

I present an alternative mechanism for achieving the benefits of a BBA, *along with many other benefits*, without its drawbacks. The approach corrects a flaw that exists at all levels of government, foreign and domestic, although the discussion emphasizes the U.S. federal government.

The well-known flaw is that regardless of what the candidates of Parties vying for the presidency say prior to election, once elected they have incentives to take actions that favor *them and their Party*. Hence, projects that provide concentrated benefits for special interest groups but greater costs to the general tax-paying populace are enacted into law.

So how do we prevent special interest dominance? Politicians currently have no incentive to tell the truth in campaign speeches; they can later behave differently without consequences. They are not, in short, "putting their money where their mouth is!" They have, in the jargon of economics, *property rights* in political lies. The incentive-correcting mechanism advanced here reassigns those property rights from politicians to voters. The mechanism could be worded as follows:

"Any Party wishing to place a candidate on the ballot for an impending election, must (in addition to existing requirements) indicate the total spending, S, that it will incur over the four-year term of election. If the elected officials of the Party spend more than S, the Party is *itself* liable to pay any amount exceeding S into a fund that will be used to retire the national debt, except under specific circumstances to be discussed further below."

The spending limit, S, is all the Parties need reveal. The elected Party can spend their budget as they wish, even lying in the speeches prior to election about their spending intentions, although that might damage their reputation, hence future election prospects. Moreover, they can allocate S among the four years any way they want—after all, the future cannot be predicted and flexibility is desirable. Importantly, however, it would be irrational for a Party to exceed S since it would either go bankrupt or be replaced at the next election (likely both). Since Parties aren't irrational, it is exceedingly unlikely that there will ever *in fact* be any money in the "fund." The timing of the announcement of S could be debated.

Might not too many inefficient projects still be included in overly large S's offered by the Parties vying for office? This remains problematic under a BBA, although *growth* in such projects might be discouraged. Under the proposed mechanism, however, *political competition* will tend to give Americans the overall level of government expenditure they wish over time. A common criticism of BBAs is that a BBA is just a ruse to halt spending growth, when some people really want more, not less, spending. Under the proposed mechanism, Americans wanting bigger government can vote for the Party offering a larger S, though I suspect that the majority would prefer a smaller more efficient government.

Total spending percentages have grown regardless of which Party is elected. This is expected, given the faulty incentives currently facing politicians. Under the mechanism, the Party ultimately winning the national election would likely propose modest expenditure cuts, say an initial rollback to 19.2% of GDP (19.7% was the actual figure for 1998). Political competition might force percentages lower in future elections.

With overall governmental spending limited to S, focus would appropriately shift to the efficiency and equity impacts of that spending. This does not, of itself, necessarily imply that programs would become more efficient. People appear to have an affinity for wasteful agricultural policies, for example. Moreover, measurement of benefits and costs for many government programs is difficult; increases in efficiency might emerge slowly.

But, many inefficient programs are straightforward to analyze (e.g., the agricultural policies). Efficiency gains from reform could be combined with transfers to make all farmers better off, if that were deemed fair. If concern is that poor farmers will be forced from family farms, a means-based test could be applied, with more efficiency gains being returned to voters in the form of lower food prices.

What if the elected political Party can only "try" to deliver its promises, there being cases in which it is unable to do so? If the elected Party is forced by circumstances beyond its control to exceed their S limit, it might be widely viewed as unfair to impose liability on them. Three important cases of this problem come to mind. First, a national disaster or a large war in some future year might occur after a party, promising to spend S, has been elected. In such cases, a congressional vote could be taken allowing a temporary supplement to S that would not count against the Party's limit, using the same super-majority rules as advocated under a BBA.

Funds can be moved among different expenditure categories, within the overall S, in the event of more minor disasters or wars. For example, resources could be transferred from social programs to defense should a small, unanticipated war break out. Or, conversely, a minor disaster might require transfers from military accounts to emergency aid agencies.

Second, what about spending that is beyond the control of politicians, being built into the system and dependent on the level of income? If a recession were to occur after election, spending automatically increases and tax revenue automatically decreases (the "built-in stabilizers" of early macroeconomic models). The mechanism proposed here is less pro-cyclical than the BBA with its focus on deficits. However, spending variations that occur automatically in a recession (e.g., unemployment insurance, food stamps) may indeed be desirable, could optionally not be counted toward S. The critical thing to be guaranteed by the mechanism is that exogenous *politician-increased* spending that ultimately violates S not be allowed. Another option is that major recessions could be treated as with major disasters, leaving the Party in power responsible for minor fluctuations.

Finally, what if a candidate of Party A, promising to spend S, is elected to the presidency, while another Party B controls one or both of the House of Representatives or Senate? The mechanism advocated here might most easily be first adopted in a parliamentary system, since the majority party appoints the Prime Minister. However, should the executive and legislative branches be split, the mechanism need not be enforced. But, it would quickly be seen to be irrational to elect a Congress controlled by a Party that differed from the President's Party; the voters would be thwarting their own desires to obtain the S that they themselves prefer!Operationally, the auditing associated with the mechanism is simple, with spending being actual dollar outflows over the time until the next election. Future promises to spend are, on the whole, valueless if occurring further out than the present four-year period. The mechanism's information requirements are actually simpler than those of a BBA that requires *annual* numbers for *both* expenditures and revenues. For projects that can only be completed in a longer time frame, only current period expenditures would count against the current budgetary period, with future period expenditures included in the S of the Party running for re-election. If that Party does not get re-elected, some such projects might be eliminated. Indeed, voters might reject an incumbent Party precisely to halt certain projects (e.g., "Star Wars" defense initiatives or an overly generous welfare expansion). Should a newly elected Party wish to continue the projects of a prior administration (as expected with popular projects), they must take responsibility for this in *their* S.

The political Parties might, especially initially, be risk averse, running on a higher S than they really plan on spending. The resulting surpluses would be not undesirable, and such liability fears should diminish over time.

There is great political competition in the present form of government. This is good, and is critical to the benefits of shifting to the proposed mechanism. Because of that competition, candidates of Parties hoping to get, and remain, elected will wish to incorporate, within their fixed S, policies seen by voters to be equitable and efficient. Little enforcement will be needed, because the mechanism is self-policing, with enforcement analogous to that of any other social contract. In cases of ambiguous auditing (likely to be rare), courts could decide whether the conditions of the "contract" had been violated.

One would increasingly expect transfers to the poor to involve means tests. Inefficient policies that are currently rationalized as "helping the poor" (but that, of course, help many special interest groups of means) would be replaced by means tests enabling Party candidates to run on smaller S's.

Elected representatives of the Party in control will be more likely to seek programs that are efficient or otherwise appeal to a majority of voters under the proposal, since that will make their S more appealing. With Parties meaningfully constrained by their spending promises, debate may turn, more than at present, to issues of the regulatory burden.

Everything argued here applies with equal force for state and local governments which spend two-thirds as much as the federal government and where spending as a percent of GDP has doubled from 7% in 1953 to about 14% today. Indeed, one mechanism by which the proposed mechanism might spread is for states to implement it first.

The proposed mechanism is likely to have several other benefits. First, it should allow real incomes to grow more rapidly if political competition results in the S of the elected party being a smaller percentage of GDP, presuming a higher rate of return to private sector investment. Second, the mechanism encourages privatization of things that should never have become centrally planned. Third, there will be more incentive to find low-cost suppliers of government goods. Fourth, the incentive for agencies to spend heavily prior to the end of a fiscal year ("use it or lose it") evaporates, since the Party could save these resources either for future contingencies or for advertising that they "did what they said they would and came in under budget." These effects are enhanced if Parties eliminate inefficient projects in their competitive scrambling to deliver lower S's.

Many of the longer-run benefits stemming from the mechanism are a result of political competition. That competition has been very intense, since so much special interest largesse is involved. However, competition will remain high under the proposed mechanism, only that competition will be to best please the voter rather than special interest groups!

It should be noted, however, that even special interest groups, collectively, might be better off under the proposed mechanism. Much lobbying expense is "defensive" in nature, undertaken to offset lobbying efforts of broadly defined competitors. And it is likely that much lobbying is undertaken for projects that have, in fact, benefits greater than costs; such projects would likely be undertaken in any event. Under the mechanism, more resources will flow into goods production and less into political manipulation, raising welfare.

Indeed, the principle harm from the proposed mechanism is to the political Parties themselves. Political contributions by special interest groups currently make political Parties much better off. If the likely reductions in those contributions to the political Parties are viewed as unfair, a fixed amount of funding could be provided by government (perhaps set at some fraction of actual recent expenditure) to all Parties receiving more than some minimal percent of the popular vote. Having done this, there would be no reason to allow any corporate or individual contributions, and that could be made illegal. Campaign finance reform would, in any event, become much less of an issue under the proposed mechanism.

The pressure of the media, focused to force political parties to "put their money where their mouth is," should not be underemphasized. If "we, the people" clamor for it, the Parties *will* eventually adopt voluntarily or be forced by legislation to adopt the mechanism advocated.

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Returning Planning to the Market: An Agenda for Private Land Use Control

Mark Pennington

"THE ISSUE IS not whether one ought or ought not to be for town planning, but whether the measures to be used are to supplement and assist the market or to suspend it and put central direction in its place. The practical problems which policy raises here are of great complexity, and no perfect solution is to be expected."

F.A. Hayek (1960, p.350) The Constitution of Liberty

The British town and country planning system represents one of those time old paradoxes of political economy. Politicians are agreed that the system encapsulates the rigid bureaucracy and special interest capture that are the hallmarks of a planned economy and yet few have any idea how to reform it.

The British Land Use Planning System

The British land use planning system is one of the few remaining relics of the Atlee government's post-war nationalisation programme. Whilst virtually all societies in the Western world have instituted some sort of government land use control in the last 100 years, none have gone so far as to introduce anything approximating the provisions of the 1947 Town and Country Planning Act. That act nationalised the right to develop land and in its key essentials has remained virtually unchanged to the present day. Outside of the agricultural sector virtually all land use changes are subject to the requirement to attain planning permission from a local planning authority, which must itself formulate local land use plans on the basis of national planning guidelines. The philosophy underlying the post-war planning legislation was fundamentally hostile to private property and market processes, with the initial intent to replace the operation of the private land development market with a state directed system, epitomised by the New Towns programme. As a consequence the planning system has mutated into a 'mixed economy' model, where the majority of production and investment decisions are made by private developers and landowners, but where the latter are subject to a detailed set of regulatory procedures.

Many of the procedures embodied in the British land use planning system are of the 'command and control' variety which, rather than working with the grain of market forces, attempt to suppress the operation of the price system. It is not much of an exaggeration to say that the practice of drawing up five or ten year plans for housing and commercial land supply owes more to Stalin than it does to Adam Smith. Planning decisions themselves, meanwhile are not the subject of a competitive bidding procedure, but are imposed via political fiat. It is the inefficiency and waste that results from this chronic suppression of the price system that I want to focus on in this article.

Planning without Prices: Distorted Information

A well functioning price system is crucial to the efficient allocation of resources in a competitive market economy. Changes in the structure of relative prices for both finished products and for inputs of land, labour and capital enable individuals to make calculations of economic value in order to determine which combinations of resources generate the highest value from the minimum set of inputs. Contrary to the conventional wisdom, the case for the market economy does not rest on the concept of a "perfect market" as taught in A-level economics. Such a perfect market does not exist anywhere, any more than a perfect government or a perfect planning office. The key question is this: Do individuals, looking at price signals and the information that is available and taking into account their own preferences make better more informed decisions in general than bureaucrats sitting in Whitehall and Town Halls? In nearly all situations people would agree that they do. In what sense is land use different? If it is different, then I suggest that we adopt land use policies that run with the grain of the market and not ignore it all together.

Like many bastions of government regulation, the British planning system is frequently defended on 'market failure' grounds and in particular is said to be essential in counteracting the externalities and neighbourhood effects that are considered an integral part of the market in land. At no point, however, do the defenders of the planning system account satisfactorily for the way in which planners are to 'correct' for such market 'imperfections.' The values and associated trade-offs that are attached to the protection of green-field sites, the location of new shopping developments, the environmental impact of different transport patterns, etc. are subject to precisely the same uncertainty and imperfect knowledge as any other goods and services. Planners, however, are not subject to a signalling mechanism equivalent to the profit and loss account, which can indicate their success or failure in responding to the relevant trade-offs. Similarly, planners do not have access to a set of relative prices for different environmental goods in order to take their decisions. Two illustrations from the contemporary British planning system should suffice to illustrate the problems brought about by the suppression of competition and the price system in this regard. Consider first the topical issue of 'sustainable urban form.'

The urban land use debate has been dominated in the recent past by a confrontation between those highly critical of the environmental effects of low-density commercial and residential development, and writers who are equally critical of proposals to encourage high density, compact development patterns. The former argue that higher density developments reduce the need for car based travel and longer commuter or shopping trips, wherein people are able to access a wider range of services within a smaller surface area. The latter, by contrast, contend that higher densities may actually increase car use. Although people may travel longer distances in low-density areas, the frequency of these visits (to a large hyper-market, for example) tends to be less, so it is not at all clear that discriminating against such developments will do anything to reduce auto-based pollution. In practice, there would appear to be considerable uncertainty concerning the effect of different urban forms on transit patterns and related levels of pollution. Central government, spurred on by the Urban Task Force and increasingly by professional bodies such as the Royal Institute for Chartered Surveyors, has issued guidelines requiring that local authorities adopt strategies of high density, 'brown-field' development to the complete exclusion of other alternatives. Both government and the professions it would seem have failed to learn the lessons of the last attempt to secure 'sustainable urban form' as manifested in the post-war New Towns programme. New Towns were supposed to lead the way to a world of minimum auto-use, but most commentators now agree, ended up increasing the overall amount of long distance commuting. The question must be asked: Have the planners really taken into account all the costs and benefits of different ways of planning our town or are they imposing their subjective preferences on the rest of mankind. Or, as Frederic Bastiat put it 150 years ago, "at what height above the rest of mankind do our rulers believe they stand?"

Given the massive uncertainties involved, the most appropriate way of dealing with these issues may not be to deliberately plan for an 'optimal' urban form, but to permit a wider variety of experiments in urban living. The latter may allow a competitive discovery process to reveal which particular ways of organising urban areas work best from the subjective view of the consumer as signalled by the relative willingness to pay for different types of development scheme.

The detrimental effects of suppressing the price system are still more apparent when one turns to the supposed 'jewel' in the crown of the British planning system–Green Belt policy. As a blanket ban on development covering some 14% of England, Green Belts pay virtually no attention to the huge variations in environmental quality that occur within the designated land. The London Green Belt, for example, whilst including wooded hills and chalk downs, also includes large tracts of land on the western and eastern urban fringes, consisting of dis-used gravel pits, quarries, and low-grade farmland/horticultural developments. Whilst there is clearly a desire of citizens to preserve aesthetically attractive sites within easy reach of the city, it is equally the case that people searching for affordable housing might be prepared to see the relatively less attractive parts of the Green Belt developed for residential purposes. The problems highlighted above stem primarily from a suspension of the signalling function provided by market prices. Without being guided by a set of relative prices, highlighting variations in subjective environmental quality between different sites, planners are unable to know how to choose effectively between competing uses for land. The results are predictable.

Returning Planning to the Market: A Property Rights Agenda for Institutional Reform

If the analysis I have presented thus far is accurate then the most appropriate way to cure the ills of the British planning system would be to make greater use of competitive market processes so as to increase the amount of experimentation, to generate more price signals and to change the incentives facing the various actors involved. The question remains, of course, can a market driven system of land use control be trusted to operate effectively in an area frequently associated with 'market failure,' and if so, what is the most appropriate way of introducing such a system. I think the answer to the first of these questions is a definite yes.

In considering this statement it is important to emphasise that the case for a market system of land use regulation does not challenge the need for 'planning' as such, but rather questions the legitimate sphere over which any particular 'planning model' should be extended. Market processes themselves involve a considerable element of 'planning' properly conceived. As the theory of the firm teaches us, firms are 'planning organisations' that emerge where there are efficiency gains to be made from replacing purely exchange-based systems with a hierarchy of command in order to reduce transactions costs.

How much 'planning' there should be, (which firms should exist and how big they should become) however, is something that can only be discovered by a process of open competition between different organisational forms. In the specific case of urban land use, it may well be the case that there is a need for institutions that can consciously plan the pattern of land development within a particular area in order to internalise various external effects. What is at issue, however, is the existence of a mechanism that can subject such attempts at conscious planning to a process of competition in order to generate price signals indicating the success or failure of different planning experiments and providing actors with an incentive to weigh alternatives. In one of his few published statements on land use planning Hayek put the issue very well, "Most of what is valid in the argument for town planning is, in effect an argument for making the planning unit for some purposes larger than the usual size of individually owned property. Some of the aims of planning could be achieved by a division of the content of property rights in such a way that certain decisions could rest with the holder of the superior right... Estate development in which the developer retains some permanent control over the use of individual plots provides at least one such alternative to the exercise of such control by political authority" (1960, 351-352).

A Proposal for Private Planning

A promising way of moving towards a new system of private planning that might offer some prospect of political success would be to adopt a variant of a proposal mooted by Moscovitz and O'Toole (2000). Moscovitz and O'Toole argue for the local community ownership of conservation easements and restrictive covenants through the creation of local recreation and amenity companies. In this proposal, property owners would continue to own their acreage on an individual basis, they would be free to maintain land in its existing use and they would also have the capacity to bring forward proposals for new development schemes–as at present. Development rights would, however, be held collectively by all the other property owners encompassed by a recreation and amenity company.

Under this particular model, the state would divest itself of development rights through the establishment of recreation and amenity companies which would purchase restrictive covenants from participating property owners in a given geographical community, paying for these with the issue of shares in the new company. The company board consisting of all property owners/shareholders in the area would then be responsible for decisions regarding the approval of new development. In turn all profits and losses attributable to such decisions would be shared out between member property owners, in a manner proportionate to the scale of their holdings. Individual landowners would no longer hold the right to the full profits from developments on their acreage and the state would no longer hold the right to approve or reject development applications. Rather, development rights would become a form of collective private property right shared by the members of the recreation and amenity company at the neighbourhood/community level under the auspices of a unified management system.

The great virtue of this proposal is that it provides a way of internalising externalities at the local scale by creating a regime of proprietary ownership. The value of the proprietary communities' assets would be tied directly to the decisions regarding land management made within its jurisdiction. In contrast to the current British planning system, where the state holds the right to refuse or grant planning permission, under the Moscovitz and O'Toole plan, the management board of the proprietary community would itself be responsible for such decisions. Where under the British planning system all the profits from a successful planning application go to individual landowners proposing new development—but where planning permission may be extremely difficult to acquire for such things as new housing—under the proprietary model, all shareholders in the community would receive a share of the profits because development rights would be held by the recreation and amenity company.

The above model of proprietary governance could help to frame an incentive structure that would discourage a 'free for all' either on behalf of developers or by nimbyist organisations, because property owners/shareholders in recreation and amenity companies would be able to consider decisions in terms of the likely effect on community asset prices. Decisions to prevent any development in the locality would be based on knowledge of the opportunity cost of such decisions–that is, the foregone financial gains from allowing new development to proceed. Likewise, decisions to allow inappropriate development and to lower the quality of life within the locality would be taken at the risk of lowering the value of company asset values. Within this context, recreation and amenity companies would have to exhibit an entrepreneurial sensitivity to market forces. A primary implication of this proposal is that all local services such as road maintenance, the provision of parks, refuse collection, as well as land use planning would be the responsibility of the relevant proprietary organisation. Companies would, therefore, have to choose the particular bundle of services that they provide and the environmental characteristics that they wish to preserve with regard to the attractiveness of such decisions to future residents and hence the likely effect on asset prices. Under these conditions, one would expect to witness a good deal of entrepreneurial experimentation by recreation and amenity boards in an attempt to discover the most desirable mix of environmental characteristics necessary to maintain a competitive edge.

This might not happen overnight. Meanwhile, the whole planning system, insofar as it remains in place should be reformed on economically rational grounds, using the price mechanism to the maximum extent and only intervening when clear externalities existed. When intervention took place it should work with the grain of the price mechanism and not involve bureaucratic, centralised direction.

Conclusion

The proposals I have just sketched would present a radical alternative to the continuation of government land use planning and would clearly require some imaginative thinking if they were to be developed successfully. I do not wish to claim that these proposals will offer a panacea for the ills of the current planning system or that the ideas I have advanced will necessarily represent a politically acceptable path to reform. Others who are perhaps a little more attuned to political sensibilities than I may be better placed to address some of these issues. What I am convinced of, however, is that any successful programme of reform will need to build on at least some of the principles I have set out in this article. As the quotation with which I commenced indicated, the very nature of land use problems means that any solution will necessarily be imperfect. I submit, however, that a system of private land use planning is likely to be considerably less imperfect than the bureaucratic regime in which we are mired today.

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