

Committee 3
Values and the Social Order:
Order by Rules and Rules by Order

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INTERNATIONAL COMMERCE AS AN INSTANCE OF NON-COERCED SOCIAL ORDER

by

Victoria Curzon-Price
Director, European Institute of Geneva University
Geneva University
Geneva, SWITZERLAND

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Theoretical Framework

"Order" in the most general sense exists when the component parts of a whole form a coherent pattern. If the components are somehow taken apart, or jumbled up in any old sequence, then no order emerges. There is no meaningful relationship between the parts. For instance, the 26 letters of the alphabet presented in an incoherent manner will convey no meaning at all, but if placed in a proper order can produce the most beautiful poetry. Or the infinite colours of the artist's palette, if mixed up together, will produce a uniform sludge, but if placed in meaningful relationship to each other, can result in a masterpiece.

Disorder produces an outcome – nonsense or sludge. But it is a single, meaningless outcome. *Order* produces an infinity of outcomes and almost perfect order produces masterpieces. Between these two extremes lies reality – imperfect orders. They are clearly valuable – but how valuable? Orders of the natural world are so impressive that they inspire some to wonder about the existence of a blind watchmaker. Nature (of which mankind forms a part) loves symmetry⁴. The man-made order of the artist clearly has aesthetic *value* to us. The spontaneous man-made orders of language, mathematics and economic exchange are a source of wonder. They clearly have a value greater than disorder, but can one say more? One way of measuring their value might be to lay emphasis on the number of outcomes that order produces. One can perhaps posit that the greater the number of outcomes that an order can produce, the greater its value to us. It is, after all, extraordinary to think that the 72 notes on a piano can produce an infinite number of tunes, or that 26 letters of the alphabet are enough to create an entire system of communication, not to speak of the 10 digits of numeric expression.

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In ordering notes, colours, letters or numbers we follow rules which no particular person has consciously designed – the archetypal spontaneous Hayekian order. They are complied with quite voluntarily, for the sanction for non-compliance is a meaningless cacophony. Not all of us can be a Mozart or a Shakespeare, but we can all (or almost all) hum a tune and write. In the economic sphere we collectively produce a similar order: with limited inputs we produce a vast number of outputs, each of which represents a unique combination of the various parts. The system is self-ordering because it rewards those who spot the best possible combinations at any particular point in time. Errors are constantly corrected. The aesthetic beauty of the system lies in the fact that although an infinite number of outcomes is *possible*, the system automatically selects those which meet people's needs in a reasonably economical fashion (notwithstanding our dire and unavoidable *ignorance* on an individual level). Thus, although the actual pattern of production and consumption can never be known exactly in its entirety, and even less predicted, we do know that by following the basic rules of exchange, we are probably doing the best we can under the circumstances.

What is predictable in human behaviour is *rule-following*. But the actual outcomes of rule-following are unpredictable, given their sheer variety.

This is, I believe, how one must interpret Hayek's definition of *social* order as "a state of affairs in which a multiplicity of elements of various kinds are so related to each other that we may learn from our acquaintance with some spatial or temporal part of the whole to form correct expectations concerning the rest, or at least expectations which have a good chance of proving correct" (LLL I p. 36). In other words, without "order" – or rule-following – no one would be able to go about their

daily lives. It is this "matching of the intentions and expectations that determine the actions of different individuals" by which order manifests itself in social life. Rule-following produces co-ordination of human actions, because it is the rule-following which is predictable (up to a point), but the outcomes of this continuous process of interaction are unique and totally unpredictable. This unpredictability of outcomes must, of course, not be confused with *disorder*. We cannot predict the actual form of the next musical masterpiece, but we can be pretty sure that it will not be an incomprehensible jumble of notes.

The benefits from order and co-ordination in the social field are not just of an aesthetic or material nature, but can be a matter of life and death. They are so great, by comparison with the losses from conflict, that one wonders why social orders are so fragile that they constantly break down – Rwanda, Bosnia, Somalia all providing contemporary reminders of the fact that social order is difficult to maintain and indeed is probably the exception rather than the rule if we care to take the sum of human experience over time and space.

Enforcement

The problem, as game theory suggests, is that rule-breaking may be in the interests of some members of society. According to North (1990, p. 12) "wealth-maximizing individuals will usually find it worthwhile to cooperate with other players when the play is repeated, when they possess complete information about the other players' past performances, and when there are small numbers of players." Conversely, cooperation "is difficult to sustain when the game is not repeated (or there is an end game), when information on other players is lacking, and when there are large numbers of players." Seen in this light, certain forms of social

coordination, and especially economic exchange, appear fragile, and may need formal rules, institutions and enforcement mechanisms for their long-term survival. As North puts it: "it is difficult to sustain complex exchange without a third party to enforce agreements" (North, 1990, p.14). And once one admits of the need for coercion, the order that is established is no longer purely voluntary and self-sustaining, but is, in part at least, a *created* or contrived order, relying on the coercive powers of the state, which of course can, and probably will be, abused.

De Jasay follows a similar line of reasoning when he observes that we have "a first-order spontaneous order that, in order to function, endure and produce its benefits, requires the successful graft of a 'second-order order' ensuring that the conventions of the first are sufficiently respected." (de Jasay, 1994, p. 32)

The Catch-22 situation in which we find ourselves is as follows: if we agree that we need a "second-order order" to prevent individual cheating, theft and free-riding in the complex, anonymous game of modern economic exchange, we must also accept the idea that *organized* elements of society will soon emerge which will learn to use the "second-order order", or the coercive powers of the state, to cheat, rob or free-ride on the backs of their fellow citizens. This, at least, is how I interpret Mançur Olsen's gloomy assessment of the "Rise and Decline of Nations" (Olsen, 1982), in which he rather convincingly describes how individuals, pursuing their own individual interests, will form groups in order to *use* the power of the state for the purpose of economic redistribution. The greater the power of the state, the more scope it has for offering redistributed wealth, the more lobbies will lobby, the faster the state will grow, until all the energies of society are taken up with the game of redistribution rather than production, leading ultimately to the collapse of that particular civilization.

This is a high price to pay for not having, at the outset, caged Leviathan. But as far as I know, we have yet to devise such a cage. We do, however, have a *rule*: to rely on spontaneous, voluntary social orders as much as possible, and to use deliberate, coercive orders as little as possible. In other words, there is a hierarchy of orders. We prefer the former because they can function without coercion over a wide range of different circumstances, without limiting the diversity of outcomes, coordinating the actions of millions of individuals and using their dispersed knowledge in a meaningful way. We tolerate the latter because no one, as yet, has offered us an alternative third-party enforcement mechanism.

The range over which the spontaneous order of voluntary exchange can extend is probably much wider than commonly believed. That, at least, is the contention of both North and de Jasay, who in different ways point to the fact that society can (but need not necessarily) develop non-state monitoring systems to enforce private property rights. De Jasay points to property-owners who invest in "fences, locks, alarms, dogs; buy insurance, install television monitors and electronic tagging against shoplifting; employ credit bureaus, private security agencies; have recourse to wise men and professional arbitrators... boycott known or suspected swindlers, avoid dealings with defaulters and bankrupts, consult quality assessors before accepting deliveries, and tip off each other about the practices and habits of traders and producers" (de Jasay, 1994, p. 38). North mentions the exchange of hostages (North, 1990, p. 55), ostracism (p. 127) and the threat of blood feuds (p. 123) in the development of European merchant law in the Middle Ages.

But North makes the point that while such private enforcement is conceivable, it tends to be very costly to run. According to him, the conditions for cooperative

outcomes to complex, anonymous exchange games are usually absent, increasing the incentive to cheat. Under these circumstances, the transaction costs of private enforcement mechanisms tend to become prohibitive:

The more complex the exchange in time and space, the more complex and costly are the institutions necessary to realize cooperative outcomes... viable impersonal exchange that would realize the gains from trade inherent in the technologies of modern interdependent economies requires institutions that can enforce agreements by the threat of coercion. The transaction costs of a purely voluntary system of third-party enforcement in such an environment would be prohibitive. In contrast there are immense scale economies in policing and enforcing agreements by a polity that acts as a third party and uses coercion to enforce agreements. (North, 1990, p. 58)

Transaction costs and unavoidable ignorance

Perhaps Hayek's greatest contribution to economics is the observation that *markets* coordinate vast quantities of economically useful *but fragmented* information contained in the minds of countless individuals, bringing about "a distribution of resources which can be understood as if it were made according to a single plan, although nobody has planned it" (Hayek, 1936,1949, p.54). This is radically different from the view of markets developed in the field of neo-classical microeconomics, where "perfect" knowledge on the part of all actors is postulated at the outset, and all that remains for markets to do is to *register* the equilibrium prices and quantities generated by perfectly informed producers and consumers, who allocate resources to meet needs in an optimal manner, moving smoothly from one perfect equilibrium to another.

In the Hayekian world, markets are spontaneously ordering resources *despite* our unavoidable ignorance:

The most significant fact about this system is the economy of knowledge with which it operates, or how little the individual participants need to know in order to be able to take the right action. In abbreviated form, by a kind of symbol, only the most essential information is passed on and passed on only to those concerned. It is more than a metaphor to describe the price system as a kind of machinery for registering change, or a system of telecommunications which enables individual producers to watch merely the movement of a few pointers, as an engineer might watch the hands of a few dials, in order to adjust their activities to changes of which they may never know more than is reflected in the price movement. (Hayek, 1945, 1949, p. 87).

The transaction costs literature, sparked off by Coase's famous article "The Nature of the Firm" (Coase, 1937), is also concerned with our "unavoidable ignorance", but looks at the problem from the opposite side, so to speak. Here the concern is that every market transaction involves *transaction costs*, which arise from the search for buyers and sellers, the need for information on their probable behaviour (are they trustworthy?), the need for bargaining to discover their true position, the need for drawing up contracts to specify quantity, quality, payment over time etc., the need for third-party monitoring and enforcement, and protection against outright theft. Sometimes these transaction costs are so high that no transaction takes place at all. The point is, however, that none of these problems arise in a world of perfect

knowledge and that most transaction costs can be traced back, one way or another, to ignorance.

Coase then proceeds to demonstrate that an institution like the firm *substitutes* for markets in cases where transaction costs are too high. The firm's hierarchy, management structure, incentives and disincentives, all replace voluntary market deals between all interested parties, which would be too costly to organize on a daily, on-going basis.

Generalizing from this point, the "new institutional economics" literature states that the role of institutions (such as property, firms, money, laws, courts, lawyers, insurance, international treaties, etc.) is to lower transaction costs (Eggertsson, 1990, pp.157–244). North makes the same point when he states that the "major role of institutions in a society is to reduce uncertainty by establishing a stable (but not necessarily efficient) structure to human interaction" (North, 1990, p. 6).

While Hayek sees the market system (based on rules/institutions dealing with "several property, honesty, contract, exchange, trade, competition, gain and privacy" (Hayek, 1988, p.12) as a way of usefully coordinating available, but dispersed, information, the NIE sees the market system itself as generating the various institutions which help to reduce ignorance and uncertainty (represented by transaction costs). Rules are central to either view.

Applying this framework to the domain of international trade

a) informal, market-generated institutions

Huge volumes of international transactions are processed daily on the basis of standard contracts based on international maritime law, itself based on the English Common Law, only a minute proportion of which give rise to disputes, most of which are settled by arbitration without recourse to formal courts. The vast majority of these transactions, between people of different cultures, languages, religions etc., must take place on the basis of trust. When speed of decision-making is of the essence, the deal is sometimes struck just over the telephone, with the "paper work" following later. In currency or commodity trading, a person's word is their bond. Most transactions involve a long chain of deals, all of which must hold for the goods to reach their destination from their original point of departure. To speak of "exporting coal from Australia to the UK" implies a single transaction between a seller and a buyer. Reality is of course very different. It is not even a chain of agreements which is involved, but a network of chains: there is a financing chain, a transport chain, an insurance chain, a royalty chain – not to speak of the actual mining chain and so forth. And the whole system works across many international boundaries, day in, day out, for millions of products.

In many ways, the reality of the network of international trade is a constant affront to the nation-state (the archetypal coerced social order), a fact frequently deplored in the political science/international relations literature and often giving rise to attempts by governments to restrict the freedom of their citizens to transact with foreigners.

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When they engage in this type of activity, they naturally restrict the number of outcomes that the international economic order is capable of yielding.

Like any network, if a bit of it is damaged, destroyed or falls into disrepair, alternative routes will be found (smuggling, sanctions–busting etc.) – but at a higher cost and with harm at the margin.

Like many networks (e.g. telecommunications) the system itself is neutral; it can be used for legal or illegal transactions, moral or immoral ones. The telephone system can be used to communicate love, hate or pornography, to organize a children's party or a delivery of heroin. The international trade network is similarly just a vehicle for communication between human beings, who will use it for their various ends, not all of which one might necessarily approve. For instance, the "single European market" offers as many new opportunities to the Mafia as to Procter & Gamble. The abolition of exchange controls by all major advanced countries has not only favoured the development of legitimate trade, but has turned the international financial system into a giant washing machine for the illegal drug industry and also helps the humble tax–dodger trying to protect his savings from the deprivations of the state. The whole off–shore banking industry, as its name suggests, takes place in a legal limbo *between* nation–states.

In a word, the international trade system has to make do with a much lighter enforcement mechanism than national trade systems. The reason for this is simple: the nation state remains very protectionist with regard to coercion. It jealously guards its monopoly of legal coercion, not only from organized criminal bands within its borders (something it finds increasingly difficult to guarantee, incidentally), but also from the judicial and policing powers of other nation states. Most attempts to

extend one nation's law into the territory of another generally fail; international police co-operation (Interpol) is a "neutered body passing no information from one country to another without express permission" (Sterling, 1994, p.219); international judicial cooperation is non-existent, even within the EU (idem). An international judicial investigation on insider dealing or business fraud is virtually impossible, as the Nadir Poly Peck case for instance shows. Enforcing contracts across international boundaries is very much more costly than enforcing them within a single national jurisdiction. International traders live in a kind of contemporary Wild West, and the sheriff is far away.

Far from being discouraged by this lawless state of affairs, they seem to like it. They even shop around for attractive regulatory environments by establishing corporate existences in joke countries, despite the risks. Again, this is hardly news, since the political science literature has long decried the "challenge" of the multinational for the nation state. (What *is* becoming news, however, is the general expansion of international organized crime in this lawless environment, which is quite another, very serious matter, the exploration of which would take me beyond the self-imposed limits of this paper.)

The market generates many risk-reducing institutions on the international level: risk-evaluation agencies, quality-assessment agencies, insurance for non-performance of contracts, forward markets for hedging against price changes, especially foreign exchange fluctuations, the Paris Club (a private sovereign debt-rescheduling institution for imprudent bankers), counter-trade experts, factoring agencies, international debt-collection firms, private police-forces, anti-kindnapping services etc.. Following the transaction costs approach, we can say that the multiplication of these "institutions" reflects the high costs of transacting

across borders, but that the gains from international trade are great enough to pay for the real resources devoted to maintaining these institutions and still leave something over for the parties to the trade.

b) formal, state-based institutions

Since gains from trade are based on differences, and since differences between countries are prodigious, it follows that the gains from international trade are correspondingly high. However, as we have just seen, transaction costs are also much higher internationally than nationally. Anything which can contribute to *reducing* these international transaction costs will increase the diversity of outcomes, while of course anything which *raises* international transaction costs will run in the opposite direction.

Unlike spontaneous market-generated institutions, which all work unambiguously to reduce international transaction costs, the role of governments in this regard is totally schizophrenic.

Most governments both promote and discourage international commerce simultaneously. For instance, they will subscribe to international treaties like the GATT or WTO, establishing an institution which is supposed to create a predictable legal framework for traders, while at the same time allowing themselves a maximum of discretion should a particular foreign trader upset a particular set of important local interests (I refer, of course, to anti-dumping duties, which have become a favourite institution for *limiting* international trade). Or they will sign up for discriminatory trade agreements, which will favour some trade flows, but will necessarily reduce others. Or they will sign up for currency-stability zones (like the

European Monetary System) – all in a good cause, since currency fluctuations vastly increase international transaction costs – but then fail to pursue the necessary anti-inflation policies which inevitably underpin any currency stability commitment.

In other words, at the inter-state level, we suffer from a degree of uncertainty which must have characterized property rights in stateless societies. This is because there is no third-party enforcement mechanism for international commitments, and one cannot rely entirely on self-enforcement. In the trade field, non-performance of obligations by states is met, ultimately, by retaliation, which adds to restrictions. However, it is interesting to note that retaliation and trade war are seldom resorted to, presumably because the costs are so high. Instead, resources are devoted to diplomacy, formal dispute-settlement procedures, arbitration, publicity, ostracism, brinkmanship and the like. The new WTO provides for one interesting development in this regard: the secretariat is empowered to act as a third-party monitoring agency when it conducts periodic Trade Policy Reviews of each and every member (Curzon Price, 1993), thus increasing the flow of information on the performance (or non-performance) of obligations.

Inter-state cooperation: a curious case of stateless order

Why, given the absence of a third-party enforcement mechanism, does the formal international economic order work as well as it does? Because it meets most of the conditions for cooperative outcomes developed in game theory: the play is repeated indefinitely, the players have acquired information on their partners' past performance and know roughly whose word can be relied upon, and there is a relatively small number of serious players. But mainly, of course, the modern nation

state desperately *needs* the payoff to cooperation – the extra wealth which is generated by the large number of potential combinations of resources on offer under a global system of exchange, as compared with the limited number of potential combinations on offer under a purely local system of exchange.

This is why the modern nation state not only plays an active part in building and maintaining the formal network of international cooperation, but tolerates the constant affront to its sovereignty constituted by private traders shopping around for ways to minimize taxes and regulations. This is why representatives of the state, trawling for votes, will criticize GATT and the WTO, but will ultimately ratify major trade-enhancing treaties and on the whole act according to them.

And in the end, this is why the political representatives of modern nation states, while dearly wishing to increase taxation and regulation in order to enhance their power, are in fact severely limited in this regard, for they live in a world of competition. In order to attract and retain the increasingly mobile sources of wealth-creation, they must create or foster market-friendly institutions, at least as attractive as those generated by other nation-states. The global market has unleashed forces which are quite the equal of those of the state, and which I believe are growing in relative strength.

endnote

1 "Humans and certain other species find symmetrical patterns more attractive than asymmetrical ones" (Enquist and Arak, 1994, p.169). One interpretation of this phenomenon is that symmetrical patterns are more easily recognized than disorderly markings and therefore serve as efficient signals for communication:

It is striking that many signals used for communication by organisms are judged to be beautiful by humans. Examples include the colours and symmetries of flowers, the patterns on butterflies' wings and coral reef fish, and the elaborate courtship displays of birds... This raises the possibility that human aesthetic sense is based on general principles of perception that have been important during the evolution of biological signals (Enquist and Arak, 1994, p. 169).

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Other studies (referred to in Johnstone, 1994) show that in a number of species females have mating preferences for symmetrical males. The interpretation of this finding is that "symmetry is an indicator of good development and hence good genes" (Mark Kirkpatrick and Gil Rosenthal, 1994).

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