

## **The process of wealth creation: a revaluation of Hayek's law, legislation and liberty <sup>1</sup>**

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“Law, Legislation and Liberty“ is a landmark contribution to economics, law and the social sciences. No one interested in those disciplines could miss it. Notwithstanding, had the book been written in a more friendly fashion, it would have been much more influential. This paper attempts to bring forward a concise version of the book's most germane issues. Section I highlights the book's relevance and main findings. Section II, is a short compact. The relevance of free exchanges gives rise to legislation. Section III synthesizes the decisive contribution of knowledge in the creation of wealth. Section IV expounds private ends need not be negotiated since only human activities contribute to satisfy concrete human needs. On this basis, Section V explains laws cannot be just the will of legislators. Legal rules should strive at structuring coherent individual incentives to surmount their conflicts obtaining mutual satisfaction in their activities. Laws enforcing the particular goals of certain groups would misguide individuals and lead to disagreement and poverty. Section VI condenses Hayek model. Section VII transcribes conclusions of Vernon Smith's Nobel dissertation. His research at the laboratory is quite supportive of Hayek. Finally, there are some comments.

### I. Law, Legislation and Liberty's relevance and main findings

What is this book's relevance to Latin Americans, the underdeveloped world and for surmounting poverty? We essay a very concise summary of the book most relevant findings. Hayek message to our scholars, politicians and interested leaders could be resumed in this sentence: Latin Americans are poor since they are infected by fallacious beliefs distorting institutions and social exchanges. Confusing ideologies weigh down on productive activities. The same applies to all underdeveloped countries. This is a quite substantive conclusion since non developed countries are inhabited by 80% of world's population and yet their combined output is 10% of the planet's<sup>2</sup>. As long as these people remain blighted with distorting ideologies and institutions they will remain inescapably undeveloped and poor.

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These notes are a byproduct of my participation in the Liberty Fund meeting hosted by Universidad Francisco Marroquín, January 29 to 31, 2009, in Guatemala.

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La Riqueza de los Países y su Gente, Blasco Garma, Ed. Lumiere 2005, ps. 6-7.

Contrary to prevalent intuition, it is not lack of professional knowledge, machinery or technologies that hampers those poor humans. What they are in wanting is sufficient comprehension of how wealth is created. How rewarding it is to free individual decision making from the unnecessary hindrances brought about by wanton coercion, both from private individuals and public officers. In other words, the main cause of widespread poverty is substandard mechanisms for coordinating individual decisions. The social systems of underdeveloped countries convey less knowledge to the individual agents. Those unfortunate people are misguided, deprived of useful incentives, less able to successfully engage in productive activities.

The social systems of the developed nations, on the other hand, transmit more coherent and enabling information. In consequence, individual activities are better coordinated; property rights more valuable and people enjoy greater incomes. They are rich not for working longer hours or more intensively, but for acting more coordinately. Knowledge to synchronize the separate personal activities is the cause of wealth. Adam Smith ventured first into this inquiry in 1776.

What does Hayek's book aim at? The main tenet is legislation made civilization and progress possible. To develop his thesis, Hayek integrates economic, social and knowledge systems, in a framework described below.

Hayek makes a momentous dismissal of the neoclassical model of all-knowing agents, where information is plentiful. The model installed in economists' minds and taught in most schools. In that vision, every production factor is exactly paid the value of its individual contribution to output. For this reason, output and personal incomes are always optimum; organizations, institutions and laws, totally superfluous. Humans experience no surprises, accidents and mistakes. Most present conflicts could not exist, since there are no personal discrepancies, all share identical visions. The few personal differences that might arise come up plainly and do not disturb the general order. In any case, humans make decisions without delay and organization.

Hayek discards the neoclassical model. He introduces truly interdependent decision makers, separately possessing quite scarce and private information (each knows her own doings and needs better than any other agent), caring more for themselves than for any other person, with diverse aims, biases and viewpoints. A crucial derivation: scarcely informed individuals have got to make strategically mutually dependent decisions. Each agent's payoffs are contingent not only on her decisions but mostly on others' activities she knows only in part. By that token, each party might deliver less or hamper others' activities more than anticipated. In that environment, the outcome of every individual decision is inescapably contingent on the activities other people separately carry out and vagaries of nature. Hence, communication is decisive, calling for institutions and organizations, as there are remarkable advantages in coordinating individual activities for the advancement of their diverse personal satisfactions. Moreover, personal ends or objectives need not be known to the other parties. In fact, liberty also means individual freedom to pursue their own and private ends.

Individual and property rights are the basic coordination tools in all societies. Such rights shape individual decision making powers and the incentive framework. The latter should preferably tend to reward each agent for her contribution and make her pay for damages and inconveniences caused or exertions demanded. However, this is not always the case, notably in the underdeveloped world.

Wealth is the measure of private property rights. The major goal of the law enforcement apparatus is to free individual decision making from unwanted coercion and thereby obtaining a resource saving delineation of individual rights. This feature probably explains the book's title: Law, Legislation and Liberty.

A coordination mechanism relates individual decisions in society to their information. Changing the coordination mechanism effectively changes the game members of society play. Different social coordination mechanisms yield different games and outcomes<sup>3</sup>; hence, the decisive contribution of legislation.

Individual rights are as valuable as the law, institutions and different organizations are structured to overcome conflicts and save aggregate costs. Wherever property rights are efficiently delineated, individual decision making and efforts are valuable and people prosper. "Law and economics are ever and everywhere complementary and mutually determinative"<sup>4</sup>.

It cannot surprise the coordination of individual activities is an extremely complex, costly and decisive endeavor. In this connection there are two opposite conceptions. On one hand, the constructivist invents omniscient people - or leadership- directing all agents to their best actions. The neoclassical model suits this vision.

In opposition, the spontaneous (free) order treats every human being on equal stands, acknowledging nobody, including the leaders, have but quite limited information, a trifle of all the knowledge society enjoys. The interests of all individuals necessarily diverge. In this vision, the best humans can do collectively is patiently negotiate an evolving framework of rules - laws curtailing unnecessarily interference by other agents. Like the Ten Commandments of the Book, legislation is a major undergird to a successful coordination system under the spontaneous order conception (interdependent decision

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Myerson, Roger. Nobel Prize Lecture, Nobel Foundation.

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Berolzheimer, Fritz. The World's Legal Philosophies. Boston: Boston Book Co. 1912, p. 23.

making individuals pursuing their own separate and conflicting ends, each having quite limited abilities and information).

General and universal rules portray a scope of activities for every human being: her individual rights and properties. Like street lights and signals ease what would otherwise be chaotic vehicle traffic, laws attempt to abate undue personal interferences (costs), thereby smoothing social exchanges.

The author asserts lawyers' law structures the main coordination mechanism in all Great Societies. Such law consists of purpose independent rules, mostly the outcome of long held customs and judicial rulings focused in solving individual conflicts. For these reasons, it is intended for all individuals and all times. Hayek emphasizes that lawyers' law is totally different from the rules guiding the activities of the political state, mostly directed at public officers, at raising taxes and controlling public expenditures. Nonetheless, the political structure plays a decisive part in the coordination system, since it monitors public officers' activities carrying on the apparatus of coercion, the enforcers of legislation. Hayek deals with at these issues at length.

In Hayek's vision, it is not the Industrial Revolution and technological advances that we owe our standard of living to. It is the other way around. Legislation necessarily preceded technological advancement. In fact, law sparked civilization by progressively freeing individual activities from unnecessary interferences through an increasingly resource saving delineation of their property rights. In my view, thank to these rules, Thomas Malthus prediction did not hold<sup>5</sup> and individual wealth rose to their present dimension and will keep on improving forever.

At this stage, it is timely recalling Ronald Coase's advice to economists: do not think of factors of production as physical entities, like tons of coal or hours of work. But as of agents' rights to act in a certain fashion, to perform given activities<sup>6</sup>. Property rights come out of transactions- reciprocal agreements to surmount conflicts, regarding other individuals, assets, goods, and spaces. In this connection, it is suitable citing Francisco Varela "according to biologists, it is not the components but the pattern of connections that confers a property. Life is an emergent property of a pattern of molecules. An emergent property is the outcome of agents' interactions; without those interactions

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Enrique Blasco Garma, 2005, p. 6.

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"The Problem of Social Costs". The Journal of Law and Economics 3, October 1960.

there is no property<sup>7</sup>". Likewise, property rights define a pattern of individual incentives and interactions. How smartly the pattern is enforced determines how precious those property rights are.

At transaction time, parties exchange promises. However, Yoram Barzel has stressed<sup>8</sup>, personal expectations diverge. What is delivered or accomplished usually deviates somehow from what other parties expect. An assortment of agents might interfere in different businesses, causing superfluous costs to other people. Ascertaining and communicating the qualities and quantities of those exchanges call for complex rules of engagement - the institutional framework and different organizations, markets, firms, families, and the political state.

The most basic and all encompassing of all these rules and organizations are law and the apparatus of legal enforcement. The role of law is to restrain individual activities bringing about unwanted costs. Nevertheless, it is costly, subject to error and necessitates organization ascertaining how accurately parties deliver what was promised and to protect them from redundant hindrances.

As individual rights become ever more coherently enforced, thanks to evolving legislation, personal activities are less prone to encroachment and thereby more productive. Law improves the coordination of activities by restraining unnecessary hindrances (costs) caused by the incongruent behavior of other individuals in attaining their personal satisfaction. For instance, theft, unstable rules, or barriers to competition unduly raise costs. More suitable laws and enforcement improve productivity.

As legislation evolved, private properties became less costly delineated. Personal rewards increased since unwanted obstructions were contained, incentivizing technological progress. The wheel of fortune started to move and bless humans. By negotiating more suitable rules of engagement, persons fostered their bonds. Ever more people and exchanges were included into progressively more integrated societies. A feedback mechanism came into being. The progress of legislation exposed opportunities encouraging new techniques and communication propping up human interactions. These exchanges urged efficiently delineated and worthier individual rights. Human progress accelerated wherever legislation restrained unnecessary coercion, empowering creative employment.

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E. Blasco Garma 2005, p. 103.

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Yoram Barzel Economic Analysis of Property Rights, Cambridge University Press, 1997, p.77..

These phenomena proceeded in some societies more intensively than in others, although technological novelties are widely available to all agents, in the planet. The asymmetries in national wealth are the consequence of divergent social coordination systems. They are the upshots of failures in comprehending the mechanisms of societal progress; distorting ideologies shaping political processes and legislations. If there were any doubt, just compare the authority of justice, the extension of the rule of law and unencumbered markets, in the laggard nations and in the advanced ones. Markets and justice are set back by erratic rules, a condition of varying enforcement, depending on personal ties, specific businesses, places and dates. It is not surprising wealth and productive activities are as stalled and asymmetrically distributed as markets and the rule of law.

Why is legislation so decisive? Production is the outcome of human actions. The latter should be the subject of economics, Von Mises pointed out<sup>9</sup>. Actions, in turn, are the consequence of individual decisions, prodded by private information and incentives - individual expectations built up on the strength of the different institutional frameworks. In a widely influential paper, Hayek (1945) highlighted that diverse social and economic institutions serve the essential functions of communicating extensively dispersed information, about the desires and abilities of the different individuals. In this manner, institutions mediate, easing the coordination of the individual activities. In this paper's last section, Nobel laureate V. Smith explains the different institutional frameworks could be compared as mechanisms for communication and coordination.

Legislation frames personal incentives and decision making powers, thereby conditioning human actions and societal output. Another friend of Hayek's, Karl Lorenz, wrote in his Nobel Prize in Medicine dissertation, "this storing of knowledge, like *any* retention of information, is achieved by the formation of *structure*. Not only in the little double helix, but also in the programming of the human brain, in writing, or any other form of "memory bank", knowledge is laid down in structures. The indispensable supporting and retaining function of structure always has to be paid for by a "stiffening", in other words, by the sacrifice of certain *degrees of freedom*. The structure of our skeleton provides an example; a worm can bend its body at any point, whereas we can flex our limbs only where joints are provided; but we can stand upright and the worm cannot"<sup>10</sup>. By the same token, the incentives granted by private property rights are supported by wide panoply of individual prohibitions, of diverse coherence (more so in developed nations). It might run counter to intuition: coherent prohibitions empower

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Human Action: A Treatise on Economics Vol 1 (LF ed.) 1996, pag. 14.

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Karl Lorenz, Nobel Prize dissertation, Analogy as a source of knowledge, pg. 105. 1973.

individuals to act more confidently and reach more ambitious objectives. Such bans render more valuable individual property rights: the complex prohibition/permission matrix conveys more information power.

Hayek greatly expanded our comprehension of economics by calling to the front line individual incentives, information, abilities and institutional constraints. The nascent Mechanism Design Theory deals with these issues more formally.

In this manner, the system of unencumbered individual exchanges produces information and wealth in vast and ever increasing amounts. Again, the true object of legislation is precisely to free individuals from uncalled-for impediments, thereby, saving resources.

This book becomes a landmark contribution. It fundamentally changes the scope of economic theory, advancing many of the critical issues of modern times. Neoclassical economics was interested in the allocation of quantities of goods and factors of production, a logical derivation of its basic assumptions, noteworthy agents' common knowledge. In his comprehensive approach, Hayek deals with flesh-and-blood, scarcely informed and strategically interdependent subjects. He puts the accent on individual beliefs and incentives embodied in legislation gauging individual rights. This scheme gives economists and social scientists tools to study critical questions about legislation, beliefs and social institutions. It unfolds a theoretical framework to analyze the sway of competitive ideologies and social rules in markets, institutions, and politics. In doing that, Hayek advances a widely analytical perspective on the connection of the wealth of nations with their institutions.

H. Simon puzzled at his students reaction. "We have become accustomed to the idea that a natural system like the human body or an ecosystem regulates itself. To explain the regulation, we look for feedback loops rather than a central planning and directing body. But somehow our intuitions about self-regulation do not carry over to the artificial systems of human society. (Thus)...the...disbelief always expressed by (my) architecture students (about)...medieval cities as marvelously patterned systems that had mostly just "grown" in response to myriads of individual decisions. To my students a pattern implied a planner... The idea that a city could acquire its pattern as "naturally" as a snowflake was foreign to them"<sup>11</sup>.

II. The relevance of free exchanges underlines the purpose of legislation.

Probably the most important revelation of economics and the social sciences is the Law of Comparative Costs or Law of Association, first made explicit by David Ricardo. "The gains derived from the division of labor and personal exchanges are always mutual. All people involved, even the less productive, could derive gains from free exchange". Obviously, Ricardo's formulation was rudimentary since personal information scarcity was not yet factored in adequately. This was not the case of Hayek's who offers a more powerful expression. "Individuals, manifestly restrained by limited abilities and information, found a break through these unavoidable individual constraints. They may specialize and compete to discover who does best what, in order to profit most from their efforts. By specializing in different employments and coordinating their activities through trade free from unwanted obstructions, humans are able to develop an increasingly knowledgeable and powerful social system. Isolated, economic agents could attain only a tiny fraction of the satisfaction through exchange".

However, specialization and competition are constantly challenged by redundant interferences. The task of legislation is precisely to liberate human decision making from unneeded coercion, both from private and public agents.

Coase explained the cost of exercising a right is always the loss which is suffered elsewhere in consequence of the exercise of that right- e.g. the inability to build a house on others' property<sup>12</sup>. Hence, costs and benefits are never disconnected from the particular legislation; they are always determined in conjunction with the institutional framework.

In that connection, the more decision makers are free to choose, the more personal exchanges will allocate rights to the party valuating them most and delineate those rights in such a manner as to improve their valuation. Therefore, the loss suffered for the inability to enjoy each particular right should always be worth less (deducting transaction costs) than the benefit to the individual right holder. Otherwise, it would change hands. This feature demonstrates the relevance of free exchanges for the well being of humanity. As long as decisions are made free from redundant interference from all parties, social exchanges would allocate individual properties -including work efforts- to who can profit most and thus is able to pay more for it. Exchanging parties would also bundle and package those rights in their most valuable manner, like separating ownership into various forms of rental agreements. For instance, a car parking facility can be sold out to individual owners, rented by the month, or leased to an operator running a-by-the-hour enterprise. Through free individual exchanges, all humans benefit most from their exertions. It entails all agents are compensated for any undue damage. However, freedom and information are necessarily limited: there are many unwarranted costs, especially in undeveloped societies.



What is legislation's purpose? Legislation attempts at abating unwanted coercion, by ascertaining the shared description and enforcement of individual rights for all parties, a non-contested scope of action for every person in society. Such rights evolved to reduce unnecessary intrusions by other people pursuing their own assorted goals. By liberating personal activities from unwanted hindrance, legislation saves costs; thereby raising the productivity of personal efforts. In this light, the competitive advantage of the leading nations is their ideology and acceptance of an efficient social system, embodied into their legislation and enforcement mechanisms.

### III. Theory of human knowledge

A cornerstone in this book is a theory of human knowledge and abilities and how to use them for the benefit of each person. "The economic problem of society is the utilization of knowledge not given to anyone in its totality", (Hayek 1945, p. 520). Individual knowledge is built up through specialization, steered by competition and trade under the protection of legislation. Over these pillars, people network into different social systems functioning like supercomputers, connecting billions of agents with the most diverse desires, abilities and knowledge. In the same manner as the output of the supercomputer depends on its software; the productivity of the various social systems depends on their ideologies, legislation and enforcement. Cultures operating with confusing ideologies and legislation will yield less valuable individual rights, outputs and incomes, since they have to put up with more obstruction. Therefore, they will be poorer, as is Latin America. Societies with sharper enforcement frameworks benefit from less interference in their personal decisions; thereby they achieve superior wealth, like USA, Western Europe, Japan, and Canada.

Knowledge applied to conflict resolution through law enforcement abates redundant obstructions and renders higher incomes. Wealth, knowledge and law are a three pronged phenomenon.

David Hume uncovered the three fundamental laws of societies: the stability of possession, its transfer by consent; and the performance of promises (Hume 1740, p. 578). In short, societal institutions, like markets, evolve on the strength of individual rights that should encourage: "by the conjunction of forces, our power is augmented. By the partition of employments our ability increases. And by mutual succor, we are less exposed to fortune and accident" (Hume 1740, 537). Hayek goes further. He explains legislation advances in the same manner as any other discipline or science: finding out and testing ever more general rules. "Our whole conception of justice rests on the belief that different views about particulars are capable of being settled by the discovery of rules that, once stated, command general assent. If it were not for the fact that we often discover that we agree on general principles applicable, even though we at first disagree on the merits of the particular case, the very idea of justice would lose its meaning. The first formulation of what has already guided the sense of justice, expressing what men

have long felt, is as much a discovery as any scientific one". The statement suits any science. Legislation is a scientific endeavor.

#### IV. Means, ends and liberty.

The great breakthrough of human kind is the rich mechanism of impersonal exchanges, conducted mostly in markets and firms. Societies advance as they come to realize unobstructed individual decision making leads to personal progress.

It is cardinal to distinguish means from ends. The latter are private –since they do not impinge on others' happiness – and endless. Each agent can aim at as many objectives as she might like. Conversely, means (resources) are exclusively human actions, in regard to goods (consuming a quarter of milk or as input in production), spaces (occupying a piece of land) and people (work). Resources are scarce: have alternative uses. Living in a community involves bargaining over the individual employment of such resources.

Liberty brings about gigantic improvements across the entire society. Unfettered personal ends are another condition of undisturbed decision making. Therefore, private ends cannot be curtailed by others' wishes, no matter what their social standing. As interferences are being eliminated, more favorable coordination procedures and individual satisfaction come up. Problem is the outcome might not please many. People reportedly with "less merits" might get ahead of others. Hayek explains this is the price to pass from the tribal or familiar association to the Great Society.

Each agent endeavors into discovering better procedures to coordinate their decisions. Each agent strives to improve her abilities to satisfy her needs indirectly, through competition and trade. Supplying means other people need on the confidence they would reciprocate competing at producing best for her. To that end, personal desires need not be negotiated since they do not incline the satisfaction of other parties. Agents should solely transact over personal activities contributing to or disturbing with their satisfaction. Particular ends – like allegedly "national policies"- usually enter in the delineation of properties only as an alibi for interfering with individual decision making.

Accordingly, societal output and personal satisfaction would be sacrificed if "national" ends or biased standards were enforced. Usually, competition and personal decision making are interfered with in order to impose a hierarchy of "political" ends. Liberty implies particular ends are not enforced, since they are private and endless.

The market order judges solely concrete acts. Each economic agent should be able to focus intensively in achieving her own personal ends. Her decision making does not need to be restricted by other people's subjective opinions or desires. Societies built on trust each one will carry out as expected integrate vastly more numerous and productive activities than those demanding acceptance of subjective standards, including a particular scale of societal ends.

## V. Laws and legislation cannot be just the will of particular legislatures or judges.

The more all-embracing and general the law, the more people and personal abilities included, the more neatly delineated incentives, the more knowledgeable and productive the society. Freedom from interferences increases the opportunities to find profitable endeavors through trade, competition and specialization. Discrimination - enforcing biased rules, following agents' identity, particular activities, situations or dates- obstructs competition, raises costs and devalues personal properties, efforts and knowledge. Discrimination thwarts free decision making and the allocation of individual properties to the potential highest bidder. Thereby, discrimination entails rejecting the most productive uses of personal abilities, holding down societal output and individual satisfaction. By the same token, changes of rules, either over time or along different personal identities or situations, result in instability of properties, non voluntary transfers of rights, and loss of wealth. Of course, agents able to twist particular rules profit from their power.

These considerations highlight legislation should not reflect the whim of congressmen or judges, or political negotiations. Similar to any scientific discipline, laws have only one purpose: liberating humans from unwanted interferences by their fellow humans, including legislators. Consistent laws save costs to society. Thus, legislation has a clear purpose and ought to have a coherent structure. The skeleton required to the task of effectively liberating humans from redundant interferences, which would be piecemeal uncovered in an evolving trial and error process. As Hayek repeatedly points out, laws ought to have the most general form intended to apply for ever, to all humans and situations, without the biases dictated on expediency grounds. Ironically, the same goal as the French Revolutionaries proclaimed: "only one and the same law and measure for all men and for all times".

Laws are messages. Claude Shannon<sup>13</sup> uncovers features to improve their informational value. The stability, simplicity, generality and coherence of legislation brings in more certainty at decision making.

Hayek endeavors to discover the main conditions legislation ought to comply with. In this connection, Von Mises alerted before: "In the course of social events there prevails a regularity of phenomena to which man must adjust his actions if he wishes to succeed. It is futile to approach social facts with the attitude of a censor who approves or disapproves from the point of view of quite arbitrary standards and subjective judgments of value. One must study the laws of human action and social cooperation as the physicist studies the laws of nature. Human action and social cooperation seen as the object of a science of given relations, no longer as a normative discipline of things that ought to be—this was a revolution of tremendous consequences for knowledge and

philosophy as well as for social action". Hayek transpires the same understanding. This view explains his condemnation of "social justice" as the imposition of certain societal outcomes, following the changing opinion of particular leaders. Social justice attempts to achieve particular ends - personal remunerations to fit the views of prevailing groups, for instance a certain income distribution. It entails interfering with free decision making; thereby reducing wealth and social output.

#### VI. Hayek's implicit model.

The following synthetically describes the implicit model in Law, Legislation and Liberty and some derivations.

1. Neoclassical theory deals with all-knowing individuals. Any agent's actions are entirely observable by all the rest. The common information assumption makes activity coordination automatic. Personal visions are utterly concurrent; conflicts nonexistent. Incomes are always maximized. Errors or misunderstandings are absent. Each agent's remuneration coincides exactly with her contribution to output. Interest can only diverge across broad sectors, for instance workers might have different preferences than land-owners. In this environment, the economic problem is how to allocate best quantities of physical factors of production, goods and services, a quite simple enterprise. Law, legislation and liberty are not relevant matters.
2. Hayek makes a momentous upgrading. He introduces information scarce individuals in substitution for the all-knowing neoclassical agent. From now on, individual knowledge is scarce and vastly diverse (Hayek 1945). Each person knows, observes, have abilities and interests others don't. Human minds and capacities are irreversibly bounded and only partially rational. People give differently nuanced meaning to signals, words, actions, contracts and rules. Thereby, they may dispute, have accidents and misunderstand each other. They have twisted and diverse accesses to reality and ways for accomplishing personal desires. H. Simon, O. Williamson, Kahneman and others have dwelt extensively upon these features.
3. A second central feature is the presence of strategic interdependence. In traditional neoclassical theory, the decision maker faces situations in which her well-being depends only on her own decisions, as she has complete information of what other parties are doing and their consequences.

In contrast, scarcely informed individuals have got to make strategically mutually dependent decisions. Each agent's payoffs are contingent not only on her decisions but mostly on others' activities she knows only in part. Her best actions depend on the unknown decisions other individuals are making, have made, or might make in the future. These features are the gist of non-cooperative game theory - interactions where agreements are not necessarily binding since personal satisfactions are partly disconnected. To enforce transactions, easing

costs and uncertainty, different institutions and organizations emerge. Legislation and the apparatus of the state answer mainly the need to channel the use of force.

4. People usually deviate somewhat from expected behavior as stated in rules, customs, laws, contracts, in different intensity. Agents may deliver less or act differently than expected. Furthermore, personal expectations normally diverge, thereby adding chances for dispute. People usually supply their most favorable information and keep the more adverse to themselves. Hence, humans are asymmetrically informed, subject to adversely selected data and morally hazardous (opportunistic). A dramatically more comprehensive decision making, social exchanges and economic problems unveil, opening up a much richer explanation of real world phenomena.
5. Multi person economic situations vary greatly in the degree and randomness to which strategic interaction is present. In the large societies of modern times, most of the individual payoffs are the outcome of strategic interactions. The same person would obtain vastly different incomes in the advanced nations than in the backward ones. The same job might pay widely differently in large firms than in small ones. In general, the same decisions would deliver widely diverse rewards depending on other players' interactions, conditioned by the relevant environments.
6. In this manner, individual actions impinge on and alter the decision maps of other persons. Therefore, there is a decisive advantage in inducing more agreeable human actions; better coordinated joint activities, focused in the satisfaction of the disparate individual ends involved.
7. As John Commons and, more recently, Oliver Williamson pointed out, individual decision making involves personal transactions overcoming conflicts through the negotiation of mutually advantageous individual activities and, thereby, building an order of coherent expectations. Transactions are reciprocal recognition of individual rights of action. Whereby, conflicts are overcome settling on particular activities to reduce joint costs and improve rewards. Thus, transactions create value. Rights, properties and rules are the outcome of different transactions. Institutions evolve to facilitate, delineate, protect, communicate and extend the reach of transactions across individuals, time and space. A coherent order (legislation and institutions) evolves to make transactions more valuable. Individual rights are the outcome of extensive transactions; hence, necessarily limited by the rights granted other parties.
8. Redundant obstruction weighs down the scope of productive activities and incomes.
9. Decision making is enhanced by an order of coherent personal expectations, supported on institutions. The later delineate working expectations for a catallaxy

of separate individual ends. Since only particular persons participate in each single transaction, although many others might bear its consequences, common rules and institutions evolve to protect the rights of the absent at each transaction and disseminate the advantages of agreements reached. In such fashion, a transaction is more valuable the more other parties abide by it. Therefore, the value of the productivity of human efforts – i.e. income and wealth – depends on the efficiency of the institutional framework coordinating those transactions. Actions take place at various dates, by different persons at different locations. Hence, communicating and protecting transactions over time, space and people, enhances wealth.

10. Wealth is the outcome of coordinating the activities of billions of people towards the fulfillment of their separate desires. Greater wealth entails better coordinated and knowledgeable efforts, over time, space and people. Institutions evolve to improve coordination; law should do likewise.
11. Laws save more resources when stable over time and other circumstances. Any change in the laws automatically redistributes properties. When wealth is reallocated by statute or force (the action of political bodies, government officials, or private robbers), it goes from more pleased about users to less appreciating ones. Otherwise, the transaction could have been voluntarily. Conclusion: every non voluntary exchange presumably diminishes combined wealth.
12. Personal interests differ. The goals of the leaders of a community cannot entirely coincide with other individuals' or the majority of agents. Thus, laws just attempting to satisfy the leaders obtain less coordinated activities and aggregate individual wealth. Private ends should not incline legislation.
13. Individuals act according to their abilities, beliefs and rights recognized by exchanging parties. Since each person has different endowments of those, each has diverse activity potentials and encounters varying conflicts and costs. Each agent necessarily has particular relative advantages and many disadvantages, over several jobs. Competition is a coordinating device, whereby each person finds her best livelihood.
14. Only means and knowledge are scarce. But personal ends are unlimited, quite diverse and do not intrude on others' wellbeing. Therefore, particular ends cannot be negotiated or ordered in a hierarchy common to all people and should not have a saying in legal rights delineation. The existence of a multiplicity of independent decision makers implies a multiplicity of independent ends. Particular desires should not be taken into account in the delineation of laws and individual rights. The objective of law is unobstructed human capabilities (the value of agents' actions); not to satisfy the ends of particular persons. To subject legislation to particular desires would weaken social output. Since personal ends differ and change over time, the stability of individual properties would be jeopardized if legislation would aim at satisfying particular desires.

15. Means are exclusively individual actions, in relation to other people, spaces and materials. Human actions should be the main interest of economic theory
16. Rights are generally delineated by permitting everything but what is specifically prohibited. The main exception is taxes, which are mandatory. Individual rights are complex sets of permissions and prohibitions. Exclusions are required to delineate individual rights (fences make good neighbors) since “all information storing is achieved by the formation of structure, by the sacrifice of some degrees of freedom”<sup>14</sup>. Legal rights are what the state enforces. Besides, there are many non legal rights enforced by families, corporations and different associations; not by the state.
17. Rights are not necessarily what is proclaimed to be lawful, but what is actually enforced in real life. Where rights are not abided by, costs are not paid by the acting party nor do benefits accrue to the producer. Hence, personal rewards and contribution tend to part; decisions get more confused; society is poorer.
18. Uncertainty is lack of knowledge. Rules, standards and signals are set to make people more knowledgeable in their interactions, improving their coordination by sharing data. There is redundant uncertainty where rights are trespassed or forcibly changed, as individual actions would be less predictable. Undeveloped societies pay higher interest rates than advanced ones and are less productive since activities are less coordinated. Upheld rights imply more knowledgeable individuals; they can trust each other more and need to spend less in the protection of their properties.
19. The fundamental importance of legislation becomes apparent. It supplies the basic individual decision making support towards satisfaction of their disparate desires. Legislation should be the upshot of comprehensive individual transactions and not of design, since individual law makers cannot have more than a quite limited and somehow distorted knowledge of reality, of what separate persons might desire and are able to perform. Legislation should aim at lowering avoidable costs.
20. The more stable the rules, the more knowledgeable the transacting parties are. Rules should change only in regard to the long run and future actions, and not depending on the particulars of transactions or exchanging parties. Expediency increases uncertainty; normally it is a shortcut for expropriation. Discriminating, biased and varying rules necessitate more description content, entailing more uncertainty and less competition. Discrimination, variation, and instability of rules hold back human capacities and wealth.

21. Institutions, rules and rights naturally aim at expanding the scope of productive activities, delineating a precious space (properties) for each individual to act in society. Laws and institutions entice personal engagement in mutually satisfying interactions.
22. When intrusion is endured, costs and uncertainty rise; rights worth less. Widespread poverty is the upshot of interference, downgrading activity coordination. The science of legislation, like any discipline, should endeavor in the piecemeal discovery of the most productive rules to free people from unnecessary hindrances.
23. Freedom from unnecessary intrusion is the aim of law. Interference is contrary to liberty; it is the corruption of undue obstruction. By the same token, getting something costly for free entails someone else is paying the costs, a victim of redundant coercion. Negative liberties are intended to foster freedom from unwanted hindrances.
24. Finally, the aim of rules and legislation is to enhance productive individual decision making. Notwithstanding, it is quite taxing and complex to evaluate different legislations or separate pieces of it. Comparing the results of different institutional frameworks might give some measurement of what legal structures are more suitable.

## VII. Findings at the laboratory

In his Nobel Prize Lecture, Vernon Smith concluded research at the laboratory is quite supportive of Hayek's, underscoring the validity of Law, Legislation and Liberty. Here are Smith's most relevant comments in this connection:

"Cartesian constructivism applies reason to the design of rules for individual action, to the design of institutions that yield socially optimal outcomes, and constitutes the standard socioeconomic science model. But most of our operating knowledge and ability to decide and perform is non-deliberative. Our brains conserve attentional, conceptual and symbolic thought resources because they are scarce, and proceed to delegate most decision-making to autonomic processes (including the emotions) that do not require conscious attention. Emergent arrangements, even if initially constructivist must have survival properties that incorporate opportunity costs and environmental challenges invisible to constructivist modeling. This leads to an alternative, ecological concept, of rationality: an emergent order based on trial-and-error cultural and biological evolutionary processes. It yields home- and socially grown rules of action, traditions and moral principles that underlie property rights in impersonal exchange, and social cohesion in personal exchange. To study ecological rationality we use rational reconstruction—for example, reciprocity or other regarding preferences—to examine individual behavior, emergent order in human culture and institutions, and their



persistence, diversity and development over time. Experiments enable us to test propositions derived from these rational reconstructions.

The study of both kinds of rationality has been prominent in the work of experimental economists. This is made plain in the many direct tests of the observable implications of propositions derived from economic and game theory. It is also evident in the great variety of experiments that have reached far beyond the theory to ask why the tests have succeeded, failed, or performed better (under weaker conditions) than was expected. What have we learned, not as final truth, but as compelling working hypotheses for continuing examination?

1. Markets constitute an engine of productivity by supporting resource specialization through trade and creating a diverse wealth of goods and services.
2. Markets are rule-governed institutions providing algorithms that select, process and order the exploratory messages of agents who are better informed as to their personal circumstances than that of others. As precautionary probes by agents yield to contracts, each becomes more certain of what must be given in order to receive. Out of this interaction between minds through the intermediary of rules the process aggregates the dispersed asymmetric information, converging more-or-less rapidly to competitive equilibria if they exist. Each experimental market carries its own unique mark with a different dynamic path.
3. All this information is captured in the supply and demand environment and must be aggregated to yield efficient clearing prices. We can never fully understand how this process works in the world because the required information is not given, or available, to any one mind. Thus, for many the arguments of the Scottish philosophers and of Hayek are obscure and mystical. But we can design experiments in which the information is not given to any participant, then compare market outcomes with efficient competitive outcomes and gauge a market institution's performance.
4. The resulting order is invisible to the participants, unlike the visible gains they reap. Agents discover what they need to know to achieve outcomes optimal against the constraining limits imposed by others.
5. Rules emerge as a spontaneous order—they are found—not deliberately designed by one calculating mind. Initially constructivist institutions undergo evolutionary change adapting beyond the circumstances that gave them birth. What emerges is a form of "social mind" that solves complex organization problems without conscious cognition. This "social mind" is born of the interaction among all individuals through the rules of institutions that have to date survived cultural selection processes.
6. This process accommodates trade-offs between the cost of transacting, attending and monitoring, and the efficiency of the allocations so that the institution itself generates an order of economy that fits the problem it evolved to solve. Hence, the hundreds of variations on the fine structure of institutions each designed without a designer to accommodate disparate conditions, but all of them subservient to the reality of dispersed agent information.
7. We understand little about how rule systems for social interaction and markets emerge, but it is possible in the laboratory to do variations on the rules, and thus to study that which is not.

8. Markets require enforcement—voluntary or involuntary—of the rules of exchange. These are: the right possession, its transference by consent, and the performance of promises (Hume). If enforcement conditions are not present, the result is unintended consequences for the bad, as markets are compromised or may fail. The game of ‘trade’ must not yield to the game of ‘steal.’
9. Reciprocity, trust and trustworthiness are important in personal exchange where formal markets are not worth their cost, yet there are gains from exchange to be captured. They are also important in contracting as not every margin of gain at the expense of other can be anticipated and formalized in written contracts.
10. People are not required to be selfish; rather the point of the Scottish philosophers was that people did not have to be good to produce good. Markets economize on information, understanding, rationality, numbers of agents, and virtue.
11. Markets in no way need destroy the foundation upon which they probably emerged – social exchange between family, friends and associates. This is supported in the studies reported by Heinrich (2000)<sup>15</sup>. Thus, individuals can be habitual social exchangers and vigorous traders as well, but as in Hayek’s ‘two worlds’ text, the ecologically rational co-existence of personal and impersonal exchange is not a self-aware Cartesian construct<sup>16</sup>. Consequently, there is the ever-present danger that the rules of ‘personal exchange’ will be applied inappropriately to govern or modify the extended order of markets. Equally dangerous, the rules of impersonal market exchange may be applied inappropriately to our cohesive social networks”.

#### Conclusions:

This work opens up a scientific breakthrough. Hayek definitely discards the neoclassical model. He introduces scarcely and asymmetrically informed individuals, making strategically interdependent decisions. Specialization propels more knowledge; trade and competition coordinate agent activities under the guidance of the institutional framework. Legislation is a scientific discipline aiming at liberating human actions from undue obstacles, thereby lowering societal costs and raising personal incomes and property rights. Particular wishes or group ends should not delineate laws.

This book offers a more comprehensive vision of social exchanges and institutions. It delivers accurate tools to face most economic, legal and social problems of modern times. It highlights the role of personal information, incentives, law in the social sciences.

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Heinrich, J. (2002), “Does Culture Matter in Economic Behavior?,” *American Economic Review*, September 2000, pp. 973–979.

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Hayek, F. (1988), *The Fatal Conceit*. Chicago: University of Chicago Press, p.

18.

It is extremely relevant to understand the causes of, and correct, widespread poverty and underdevelopment of nations.