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Markets and the law

A "market" is a forum of exchange, a place where trade is carried out. In a narrow sense the term refers to a physically defined locality where buyers and sellers meet, like a neighborhood farmers' market or a local fair. In its more abstract meaning it refers to any kind of exchange network, in the general sense of a social arrangement in which participants are inter-connected through actual and potential exchange transactions. Depending on what criterion is used to define the relevant set of actual or potential trading parties, various kinds of special markets can be distinguished for analytical purposes, even if one acknowledges that in reality such markets cannot be strictly isolated from the more inclusive exchange environment. Financial markets, the US used car market, the world crude oil market, or the market for Van Gogh paintings are examples from an indefinitely long list of special markets that might be defined.

1. Markets as social arrangements

As social arrangements markets are constituted by bilateral, actual and potential, exchange transactions. By contrast to theft or coercive taking, exchange is a peaceful method of obtaining things that one desires. It is based on mutual agreement between the trading parties. Given the noted alternative methods of personal enrichment, people can be expected to engage in exchange when and where the alternatives appear less attractive. This is normally the case where people meet within a normative-legal-institutional framework that defines and enforces property rights. Though, to be sure, even in the absence of a shared normative order people may have prudential reasons for pursuing their interests through exchange rather than violent methods. As Max Weber (1978: 640) observed, even someone who, like the seafarer of Antiquity and the Middle ages, prefers to take without pay whatever he can, may choose to resort to peaceful exchange where he is "confronted with a power equal to his own" or where he regards it "as shrewd to do so for the sake of future exchange opportunities which might be endangered otherwise." In fact, the interest in exploiting potential gains from trade outside of one's own inherited community can be seen as a principal driving force in the evolution of a normative-legal order that extends beyond traditional community limits. As Weber (ibid.: 637) put it: "The market is a relationship which transcends the boundaries of neighborhood, kinship group, or tribe. Originally, it is indeed the only peaceful relationship of such kind."

To say that markets are constituted by *potential* as well as actual exchange transactions points to the role of *competition* as the essential market force, a role that Weber (ibid.: 635) underlines when he defines: "A market may be said to exist wherever there is competition, even if only unilateral, for opportunities of exchange among a plurality of potential parties." Competition means that sellers can choose among potential alternative buyers, and that buyers can choose among potential alternative sellers. The terms at which exchanges are actually carried out in a market cannot be adequately understood without considering the potential alternative transactions that the respective parties might have chosen, but did not. As, again, Weber (ibid.: 636) puts it, a market transaction "is always a *social act* insofar as the potential partners are guided in their offers by the potential action of an indeterminately large group of real or imaginary competitors rather than by their own actions alone."

"*Competition for opportunities of exchange*" (Weber) is constitutive of markets. It is also the source of a fundamental ambiguity in people's attitudes towards markets. While one's own interests are furthered by competition on the other side of the transaction, competition on one's own side is often perceived as a nuisance. As seller one welcomes any increase in the pool of potential buyers, and as buyer one welcomes an increase in the plurality of potential sellers, because this can only improve the terms of trade. Conversely, competition on one's own side of the transaction, be it as buyer or as seller, is much less welcome as it tends to limit the gains that one can hope to realize in the exchange. Despite the benefits that an open market with free entry of potential buyers and sellers has to offer to all parties, there are obvious benefits to be had from the privilege of being in one's own role protected from competition. Interests in securing the benefits of protectionist privileges, on the one side, and interests in realizing the gains that can be had from "exchange with the highest bidder" (Weber ibid.: 638), on the other side, are two opposing forces that shape a political community's legal-institutional framework and determine the extent to which it facilitates or inhibits trade within and across its boundaries. Medieval feudal and guild restrictions heavily favored the former, modern market economies are the product of the growing weight of the latter interests.

Markets are a paradigm example of a self-generating or *spontaneous* social order (Hayek 1973: 37), i.e. of social arrangements in which the activities of participants are coordinated in a spontaneous manner, through mutual adjustment or adaptation of separate decision-makers, without any deliberate, central direction. In this sense the order of the market can be contrasted, "as a specific type of social structure" (Swedberg 1994: 255), to the deliberate, centralized coordination of activities that occurs within *corporate entities* or *organizations*, i.e. within social units such as the "family, the farm, the plant, the firm, the corporation and the various associations, and all the public institutions including governments" (Hayek 1973: 46). It is one of the central themes in the works of F.A. Hayek that the distinction between "the two kinds of order" (ibid.), *market* and *organization* (Vanberg 1982), is of fundamental importance for an adequate understanding of the nature of societal phenomena in general and of the order of the market in particular. The failure to appreciate adequately the nature of the market as a spontaneous social order is, in Hayek's view, a major source of confusion in discussions on economic theory and, in particular, economic policy, a confusion that he attributes in part to the ambiguity that is implied when the term "economy" is used to describe the order of the market. As the term is derived from the Greek word "oikonomia," which means *household-economy*, an "economy, in the strict sense of the word, is an organization or arrangement in which someone deliberately allocates resources to a unitary order of ends" (Hayek 1978: 178). In order to avoid any misleading connotations Hayek suggests to speak of the order of the market not as an economy but as a *catallaxy* – derived from the Greek word "katallatein," which means "to exchange" (Hayek 1976: 108).

According to Hayek (1976: 115), the operation of the market system and the way it coordinates the actions of market-participants can be understood best by thinking of it as a game, "the game of catallaxy." The game metaphor is meant to emphasize two essential attributes of the competitive market process. First, it "proceeds, like all games, according to rules guiding the actions of individual participants" (ibid.: 71). And, second, as with all genuine games, the particular outcomes of the "game of catallaxy" cannot be predetermined but must always remain to a large extent unpredictable, due to the multitude of contributing factors and to the inventiveness of the participants who are free to choose their strategies within the limits defined by the general rules of the game. Indeed, that particular market outcomes cannot be predetermined is but a consequence of the fact that the "rules of the game" are the essential device by which the moves of players in the "game of catallaxy" are coordinated. These rules are typically negative rules that exclude as impermissible certain kinds of strategies, but leave significant scope for choice. By contrast, the essential coordinating device within organizations or corporate arrangements are positive *commands* rather than (negative) general rules of conduct, commands either in the form of specific orders or in the form of generalized commands as they are implied in "organizational rules" that define the tasks to be performed by persons in particular organizational positions.

By speaking of the market as a "game of competition" that is played according to certain rules, Hayek underscores the inherent connection between *markets* and the *law*. Since the coordination of actions within markets is based on certain general rules of conduct that impose constraints on the behavior of market participants, it follows that only where suitable rules are in force a market order can be expected to emerge at all, and that the particular nature of the legal-institutional framework within which markets operate will determine their overall working properties. As Hayek (1960: 229) puts it:

> "If there is to be an efficient adjustment of the different activities in the market, certain minimum requirements must be met; the more important of these are ... the prevention of violence and fraud, the protection of property and the enforcement of contracts, and the recognition of equal rights of all individuals to produce in whatever quantities and sell at whatever prices they choose. Even when these basic conditions have been satisfied, the efficiency of the system will still depend on the particular content of the rules."

If, as Hayek points out, the order of the market is based on rules, one should expect the "relation between the character of the legal order and the functioning of the market system" (ibid.) to be a central theme of the social science that concerns itself with the study of markets, economics.

2. Economics as the science of markets

The study of markets as exchange arrangements has traditionally been considered the domain of economics (Weber 1978: 635). Indeed, it has even been suggested to speak of economics as *catallactics*, in order to underscore the discipline's principal concern with the market as a spontaneous exchange-order or catallaxy (Hayek 1976: 108; Mises 1949: 233ff.; Buchanan 1979: 19, 27). In light of their universally acknowledged prominence as the discipline's principal subject it is more than surprising how little attention has been paid in mainstream economics to an explicit discussion of markets as social arrangements and, in particular, to the issue of how their working properties are affected by the legal-institutional framework within which they operate.

The "peculiar fact that the literature on economics ... contains so little discussion of the central institution that underlies neo-classical economics – the market" (North 1977: 719) has repeatedly been noted (see e.g. Hayek 1960: 229; Brennan and Buchanan 1985: 13; Coase 1994: 6; Swedberg 1994: 257). In standard economics textbooks, markets are typically defined in terms of the institutionally disembodied mechanics of demand and supply, i.e. "the forces created by buyers and sellers that establish the prices and quantities exchanged of resources, goods and services," while, as Coase (1988: 7) notes, "discussion of the market itself has entirely disappeared." In mainstream economic theory, Coase (1988: 5) summarizes, the market is, for the most part, assumed to exist and is not itself the subject of investigation, with the result "that the crucial role of the law in determining the activities carried out ... in the market has been largely ignored."

The neglect of the institutional dimension of markets in mainstream economics can be directly traced back to the research program that Leon Walras defined in his "Éléments D'Économie Politique Pure" [1874] for the "science of pure economics," a program that gave rise to the modern neoclassical orthodoxy and its theoretical pinnacle, the Arrow-Debreu general equilibrium model. Strongly influenced by the theoretical physics of his time, Walras' ambition was to develop "the pure theory of economics or the theory of exchange and value in exchange ... (as) a physico-mathematical science like mechanics or hydrodynamics" (Walras 1954: 71), sciences that, as he saw it, "abstract ideal-type concepts ... and ... construct *a priori* the whole framework of their theorems and proofs" (ibid.). The task he defined for the science of economics was to follow "this same procedure," namely to form an ideal-type concept of the market, with "ideal prices which stand in an exact relation to an ideal demand and supply" (ibid.). Pure economics, thus conceived, is concerned with "how prices result from under a hypothetical régime of absolutely free competition" (ibid.: 256), i.e. a régime with no obstacles to the realization of potential gains from trade and to the attainment of "the maximum of utility" (ibid.). Pure economics need not be concerned with whether or not the hypothesized "absolutely free competition" can be observed "in the real world" (ibid.: 255). It supposes "that the market is perfectly competitive, just as in pure mechanics we suppose, to start with, that machines are perfectly frictionless" (ibid.: 84).

From the domain of "pure economics" which studies "the nature, causes and consequences of free competition" (ibid.: 255), Walras explicitly excluded phenomena that are "to be classified under the heading of institutions" (ibid.: 63), in particular phenomena concerned with the "problem of property" or "the mode of appropriation" of scarce things (ibid.: 77). In his account, pure economics bears "clearly the mark of a natural science" (ibid.: 56). Its subject, value in exchange, "partakes of the character of a *natural* phenomenon" (ibid.: 70), because it results "naturally under given conditions of supply and demand" (ibid.: 69). By contrast, the "theory of property" or the "theory of institutions" is, in Walras' scheme of things, assigned to the domain of "moral science or ethics" (ibid.: 63, 79), because its subject, the mode of appropriation, is "not a natural phenomenon" (ibid.: 76) but "depends on human decisions" (ibid.: 77). It is a "phenomenon which is fundamentally social and which gives rise to questions of justice or of the mutual co-ordination of human destinies" (ibid.: 77).

In Walras' research program, pure economics was not meant to be *all* of economics. While the study of institutions and the rules of property was seen to be outside of the domain of "economics as an exact science" (ibid.: 47), it was considered to be part of economics as a more broadly conceived enterprise. As Walras put it: "Appropriation being in essence a moral phenomenon, the theory of property must be in essence a moral science ... or, as we shall designate it, *social economics*" (ibid.: 79). Yet, the part that his "social economics" would have had to play in a more broadly conceived economics was never developed in what has come to be known as the Walrasian tradition in economics. The neoclassical mainstream tradition remained occupied with advancing and formalizing in ever more refined ways Walras' program for "a scientific theory of the determination of prices" (ibid.: 40), and left unattended the institutional issues that Walras had assigned to "social economics."

3. Institutional economics: old and new

Pioneering as Walras' enterprise of formalizing economic theory along the model of a physico-mathematical science was, it was by no means an entirely unprecedented project. It was very much in line with an established trend among mainstream economists of developing ever more abstract models of the price system, a trend the early beginnings of which are marked by the change in emphasis from the work of Adam Smith with its attention to institutional issues to the writings of David Ricardo from which such attention had largely disappeared (Demsetz 1982: 6). Post-Walrasian neoclassical economics must therefore be seen as merely continuing a theoretical course that had already been embarked on before, a course that made it treat markets in a manner about which Demsetz (ibid.: 6f.) notes: "Markets became empirically empty conceptualizations of the forums in which exchange costlessly took place. The legal system and the government were relegated to the distant background by the simple device of stating, without clarification, that resources where 'privately owned'."

It was in opposition to such narrow focus on "the market as an abstract price-making mechanism" (Swedberg 1994: 255) that unorthodox approaches such as, in particular, the German Historical School and the American institutionalist tradition insisted on the necessity of paying attention to the details of the legal-institutional framework within which market activities are carried out, if one is to arrive at an adequate understanding of real world economic processes.

In his "Grundriss der Allgemeinen Volkswirtschaftslehre" (1904) Gustav Schmoller, head of the "younger" Historical School, commences an extended discussion on the concept of the 'market' by stressing that in any community of peacefully trading people economic transactions take place under the umbrella of customary, legal and moral rules, and that knowledge of the historical development of such legal-institutional provisions is prerequisite for an understanding of the development of trade and commerce (ibid.: 15). There never existed, he maintains, anything like "absolutely free competition," but economic activities were always embedded in a "system of norms, of constraints, guidelines, laws and prohibitions, that regulated the stream of economic life, by ruling that certain kinds of agreements are illegal or not binding, that some contracts are not enforceable while others are void or contestable" (ibid.: 16). After such introductory reminder, Schmoller provides a detailed historical account of the evolution of market institutions, from their primitive origins in inter-tribal arrangements for peaceful exchange to their modern incarnations (ibid.: 17ff.).

Among the American institutionalists, John R. Commons is known for his painstaking effort to portray, in great detail, the legal-institutional framework that conditions the operation of markets as social arrangements (Vanberg 1997). In his "Legal Foundations of Capitalism" (1957 [1924]) he traced the gradual process of legal evolution from which the kind of socio-economic order emerged upon which the analysis of economics as the study of markets concentrates. His central message was that the system of market competition, that is at the core of economic theory, is not a "natural phenomenon" but, rather, a societal enterprise in the sense that it presupposes a legal framework which is a product of civilization, not a "provision of nature." As he reasoned, the "simple system of natural liberty" that Adam Smith spoke about, and that his formula of the "invisible hand" was meant to describe, consisted of "nothing other than the working rules of an orderly society" (Commons 1957: 137), an institutional framework that was by no means a present of nature but "the fine fruit of evolving centuries of working rules" (ibid.: 138).

The "old" institutionalist critique did little to change the analytical focus of mainstream economics, partly because it not only challenged the institution-blindness of economic orthodoxy but also seemed to depart from "hard core" elements of the economic tradition, in particular its methodological individualism; partly because, faced with the "infinite variety of market phenomena" (Schmoller 1904: 112), the institutionalists' concern with historical detail tended to result in descriptive studies with little theoretical focus. A more serious challenge to the self-sufficient Walrasian tradition of pure economics has come, though, from a number of unorthodox approaches that began to emerge in the 1960s and that are, summarily, referred to as the "New Institutional Economics." These approaches, including the Economics of Property Rights, Law and Economics, Public Choice and others, seek to correct for the institutional deficiency of mainstream neoclassical economics, yet – by contrast to the "old" institutionalism – remain firmly within the classical economic tradition, in fact, they are viewed by their advocates as a revival of essential parts of the Smithian heritage.

One of the most influential contributions to the development of the New Institutional Economics, and one that is of particular interest in the present context, stems from Ronald Coase. In two complementary, path-breaking articles Coase points to *transaction costs*, i.e. the costs of carrying out economic transactions among persons, as the key to an understanding of the role of market institutions. In his *The Nature of the Firm* (1988: 33-55), a paper that was originally published in 1937 but made its impact only decades later, he raises the question of why, given the efficiency of market coordination, there exist at all firms, i.e. centrally coordinated organizations, within the spontaneous, non-centralized order of the market. The answer he gives is that this is so because there are costs to market transactions, such as the costs of finding a suitable exchange partner and of negotiating and enforcing agreements. To the extent that such costs can be reduced by organizing transactions within firms, there is an economic rationale for their existence. In *The Problem of Social Cost* (ibid.: 95-156; orig. 1960), Coase argues that the legal framework within which market transactions take place *matters* because it affects the costs at which such transactions can be carried out. Coase's argument became mostly known, though, in its *negative* version, as the so-called *Coase theorem*, which says that, as long as property rights are clearly defined at all, the allocation of resources is not affected by *how* they are defined, *if transaction costs are zero*. The reason being that, no matter what the law says about "who has the right to do what," with zero transaction costs, rational economic agents can always trade entitlements until they are in the hands of those who can put them to their most valuable uses (ibid.: 14).

It is ironic that Coase's argument came to be condensed as the Coase-theorem, since the theorem's "institutions do not matter"-message is exactly the opposite of what Coase wanted to emphasize (1988: 15, 174). The fictitious world of zero transaction costs in which such institutional neutrality would hold is, as he points out, the world "of standard economic theory" (Coase 1994: 10) but not the world that he finds worthwhile to study. If we move, he notes (ibid.: 11), from the hypothetical regime of zero transaction costs to the real world of positive transaction costs, what becomes immediately clear is ... (that) the legal system will have a profound effect on the working of the economic system and may in certain respects be said to control it." In Walras' (1954: 256) "hypothetical régime of absolutely free competition," the model-world of neoclassical orthodoxy, it is sufficient to assume that private property rights are assigned *somehow*. If, as is presumed for such regime, no obstacles exist to the realization of potential gains from trade, then rational and fully informed economic agents can be predicted to fully exhaust all potential gains so as to attain "the maximum of utility" (ibid.). It is in such context that, for instance, G. Debreu can say of his "Axiomatic Analysis of Economic Equilibrium," that its task is to explain how prices result "from the interaction of the agents of a private ownership economy" (Debreu 1959: vii), without giving any further detail of the kinds of institutions that characterize his "private ownership economy."

As strange as the neglect, among mainstream economists, of the market as an institutional arrangement may seem, it is, Coase argues, but a systematic consequence of the orthodox model. As he puts it: "Markets are institutions that exist to facilitate exchange, that is, they exist in order to reduce the cost of carrying out exchange transactions. In an economic theory which assumes that transaction costs are nonexistent, markets have no function to perform" (Coase 1988: 7). For an economic theory, however, that aims at explaining the real world of positive transaction costs it "is hardly possible to discuss the functioning of a market without considering the nature of the property rights system, which determines what can be bought and sold and which, by influencing the cost of carrying out various kinds of market transactions, determines what is, in fact, bought and sold, and by whom" (Coase 1994: 46).

In other words, the separation that Walras wanted economists to draw between a "pure economics," concerned – as an "exact science" – with the natural mechanics of demand and supply, and a "social economics," concerned – as a "moral science" – with institutional and property rights issues, is difficult to maintain once one acknowledges, "that what are traded on the market are not, as is often supposed by economists, physical entities but the rights to perform certain actions, and the rights which individuals possess are established by the legal system" (Coase 1994: 11).

4. Markets and economic policy

The difference in their respective outlooks at markets that separates mainstream neoclassical economics from the new institutional economics has its counterpart in differences between their respective approaches to issues of economic policy. Taking the concept of perfect competition as its starting point, the neoclassical approach tends to judge real world markets in terms of its reference-model, and where it finds reality to fall short of the ideal standard, it diagnoses a need for political correction of "market failure." Critics have chastised such reasoning as "nirvana approach" (Demsetz), noting that "we do injustice to the achievement of the market if we judge it ... by comparing it with an ideal standard which we have no known way of achieving" (Hayek 1978: 185).

By contrast, by looking at the market as a "social institution which facilitates exchange" (Coase 1988: 8), the new institutional economics starts from the recognition that markets are legal-institutional arrangements and that all we can meaningfully compare – and choose among - are alternative, actual or potential legal-institutional frameworks. As Demsetz (1969: 1) summarizes the contrast:

> "The view that now pervades much public policy economics implicitly presents the relevant choice as between an ideal norm and an existing 'imperfect' institutional arrangement. This *nirvana* approach differs considerably from a *comparative institution* approach in which the relevant choice is between alternative real institutional arrangements. In practice, those who adopt the nirvana approach seek to discover discrepancies between the ideal and the real and, if discrepancies are found, they deduce that the real is inefficient. Users of the comparative institution approach attempt to assess which alternative real institutional arrangement seems best able to cope with the economic problem."

If markets have to be seen as legally framed social arrangements, there is no other way in which they could be meaningfully described than in terms of their legal-institutional make-up. The way they have used the concept of the "perfect market" has long served economists as a convenient device to evade the need to be specific about what kind of legal-institutional arrangement they mean to be descriptive of a "perfect market." Yet, if that concept is to provide any real guidance to economic policy, it must be specified in legal-institutional terms. And it is indeed, as Coase (1988: 9) notes, not without significance that the kinds of organized markets, like stock exchanges or commodity exchanges, that are "often used by economists as examples of a perfect market and perfect competition, are markets in which transactions are highly regulated." It suggests, Coase adds, "that for anything approaching perfect competition to exist, an intricate system of rules and regulations would normally be needed" (ibid.).

The comparative institutions approach puts an end to the pretence that anything meaningful is said by reference to "perfect markets" in economic policy discourse, as it insists that all diagnoses of deficiencies in the operation of existing markets, and all suggestions for corrections, have to be specified in terms of feasible alternative institutional provisions. It views economic policy as "a choice among alternative social institutions" (Coase 1988: 28), a choice that is to be informed by knowledge of how "the economic system would work with alternative institutional structures" (ibid.: 19f.). It recognizes that the task of responsible economic policy cannot be to measure the performance of real world markets in terms of an unattainable theoretical construct, but is "to devise practical arrangements which will correct defects in one part of the system without causing more serious harm in other parts" (ibid.: 142).

The comparative institutions approach to economic policy requires, as its theoretical foundation, an economics that provides knowledge of feasible institutional options, of the working properties of alternative institutional arrangements, and of the predictable effects of potential institutional reforms. To provide such knowledge opens up a rich and demanding research program for economists to pursue. To be sure, the adoption of such a program would mean a significant change from the direction that modern economics has come to take, even if, in essence, it would only mean to reactivate an integral part of its original, Smithian research agenda.

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