

ECONOMIC FREEDOM AND THE EVOLUTION OF LAW

Bruce L. Benson

Lon Fuller (1964: 30) defines law to be “the enterprise of subjecting human conduct to the governance of rules.” The key components of economic freedom arise through such an enterprise when institutions of governance support obligations to respect private property rights, freedom of enterprise, and voluntary contracts. Indeed, the underpinnings of both law and economics are identical. As David Hume (1751) observed almost two and a half centuries ago, the primary motivation for developing rules and governing institutions is that rational individuals are attempting to find ways to expand personal well-being or “wealth” in the face of scarcity. And not surprisingly, both the enterprise of law that supports a free market and the market itself actually tend to evolve spontaneously through similar processes (Menger 1883; Hayek 1973; Polanyi 1951; Benson 1989, 1992a, 1995c, 1998c).

Friedrich Hayek (1973: 98) distinguishes between the “order of actions” and the “order of rules” and suggests that, for given rules, the order of actions is what emerges from the spontaneous process governed by the order of rules. He also argues that the order of rules can emerge spontaneously, just as the order of actions does. Building on Hayek’s work, as well as others, I shall argue that many rules and institutions for governance evolve as the unintended outcomes of individuals separately pursuing their own goals (e.g., customs), just as markets do—that is, they are, as Hayek (1967: 77) explains, “the result of human action but not of human design.”

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Bruce L. Benson is DeVoe Moore Professor and Distinguished Research Professor in the Department of Economics at Florida State University. This paper expands upon Benson (1997c) which was, in turn, drawn from Benson (1994b, 1995c, 1997a, 1997b), and is part of a large project on “the Evolution of Law,” which has been supported by two fellowships from the Earhart Foundation, grants from the Institute for Humane Studies and the Carthage Foundation, and a book contract from the Independent Institute.

When rules and governance evolve spontaneously through voluntary human interaction, both market and nonmarket institutions develop the way they do because individuals discover that the actions they are intended to coordinate are performed more effectively under one system or process than under another. They both facilitate wealth creation through voluntary interaction. Rules and institutions vary in quality, of course, so as individuals discover new rules or institutions that prove to be better than the ones they have been using (either because they observe others who have better rules or institutions and emulate them, or because they experiment and innovate), the new rules or institutions will be adopted unless the transactions costs of such an adoption are prohibitive. Thus, more effective rules and institutional arrangements tend to replace less effective ones as individuals observe, learn, imitate, and secede in order to migrate when superior competitive alternatives are available. Furthermore, existing rules and institutions influence the discovery process by motivating individuals to search in different directions for innovations—that is, there is a path dependency to the evolutionary process.

Economic freedom can also be undermined by rules and institutions of governance. After all, as Franz Oppenheimer (1908) explains, there are two ways for an individual to expand personal wealth: (1) “economic” processes that consist of cooperative voluntary interactions, including team production through the division of labor and voluntary exchange; and (2) “political” processes that take wealth produced by others through the use or threat of force (and/or guile). Furthermore, rules and governance institutions can facilitate either of these means of expanding an individual’s wealth. Thus, understanding the sources of and barriers to economic freedom requires recognition of conflicting incentives to establish rules and institutions that facilitate wealth expansion and that take wealth from others. This point is elaborated on below, before exploring the rules and institutions of customary law that evolve in a cooperative environment and considering the rules and institutions that are likely to arise when wealth transfers are the objective of a legal authority (see Benson 1997a, 1998a). After these issues are discussed, it will be explained that moral behavior and economic freedom are complementary consequences of customary law, and that the state with its authoritarian legal institutions is more likely to undermine both than to support them.¹ Finally, it will be suggested that for the emerging economies of the world to achieve economic freedom, states must allow customary commercial and property law to evolve.

¹On the relationship between institutions and moral behavior, see Benson (1997a, 1997b).

Wealth Seeking and the Evolution of Law

Competition over the use of scarce property is inevitable. Unilateral efforts to turn a property claim into actual ownership requires a sufficiently strong threat of violence to exclude others making conflicting claims. Since several individuals are likely to have similar incentives with regard to any scarce resource, violent competition could consume vast amounts of resources. Is such a Hobbesian “war of all against all” inevitable? No. For instance, individuals with similar capacities for violence (and therefore similarly small expectations of winning a war) might agree to recognize an equal initial distribution of private property rights to scarce resources. The incentives to live up to this agreement are largely positive: individuals expect to increase personal wealth by focusing resources in productive activities rather than protective or aggressive activities, as a result of reciprocal commitments to respect property claims.

Of course, a Hobbesian war might arise if some parties believe that their relative capacities for violence substantially enhances their probabilities of winning more wealth, but historical and anthropological evidence suggests that the earliest men lived in groups that were largely cooperative in nature (Ellickson 1993, Ridley 1996). This is not surprising since significant differences in the capacity for violence probably did not exist until wealth began to accumulate, so mutual deterrence tended to prevent wealth transfers, leaving cooperation as the most attractive means of increasing personal wealth. Furthermore, even when one party’s capacity for violence is substantially greater than other parties, continual violent conflict is still not likely to be the norm, as the weaker party will submit to the stronger if submission is expected to be less costly than conflict. Indeed, if an individual has an absolute advantage in violence he will be in a position to induce other individuals to accept (under duress) slavery, thus concentrating all property rights (including the ownership of other persons) and wealth in the hands of one “authority.” Of course, he will also have to maintain his position of dominance in order to assure continuation of the very uneven distribution of rights and wealth. After all, the slave’s incentives to accept the situation are “negative”—subjugation is expected to be better than the alternative very high probability of losing everything.

Between the extremes of voluntary agreements and coercively imposed slavery, many other nonviolent possibilities actually exist. The resulting arrangement involves extortion for “protection” from the individual receiving the payment, however, rather than payments for protection from other threats. Some protection rackets involve

large extortion payments (e.g., tribute or taxes), concentrating wealth, while others are characterized by dispersed private property rights and modest extortion payments to someone with a comparative advantage in violence. For instance, it may well be that the person choosing to pay the extortion could effectively produce a sufficient counterforce to overthrow the extortionist. But if the payment demanded is not too great, then for an individual capable of producing considerable wealth through economic processes, the cost of creating this counterforce may be too high to make it worthwhile. Thus, the extortionist is constrained in how much he can extract. Such extortion can be facilitated by the establishment of governance institutions to impose distributional rules. Let us first consider a spontaneously evolving voluntary legal order, however, before turning to the implication of extortion and law.

Customary Law and Cooperative Institutions

Voluntarily recognized “trust rules,” to use Viktor Vanberg and James Buchanan’s (1990) terminology, essentially involve explicit or implicit agreements to adopt predictable behavioral patterns or “norms” in dealings with a limited number of identified individuals. Since the primary source of conflict is scarcity, trust rules focus on property allocation. As Hayek (1973: 107) explains, “The understanding that ‘good fences make good neighbors’, that is, that men can use their own knowledge in the pursuit of their own ends without colliding with each other only if clear boundaries can be drawn between their respective domains of free action, is the basis on which all known civilization has grown. Property, in the wide sense in which it is used to include not only material things . . . is the only solution men have yet discovered to the problem of reconciling individual freedom with the absence of conflict.” Indeed, the absence of conflict may be the primary objective of such agreements, given the relatively low probability of winning such violent confrontations, as even in many animal societies “the delimitation of territorial ranges or ‘property’ . . . serves. . . to eliminate unnecessary fighting” (Hayek 1973: 75). Security of each individual’s property claims is increased as violence is avoided by accepting an obligation to respect property rights of other individuals who are expected to reciprocate by doing the same. As individuals’ time horizons lengthen, they can plan better, and resources can be allocated to maximize the potential for long-run wealth creation. Furthermore, the potential for wealth expansion through trade arises.

But why would individuals expect others to reciprocate by accepting such obligations? Individuals' promises must be credible for trust to develop, but as Vanberg and Buchanan (1990: 18) explain, "Because compliance and non-compliance with trust rules are . . . 'targeted,' the possibility exists of forming cooperative clusters." In this light, imagine an evolutionary process in which some people recognize the high cost of unilateral violence as a means of establishing property rights. Individuals with similar capacities for violence and facing the likelihood of repeated conflict (e.g., neighbors) form relatively tentative bilateral relationships, accepting obligations to limit claims in exchange for promises to recognize each others' property boundaries. As individuals begin to trust one another, other types of interaction (social, economic, religious, joint production of protection against outsiders, etc.) begin to develop. The positive incentives to cooperate expand because of the benefits from such interactions. Initially, the threat of violent retaliation is likely to be the main source of credibility backing promises. But if individuals realize significant benefits from an ongoing bilateral relationship, a rule violation can be "corrected" through a "tit-for-tat" strategy that threatens retaliation in kind (rather than exclusively through violence) in an effort to induce the violator to once again recognize the rules. The tit-for-tat strategy "does not seem to be the height of morality," as Robert Axelrod (1984: 137) suggests: it has a "slightly unsavory taste" but "a moral person can't do much better." Under these circumstances, the threatened tit-for-tat sanction is not the only source of credibility, however. Indeed, it is a relevant threat only because of the recognition of *positive* long-term benefits of remaining on good terms with the other party. Such reciprocity has implications for the evolution of moral behavior because it means that an individual can face an immediate choice of bearing costs by recognizing another's property rights but perhaps without an immediate gain, in expectation of future reciprocal behavior by someone else. Michael Taylor (1982: 28) explains that "reciprocity is made up of a series of acts each of which is short-run altruism (benefiting others at a cost to the altruist) but which together *typically* make every participant better off." Because the long-term reciprocal response is uncertain, however, a repeated-game situation does not guarantee unconditional cooperation in the form of short-term altruism. The dominant strategy still depends on expected payoffs, frequency of interaction, time horizons, and other considerations (Ridley 1996: 74–75), but additional incentives for cooperation and altruistic behavior can also arise.

As the benefits from one bilateral relationship evolve, incentives to develop similar benefits with others arise and a loose knit group

with intermeshing reciprocities begins to develop. This has the perhaps unintended consequence of creating competition, and a low-cost option to retribution or tit-for-tat sanctions arises: unconditional cooperation with anyone in the cooperative cluster, along with a refusal to interact with an individual who is known to have adopted noncooperative behavior with anyone in the evolving community and the spread of information about noncooperative acts. Vanberg and Roger Congleton (1992) refer to this response as “prudent morality,” and given that reputation information spreads quickly within a group, the intended consequences of retribution and of prudent morality become quite similar. If everyone spontaneously responds to information about a rule violation, the violator is excluded from all interaction with everyone else in the community. Social ostracism is the result and it can be a very significant punishment. In fact, an individual’s incentives to exact physical retribution or tit-for-tat punishment are weak when competitive alternatives exist and information is easily spread. Essentially, investments in communication mechanisms substitute for investments in capacity for personal violence, and ostracism substitutes for self-help sanctions. Indeed, Vanberg and Buchanan (1990) explain that once a group is formed based upon intermeshing bilateral trust rules, “solidarity rules” (obligations that are expected to be followed by all members of a group because compliance benefits everyone) can develop.

Solidarity rules are things like “inform your neighbors about individuals who violate trust rules” and “boycott untrustworthy individuals,” and they also evolve spontaneously. Related rules like “watch out for your neighbor” and “inform everyone when a rights violation occurs” tend to follow and multilateral cooperative policing (respond to the “hue and cry”) as a mutual insurance of property rights ultimately evolves. The empirical fact is that one joint product of close-knit groups is watching to prevent theft and violence and cooperation in pursuit and prosecution when either occurs (Benson 1991a, 1992b, 1994a).

Unexpected drastic reductions in wealth (e.g., fires, storms, accidental death of the household head) can lead to predictable changes in the incentives to accept obligations, so a cooperative group also tends to establish mutual insurance arrangements to protect people from the consequences of occurrences that might force them to steal in order to survive. Such arrangements might also be characterized as short-term altruism, but rational self-interested individuals will voluntarily transfer wealth to someone in distress in an attempt to create positive incentives for that individual to continue respecting their property rights. Furthermore, there is also a reciprocal assurance that

they can receive wealth transfers in the future, without resorting to theft, if they are in distress. Individuals who do not follow solidarity rules (e.g., contribute to cooperative policing and mutual insurance arrangements) are also ostracized, so free-rider problems are not significant.

Other institutional arrangements also evolve. For instance, a dispute may arise over ownership of a previously unclaimed asset. Similarly, policing is imperfect so someone accused of a rule violation may not be guilty and dispute the charge. Disputes can be resolved by violent “prosecution” and exclusion of the loser, but in a close-knit group such violence can have significant negative spillover costs, particularly if opinions of individuals in the group are mixed. These costs can be reduced by developing nonviolent means of resolving disagreements and clarifying property rights (as well as rules for claiming previously unclaimed property, such as a rule of original acquisition), and by making acceptance of a judgment relatively attractive for the loser. For instance, a mutually acceptable mediator or arbitrator might be chosen from among the most reputable members of the community, or from a pool of competitive dispute-resolution specialists. Since this third party must be acceptable to both disputants, “fairness” is embodied in the dispute-resolution process. The rule violator may also be allowed to buy his way back into the community by paying an appropriate restitution, rather than being subject to physical punishment or exclusion. Given that the chosen arbitrator/mediator convinces individuals in the group that a judgment should be accepted, the ruling can be backed by an ostracism threat, of course, although in general, dispute resolutions are likely to be accepted because even losers recognize that the long-term benefits of behaving in accordance with members’ expectations probably exceed the restitution payment (or the costs of exclusion). Numerous historical and anthropological studies demonstrate that restitution and voluntary third-party dispute resolution are common institutions in close-knit groups’ legal systems (Benson 1991a, 1992b, Pospisil 1971).

All such institutional developments tend to be spontaneous and unplanned, and the result is a movement toward increasingly secure private property rights under “customary law.” Indeed, “There is abundant evidence that a . . . group need not make a conscious decision to establish private property rights. . . . People who repeatedly interact can generate institutions through communication, monitoring, and sanctioning. . . . Contrary to Hobbes and Locke, a property system can get going without an initial conclave” (Ellickson 1993: 1366). Thus, no central “authority” with coercive powers is necessary to produce law in such a cooperative social order. In fact, strong coercion

is only required when strong incentives to resist imposed rules exist, generally because imposed law tends to discriminate between individuals and groups, allocating substantially more wealth to some than to others.

Entrepreneurship and Evolving Customary Law

The potential benefits of team production (e.g., in hunting, protection, religious or social activities, and trade) and expanding groups suggests a potential entrepreneurial role in group development. One or more persons may emerge as “community leaders,” not because of an ability to threaten violence but because of an ability to recognize opportunities to gain from cooperation and to persuade others that the benefits of cooperation and recognition of obligations will be beneficial for all of them. Thus, as Michael Polanyi (1951: 165) stresses, the evolving spontaneous order in legal rules and institutions may, in part, be “based on persuasion.” Such a leader need have no special power or authority to make and enforce rules. Maintenance of a network of trust is sufficient so that others respect the entrepreneur’s opinion about what the rules are or should be.

The capacity to attract followers is likely to depend on a perception that the person is a “wise man” (or woman) with whom others wish to consult, and a very productive *and* trustworthy individual with whom others can interact in joint production or trade to expand their own wealth. Indeed, it is likely that only trustworthy and successful individuals will be voluntarily recognized as leaders within small groups. The wealth accumulated by an individual in a close-knit cooperative community almost always depended on that individual’s work effort and skill, and his or her ability to cooperate with others, since wealth is most effectively expanded through joint production or division of labor and voluntary exchange. Therefore, anyone who acquires sufficient property to reach the status of leadership is likely to be a mature, skilled individual with considerable physical ability and intellectual experience, and perhaps more important, someone who has a history of cooperative behavior. Such personal capabilities are deserving of respect, and, in fact, those who gain wealth in cooperative societies are generally held in very high regard (Benson 1991a, Pospisil 1971).

Those seeking leadership will have to indicate their willingness to provide wise advice and decisions to the community. As dispute resolution mechanisms evolve, these entrepreneurs have incentives to offer their services as arbitrators or mediators, both in order to gather information and to demonstrate wisdom and trustworthiness. Furthermore, “The way in which capital is acquired and how it is

used make a great difference; the [members of a community] favor rich candidates who are generous and honest. These two attributes are greatly valued” (Pospisil 1971: 67). Indeed, long-term leadership requires that gains from entrepreneurial innovations in rules and institutions be dispersed through the community of individuals who follow the entrepreneurial leader. If the benefits are exclusively captured by the innovator, the individual will be unable to attract followers. Thus, a self-interested entrepreneur’s “greed” must be tempered. An individual with a long time horizon, seeking a position of leadership in order to enhance personal wealth accumulation efforts within a close-knit community, will rationally choose to pursue innovations that benefit others in the group and generously spread the wealth. Someone with an ability to recognize the gains from innovations in rules and institutions that generate dispersed benefits and with entrepreneurial skills in persuasion, however, may naturally accumulate greater wealth as the group evolves. The individual is able to personally instigate more joint ventures, wealth-enhancing exchanges, and various social forms of interaction that enhance the individual’s well-being. Furthermore, those who benefit from the entrepreneur’s projects tend to reciprocate when they perceive some wealth-enhancing opportunity, by seeking out the entrepreneur as a partner or investor.

Innovations in rules and institutions that may generate disproportionately large returns for the entrepreneur can also be accepted if the entrepreneur generously disperses the benefits in the form of gifts. Indeed, in primitive societies, the honor of being recognized as a leader is often “purchased” through public displays of generosity demonstrated at occasions such as marriages and in connection with disputes, in the form of “gifts” on behalf of the leader’s followers in order to secure good marriages or buy peace among disputants. By achieving (purchasing) prestige as a wise and generous individual, however, such a leader expects to benefit in the future for reasons suggested above. As Matt Ridley (1996: 138) puts it, such acts “scream out ‘I am an altruist; trust me.’” Thus, incentives to build a reputation as a wise, trustworthy, capable, and generous individual are strong. Not surprisingly, “gift exchanges” and “potlatching” are common practices in such societies all over the world (Ridley 1996: 114–24). Indeed, “For all the protestations of Karl Marx and Max Weber, the simple idea of gains from trade lies at the heart of both the modern and the ancient economy” and therefore, “the origin of the market, with all its capacity to exchange goods of different kinds, exploit the division of labour and provide a hedge against dependence on one good, may lie in the reciprocal food-sharing arrangements of a hunter-gatherer

band” (Ridley 1996: 199, 114), as well as in subsequent gift exchanges among increasingly wealthy groups. This brings us to one of the key points to be made here: an examination of relationships in modern international commerce (Benson 1992a, 1998c, 1998d), within domestic trade associations (Bernstein 1992; Benson 1995a, 1998b), and between neighbors in stable economic communities (Acheson 1988, Ellickson 1991) reveals that they are ruled by modern versions of the same kinds of institutions that develop in primitive customary law.

Intergroup Relationships

Neighboring communities may compete for the same scarce resources, but they also may offer opportunities for mutually advantageous cooperation. Warfare is not the only type of intercommunity relationship. Cooperative arrangements can and often do evolve between members of different groups (Benson 1995b). Even in primitive societies, entrepreneurs establish extensive trade networks that cross community boundaries (Benson 1991a; Ridley 1996: 195–211), but as such arrangements evolve they also have to be accompanied by various institutionalized rules to function effectively (Benson 1989, 1991a, 1998d). Groups need not formally “merge” and accept an entirely common set of rules governing all types of interaction, however. Individuals only have to expect each other to recognize a common set of rules pertaining to the types of inter-group interactions (e.g., trade) that evolve. Indeed, a “jurisdictional hierarchy” often tends to arise wherein each group has its own norms for intragroup relationships, with a separate and possibly different set of rules applying for intergroup relations (Pospisil 1971; Benson 1991a, 1992b, 1995b). Prudent morality might dominate within groups, for instance, while at least initially, retribution threats or tit-for-tat applies between groups where reputation effects and boycott sanctions are weaker.

To facilitate intergroup cooperation, entrepreneurs who expect to benefit often promote the use of internal sanctions to bring community members to justice when they attempt to take advantage of (e.g., attack) members of the other cooperating group (Benson 1991a). These entrepreneurial leaders also may serve as arbitrators of disputes arising between members of the different groups (Pospisil 1971, Benson 1995b), in order to enhance their reputations as fair and cooperative (trustworthy) individuals, but in doing so the security of property rights is increased for both groups. Many intragroup norms will be commonly held, of course, and emulation also will occur where differences initially exist but individuals observe and perceive superior arrangements among other groups (Benson 1989, 1998c, 1998d), so the evolution of common norms recognized and applied in a very

extensive web of communities is clearly possible (Benson 1989, 1998d; Putnam 1993; Hayek 1973). In other words, cooperation is one potential solution to intergroup conflict, although the transactions costs of such cooperation are obviously relatively high and the likelihood of differences in the opportunity costs of violence across groups due to differences in resource endowments (e.g., fertile land) and investments (e.g., hunters may develop technologies that are effective at warfare while gardeners may not) are relatively great, so intergroup conflict can also be expected.

Extortion and the Evolution of Law

Suppose that an individual has a significant comparative advantage in violence and chooses to take wealth produced by others. The result is a “negative sum” undertaking since the transfer process and any efforts to resist it consume resources that could be used to create new wealth. Nonetheless, an individual with a comparative advantage in violence may expect to be better off by taking other’s wealth than by cooperating, producing, and trading. Given that information spreads, the individual who employs a comparative advantage in violence develops a reputation for doing so. Such a reputation can be quite valuable, as increasingly, the threat of violence alone may be sufficient to extort transfers without physically taking them. Once such a reputation develops, however, the potential for entering cooperative relationships is reduced, as anyone with whom the extortionist does not have a prior trust arrangement will not believe the extortionist’s promises. Therefore, the decision to take wealth often involves a permanent commitment to extortionist behavior, creating incentives to establish an environment that will produce a steady stream of transfers from those subjected to threats—that is, rules and institutions will be designed in an effort to minimize the costs of continual extortion. Among other things, this implies that the extortionist will attempt to establish a monopoly in violence. After all, if a target for extortion can turn to another specialist in violence who sells real protection, or to a cooperative group jointly producing protection, then the extortionist’s ability to extract wealth is severely limited. Thus, the extortionist must erect barriers to exit from his jurisdiction. Furthermore, an extortionist is likely to develop institutions intended to lower measurement costs, keep records, reduce collection costs, institutionalize threats, and so on.

The scale of violence required to compete for and maintain sufficient power to maintain extortion will be greater than a single individual can produce, of course. Therefore, an entrepreneur in extortion

generally establishes a “firm”: others, who have a comparative advantage in violence but less entrepreneurial skills sell their services as inputs (e.g., strong-arm enforcers, army or police personnel, producers of tools or symbols of violence) in return for part of the wealth transferred. Such “protection firms” require cooperation in production, so behavior between people working in the firm will be quite different than their behavior toward those subjected to extortion. In fact, historically, many examples of organized aggression involved cooperative communities with established trust relationships such as those described above, who were persuaded by an entrepreneurial “leader” (e.g., tribal war chief, head of a mafia family) that they could expand their wealth at relatively low costs through raiding or conquest. Nonetheless, such an organization for violence can become a source of competition for the entrepreneur’s power if some of its members feel that they can carry out a successful coup d’état, so the extortionist has incentives to keep the evolving military/policing organizations decentralized (raising the cost of collusion) and to create an adversarial competition between them for portions of the wealth transferred.

The extortionist can also reduce the incentives for competitive entry by transferring some wealth to potentially powerful individuals in *exchange* for an agreement not to oppose his extortion efforts directed at others. As a result, the protection racket can involve a mix of extortion of the weak and protection of the relatively powerful. In order to maintain power, the extortionist also has incentives to redistribute wealth as the relative power of subgroups within his jurisdiction changes. The redistribution involves an effort to obtain the support of the subgroups whose comparative advantage in violence appears to be developing, in order to avoid competition for power. Thus, while mutual insurance arrangements in cooperative systems transfer to the disadvantaged who may have relatively weak incentives to respect property rights, extortion-based systems transfer to those who are becoming wealthy and/or powerful, as they have weaker incentives to respect the extortionist’s claim to sovereignty. Of course, there is a potential danger of the poor organizing effectively and revolting too, so some transfers may flow in their direction if they are perceived as a developing threat. In a relative sense, however, transfers to the wealthy and/or powerful will actually dominate, and any transfers to the poor will predominantly flow from others who lack wealth and power.

To facilitate this redistribution process, the cost of allocating transfers can also be lowered. Because the resulting transfer process is a negative-sum game, for instance, subgroups have incentives to compete for favorable treatment from the extortionist. The extortionist

may encourage such competition, since by keeping subgroups divided into adversarial camps the possibility of a strong coalition forming to overthrow his rule is reduced. Furthermore, institutions should develop through which the competition for transfers can be channeled and observed. By focusing such competition in “advisory councils” or “representative assemblies,” for instance, the cost of gathering information about the relative power of groups is reduced, as is the cost of interacting with various powerful groups. Powerful groups also see their interests linked to the interests of a “sovereign” as institutionalized exchanges of support for privileges develop, and, therefore, they may be less likely seek wealth by challenging the extortionist for power. An effective entrepreneur in extortion might also be able to simultaneously lower the cost of ruling and legitimize his claim as the monopoly source of rules and rule interpretation by establishing “adversarial” dispute-resolution forums (e.g., courts or assemblies) backed by threats of violence because disputes are often over distributional issues.

Oppenheimer’s (1908) political means of wealth expansion is a parasite on the economic host, so at any point in time an extortionist is constrained as to how much can be transferred. Indeed, the extortionist faces a trade-off. Large levels of extortion in the short term reduce productivity, wealth creation, and the potential for transfers over the long run. The actual degree of transfers in any period, therefore, depends in part on the extortionist’s time horizon. With any time horizon at all the extortionist is likely to recognize some private property rights and allow some cooperative organizations in order to create incentives for those subject to extortion to continue producing more wealth. Nonetheless, the potential for transfer means that all property is in a common pool open to political competition, at least to a degree, although security of property assignments varies considerably depending on the relative political power of those in the extortionist’s realm.

To the degree that the extortionist is successful in legitimizing his claims to sovereignty and preventing exit, the result is a perception that there is a single legitimate source of rules in a geographic jurisdiction (see Benson 1998a). The sovereign may attempt to design and impose his own rules, but he is also likely to claim to be the source of customary laws adopted from cooperative groups, because they are low cost mechanisms for facilitating wealth creation that he can then tax. His “law” must be above and able to alter the norms generated by such institutions, however. Thus, for instance, many early codes by kings claiming to be lawgivers were largely codifications of customary law with modifications to dictate distributional issues (Benson 1989, 1992b).

The widespread belief that the “state” is the source of all “law,” suggests that many historical claimants to sovereignty have been relatively successful, since most (all?) modern nation-states clearly evolved from nonstate extortionist institutions (e.g., tribal war chiefs became kings and kingdoms became nation-states). But the “law” of the state serves many conflicting functions, simultaneously harassing and protecting private interests, extorting wealth and encouraging its production, maintaining the class structure and cutting across classes, integrating parts of society and disintegrating other parts. Law (in a positive sense) and justice (in a normative sense) clearly are not synonymous.

The rent-seeking literature stresses that theft and involuntary wealth transfers have identical economic implications. Wealth is dissipated in this competition as individuals invest resources in an effort to benefit from redistributions while others invest to prevent them (Tullock 1967). They also have similar moral implications. The competition for potential transfers of property rights by the extortionist both reflects and reinforces (or causes) the basic attitudes of individuals toward other people’s property claims, including other people’s lives and possessions. Benefactors who openly condone the transfer process do not recognize an obligation to respect other people’s property rights. Indeed, they believe that they have the “right” to take property from others through political action. Modern manifestations of such beliefs include claims of “rights” or “entitlements” to welfare, education, medical care, social security, disaster relief, farm subsidies, jobs protected from competition, and so on, all of which require taking property from someone else. In rationalizing their claims, members of each benefactor group have incentives to recognize such entitlements for other groups as well, and the ruler has incentives to take advantage of these incentives in an effort to legitimize a claim to sovereignty and undermine opposition. He can claim that the same morality that underlies voluntary transfers also underlies and justifies involuntary transfers. Little wonder that others who actually are poor but do not have the political power necessary to benefit from such takings adopt a similar attitude toward property rights and easily turn to theft. After all, it is reasonable to believe that many who have wealth obtained at least part of it through the political process rather than through production and/or voluntary exchange; and since the transactions costs of determining how a person actually gained wealth are high, the tendency will be to view all wealth with suspicion. Since the origins of property rights to wealth are now at least partly due to political influence rather than cooperation and production, the incentives to respect property rights are further undermined.

Recall that a person who accumulates wealth in a cooperative community tends to be held in high regard, in part because the accumulation of wealth is largely a function of skill, hard work and trustworthiness, and that such individuals also have incentives to advertise their wealth by making generous gifts to others in order to purchase prestige. However, when politics becomes a source of wealth, the incentives of wealthy individuals, whether they accumulated wealth through production or through politics, to advertise their wealth with public display of generosity is undermined. Indeed, people with wealth may be seen, rightly in many cases, as “enemies” who obtain wealth at the expense of others, and they are likely to be popularly perceived as attractive targets for future reverse transfers or theft as individuals attempt to get back what they feel is “rightly theirs.” As mechanisms for signaling trustworthiness such as public gift giving (also voluntary dispute resolution which tends to be replaced by the ruler’s courts or self-help violence) are undermined, the potential for cooperative interaction to expand wealth through economic means is also reduced. In addition, since the political process of wealth transfers tends to undermine the security of private property rights, voluntary benevolence as part of a mutual insurance arrangement also is reduced. The political process of involuntary transfers clearly tends to make people more “selfish,” reducing the potential for moral behavior even in their private dealings.

Economics versus Politics and the Evolution of Law

The power of a sovereign almost never becomes absolute, but the existence of a coercive extortionist still affects cooperative groups’ customary law. As Hayek (1973: 51) explains, “spontaneous order arises from each element balancing all the various factors operating on it and by adjusting all its various actions to each other, a balance which will be destroyed if some of the actions are determined by another agency on the basis of different knowledge and in the service of different ends.” Actual deliberately designed rules are rarely able to completely dictate the targeted behavior because knowledge is incomplete for the rule maker, and policing is imperfect (Hayek 1973). There are too many uncontrolled margins and unanticipated responses for a rule designer to consider. Nonetheless, such designed rules do *influence* behavior. Indeed, because the extortionist and his judges and bureaucrats cannot fully anticipate the consequences of their actions, such actions inevitably cause trains of readjustments through time (Hayek 1973: 58–59). In particular, deliberate efforts to impose rules create incentives to circumvent those rules (e.g., see Steven

Cheung's [1974] discussion of the consequences of price controls, or consider the size of underground or informal sectors all over the world). In this context, the search for ways to avoid the rules also can significantly alter the path of the spontaneous evolution of norms and behavior.²

The possibility of opportunistic behavior by the extortionist shortens everyone's time horizon, of course, and the potential for changes in "tax policy" to capture the gains arising with investments in reputation, repeated-dealing reciprocities, and various kinds of cooperative joint-production efforts reduces the expected gains from cooperation. Furthermore, the legitimization of coercive rules and institutions stifles the development of trust relationships, as the honoring of any commitment tends to be perceived as arising primarily because of the deterrent effect of threatened sanctions from the sovereign. Therefore, fewer voluntary organizations are formed, and those formed often perform fewer functions. Moreover, to the degree that such functions are demanded by powerful political interests, the extortionist may try to force continued production, and, if that fails, he may attempt to produce them through his growing bureaucratic apparatus (Benson 1992b). The literature on rent seeking depicts the process as a negative sum game because resources are used up in the process of competing for transfers, but a more significant cost is that the potential for wealth expansion through economic processes is substantially reduced.

Polycentric Law and Situational Morality in a Political World

A system of rules and institutions for governance is necessary for the creation and expansion of wealth through joint production, special-

²A spontaneous order is often contrasted to a deliberately designed social arrangement created by some centralized ordering authority. In a static framework such a designed order might appear to be reasonable, but in a dynamic world it is not. Designed rules can disrupt spontaneous orders but they do not replace a spontaneous order with a designed order. They set off a chain of spontaneous reactions. As ways around such rules are discovered, the rule makers are likely to respond with new rules intended to block such maneuvers, those subject to the new rules react again, leading to more blocking efforts, and so on. Therefore, deliberately designed rules and institutions also evolve spontaneously as rule makers and their subjects attempt to discover ways to achieve their subjective and often conflicting ends. In other words, the evolution of intentionally created rules also tends to be path dependent, as such rules are influenced by what has come before and they in turn influence the path of the spontaneous evolution that follows. Thus, imposed rules influence the subsequent path of spontaneous evolution and any spontaneous order that results, but the result is clearly not a designed order (Hayek 1973: 58–59). The perception that deliberate design is an alternative to spontaneous order in any situation other than a very simple arrangement is incorrect.

ization and trade. A system of rules and institutions of governance is also necessary for ongoing involuntary wealth transfers to be sustained. The institutions of a market economy develop from the former and the state evolves from the latter. Property rights evolved long before states did (Ellickson 1993), and as Ridley (1996: 114) explains, the origins of the market economy (exchange, division of labor, insurance arrangements) trace back to reciprocal food-sharing arrangements in hunter-gatherer bands. On the other hand, the modern nation-state traces back to successful establishment of extortion by individuals and groups with comparative advantages in violence (Oppenheimer 1908, Benson 1998a). Economic activity does not disappear with the development of the state, of course, in part because specialists in extortion require the production of wealth in order to provide them with their income. Furthermore, as Laura Nader and Harry Todd (1978: 29–30) explain, even within modern developed nations, there are “enclaves that either do not need or actively avoid contact with the national [legal] system.” In this regard, avoiding the control of the state is most likely to occur where the benefits generated through voluntary interaction are very large (so the costs of submission are large) or where the relevant group members’ wealth is mobile so they can interact across the jurisdictions of different authorities and inter-jurisdictional competition occurs.

The international merchant community of early medieval Western Europe is one such example (Benson 1989, 1998d). Commercial law, *lex mercatoria* or the “Law Merchant,” consisted of rapidly evolving customary norms, and disputes were resolved in the merchants’ own courts. Strong incentives to cooperate through exchange, to live up to promises, to respect one another’s property rights, and to support an unbiased and fair dispute resolution system arose because of positive benefits associated with repeated dealing reciprocities and reputation effects, and because of the potential for ostracism. Similarly, modern international commercial law, which evolved from this medieval legal system, remains as a largely voluntarily produced and enforced system of spontaneously evolving norms, despite many attempts (some successful for short periods) by various coercive governments (some supported by politically powerful merchants seeking special privileges) to subjugate it over the centuries (Benson 1989, 1992a, 1998d). As Hayek (1973: 81–82) notes, “The growth of the purpose-independent rules of conduct which can produce a spontaneous order will . . . often have taken place in conflict with the aims of the rulers who tended to try to turn their domain into an organization proper. It is in the *ius gentium*, the law merchant, and the practices of the ports and fairs

that we must chiefly seek the steps in the evolution of law which ultimately made an open society possible.”

The foregoing suggests that, “Contrary to a common perception, markets are not parasitic on moral attitudes that have to rely, for their nourishment, on other social settings. Instead, the more the essential features of markets (coordination by voluntary contract) are applicable, the more the market reinforces the virtues of honest behavior that in turn, make them work effectively” (Vanberg and Congleton 1992: 429). Not only is customary law based on respect for property, trustworthiness, unconditional cooperation with others who cooperate, and other forms of moral behavior, the source of economic freedom that is vital to the functioning of competitive markets, but through history, it has been the international merchant community that has probably been the most successful at resisting the political forces that undermine the incentives for moral behavior and maintaining the conditions for economic freedom. Resistance by commercial groups has also been strong within some nation-states (Bernstein 1992, Benson 1995a, 1998b), but unfortunately, members of merchant communities are also susceptible to the incentives to take wealth, and they tend to have considerable bargaining power in political arenas because they can threaten to exit. Therefore, rulers have incentives to grant large and mobile merchants special privileges within their domains that produce wealth transfers to the merchants in exchange for a portion of the transferred wealth (or perhaps, simply to generate more wealth production on the part of relatively immobile resources that are inputs to or complements of the merchants’ enterprises). Thus, throughout much of history merchants have also been a major threat to economic freedom as they have taken advantage of rulers’ coercive powers to obtain wealth transfers within political jurisdictions.

Medieval mercantilism was a system dominated by merchants dealing with kings to restrict economic freedom in favor of domestic monopolies and guilds, for instance, and that system still has a firm hold within many 20th-century economies (de Soto 1989). In fact, in every political jurisdiction, economic regulations undermine economic freedom by limiting competition and generating rents for businesses (Stigler 1971). Indeed, modern merchants often belong to trade associations that facilitate trade between members and with consumers by enforcing their own customary rules through internal governance institutions—such as communication channels, arbitration services, and ostracism threats (Benson 1995a, Bernstein 1992)—and simultaneously lobby for privileges such as licensing restrictions that limit others’ economic freedoms. Similarly, a modern corporation has plants that produce new wealth sold through voluntary exchange and “plants”

(lobbying offices) that pursue monopoly franchises, protective tariffs and quotas, and other entry barriers that are the antithesis to economic freedom.

Thus, merchants behave differently in different institutional environments, cooperating when it pays, but seeking transfers and undermining economic freedom when the relative price of morality is too high and, as a consequence, the economy and the state have become even more tightly intertwined, to the detriment of economic freedom. It is not “economic power” that undermines moral behavior and economic freedom, however; it is political power. After all, business groups are not the only organizations that successfully operate in both the economic and the political spheres.

Even in a society with a very strong extortionist ruler, some cooperative groups always remain. Numerous examples of centralized coercive systems can be cited where “parallel” predominately cooperative systems of norms and institutions actually dominate many and at times even most interactions (e.g., see de Soto 1989, Acheson 1988, and Ellickson 1991). While the basic cooperative means of maintaining social order exist, they may take “atrophied and attenuated forms” (Taylor 1982: 65). Hernando de Soto’s (1989) detailed analysis of the “informal” sector in Peru is particularly revealing in this regard, as he explains that the “squatter communities” are very well organized and members respect each others’ property claims and cooperate to enforce rules of behavior. Nonetheless, the existence of a coercive state claiming authority over these communities raises transactions costs for such groups. The authority may decide to use the state’s coercive institutions to take the property away from the informal communities at any time, so property claims are relatively insecure and time horizons are relatively short, compared to what they would be in the absence of the state’s threats.³ Under such circumstances,

³Similarly, while these informal groups can enforce their own norms, doing so often require tactics that violate the extortionist’s “law.” Ostracism is less effective when property rights are tenuous due to the threat posed by the state, because short time horizons make repeated dealing arrangements and reputations less valuable. If prudent morality or tit-for-tat strategies are ineffective, the victim of a rule violation may opt for retribution. The result need not be violent: it could involve the seizure of an asset, for instance. However, that may not be an attractive option because such a seizure might be treated as a “theft” by the political authority, particularly if the offender has some political influence. Thus, retribution may involve destruction of an asset (vandalism) belonging to an offender, which is likely to be easier to cover up than a seizure (Ellickson 1991: 217; see also Acheson 1988), or even physical punishment (assault). Cooperative clusters may still aid the victim in the “illegal vigilante” exaction of retribution, of course. Under such circumstances, a considerable amount of “crime” may be “undertaken to exercise social control” (Ellickson 1991: 213; see also Acheson 1988, and de Soto 1989). Indeed, such a system is not far from the Hobbesian jungle, but it is because the predatory state exists, not because of the lack of a state legal system.

many individuals in the informal sector have incentives to pursue political influence in order to increase the security of their property rights and gain access to more effective means of enforcing their customary rules (either through more effective private institutions that evolve with the increasing security of property rights or through the use of the state's coercive sanctioning apparatus).

In sum, when a strong coercive power exists, economic success requires that property rights be recognized and supported by that power—that is the essence of a protection racket. If the state did not exist, property rights still would (and, as illustrated by the international law merchant, so would law in support of exchange and contracts). State recognition of property rights is required to achieve the most efficient use of resources then, but only because the state is a threat to those rights. Thus, if and when sufficient bargaining power is accumulated by a group (either because the group controls wealth that the extortionist wants access to and is willing to grant privileges to get, or because the group is seen as a threat to the stability of the political system), the ruler may be willing to negotiate with them, and recognize their property claims (making them subject to taxation, of course). The property rights become more secure, and the group's economic performance improves. As such groups are recognized and some members improve their political skills, their political power can also grow, and they will tend to simultaneously pursue both economic and political means of wealth enhancement (de Soto 1989). To the degree that there are different margins along which individuals and their organizations can adjust in an effort to capture wealth, it is reasonable to expect that they will do so as long as the expected gains exceed the expected costs.

How Can Economic Freedom Be Established?

Over a century and a half ago, Alexis de Tocqueville (1836: 457) wrote, "In the United States there seems to be more liberty in the customs than in the law." In this light, consider the emerging economies of Eastern Europe. Many of the emerging states have been unable or unwilling to establish a legal system that can support private property rights and enforce contracts. As a consequence, many entrepreneurs have turned to private protection services to secure their property and enforce their contracts, much as medieval merchants had to do as they began to trade across political boundaries during the formative period of the Law Merchant (Benson 1998d). Entrepreneurs from these economies who enter international markets are being introduced to the modern Law Merchant's customary commercial law

and its institutions for governance (private arbitration, information channels, and ostracism), however. These traders can see the benefits of such arrangements and attempt to emulate them in their intra-national dealings. Indeed, informal and even formal groups of trading partners are developing in places like Poland, Hungary, and the Czech Republic, much as they did in North America during the colonial period and western expansion when the state was unable to provide protection for property rights and unwilling to enforce contracts (Benson 1991a, 1995a). Repeated dealings and reputation effects are being used to support trade among the members of these groups, and some of them are also turning to arbitration when disputes arise (some groups in Hungary apparently have agreed to take all disputes to an international arbitration tribunal in Geneva, for instance, in order to avoid their other options: violence, exit, or use of inefficient national courts).

These developments may not be as rapid as some observers would like, and many political, economic, and legal consultants and academics suggest that the emerging democratic states must step up their efforts to establish commercial law. But the fact is that it takes time for the private institutions to evolve that are necessary for the development of customary law in support of private property and contract, and an attempt to shorten that time by introducing the state could actually slow the development even more by undermining incentives to develop private cooperative arrangements and by creating incentives for entrepreneurs to invest in rent seeking. Furthermore, reliance on the state for rules and legal sanctions at this early stage may mean that the future evolution of arbitration and customary commercial law may be along a very different path than the one taken in the economies of Western Europe and North America where the state did not claim jurisdiction until long after the evolutionary process was under way.⁴

The governments of North America and Western Europe have certainly moved down the path toward less economic freedom over the past century or more, but movement along that path is relatively difficult due to the strong customary law tradition that has existed. Eastern Europe may never establish economic freedom if the state gains power over the law of property and contract at this early stage in their development. After all, Eastern European legislators, bureaucrats, and judges are even less likely to understand the important legal underpinnings of a successful market economy (e.g., private property and enforceable contracts) well enough to provide effective

⁴Svetozar Pejovich (1997) makes a similar but broader point about Eastern European state efforts to spur the development of markets in general.

support for them than Western European and North American judges, bureaucrats, and politicians (Pejovich 1997). Laissez faire appears to be the best policy for emerging economies in the area of property and contract law as well as in economic policy itself.

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