

Glossary

CAPITALISM is a system of coordination of human economic activity that is based on institutions that guarantee private property and give individuals (or small groups) autonomy to use their property rights, as long as that does not infringe the rights of others. It facilitates decentralised, spontaneous and creative responses to changes and emerging problems.

CATALAXY refers to the process of market exchange which generates and tests new knowledge as to its usefulness to potential buyers. Catalactic market processes facilitate ongoing discoveries of new wants and new resources to meet them. This dynamic-evolutionary concept is appropriate to the growing “knowledge economy”—rather than “economising”, i.e. rationing scarcity and using *given* resources to maximise predetermined ends.

Economic **COMPETITION** takes place in the **MARKET**, (a) between rivalling suppliers who incur the transaction costs of knowledge search and presenting themselves, so that they are positioned as attractive contract partners for potential buyers, and (b) between rivalling buyers who incur transaction costs to position themselves favourably vis-à-vis sellers. Since one can never be sure what return one gets from incurring knowledge exploration costs, competitive rivalry is often unpopular. But the incurring of such transaction costs is essential for prosperity and the control of economic power. Therefore, the agents of public policy should resist protecting buyers or suppliers from the need to bear transaction costs (see RENT SEEKING).

CONSTITUTIONAL ECONOMICS is a fairly new line of inquiry, which has developed out of **PUBLIC CHOICE ECONOMICS**. It is based on the insight that institutions matter and that alternative institutional arrangements can make a great difference to economic outcomes. It focuses in particular on institutions of a constitutional character, i.e. fairly abstract, overriding rules that are considered rather permanent and that constrain adjustments in lower-level rules. “Constitutional” in this sense does not necessarily relate to a nation’s written or unwritten political constitution. Constitutional economists raise the question what economic and political principles and *meta* rules are desirable (normative constitutional economics) and what constitutional changes are needed to obtain certain economic results (positive constitutional

economics).

CORRUPTION is defined as a systematic and intentional breach of accepted rules for material gain, treating different people differently and using deception, fraud or guile to disguise the act. Corruption can be seen as a market for political interventions in free markets and the rule of law, where political favours and preferments are traded in exchange for material and political gain of those with the power to award favours.

ECONOMIC GROWTH is the sustained rise in productivity and real per-capita living standards, let us say over a decade or more. It is normally measured in terms of real output per inhabitant or worker. Economic growth is a supply-side phenomenon, which means that it is tied to the steady increase of a society's capacity to supply goods and services by mobilising labour and skills, capital and technology, and natural resources. This requires a growing division of labour (specialisation) based on confidence-inspiring rule systems.

EVOLUTION was seen as the fundamental phenomenon of economic life by the classical liberals of the 18th and early 19th centuries. Since then, Austrian economics and evolutionary economics have continued this intellectual tradition (whereas neoclassical economists closed the model to new, unpredictable developments and reduced the analysis to comparative-static analysis). The wants of the citizens, and resources to satisfy them, are subject to variations, selections and rejections by numerous, decentralised market participants. What survives in market processes is ultimately determined by the valuations of buyers (consumer sovereignty). Products that attract enough "dollar votes" to make a sufficient profit will survive. Those who do not, will lose critical mass and disappear. Different from biological evolution, the process of economic evolution is fed by the deliberate, intelligent actions of entrepreneurs and buyers. Like biological evolution, it tends to follow a path that is evident in hindsight, but that is open-ended and unpredictable in its future detail.

The term **EXTERNALITY** is used by economists to denote costs and benefits that cannot or are too expensive to be sheeted home to the decision maker who causes them (they cannot be internalised). Thus, industries that burn fossil fuels do not bear the full costs they impose on humanity and the environment (external costs). Other activities cause benefits which cannot be captured cost-effectively (external benefits, for example when people vaccinate themselves and thus reduce the contagion risk of all others in a community). Better measurement technology now often permits the conversion of externalities into internalisable costs and benefits. For example, we are now able to measure road usage with transponders and charge road users accordingly. In other cases, collective action will remain the best way to compensate for externalities, taxing the creators of external costs ("polluter pays") and subsidising the originators of external benefits. Cases with extreme externalities come close to pure PUBLIC GOODS (see below).

The reason why externalities should be compensated for is that private economic choices only yield the highest attainable economic welfare in the community, if activities which cause external costs are not overextended (because they seem too profitable) and activities that cause external benefits are produced sufficiently (despite the fact that they do not seem privately profitable).

FUNDAMENTAL VALUES (or beliefs) are widely shared high priorities that inform human conduct, such as freedom, justice, security, prosperity and peace. These values tend to inform human action in invisible but dominant ways, similar to DNA information influencing an individual's characteristics. Fundamental values tend to remain fairly constant over time, but many social reformers have tried to influence them by education or propaganda. Thus, we witness current attempts to reshape basic values with regard to the environment.

INSTITUTIONS are defined here as rules whose violations incur sanctions of some kind. The sanctions can be informal, as for example when cheats are spontaneously excluded or suffer the loss of their good reputation, or formal, as for example when thieves are punished by law courts. Most institutions are internal to society, ie. they emerge from experience and are adopted in a community because they have been found useful. But some institutions are external, ie. are designed by authorities that have been empowered by a political process and are enforced by formal coercive means.

Institutions are not organisations (see **ORGANISATIONS**). Numerous institutions are obeyed by communities without being embodied in organisations.

Institutions define what is the framework for social interaction. They are essential for cultural and social cohesion. Institutions reduce uncertainty and thereby facilitate human interaction, for example in allocating resources and finding and testing innovative knowledge. By encouraging the search for and the finding of useful new knowledge, institutions enhance economic prosperity. They also help to reduce conflicts and to settle remaining conflicts in predictable and constructive ways. Thereby, they advance social peace and confidence. This is also conducive to prosperity. Universal, non-discriminatory institutions give people the feeling that they are justly treated. Appropriate institutions are also likely to induce people to conserve scarce resources.

Institutions are essentially man-made. They represent a community consensus and therefore evolve over time. By the same token they can also be examined and consciously adapted and reformed.

The **KNOWLEDGE PROBLEM** constitutes the central, fundamental issue of economics. People often do not know what their wants are and where to find resources to satisfy them. In the modern, complex economy, growth depends on how new knowledge is explored and tested as to its usefulness

to many diverse people. One way to do this is to ensure that enterprising people can appropriate the gains from useful new knowledge and must bear the losses from unwanted property uses and innovations. Competitive market processes (see COMPETITION) force resourceful people on both sides of the market to tackle the insidious knowledge problem by spontaneous exploration and testing procedures. An alternative way to gain knowledge is for appointed analysts and planners to engage in systematic research and development. But this tends to work only in settings which are not very complex.

Economic **LIBERALISM** is a philosophy and programme of collective action that favours individual autonomy and responsibility (civil, economic, political freedom) as an end in its own right. It advocates the largest possible use of private property and competition as a means to coordinate autonomous human actions. While not denying a role for the state, liberalism rejects most types of coercion and interference in economic life by governments and interest groups. Contemporary economic liberalism owes much to the classical liberalism of 18th century British, French and German writers, such as John Locke, David Hume, Adam Smith and Immanuel Kant, who argued for a minimal state and against political power to discriminate among the economic interests of different citizens. The concept of liberalism, as defined here, aims at enhancing negative liberties from coercion (in contradistinction to the modern American meaning of “liberalism”, which stands for “generous with the taxpayers’ resources to promote the material ends of organised groups by coercive redistribution and intervention” and in contradistinction to European “Big-L Liberalism” which has often been a political programme of intervention and support for well-organised interest groups).

ORDER is defined as the existence of recognisable patterns in nature or society. Order is useful because people with inherently limited cognitive capacities can interact more confidently and effectively when things are orderly. Order can be imposed on the basis of a design (example: train traffic is ordered by schedules, signals and other coordinating devices), or it can be the result of all component elements following spontaneously a set of shared rules (example: car traffic is coordinated and expedited by adherence to traffic rules). The centrally designed **IMPOSED ORDER** can be an effective way of pursuing human purposes when the subject matter is relatively simple. However, the more complex and changeable the phenomenon is, which needs to be ordered, the more likely it is that **SPONTANEOUS ORDERING** is more effective. This became clear from the resounding failure of the designed, imposed order of the centrally planned economies in communist countries and the continued prosperity of the free market economies.

Human conduct is more likely to be ordered effectively, if the rules themselves are ordered, ie. that there are no contradictions among different rules. Such an **ORDER OF RULES** is more easily achieved if the rules are predominantly proscriptive, ruling out harmful actions, and not prescriptive, commanding people to act in certain ways. **ORGANISATIONS** are more or

less permanent combinations of production factors under some form of leadership, which imposes a hierarchical order. This does not mean that organisations, such as business firms, clubs, or government agencies, do not also have to rely in part on coordination by spontaneous rule compliance. Indeed, many organisations embody institutions, such as work practices, which do not survive outside organisations. Nevertheless, organisations must not be confused with institutions (as is often the case in common usage).

PRIVATE CHOICES occur when people use their own property through voluntary, bilateral contracts. **PUBLIC CHOICES** (or **POLITICAL or COLLECTIVE ACTIONS**) involve groups of people who are expected to contribute resources (e.g. through taxation) and gain advantages (e.g. from using public services). This frequently involves the appointment of agents, for example the election of parliamentarians. Since the trade-offs between give and take in public choice are typically less direct, the motivation to perform is often weak and principals often find it rational to remain ignorant, so that agents have scope for opportunistic, self-seeking behaviour (see agent-principal problem). Public choices also tend to require more costly monitoring and adjudication procedures to ensure that the will of the principals is done.

PRINCIPLE-AGENT (P-A) PROBLEM easily arises when someone (an agent) acts on behalf of another (the principal). The agent typically has superior knowledge of the task and tries to exploit this to act opportunistically, for example by shirking risks, enjoying high on-the-job consumption and enhancing his income at the expense of the principal.

The P-A problem has been diagnosed in business corporations. There, it is constrained by competitive markets that surround the business. Managers (the agents) cannot easily get away with massive opportunism at the expense of poorly informed shareholders (the principals), because capital markets, markets for managers, and markets for the control of companies (takeovers) will soon reveal manager opportunism. Similar competitive checks are, by and large, lacking in government. The citizen (and at the same time the principal) can be less sure that the agents (parliamentarians, bureaucrats, judges) will not act in self-serving ways at his expense, for example by corrupt practices or rent-creation which assist with re-election or gives the agents political clout.

PROPERTY RIGHTS allow the owners to exclude others from using their assets (passive rights) and to use, benefit from, and dispose of assets in cooperation with others (active property rights). The enjoyment of property rights causes exclusion and coordination costs, largely because of knowledge problems about how others will behave.

Property rights attach to assets, they must not be confused with the asset itself. Property rights are not only attached to physical assets, but also to many intellectual assets, as well as to one's person and labour. To be of full use, property rights should be divisible and transferable.

Pure **PUBLIC GOODS** are goods and services in whose provision costs

and benefits cannot be internalised (see externalities), either because potential users do not have to rival with each other, and/or because potential providers cannot supply such goods exclusively to people who would buy them. Examples for non-rivalrous demand are street lighting and national defence: enjoyment of these services by some does not detract from the enjoyment by others. It is also impossible to provide protection from external aggression exclusively to some, but not to other citizens. Once security is provided for some members of a nation, the others can free-ride. Hence, national defence is a public good.

It does not necessarily follow that public goods have to be provided by socialised means of production, only that government secures access for all. Thus, street lighting can be produced by private suppliers and paid for out of taxation. The case for **PUBLIC OWNERSHIP** rests on the need to exert direct control by the purse strings over activities where competition would be costly. Hence, national defence is provided by a government-run military force, rather than by reliance on hired competing mercenary forces, whose competition might inflict 'collateral damage'.

RATIONAL BEHAVIOUR in simple, static contexts can be guided by known ends and known means (**END-MEANS RATIONALITY**). But frequently one observes other types of rational behaviour. Given limited knowledge of the means, people adjust their ends in the light of past experience (**BOUNDED or ADAPTIVE RATIONALITY**), or behave in creative-entrepreneurial ways to overcome existing physical or institutional obstacles, typically without being able to fully assess the costs and the benefits *ex ante* (**CREATIVE or ENTREPRENEURIAL RATIONALITY**). These types of behaviour are all entirely rational. They are indeed necessary for widespread and sustained prosperity.

RENT SEEKING is an aspect of collective action based on the knowledge problem. It is a manifestation of the principal-agent problem (see above). Organised suppliers typically seek material advantage by obtaining an intervention in competitive market processes. Political agents (parliamentary parties, politicians, bureaucrats) provide such interventions (a) because that will give them augmented influence or financial rewards and (b) because the citizen-principals find it too costly to inform themselves about such interventions and to organise themselves against such selective preferment. Rent seeking tends to undermine genuine competition among suppliers and hence prevents them from incurring the transaction costs, which are essential for innovation and growth. It also corrupts political life.

The term **SOCIAL CAPITAL** is sometimes used to refer to the system of internal and external institutions of a society. This signals that the institutions have an effect similar to physical or skill capital on the productivity of production factors, such as labour or natural resources. Just as better tools enhance the productivity of labour, so do more effective, more credibly enforced institutions enhance the division of labour and knowledge, and

hence the productivity of labour. Social (or cultural) capital must not be confused with socialised capital, i.e. the ownership and control of assets by large collectives, such as the state.

TRANSACTION COSTS are the costs of coordinating people in markets. They arise because of the knowledge problem and have to be incurred to find and test knowledge, specifically by finding contract partners, materials and productive knowledge, negotiating and concluding contracts, monitoring contract fulfilment, as well as obtaining redress and compensation for non-fulfilment of promises. In modern economies, the division of labour is so complex that transaction costs have risen to close to half of all the costs of producing and distributing the national product. Devices, such as modern communications and computing technology and appropriate, business-friendly institutions, can economise on transaction costs. (When coordination occurs within organisations, we speak of **ORGANISATION COSTS**).