

FREE-MARKET ECONOMIES, RULE OF LAW AND POLICY-MAKING

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Abstract

This paper analyzes the main features of a free-market system, where uncertainty can be reduced, but not eliminated, and government intervention is legitimate only when it originates from a clear principal-agent link between policy makers and a very large majority of the population. In particular this requires a tight constitutional framework, so that incumbent policy makers can be removed whenever they engage in rent-seeking activities and violate the principal-agent contract.

Nevertheless, government agents usually manage to acquire some power, not only authority. As a consequence, free-market principles are violated, and individual property rights are transferred to an extent which goes beyond the level some individuals are willing to agree to. Although governments still draw their legitimacy from the people, the principal-agent link is weakened, and a free-market model is replaced by a mixed economy. Constitutional engineering may help in slowing down the involuntary transfer of power from the individuals to government(s), but it cannot stop it.

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### Free market is no Nirvana

According to the free-market ideal economic agents should be free to exchange resources, goods and services in order to maximize their objectives - personal satisfaction as consumers and owners of production factors, profits as producers. To this purpose, agents generate and exchange information. They create suitable institutional arrangements in order to ease interaction, to assign, protect and trade property rights; and they also agree on transferring some authority to government bodies, at a local or at a national level. In a free-market system, however, the object of the transfer is authority, not power. Accordingly, the individuals act as principals, whereas those to whom authority is transferred - and can exercise such authority within the geographical and/or functional limits imposed by the principals - are the agents. In a free-market framework, agents are therefore responsible to their principals; in particular, agents can be removed, and the realm of their authority can be modified. And when the principal-agent relationship becomes blurred, the free-market economy slides towards the mixed-economy pattern, or towards the command-economy model.

Surely, the result of all these activities is not a Nirvana economy. That is, it is not a situation where everybody behaves in the most efficient way by using all the information available, so that resources are allocated to their most productive uses in a world with no transaction costs, where everything can be predicted with great ease, and uncertainty eliminated. In fact, acquiring and storing information is expensive, and agents may not be willing to produce and process all the data which would be necessary to take a perfectly-informed decision. Externalities cannot always be fully internalized. The ownership of property rights may be expensive to enforce or to exchange, so that otherwise desirable transactions do not take place. Moreover, risk and uncertainty remain a permanent feature of the economic life of an individual and of a society as a whole. More generally, uncertainty is an intrinsic feature of innovation, which follows from the people's efforts to better their condition. The very fact that innovation occurs implies that operators expect products and processes in the future to be different from

today. The new products and processes available in the future are obviously unknown (uncertain). Hence, from this point of view, the presence of uncertainty is indeed desirable, for it witnesses the presence of fast technological process, of a vital and rapidly growing economic context.

From the above one may perhaps derive the impression that a free-market economy is some kind of a second best, after Nirvana. This would be wrong. Although Nirvana represents a static optimum by definition, it would be clearly sub-optimal in a dynamic context. In fact, in a Nirvana state of the world there would exist very little incentive to improve, to create new products and to experiment new processes. Scarcity would no longer be relevant, growth would become impossible. It would be the end of economics, but economic problems (such as scarcity and the quest for better living conditions) would still be with us. And that would be hardly desirable.

A free-market economy should not be confused with the long-run version of the Nirvana state, either. For a free-market economy tends to a long-run competitive equilibrium, but never reaches it, unlike its Nirvana benchmark paradigm. This is due to the innumerable imperfections which make the difference between the textbook version of perfect competition and the real world. And also to the features of such equilibrium, which change continuously, so that the adjustment process never ends. Indeed, such never-ending and imperfect adjustment process is at the very heart of growth. It encourages agents to innovate and improve their decision-making process in order to reduce the scarcity constraints and the cost of those very imperfections (frictions and sources of inefficiencies); and it rewards their efforts.

#### Imperfection, the rule of law, and beyond

There is now widespread agreement that a free-market economy is the best of all possible worlds (including Nirvana), for it creates opportunities to innovate and improve welfare, both for the individual and from a public-interest point of view. Hence, individuals are thought to be the obvious candidates to take the decisions that affect their own well-being. It follows that property rights should be defined and assigned to the individual, who should then be free to exchange them, and enforced.

In addition, "free" citizens are deemed capable of generating the appropriate institutional arrangements to enhance suitable interaction, either directly among themselves through informal rules, or through the intermediation

of a public body. In a free-market system there is no need to impose - possibly by relatively modest majorities of voters - some wiser and almost omniscient agent to tell people what do, and perhaps force them to do it, allegedly for their own good. If such an entity is actually useful, the population will create it spontaneously, and provide it with the authority which is deemed adequate for the purpose.

This certainly applies to monitoring and enforcing the property-right system, a task which the public agent usually fulfills more efficiently than an individual or a group of individuals. But government intervention can also extend beyond monitoring. In particular, government intervention may be considered suitable in order to provide given sets of goods and services, or to solve a wide range of collective-action problems, whereby desirable outcomes could not obtain otherwise. For instance, individuals' behaviour may be distorted by informed guesses about other individuals' actions. Some operators may thus decide not to take action unless others do, even if their action would have made everybody in the community better off. Similarly, some sets of individuals may decide that there are ways to contribute to the costs for an amount which corresponds to less than their share of the benefits; once again, sub-optimal outcomes are often the consequence. Under such circumstances, governments<sup>1/</sup> may thus become responsible for policy making, both in the domain of production (directly or indirectly, through regulation), and of income redistribution.

Yet, some authors would argue that public authorities (governments) should only provide the "rule of law", that is the rules of the game according to which actors can operate freely. In their view, a policy-making role for governments is not compatible with a role of pure agent.

Of course this raises a crucial question as regards the possibility of having policies in a free-market system. And it explains why the remaining sections of this chapter are devoted to such a very basic issue. Indeed, the difference between the authority to monitor and the authority to decide is critical in this context. The former - called "the rule of law" - refers to the monitoring and effective enforcement of the property-right system; the latter - henceforth "policy making" - refers to the possibility of creating

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<sup>1/</sup> Albert Breton has recently pointed out that it would be wrong to consider "government" as one monolithic structure; rather, there are many layers of governmental authority, to which authority can be delegated. That explains the use of the term "governments" in this context.

new rules, supposedly in the public interest<sup>1/</sup>. In principle, both categories of authority are compatible with a free-market system, as long as government intervention is based on "authority", rather than "power"; i.e. as long as government officials operate as pure agents, and the so-called "private sector" is acknowledged to be the principal. It will be argued, however, that this principal-agent requirement is most likely to be violated in practice.

#### On the role of governments

In this light, it is apparent that the debate on the role of governments in a free-market economy revolves around three broad categories of topics: (1) the evaluation of the features which legitimize the transfer of authority from the realm of individual decision-making to government; (2) the analysis of the incentive systems to which government behaviour responds, that is the extent to which the civil servant's personal goals depend on his ability to deliver in the public interest; and (3) the birth and evolution of the institutional frameworks.

Of course, such topics are closely related. If the transfer is not legitimate, the substance of the transfer is not only authority, but includes power as well. Under such circumstances the principles of a free-market society would thus be undermined, since property rights would not be the object of a voluntary exchange, but rather of arbitrary extortion carried out by a more or less qualified majority. In addition, the rules which affect the creation and development of a society are influenced by how much power is attributed to the institutional actors. If such actors have only authority, but no power, then institutions adapt to the needs of a free society and the state limits the production of goods and services to those areas where it is more efficient. Should agents prove unable to adjust, then the public body would lose authority - either agents are replaced, or the unsatisfactory set of norms is cancelled. But if agents have at least some power, and therefore are not entirely dependent on the public, then officials will be able to take advantage of their power in order to pursue their own personal interests, and even to change the rules of the game so as to expand their rent-seeking opportunities.

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<sup>1/</sup> This distinction is the same as that put forward in J. Buchanan and G.R. Tullock, *The Calculus of Consent, Logical Foundations of Constitutional Democracy*, Ann Arbor, University of Michigan Press, 1962.

This insight can easily lead to extreme views. On the one hand, it is argued that unless some kind of a Wicksellian rule holds - i.e. unanimity or quasi-unanimity for constitutional law-making - governments are bound to develop their own interests, make it difficult for the principal(s) to control them, and eventually become some kind of rent-seeking leviathans living at the expense of the community. Put differently, it would be impossible to imagine a rule-of-law function for government, for it would be just the first step towards "unauthorized" policy making. Contrary to this view, it has been maintained that governments in fact compete among themselves, and are subject to an effective system of check and balances, so that their role is by and large consistent with the desires of the population. Hence, they are efficient, that is they are welfare maximizing; and they may well be required to redistribute income and/or produce services and commodities, if in the public interest. From this standpoint, there would be no need to analyze what the role of government should be; just as it would make little sense to discuss about what and how much a firm should produce in a competitive environment.

If the former view is accepted, and given that consent on rule-of-law is usually based on a qualified majority at most, then governments should be denied any role, for they would interfere with private economic activities, expand rent-seeking and thwart opportunities for growth. This we call the traditional (normative) *laissez-faire* illusion. At the other extreme, the check-and-balances belief supports virtually any role for government, both in the rule-of-law and in the policy-making domains. Short-time imbalances remain possible, of course; but the check-and-balances system makes sure that the median voter forces the public body to pursue the most efficient outcomes, in order to preserve its authority. This we call the neo-classical myth of institutional engineering, which is derived from a positive interpretation of the *laissez-faire* dogma.

#### From the normative *laissez-faire* fallacy ...

The "no-government" hypothesis is usually known as *laissez-faire*. It has not much to do with the free-market notion, although it is undeniable that both the *laissez-faire* and free market ideas share a deep mistrust towards the role of the state as producer of private goods, and an almost equally deep fear of the state as the instrument to carry out income redistribution. But that is where the similarity ends.

Indeed, the *laissez-faire* misconception is one of the major threats to the notion of a free-market economy<sup>1/</sup>. In contrast with a free-market framework, the *laissez-faire* dogma denies all kinds of role for the state. This is not just theory, of course; for there are plenty of (undeveloped) countries where the state does not exist. The consequences of such a regime are however hardly desirable, for in a world with no rules all agents tend to behave as short-term bandits. Uncertainty dominates, and the resources required to reduce it - even in the very short run - leave very little for productive activities. In other words, a *laissez-faire* situation is characterized by anarchy, rather than by freedom; at least until some informal institutional arrangement emerges. Obviously, there is little room for a market to develop in the meantime. In most cases, an autocrat will eventually take power. *Laissez-faire* will thus be more likely to persist under a totalitarian regime, where the autocrat nullifies spontaneous attempts to reduce uncertainty through contracts, and thus makes the allocation of property rights insignificant.

The empirical evidence is by and large consistent with such a prediction. An economy usually develops more easily in a democracy, where the opposition to the rule of law is weaker; while widespread poverty tends to persist under totalitarian regimes, which of course tend to favour anarchy, and where violence is routine. In particular, it is apparent that a free economy is not compatible with the *laissez-faire* model, since in the latter property rights are breached systematically by means of violence. And of course there can be no freedom without property rights.

Yet, although the normative value of the *laissez-faire* dogma is now considered unacceptable in virtually all quarters, it still survives. It is popular among those who fail to perceive the difference between anarchy and free market, and refer to the former in order to discredit the latter. It is also important, and perhaps a little more useful, as a benchmark in order to evaluate and compare different institutional systems.

... to positive *laissez-faire* and social engineering

Although the economic profession does not give any credit to its normative implications, a substantial number of authoritative scholars has been considering *laissez-faire* a methodological guideline in order to

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<sup>1/</sup> See F. Hayek, *The Road to Serfdom*, Routledge, Kegan and Paul, London 1944 (p.13, 1979 edition).

formulate positive assessments about how an economy works in a democracy. This is the current neo-classical interpretation of *laissez-faire*, whereby agents are no longer left to themselves in an institutional vacuum, but are assumed to operate in a democracy. Within this framework, the positive interpretation of the *laissez-faire* tenet maintains that all the institutional arrangements which characterize a democratic country are going to be efficient, for they are generated by the interaction of the market and electoral forces, until an equilibrium solution is reached, whereby the marginal benefits of government intervention equal marginal costs.

As a consequence, the neo-classical view of how a free-market economy operates rejects the traditional version of *laissez-faire*, which is critical of all government policies. Instead, it accepts a positive version which is against any attempt aimed at tampering with the role of governments, which in turn is supposed to be the result of a democratic decision-making process. Governments are thus deemed to be the outcome of a competitive process whereby agents buy desirable goods (or services) and equalize the marginal costs of providing government services and the marginal benefits of such services.

Positive *laissez-faire* often leads to social and institutional engineering. This can be explained by observing that success in reaching a desirable competitive-equilibrium solution in ordinary law-making depends crucially on the nature of the interaction among agents, which is disciplined by constitutional arrangements. Thus, the neo-classical approach holds that if the constitutional framework is "adequate", market failures cannot persist. The political market typical of democracy would always provide a suitable government solution. And agents would for instance agree on transferring production - or assigning new regulating powers - to government authorities. Or they would take such authority away, or perhaps move it from one government to another.

It then follows that if the political market is not able to generate suitable solutions to a market-failure problem, intervention is required in order to remove the impediments to a smooth functioning of the democratic decision-making process, and solve all possible collective-action problems quickly enough. Constitutional engineering is thus needed in order to create or restore a satisfactory institutional environment, or just to speed up institutional change. In the long run, however, constitutional changes are assumed to occur spontaneously, as long as agents are able to interact, and

influence the law-making process according to their expected flows of cost and benefits.

This comes very close to violating the "rule of law", though. For according to the positive *laissez faire* approach, the traditional collective-action problems are eliminated by the fact that the strength of the coalition supporting or opposing constitutional change reflects the cost and benefits of such change. If so, the outcome would be efficient, but at the same time it would eliminate the need for a Wicksellian majority, or indeed for a majority altogether. Social engineering would follow, since individuals could be deprived of their property rights by more or less qualified majorities, whose action is justified by their very intensity, rather than by their legitimacy.

This approach raises a vast number of other issues - spanning from economics to ethics, to political science - which cannot be covered adequately in these pages. All of them, however, focus on the one basic point mentioned at the beginning of this chapter. That is, on our understanding of the way a free-market economy works and, in particular, of how institutional frameworks created in a democratic environment may enhance or hinder its activity.

#### The impossibility of the free-market ideal

As has been pointed out earlier on, a free-market economy exists and produces its benefits only within a formal and/or informal, fairly complete, institutional framework. A reasonably precise and known system of rules and sanctions allows agents to maximize their welfare by taking into account the possibility of interacting with other actors (specialization by product and by process) and by extending their objective into the future (investment). In addition, it is essential that some authority is transferred to a public body, to be made responsible for the enforcement of the rule of law. An inefficient public body is still much more desirable than private solutions. Similar comments may also apply to policy-making functions. In both cases, however, a free-market economy remains such only if individuals maintain full control of power.

#### *The rule-of-law problem*

Let us now focus on the rule of law. This term refers to the important but rather limited number of areas where the provision of services by

government corresponds to situations similar to natural monopoly - national defense, basic infrastructure, law and order and, more generally, enforcement of property rights. In all these cases a public authority is usually thought to perform more efficiently than individuals. In particular, it is assumed to be preferable, as long as it broadly suits the needs of the public interest, and does not exceed in taking advantage of the monopoly power and thus in extracting rents. One can therefore think of a trade-off between the inefficiencies and rent-seeking activities associated with government, which is protected by a legal monopoly and draws legitimacy from the electorate<sup>1/</sup>; and the inefficiencies associated with a private monopolist, who might be tempted to exploit his current monopoly on the use of violence (defence, law and order) in order to maximize rent-seeking and rent-extraction.

Of course, incumbent politicians and top bureaucrats realize that their inefficiencies and rent-seeking activities may give birth to opposition, so that their prospects for long-term office are jeopardized. Actually, some time after inception, opposition emerges anyway, since at least some of the principals are going to be unhappy about the original rule-of-law framework, either because the existing framework is not thought to be enforced satisfactorily, or because the constitutional framework is thought to need revision. This is almost inevitable, since *ex-ante* uncertainty and fear of normative *laissez-faire* usually induces some principals not to oppose the birth of a given set of "initial" institutions. That is, lack of information about the cause-effect mechanisms associated with them, about the practical details of enforcement, and about civil servants' misbehaviour often induces principals to accept constitutional arrangements which anyway allow them to escape the normative-*laissez-faire* trap. All this makes sure that the necessary majority is acquired, so that the initial institutional construct sees the light. But of course the very reasons which induced people to accept a sub-optimal institutional arrangement guarantee that sooner or later, at least in some quarters, the desire for change comes to the surface.

Opposition, though likely, is however not enough to deter government

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<sup>1/</sup> The greater the degree of legitimacy, the vagueness about the terms of the authority transfer, and the uncertainty of the private-monopoly option, the larger the amount of inefficiency and rent-seeking carried out by governments. For an application to the history of trade policy see D. Verdier, *Democracy and International Trade*, Princeton University Press, Princeton, 1994.

officials from shirking and departing from ideal action in pursuit of the public interest. Both because the rules of the game contain a bias which favours the incumbent government actors; and because officials strive to engage in policy making, to transform authority into power.

As regards the first point, the very fact that a qualified-majority rule is usually required to create and/or to change a constitution originates an asymmetry whose relevance can hardly be overestimated. The Wicksellian principle is indeed accepted relatively easily at the beginning of a constitutional history, say after a war, or a very major crisis<sup>1/</sup>. But it works in reverse gear when a substantial minority or even a not-large-enough majority is unhappy with the existing institutions. The Wicksellian majority is no longer required to legitimize a constitutional framework already in place. Put differently, you need a qualified majority to agree on the initial constitutional arrangement, and such a majority is relatively easy to obtain when the opportunity cost of not reaching an agreement is very high (normative *laissez-faire*). But you also need a qualified majority in order to change such an arrangement, even if it turns out to be unsatisfactory for a fairly large share of the population.

Agents know this, of course, and behave accordingly, in order to weaken their links with the principals, and thus create opportunities for rent-seeking. This last goal is pursued by making sure that the constitutional framework allows governments to be made responsible for some amount of policy-making. As will be made clear shortly, policy making creates more opportunities for rent-seeking and also makes it easy for agents to collude against their principals. In addition, actors look for legitimacy to their discretionary actions, so that governments end up by using resources to foster their own power, to the detriment of the rest of the population, and blur the line between personal inefficiencies and institutional shortcomings. As has been noted by several authors, even the most neutral constitutional frame is subject to interpretation by those in charge of its enforcement<sup>2/</sup>.

The "Wicksellian asymmetry" described above is virtually unavoidable, for it stems from the initial quest for stability, at the expense of the need

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<sup>1/</sup> See M. Olson, *The Rise and Decline of Nations*, New Haven, Yale University Press, 1982.

<sup>2/</sup> See for instance P. Bernholz, "On the political economy of the transformation of political and economic regimes", *Virginia Political Economy Lecture Series*, Fairfax (Va.), 1992.

for a flexible institutional arrangement and of a pure principal-agent relation. Thus, it is inevitable that government agents acquire some power, not only authority. As a consequence, free-market principles are violated, and individual property rights are transferred to an extent which goes beyond the level some individuals are willing to agree to. Although governments still draw their legitimacy from the people, the principal-agent link is weakened, and a free-market model is replaced by a mixed economy. Of course, should governments draw legitimacy from other sources than the electorate (say, principles and ideologies), then the shift towards a command-economy context would be more likely.

The outcome is well known - distortions and deadweight welfare losses. On the one hand governments are required to use their discretionary power in order to pursue particular gains, rather than the general interest; on the other, governments use this power and these demands for their own rent-seeking activities.

#### *The policy-making problem*

The effect of the Wicksellian asymmetry described above becomes particularly powerful when governments use their rule-of-law power to legitimize policy making. This takes place when Wicksellian majorities legitimize transfers of authority to governments, and non-Wicksellian majorities (or even minorities) allow governments to use such authority in order to acquire power. The exercise of power generates rent-seeking through three channels: pure redistribution (for instance, state pensions financed on the basis of a PAYG criterion), production (as is the case for state-owned firms), redistribution through production (a typical example is provided by many national health-care programs)<sup>1/</sup>.

Once again, it is worth emphasizing that in principle policy making is not necessarily in contrast with the free-market ideal. Rather, the crucial constraint is that in a free-market economy such activities must be agreed upon by a Wicksellian majority, which are to decide both on whether such matters must be delegated to government agencies and, if so, on the layer of

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<sup>1/</sup> In fact, the outcome is still a matter of redistribution even in the case of production, since tax payers are asked to pay for the losses accumulated by inefficient state firms, or consumers are asked to pay a higher price for goods and services produced in a normative-monopoly regime.

government which should be made responsible.

Can governments be forced to operate as agents, as the positive *laissez-faire* approach discussed earlier maintains? The answer is "no", both because there exist information and collective-action problems, and because governments behave in a non-competitive way.

When government agents have authority, they will try to maximize their degrees of freedom on issues of economic relevance, so as to increase they rent-seeking opportunities, possibly in a long-time perspective. Thus, they will try *ad hoc* interpretation of the constitution, by promoting the formation of simple majorities or strong-enough minorities to support their action or, when necessary, by acting as simple brokers, and thus play one coalition against the other.

This is the core strategy of most redistributive policies, which usually contain two elements. One plays in favour of the interest groups that have fought in favour of the redistributive bills at the moment of their inception, and tends to decay with time. The other tends to obfuscate the size and sign of the net flows involved, so that groups become hesitant to galvanize into an effective coalition against redistribution. This result is obtained through substantial increases in public expenditure, regulation, and a large number of different policies aimed at cutting through possible coalitions of losers, leading to fragmentation. The ultimate aim is to make popular drive against policy-making rewarding for everybody only if such a movement regards a major downsizing in overall redistribution. But that would imply that many bills should be cancelled more or less simultaneously; that interest-group fragmentation is avoided; and that information costs for the individual fall substantially. These constraints are very difficult to meet. The legislative processes usually allow the examination of one bill at a time, so that time-inconsistency issues prevail. Furthermore, the cost of information tends to rise dramatically when new legislation involves the evaluation of many policy-making programmes at the same time, with all the interaction effects. Finally, the uncertain flow of benefits due to a reduction in policy-making is discounted at a much higher rate than the certain flow of costs due to the reduction in subsidies, job security, trade protection, and the like.

In short, public opinion exerts a rather soft constraint on government action in modern democracies. In this light, the similarity and extreme vagueness (if not inconsistency) of the official economic agendas of the

various political parties witness the little pressure imposed on them by the electorate; and they also witness the capacity of the policy makers to behave as principals, with enough degrees of freedom to pursue their own personal aims, irrespective of the public interest.

This takes us to the second and final point. Governments face weak controls from the electorate, there is no free entry (new agencies are created by the incumbent politicians and rent-seeking groups, not by the candidates to government), and bureaucrats and politicians are fairly mobile among the various layers of governments. Hence, collusion is much more likely to emerge than competition. Federal constitutional frameworks may indeed prevent collusion better than in unitary states. But there is substantial evidence that in the long run collusion takes over, so that Federal governments eventually succeed in subtracting authority and power from the peripheral governments. Put differently, federal constitutions are preferable, for they slow down the slide toward a mixed-economy state. But they are unlikely to keep intact the original principal-agent relation, which makes sure that a free-market economy obtains.

#### Concluding remarks

The analysis of the role of government in a free-market economy put forward in this chapter has shown that it is virtually impossible for an economy to be run according to free-market principles, once individuals decide to transfer some authority to government. Even if such authority is restricted to the rule of law, the Wicksellian asymmetry makes sure that government "agents" do not bear the cost of not pursuing the public interest through a competitive mechanism. Eventually they manage to get hold of some power, and thus engage in rent-seeking by introducing some elements typical of a mixed economy. Yet, the transfer of authority (and power) to governments is still desirable, for the rule-of-law services provided by governments in democracies are far more efficient than the outcome associated with other solutions; even if that implies the distortions and deadweight welfare losses associated with policy-making and rent-seeking.

It then follows that the free-market system should be considered as benchmark, rather than a realistic possibility. For it is virtually impossible to reach almost unanimity on an institutional framework, unless the alternative is anarchy. And once institutions are there, a path-dependent

process sets in, so that the economy slides away from the free-market model, as the transfer of authority becomes transfer of power. Surely, constitutional engineering at the start may help in slowing down the involuntary transfer of power from the individuals to government(s). But the scope for such exercise is more limited than one may imagine, since the initial effort to shape the best possible institutional shell should nevertheless be consistent with the existing set of informal rules, with the widely-accepted customs and standards in use. Failure to meet this consistency requirement would deprive formal rules of legitimacy. The quest for perfect world would weaken the rule of law and lead to normative *laissez-faire*, anarchy, and possibly totalitarian solutions.

## SUGGESTED READINGS

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