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Economic Growth and Institutional Coherence

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Abstract: The paper aims at integrating the Lachmannian concept of institutional coherence and flexibility into the Austrian, entrepreneurial theory of economic growth. Using this as a general framework together with the Misesian interventionist theory, it explains some general features of the relationship between regulation and economic growth. The paper argues that as regulatory institutions have a restrictive effect on the entrepreneurial process of the market, the enforcement of these rules is a crucial factor in determining the extent and the way countries shape their regulatory environment. By this the paper identifies a channel through which enforcement contributes to economic development.†

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1 Introduction

With the rise of New Institutional Economics, even mainstream economics accepts the fact that institutions matter. By this they mean that it is not only factor accumulation, but also the 'rules of the game' that determine the economic growth of a country (Easterly – Levine 2001). The economists of the Austrian School have always stressed the role of institutions more firmly than the neoclassicals. It was during the so called calculation debate that this difference between Austrian and neoclassical economists became clear (Boettke 1997:31-36): in his famous paper Mises (1920 [1990]) argued that without two fundamental institutions, private property and money, rational calculation (and thus socialism) is impossible.

This paper aims at examining the relationship between economic growth and institutions in an Austrian perspective. As Boettke (2001) has shown, the problem is not what institutions are necessary for economic growth, because we know the answer to this question: private property, the rule of law, stable money, and the freedom to contract. What we do not know is how to acquire these institutions. The examination of institutional coherence is one possible way of dealing with this broader problem. In this paper I argue that the fundamental institutions of the market economy have an effect on the level and coherence of the regulation of a country. It is not only the political system, but certain fundamental market institutions too that determine regulation.

The paper is structured as follows. In next section I will discuss some fundamental features of the relationship between the regulation of entrepreneurship and economic growth. Section 3 provides a broad framework for understanding the institutional conditions of coherent regulation, which is Lachman's institutional theory. In section 4 I will argue that the theory of interventionism is a possible explanation for the facts discussed in section 2. Finally, in section 5 I will look for the institutional conditions for regulatory coherence. Section 6 concludes.

2 Three facts about regulation and growth

A data set currently compiled and continually refreshed by the World Bank in the report 'Doing Business' makes it possible to examine the regulatory environment of en-

trepreneurship and its effects on economic performance. The most important of the facts about the effect of regulation is that those countries that regulate less are richer than those that regulate more. Djankov et al (2006) create an aggregate index for measuring business regulation and show that even after controlling for several possible determinants of growth, those countries which have more business-friendly regulation have also a higher rate of economic growth. Djankov et al. (2002) have also shown that the greater the number of procedures required to start a business, the more frequently occur various variables associated with negative social outcomes, such as water pollution, accidental death from poisoning and the unofficial economy.

As explained in detail in the next section, the notion of institutional coherence comes from Lachmann (1970). He does not give an exhaustive definition of the term, which he uses as the synonym for institutional unity and consistence, but reading Lachmann (1970), one can conclude that institutional coherence refers to the fact that the elements of institutional structure complement each other, and thus the institutional structure is characterized by some unity, in which there are no logical contradictions. As a result of this complementarity, there are certain circumstances in which the whole structure has to change in order to remain coherent, because new institutional elements do not fit into the structure.

The notion of coherent or consistent institutions also appears in the empirical literature dealing with market regulation. This new data set also makes it possible to examine the correlation of certain aspects of the regulation of entrepreneurship. In the World Bank report, 'Doing Business in 2004', the correlations between different regulatory means[1] are measured in a cross section of 133 countries (Worldbank 2004:89-90). These results enable us to draw two conclusions. First, different areas of market regulation move in step to a significant extent. If, for example, a government regulates the entry of firms into the market more severely, it is probable that hiring and firing a worker is also more burdensome than in a country where entry is freer. Second, the correlation between areas of regulation is stronger and more significant in developed than in developing countries. As shown in World Bank (2004:89-90), the correlation between different areas is statistically significant in more cases in developed countries than in developing coun-

[1] In the year 2004 report data on regulation is available for the following areas: starting a business, hiring and firing workers, enforcing contracts, getting credit, and closing a business.

tries, and even though the correlation is significant in both developed and developing cases, the relationship is stronger in developed countries.

Botero et al. (2004:1371-3) have also pointed out that the different areas of regulation of entry and of the labor market strongly correlate. They see this fact as verifying the legal theory approach of regulation. According to this, how much and what kind of regulation governments apply in different markets depends on the legal origin[2] of that country. Since the legal origin shapes the government approach toward regulation in general, this theory concludes that regulations in different areas have to go hand in hand. The correlation is thus explained. However, they do not provide us with an explanation of the mechanics lying behind this empirical evidence. What is the causal relationship between law and regulatory coherence? In addition, they do not, and do not intend to, explain why this mechanism is stronger in developed countries.

3 Levels of the institutional structure

The fact that regulatory coherence may be rooted in the institutional structure of a country suggests that there are fundamental institutions which determine how other – non-fundamental – institutions will develop. Below I will argue that this approach is closely related to the issue which Lachmann (1970) posed as the contradiction between institutional flexibility and institutional coherence. Lachmann's theory provides a framework in which I will examine the questions raised in the previous section.

Lachmann's main questions refer to the institutional structure as a whole (Lachmann 1970:51-52). First, institutions have to adapt to the changes of the economic and technological environment, but at the same time, they must remain stable to be able to play their coordinative role in the economy. Second, if the institutions coordinate the actions of the economic players, what coordinates the institutions? To put it another way, what makes the institutional order a unity? And third, if some institutions within the whole structure have to change, or if and when new institutions arise, what makes it possible for the new institution to fit into the whole structure? To put it simply again, what makes

[2] A country's legal code can be of English (common law), French (civil law), German, Scandinavian, or Socialist origin.

it possible for the institutional structure to preserve its unity after some of its elements have changed?

In answering these questions, the starting point for Lachmann is Max Weber's insights. He analyzes Weber's several works in detail, but the most important here is that referring to the roles different players play in institution building. According to Weber (Lachmann 1970:60-66), institutions are, at the very origin, the innovations of an individual or of a certain group of people. At the beginning, institutions are not the results of the unanimous vote of a community. These innovators are not, however, the ones who make the institutions work. There is another group whose members run the institutions, and, very importantly, who interpret its purpose differently from the innovators. A third group consists of those people whose actions the institutions coordinate, and for whom the institutions represent points of orientation. He also mentions a fourth group, the members of which simply learn to use the institutions by tradition without knowing its original (or any) purpose. Of course, this line of reasoning deals with the evolution of undesigned (organic) institutions and the focus of the present paper is regulation, which typically consists of designed institutions. But the latter description of different groups is still valid in the case of regulatory institutions, and Lachmann's (1970:69) main question still remains: "What reasons have we to believe that all institutions, designed and undesigned, will easily fit into a coherent whole, when already the undesigned by themselves leave us in some doubt?" This is the main problem of Lachmann's work: the problem of the coherence and permanence or coherence and flexibility of the institutional structure. As the undesigned institutions evolve spontaneously, and thus unexpectedly, two problems arise: (1) As mentioned above these institutions have to fit into an already existing system; beside the fact that the new institutions have to replace old ones, they have to be able to complement the others. (2) Designed institutions can only react to known or possibly known situations, but the undesigned institutions, as a result of the discovery process of the market, bring genuine uncertainty into the picture. This means that because of the creative process of institutional evolutions, situations which nobody could ever conceive before may arise, making the design of institutions impossible.

One possible answer to this problem – according to Lachmann – is a two level institutional structure. The first level consists of external, designed institutions which are relatively stable, while the second level is where internal, undesigned institutions can

evolve in the interstices of external institutions. The coherence of the institutional structure thus depends on the existence of some fundamental institutions that allow the others to change.

Several important conclusions can be drawn from the discussion above. First, some institutions have to change during the process of development, and this process of institutional change is the result of entrepreneurial discovery.[3] Thus internal institutions are the "crystallization" of entrepreneurial discoveries which can spread by imitation.

Second, external institutions should be those which do not have to change quickly. That is, the government has to design those institutions which do not have to adapt to changes in the economic environment. The latter changes mainly refer to entrepreneurial discoveries other than the creation of new internal institutions. The fact that in the mixed economy the government can make any internal institutions external does not assure that those external institutions should be external. Exactly because they are fundamental institutions of the market.

Third, some fundamental institutions have to stay stable. In the market economy these are private property and the freedom of contract (Mises 1920 [1990]). Lachmann adds another reason why the freedom of contract is important: without this institution it is impossible to discover new internal institutions.

4 Interventions and growth in Austrian theory

In this section I will argue that the Austrian (misesian) theory of interventionism provides a possible explanation as to why regulatory rules move together across different regulatory areas. Further, I will demonstrate that the theory can also explain why regulation harms growth and why more a severe regulatory system is more difficult to cut down. I propose that regulatory measures are internal institutions that the interventionist government defines as external "artificially".

[3] On the kirznerian entrepreneur and entrepreneurial discovery see later.

4.1 Mises's theory of interventionism: regulation leading to further regulation

Ludwig von Mises was one of the greatest critics of the "economic system" which is capitalist in the sense that it is based on private property, but where the government intervenes in the working of the market so as to modify the allocation of resources. As Mises (1929 [1996]:20) put it, "interventionism is a limited order by a social authority forcing the owners of the means of production and entrepreneurs to employ their means in a different manner than they otherwise would". This means that interventionism is the misesian expression for what we call now a mixed economy.

In his writings dealing with interventionism, A Critique of Interventionism and Interventionism: An Economic Analysis, Mises makes it clear that the question is not whether we need a government to enforce contracts; the question is rather what is the proper scope of government (Mises 1926:18). The main question posed here by Mises is whether interventionism as an alternative system of laissez faire, and socialism is a possible and stable third system. His answer is no, it is not.

According to Mises, interventionism is not stable because the intervention always has unintended consequences which require further intervention if the government still wants to reach its objective. Thus, interventionism is an ever expanding package of regulatory measures, and as such, is not stable. In the end, either the economy becomes socialist, or it goes back to laissez faire. "There is no other choice: government either abstains from limited interference with the market forces, or it assumes total control over production and distribution. Either capitalism or socialism; there is no middle of the road" (Mises 1926 [1996]:26). I do not intend to deal with the puzzle that despite this prediction, each economy of the developed world has been 'mixed' during last century, and although they undergo changes, they do not seem to go back to laissez faire. This puzzle is elaborated on by Ikeda (1997), or Higgs (2003).

Here, I am focusing on Mises's argument, and on how this argument can be applied to explain the above-mentioned correlation between measures of regulation. The definition of interventionism given by Mises does not include every possible interventionist measure taken by the government. The definition excludes partial socialization of the

factors of production and "market-friendly" interventions. It is not intervention when a government buys and sells goods on the market. Basically, there are two means of intervention: "restrictions of production" which refers to direct burdens on production imposed by the government; and "interference with the structure of prices" i.e. setting minimum or maximum prices in the market for goods, or factors of production.[4] Mises's argument highlights the interrelationships between these measures.

In the present context this argument is important because it can give an explanation for why regulatory institutions move together. In general, the argument is as follows. Introducing a regulatory measure has unintended consequences which make impossible the very aims the authority wanted to achieve. To correct this 'mistake' the authority introduces another, different measure to correct the unintended consequences. But the new measure has again unintended and unexpected consequences which threatens the original aim of the intervention. The means of intervention complement each other, and the mechanism behind this complementarity is the logic of intervention.

We can better understand this mechanism by examining Mises's examples more closely. One of his examples of the interventionist process is that of a maximum price on some agricultural products. The aim of the regulator is to deliver the product to the consumers more cheaply than before. The price set as a maximum, however, must be lower than the equilibrium price of the product, otherwise this kind of regulation makes no sense. As a result, there will be a shortage on the market for that certain product. The government has to take new interventionist measures to correct the problem. One possible intervention is rationing; that is, defining how much of the product one consumer may consume. Rationing is not enough to deliver as much product to the consumers as the government wanted to before, because it cannot eliminate shortage. It has to take further measures to prevent the producers moving their factor of production into another

[4] Mises is not perfectly consistent concerning how many categories of intervention he differentiates between. In his earlier work (Mises 1926 [1996]) he discusses the possibility of including taxation as a third class of interventionist measure, but he rules it out, claiming that the effects of a certain tax are the equivalent of either a kind of production control or a kind of price control. However in his magnum opus (Mises 1949 [1996]) he deals with taxation as an alternative type of government intervention. For a critique of Mises's taxonomy of regulatory measures see Lavoie (1982). He argues that Mises's analysis of interventionism is incomplete and partially incompatible with the misesian view of the market process. His main critique refers to the way Mises deals (or does not deal) with the role of the expenditure side of government interventions.

industry. To sum up, the regulation of a market for a certain product will imply the regulation of the market for factors of production. In this process the regulation becomes deeper and more extended.

Another example is a minimum price on labor; the minimum wage (Mises 1926 [1996]:26-29, 1923[1996]:148-150, 1940[1998]:30-34). Since labor is not the only factor of production and labor is not the only source of income, the minimum wage does not increase the income of each factor of production proportionally. This will decrease the consumption of the owners of capital, and this, in the end, will decrease the demand for labor and result in unemployment. This latter being again an unintended consequence, the government has to react. The reaction can be twofold. Either, the government will force the employer (the owners of capital) to employ those without a job, or they will force them to pay more taxes so as to compensate the unemployed for their lost jobs and incomes. Either of these two possible interventions will decrease the capital owners' income, and thus reduce the capital stock. Because of this, in the end the real wage will be lower than it would have been without imposing the minimum wage. Certainly this was not what the interventionists intended.

If the minimum wage takes effect only in one industry, then the real wage increases only in that industry, and this will lower the wage in other industries. To avoid this consequence, the government has to ban or at least limit the hiring of workers in the industry in question. This, through the mechanism described above, reduces the income of the other factors of production, and in the end, the amount of production. Again, to avoid this unintended consequence, the government will take further restrictive measures.[5]

Mises also has shown that the problems triggered by labor market regulation can only be more intense when applied together with other regulations, for instance with protectionism. Regulation of foreign trade, for example imposing tariffs on imports, will induce the labor force to move from the export sector to the import sector. The more

[5] Benham (2005) emphasizes that responses to new regulation do not necessarily occur in the price-quantity dimensions and he provides a taxonomy of the licit and illicit responses a new regulatory measure can trigger. The possibility of various kinds of reaction contributes further to the conclusion that regulation will always have unintended consequences. He also discusses several examples of regulation leading to further regulation but he stresses the role of a different mechanism than Mises does. The "path dependence" of regulation is in a great part due to the fact that new regulations create new interest groups and these new interest groups want more regulation to avoid the side effects of previous regulations.

severe the regulation of the labor market, the harder it is for this process to take place, and the more distortion the protectionism will cause in the structure of production.

Nevertheless, Mises (1940 [1996]:28-29) deals with two cases in which price regulation does not necessarily lead to inefficiency. In the first case, some specific factors of production are applied in the industry, and they are used to their full potential. Setting a maximum price will not reduce production until the rent of the marginal producer is positive. But this kind of regulation will still cause a shortage, which will induce the regulation authority to react.

In the second case the industry is monopolistic. If this is the case, the price can be reduced until it reaches the equilibrium price of a possible competitive market. We must add, however, that monopolies and cartels can easily be a result of a former regulation. Thus, this example strengthens further the misesian conclusion that interventionism is an ever-expanding set of regulatory measures.[6]

In sum, the basis of the misesian argument and the mechanism behind the relationship of different regulatory measures is the fact that "the effect of intervention is the very opposite of what it was meant to achieve" (Mises 1923 [1996]:150). This suggests that Mises does not apply the approach of modern political economy or public choice theory and does not integrate some model of politics into his analysis. He does not intend to explain how regulatory measures come into being. Although the title of his famous paper 'theory of price controls' suggests to the present day reader that it deals with how the existence of price controls can be explained, what it elaborates on is the consequences of price controls. Despite all this, Mises does not naively suppose that politicians are benevolent and work for social welfare. He makes it clear that price and production controls are to serve the interest of some group of society against the interest of another group. He identifies restrictive measures with privileges given to some group of people. "The interventions, therefore, may be regarded as privileges, which are granted to some at the expense of others" (Mises 1940 [1998]:19). The misesian analysis begins when those in power have already decided which interest group to support. The purpose of the analysis

[6] Even "market failures" to which regulators often refer as a reason to regulate may result from a former (and forgotten) government intervention. Coase (1960), for example, shows in his seminal paper that even one example of Pigou could be seen in this light. One of Pigou's examples for negative externality refers to the uncompensated damage that sparks coming from railway engines cause to woods. Coase (1960) pointed out that this situation was the result of a law.

is to show that price or production controls cannot help to achieve the aim, because these measures will eventually harm that interest group whose grants the government intended to raise. All this means that Mises takes the purposes of economic policy as given: he does not argue against the aims but the means.

Since the purpose of this paper is to analyze the formation of the restrictions of entrepreneurship, the direct product restrictions seems to be more important than price controls. The market restrictions which present day economies apply, such as licenses to start a business or to enter a different branch of business, administrative procedures required for exporting, importing or selling and buying a property, regulations to protect consumers and so on, can be classified into the latter group. However, the mechanism through which direct restrictions of production take their effects and induce further restrictions is no different from that of price controls. The argument against them is the same too: Mises (1949 [1996]:743-757) does not doubt the aims of this kind of policies. Rather, he shows that these means are not sufficient to achieve the purposes set out by the authority. And if it is true, restrictions on production start the same spiral of interventionist measures as price regulations do.

Two conclusions come to mind. First, although interventionist measures are designed and thus external institutions in the lachmannian sense, they do not belong to the fundamental institutions of the market, since the misesian analysis shows that an interventionist system is not stable. It cannot solve the stability versus flexibility problem, because the reactions of the system cannot reduce efficiency problems. Second, the process of interventionism is an explanation as to why different regulatory measures correlate; that is, why more severe regulation in area or industry implies similarly severe regulation in another one.

4.2 Intervention, coordination and growth

The notion of growth is inherently connected to the notion of welfare. By referring to 'growth' we intend to refer to the increase in welfare. The traditional (neoclassical) understanding of aggregate economic growth can be derived from neoclassical welfare theory and from the notion of social welfare. As Kirzner (1973, 1998) argues, this concept is not compatible with that of the entrepreneurial market process and the view of the

market which is not based on the problem of resource allocation but on the knowledge problem.

However, is there at all any normative concept which can fit into the Austrian view of the market economy, and which can be a basis for an Austrian growth theory? Kirzner (1973:212-242, 1998) argues that a normative concept compatible with subjectivist views is coordination. He defines coordination (Kirzner 1998:292) as a state of affairs in which "each action taken by each individual in a demarcated set of actions, correctly takes into account (a) the actions in fact being taken by everyone else in the set, and (b) the actions the others might take were one's own action to be different". According to Kirzner (1973, 1998), this kind of a normative criteria satisfies the subjectivist requirements because it requires the construction of no aggregate welfare function, but one does not have to assume even the existence of social welfare.[7] It is only the compatibility of individual plans that count, and not the final state or allocation at which these plans are aimed.

We can conclude from this short overview of the role of coordination in the Austrian welfare theory that a possible subjectivist definition of growth is the improvement in coordination. This latter occurs when the market system moves from a less coordinated state of affairs to a more coordinated one.

Ikeda's (1998) theory, by which he develops further Mises's theory described above, is crucially important from the viewpoint of the present paper, since he integrates the notion of coordination into the theory of interventionism. As he argues, there are two possible 'coordinational understandings' of the theory of intervention. According to the first one, the coordination is only reduced when the vicious circle of intervention is ended, i.e. when the social ownership of assets is the name of the game. In this view the change in discoordination is discontinuous, because the decrease in coordination occurs only at the end of the process. Until the end, the level of coordination does not change. According to the other interpretation for which Ikeda (1998) argues, discoordination can also continuously change, i.e. in this case, decrease. Every interventionist measure pushes the market order a bit further away from full plan coordination. This latter view will be useful in the present context too.

[7] "It is possible to evaluate a system of a social organization's success in promoting the coordination of the decisions of its individual members without invoking any notion of social welfare at all" (Kirzner 1973:216-217).

Ikeda integrates his interpretation of interventionism into the theory of the market process. In short, this view holds that the market is a process of trial and error and of entrepreneurial discoveries. During this process the market is always in disequilibrium, expressed in arbitrages which are continuously discovered and utilized by entrepreneurs. Entrepreneurs make mistakes too, however. They make errors of judgment (Ikeda 1998:39-40) when they refuse an offer higher than their reservation prices, because they wrongly expect a better offer; or when they take an offer because they wrongly do not expect a better one. And they also make errors of neglect, when they do not notice an offer which they would otherwise accept. The underlying hypothesis of Ikeda (1998) is that the errors of neglect are more difficult to discover and they can only be perceived by a more dynamic form of discovery. In this framework interventionism is the process of curing and discovering errors – but only those of judgment. These are those judgments which are manifested in spectacular disequilibrium phenomena. Errors of neglect 'only' imply an inefficient allocation of resources. A possible start of the deregulational spiral is when these mistakes become visible too.

It is also important that Ikeda (1998) shows that the further the system is from the state of full coordination, the less possible it is to get back, because of the greater number of mistakes the players will make. This argument is based on the notion of interdependence between markets. An entrepreneurial action takes its effect on several markets' equilibrium prices. If an entrepreneurial discovery brings one market closer to the equilibrium, it makes it possible for the players of other markets to calculate with prices closer to the equilibrium, and this is why their calculations will be more correct. The less 'disequilibrative' the prices are on which they calculate, the more mistakes they will commit, and the less possible it is that their entrepreneurial actions will push the whole market back toward full plan coordination. In sum, as in interventionism the system of prices does not express profit opportunities correctly any more, the probability of taking back the market close to the equilibrium by entrepreneurial discoveries will decrease.

Another very important reason why the further we are from the state of laissez faire, the more discoordinated the system is, is the following (Ikeda 1998:43-45). (1) The more weakly the property rights are defined, the more impossible it is that the entrepreneurial action will improve coordination, and (2) interventionism weakens property rights. That is, the more interventionist measures the government takes, the less secure the property

rights are, and the more distorted the market prices are. This conclusion comes from the fact that the extent to which prices can play their calculational role depends on how secure private property is. In its extreme form this was the most important argument of Mises in the calculation debate (Mises 1920[1990]): because it is without private property, has no price system and thus no economic calculation, socialism – an economic system based on public ownership of the factors of production – is impossible. Of course, interventionism is not socialism because it does not put an end to the system of private property, but it violates that. First, because the interventionist measures, controls, subsidies, and taxes levied to finance them limit the use, sale, and the income from private property and thus they weaken the rights to private property. In addition, since by interventionist measures the government always privileges an interest group, these measures do not have an equal effect on each type of private property, which makes the distortions on the price system more severe.[8]

Three conclusions of Ikeda's theory must be emphasized here. First, integrating the notion of coordination into the misesian theory of interventionism explains the fact mentioned in section 2 that the countries that regulate more are poorer and grow more slowly. As we have seen, the more regulation there is, the less possible it is for an entrepreneur to improve the coordination of the whole system. But an improvement in coordinating is growth itself.

Second, it provides an answer for the question why undeveloped countries that regulate more cannot deregulate as easily as developed countries can. As the regulatory measures serve some interest group (Stigler 1971), it is always difficult to cut them back. Just as Ikeda's theory can explain why entrepreneurs with greater interventionism can discoordinate with greater opportunity than those with less interventionism, it also explains why the interest groups of undeveloped countries can argue more effectively against free entrepreneurship.

Third, with the help of Ikeda's insights we are able, at least in theory, to identify a criterion for when the process of interventionism will cease to work and possibly turn back, starting a reverse process toward less regulation. This is the moment when the government has to choose whether to eliminate interventionism or to go further on the

[8] "Every step that takes us away from private ownership of the means of production and from the use of money also takes us away from rational economics" (Mises 1920:13).

road to socialism.[9] This moment comes when the errors of neglect committed because of interventionism become spectacular and make it clear for politicians that the process has to be turned back. An important remaining question is what determines the speed at which these errors of neglect accumulate.

5 Interventionism, entrepreneurship and enforcement of rules

So far I have been arguing as follows. Lachmann's theory of institutions implies that an institutional structure that solves the flexibility-stability problem must have two levels. The stability of external institutions assures that internal institutions resulting from the discovery procedure of the market can continually change. Regulatory institutions are designed, but not fundamental institutions of the market economy. As we have seen from the misesian analysis, interventionism, the system based on the interrelated measures of regulation, is not stable. The theory also explains the fact that measures of interventionism correlate through countries: one measure implies another that implies yet another and so on. The existence of such interventionist measures prevent the market process from reducing discoordination as fast as it can on the free market, the consequence of which is that the countries that regulate more are poorer than those that regulate less. The reduced probability of reducing coordination also provides some explanation as to why it is more difficult to reduce regulation for those countries that regulate more.

In the following paragraphs I will argue that interventionism paralyzes the discovery procedure of internal institutions, and this continually raises the extent to which the above mentioned errors of neglect are present. How effective the government is in this activity is a function of the efficiency of the enforcement of the rules. Being efficient in enforcing the rules, the government makes the errors of neglect more spectacular and the deregulation more urgent.

[9] "If governments do not give them [interventionist measures] up and return to the unhampered market economy, if they stubbornly persist in the attempt to compensate by further interventions for the shortcomings of earlier interventions, they will find eventually that they have adopted socialism" (Mises 1940 [1998]:91).

5.1 Entrepreneurship and growth

Some recent writings (Holcombe 1998, 2003a, 2003b, 2003c) explain economic growth in terms of kirznerian entrepreneurship and make important contributions to the understanding of the creative process of the market.[10] Holcombe (1998) recognizes that in order to explain the growth process by the theory of market process and entrepreneurship, we must give some explanation for the birth of profit opportunities; otherwise it is still exogenous shocks that keep the market in motion and cause growth.

Holcombe (2003a, b) differentiates between three sources of profit opportunities: factors that disequilibriate the market, factors that enhance production possibilities, and the activities of other entrepreneurs. Furthermore, he argues that the latter is by far the most important "origin" of profit opportunities. This category of the origin of profit opportunities refers to the fact that "[w]hen an entrepreneur takes advantage of previously unnoticed profit opportunities, this creates new profit opportunities, allowing other entrepreneurs to act" (Holcombe 2003a:33). According to this, what keeps the market process in motion is entrepreneurship, which by exploiting existing profit opportunities creates new ones. Thus, even the mistakes entrepreneurs commit represent profit opportunities to others, because they can learn from, and correct the mistakes.

If we differentiate between two types of entrepreneurial action, perception of profit opportunities and their exploitation, then it is the exploitation that serves as an origin for a new opportunity. As perception of profit opportunities cannot by its nature be transferred to other people, it would be impossible to identify the causal link between the perceptions of two different entrepreneurs. This also implies that new profit opportunities created by the exploitation of profit opportunities cannot be predicted by the nature of the market process, because if they were, they would be exploited at once.

The regime of market regulation, described above as interventionism, prevents or at least slows down this process. The essence of interventionism is a prevention of the exploitation of profit opportunities: the government forbids some exchanges that otherwise would have occurred. But as we have seen, interventionism does not remain only a one-time prohibition of a certain type of entrepreneurial activity; it is the continuous

[10] Holcombe's 1998 article started a debate in the Quarterly Journal of Austrian Economics (see Hülsmann 1999, Shostak 1999, Holcombe 1999).

prohibition of different kinds of entrepreneurial activities. This is because by preventing the exploitation of some arbitrages, it creates new ones, the exploitation of which induces a new turn of regulation and so on. Thus, interventionism is also a process of creating and exploiting arbitrages; but while intervention creates profit opportunities by force, entrepreneurial activity creates profit opportunity by discovery. The exploitation of profit opportunity created by discovery is what we call economic growth, while the exploitation of profit opportunities created by force can only mitigate the discoordinating effect of regulation. The regulatory measure does not bring about a new state of full plan coordination toward which the economy can move closer through the acts of the arbitrage-perceiving entrepreneurs, but entrepreneurial discovery does.

Since the exploitation of present arbitrages is the source of future profit opportunities and interventionism is the process of preventing the exploitation of arbitrages, market regulation is equivalent to the elimination of future profit opportunities. This is the way in which errors of judgment today are transferred to errors of neglect tomorrow. The more seller and buyer remain disappointed because of exchanges prevented by restrictions – that is, the more errors of judgment occur today – the more arbitrages remain unexploited, and the less profit opportunities remain uncreated and unnoticed, that is, the more errors of neglect there will be in the future.

Entrepreneurs can exploit profit opportunities by creating internal institutions described in section 3 dealing with Lachmann's theory. To exploit arbitrage, the entrepreneur needs to employ factors of production, which the freedom of contract, a fundamental institution (beside private property) of the market economy, makes possible for her or him. A new form of contract is a new technology of exchange, and as a new internal institution, it is a form of exploitation of profit opportunities. As such, this is an entrepreneurial action which creates further profit opportunities. Sooner or later, this new form of contracting will be outperformed or replaced by others. As Greif (2005) and Brousseau et al. (2004) point it out, there can be competition even between private institutions; that is, between institutions with not only two, but several parties, and enforced by a private agency. The discoveries of such internal institutions are an inherent part of the entrepreneurial market process. From this viewpoint interventionism is the replacement of this process with regulatory rules: the authority sets the terms of contracts instead of the actors and monopolizes the market for institutions (Pejovich 1994)

by declaring one enforcement agency "official". By doing this, the government prevents the exploitation of further profit opportunities by the innovation of new internal institutions. Interventionism blocks the interstices in the institutional structure. This is another channel through which regulation undermines the freedom to contract.

5.2 Enforcement and entrepreneurship

We must realize that so far we have assumed that beyond the fact that interventionist measures are taken, the players face perfect institutions in the market. This may not be so, however. As I briefly discussed before, Ikeda (1998) argues that interventionism can weaken property rights, and I have argued that it weakens freedom of contract. But beside property rights and freedom of contract, which are the most important fundamental institutions of a market economy, institutions of enforcement also play a crucial role mainly in economies based on impersonal exchange, as emphasized for example by North (1990:54-60). The institutions of enforcement assure that those patterns of conduct which other institutions prescribe should be followed. The efficiency of enforcement can thus be characterized by whether the players follow the rules of the game manifested in the institutions of society. The enforcement of the rules is perfect if all players accept the rules as a constraint.

Not only private contracts, but, of course, the regulatory measures introduced by governments are enforced by the state. What I am proposing is that enforcement through its effect on entrepreneurship affects the coherence of regulatory institutions. My argument is based on the role of the entrepreneur and on the nature of the discovery procedure discussed in previous paragraphs. Interventionist measures prevent the exploitation of profit opportunities and prevent the possible discoveries of future profit opportunities as their origins are the exploitation of present opportunities. This argument is valid if the regulatory rules are perfectly enforced. In the case of perfect enforcement those arbitrages which are forbidden by the rules cannot be realized. Its effect for the future entrepreneurial process is the same as if the profit opportunities had not been perceived at all. On the contrary, if these rules are not enforced at all (if the enforcement is perfectly inefficient), they do not represent obstacles for the entrepreneurial process.

However, the reality lies somewhere between the two: rules are enforced imperfectly. Regulation provides incentives for "unproductive" and even "destructive" entrepreneurship as argued by Baumol (1990), because some rules stipulate rent seeking. In our coordination language, the argument goes that the regulatory rules create profit opportunities the exploitation of which does not bring about a better coordinated state of affairs. Enforcement can be further weakened by the fact that regulation can also induce evasive entrepreneurship. As Leeson and Coyne (2004) show, evasive entrepreneurship, which aims at evading the legal system, is not rare in undeveloped countries, giving a reason why these countries remain undeveloped. All these entrepreneurial activities such as unproductive and evasive entrepreneurship result from the weak enforcement of the rules.

Corruption is a sign of poor enforcement. According to Mises (1949 [1996]:736) corruption is a regular effect of interventionism. However, it may be not only the effect, but also the aim of the regulation (Shleifer – Vishny 1993:611-613): government officials may use regulation to influence economic actors to substitute those economic activities on which it is difficult to collect bribes for those on which it is easier.

Regulation has two important effects on markets, both of which become more serious as efficiency of enforcement increases. The first is the effect on the allocation of resources, and this is what Mises described as the unintended consequences of intervention. As the efficiency of enforcement increases, unintended effects of regulation which induce the regulators to regulate further (or provide them with an excuse to regulate further) become more serious.[11] Thus, the more efficient the enforcement, the more relevant the misesian argument is. The second effect of regulation is the effect it has on the process of entrepreneurial discovery which I outlined in this section of the paper. The more efficient the enforcement of the regulatory rules are, the less profit opportunities are exploited, and the less profit opportunities will be created for the future, which means that more errors of neglect will occur in the future. As enforcement increases, this effect also becomes more severe, because more profit opportunities remain undiscovered.

[11] In an empirical paper, Almeida and Carneiro (2005) examine the effects that the enforcement of labor regulations has on the performance of firms in Brazil. Since throughout Brazil the regulatory rules are the same but enforcement differs from region to region, they are able to detect the effect of efficiency. They find, consistently with the argument above, that stricter enforcement lead to worse firm outcomes, such as real wages, productivity or investment. They argue that this is the result of lower labor market flexibility in the case of more efficient enforcement.

This lets us conclude that in those countries where enforcement mechanisms are more efficient, market regulation will be both more coherent and easier. The first type of effect makes the interventionist process work faster, while the second kind provides more incentives for the regulators to deregulate.[12]

In sum, weak enforcement on the one hand creates unproductive profit opportunities and, on the other hand, makes it possible to realize some of those arbitrages which would have been realized without regulations.[13] Conclusively, provided that there is a critical number of errors of neglect which "shake the entire politico-economic system" (Ikeda 1998:40), the more efficient the rule enforcement is, the sooner this moment will come. Efficient enforcement spurs deregulation by making discoordination more spectacular to decision makers.

6 Conclusion

In this paper I have applied Lachmann's theory on institutions and the misesian theory of interventionism to explain the facts that (1) the countries that regulate more grow more slowly, (2) different measures of regulations move together across countries, and (3) developed countries regulate more coherently. My basic argument is that the causes are to be found in the fundamental institutions of the market. This is why the framework of my analysis is the lachmannian structure of external and internal institutions. Mises's theory of interventionism can explain how one burden of free exchange can lead to another measure of regulation and so on, until the economy ends up in a state of full socialism. Thus, it is an explanation for regulatory coherence. Together with the coordinational argument it can also explain how regulation harms growth.

The question I focused on in the second half of this essay is why developed countries regulate less and more coherently at the same time. To provide an answer, I modeled the growth process as a procedure of entrepreneurial discoveries, and I argued that the aim of

[12] To use the typology of Bradley (2003), the efficient enforcement of rules is a criterion which can turn the misesian method of interventionist expansionary cumulative dynamics into contractionary dynamics.

[13] Stephen et al. (2004) argue that poor enforcement can be conducive to "nascent entrepreneurship" in countries with financial institutions. The possibility of non-repayment of loans is a device for the entrepreneur to overcome cash-flow problems during the initial period of his or her entrepreneurship. Poor institutions, the authors argue, can substitute for financial institutions, or to put it simply, poor institutions compensate the entrepreneurs for the lack of financial institutions.

regulation is to prevent this procedure. Enforcement plays a crucial role in determining when the accumulating errors of neglect will shake the system. As developed countries have more efficient formal and informal institutions of enforcement, the misesian "regulatory spiral" moves faster and stops earlier because the errors will be revealed sooner. The paper thus highlights a channel through which enforcement contributes to economic development. The cost of the entrepreneurial discoveries that would have occurred without the regulation is the unintended consequence of regulation that can stop the vicious circle of interventionism. Enforcement does not only contribute to economic development directly by property rights and freedom to contract, but indirectly by making the consequence of the regulatory rules more severe for the regulators. The argument outlined in the paper can be seen as a small step towards analyzing entrepreneurial discovery and kirznerian entrepreneurship in an imperfect institutional environment as suggested by Subrick and Beaulier (2004) as a possible agenda for future research in Austrian economics.

A broader context of my argument is that interventionism undermines all three fundamental institutions of the market: private property, freedom to contract, and enforcement institutions. Ikeda (1998) shows how it undermines private property by unevenly restricting the right to different kinds of private property (section 3.2.). It is almost obvious that interventionism undermines the freedom to contract, too. However, as I argued, it does not only exclude some present profit opportunities, but by forbidding their exploitation, it prevents the discovery of some future arbitrages. Furthermore, interventionism undermines enforcement by providing incentives for rent seeking and corruption.

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