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Markets and Regulation: On the Contrast Between Free-Market Liberalism and Constitutional Liberalism

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Abstract. A liberalism that does not close its eyes to the constitutional level of choice must seek to extend the same fundamental logic that it applies in its theory of the market to the questions of what the sovereignty of the individual can mean, and how it can be secured, in constitutional matters. The problems that arise with such an extension to the constitutional level may well be more difficult than those that the liberal theory of the market has to deal with, and the conclusions that a constitutional liberalism arrives at may be less determinate that what the free-market approach pronounces. Yet, if these difficulties are inherent in the subject matter, and if the indeterminacy follows from arguments that we are required to accept, then denying them does not seem to be a promising strategy for strengthening the liberal paradigm.

JEL classification: H10, K20, L50, P10.

1. Introduction

In the New Palgrave's entry on "regulation and deregulation" the authors note, "Both theoretical and empirical research question the extent to which regulation can achieve the goals for which it has been promulgated" (Breyer and MacAvoy 1987:129). The disillusioned view of the promises of regulatory policies expressed in this summary judgement has by now become widely accepted wisdom within the economics profession.[1] And public-choice economists have long been arguing that regulation is the prime arena of rent-seeking politics, that it largely serves to provide privileges to concentrated interest groups at the expense of the public at large.

The purpose of this paper is not to add to the discussion on the dismal record of regulatory politics. Its purpose is to inquire into some of the more fundamental conceptual and theoretical issues of the relation between markets and regulation. More specifically, confining my analysis to a classical liberal approach to the nature and the function of markets, I want to contrast two varieties of liberalism that, as I shall conjecture, systematically differ in their underlying view on "markets and regulation," even if they arrive at similar conclusions in most issues of practical economic policy. My thinking about this matter was stimulated by reading about an incidence at the 1949 meeting of the Mont Pelerin Society, a society of classical liberals that F. A. Hayek had founded in 1947 at Mont Pelerin in Switzerland. In

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an article by Wilhelm Röpke, one of the MPS's founding members, in which he recounts his memories of Walter Eucken, also a member of the MPS and one of the founders of the Freiburg School of Law and Economics,[2] Röpke reports that at the respective 1949 meeting (which took place in Seelisberg, Switzerland) an argument erupted between Ludwig von Mises and Walter Eucken. Röpke tells us not much about the encounter,[3] nor have I been able to find more detailed accounts in other sources.[4] It is apparent, though, from his report that Röpke considered the exchange between Eucken and von Mises to be symbolic of a conflict of opinion that, as he notes, repeatedly resurfaced within the Mont Pelerin Society, and it seems obvious to me that it must have had to do with the fact that the two persons, Eucken and von Mises, represent, with their respective works, distinctiveley different perspectives on the nature of the liberal market order, perspectives that revolve around different organizing concepts. In the case of Mises this is the notion of the *unhampered market*, and in the case of Eucken it is the notion of the market as a *constitutional order*. For the purpose of abbreviation I contrast these perspectives as *free-market liberalism* and *constitutional liberalism*.

It seems to me that—without being necessarily associated with the names of their two early advocates—the two types of perspectives do continue to play an important role in classical liberal scholarship, and that the difference between them is of relevance for the issue of regulation, if not necessarily in the conclusions at which one ultimately arrives, but clearly so in the general logic of the arguments by which one arrives at these conclusions. In what follows, I want to examine more closely the ways in which the contrasting perspectives inform the general arguments that underlie liberal reasoning about the problems of regulation.

2. The "Unhampered Market" and the Argument Against Regulation

At first glance, the Misesean concept of the "unhampered market economy" appears to provide a clear-cut and unambiguous criterion for deciding what counts, descriptively, as regulation as well as for answering the normative question of what is wrong with regulation.[5] If one can, as Israel Kirzner (1985) implies in his article on "The Perils of Regulation," clearly distinguish between "the hampered (that is, regulated) market economy" (ibib.:122) and the unhampered, "unregulated market" (ibid.:141), then any form of regulation must be viewed as an impediment to the smooth working of market processes.[6] On closer inspection, though, the issue quickly gets more complicated as soon as one acknowledges that regulation can hardly be said to be a well-defined, concise concept, but is, instead, a term that has taken on a rather broad and somewhat diffuse meaning. It has become a summary name for various kinds of policy measures that may exhibit certain common properties but that are clearly different in other regards.

There are, presumably, several dimensions along which the various policy measures that are commonly classified as regulations could be distinguished. Of particular importance in the present context is the contrast between, on one side, "regulation as *intervention in* market processes" and, on the other side, "regulation as *framing of* market processes," in the sense of circumscribing the terms under which these market processes unfold. The difference that is of relevance here, and that can also be described as "regulation by *command* versus

regulation by *rules*," is glossed over when the term regulation is equally applied to such things as "imposed price ceilings and floors," "mandated quality specifications" (Kirzner 1985:139), "an impeded merger" (ibid.:141) or "efforts of regulators to legislate prices at other than equilibrium levels" (ibid.:143), as well as to provisions like "child labor laws" (ibid.:134), or regulations that concern "the side effects (such as environmental pollution, or spread of disease, or exposure of the young to pornography) generated by uncontrolled market activity" (ibid.:139). Certainly, one may choose to use the term regulation in such inclusive manner, but when it comes to diagnosing the detriments "of government regulation of the market process" (ibid.:149) such undiscriminating use can be easily misleading.[7]

That clarity should require one to draw a clear distinction here, nobody has stressed more emphatically than F. A. Hayek. He points out, in particular, that confusion must result if the various kinds of regulations are equally described as "government intervention." The term 'interference' (or 'intervention'), he insists, is properly applied only to specific orders, aimed at particular results (Hayek 1976:128), such as "decisions as to who is to be allowed to provide different services and commodities, at what prices or in what quantities" (Hayek 1960:227). It is misapplied if it is used in reference to "all those general regulations of economic activity which can be laid down in the form of general rules specifying conditions which everybody who engages in a certain activity must satisfy" (ibid.:224).—It is apparent that Mises, when he spoke of "government interference" and of "regulated markets," was foremost thinking of *regulation by command*. He spoke of economic activities being "regulated, guided, and controlled by *authoritarian decrees and prohibitions*" (Mises 1985:76); in "fixing the prices of goods and services" he saw the "crucial acts of intervention" (ibid.), and he described the "hampered market economy" as one where "government interferes with the operation of business by means of orders and prohibitions" (Mises 1949:714).[8] Accordingly, the arguments that Mises advanced against government interference are arguments against *regulation by command*. It is essential for our purposes here to understand why such arguments cannot be simply extended to *regulation by rules*, and that, if a case against instances of the latter is to be made, it must be grounded on different kinds of arguments.

There is a straightforward argument for why interventions by *regulatory commands* "run counter to the very principle" (Hayek 1960:222) of market coordination, and there is an equally straightforward argument for why attempts to improve market outcomes by such interventions are likely to make things worse. As Hayek (1976:115) has suggested, the best way to understand the operation of the market system, is to think of it as a "wealth-creating game," the "game of catallaxy."[9] Within the rules that define the game, market participants are left free to use their resources in ways that they, based on specific knowledge, perceive to be most profitable. It is precisely because in such manner the knowledge that exists dispersed in people's heads can best be utilized that the game of catallaxy can unfold its wealth-creating potential. Yet, as with any genuine game, one cannot have it both ways: One cannot play a game and, at the same time, seek to assure specific outcomes. The point of playing the game of catallaxy is to leave it to market participants to make their own choices within the rules of the game, with the consequence that the particular outcomes that emerge from their separate choices must remain indeterminate. It is inconsistent with the logic of such a game to seek to assure particular results by commanding the players how

they are to play the game. Whether the game is worth playing can be properly judged only in terms of the desirability of its *pattern of outcomes*, not by looking at particular results and asking whether they might not be improved upon by discretionary intervention. We can certainly imagine instances in which such intervention may do some good. Yet, this is not the relevant issue. The relevant issue is whether by giving governments authority to intervene by discretionary commands we can realistically hope to arrive at more desirable overall patterns of outcomes than if governments are denied such authority.[10] Spelling out the reasons why this is not the case has been the essence of liberal teaching on the merits of the market order. These reasons have to do, in particular, with the knowledge problem that is the central theme of the Mises-Hayek critique of central planning, a critique that can, indeed, be generalized to the issue of regulation by command.[11] And they have also to do with the fact that discretionary government interventions are susceptible to become instruments for granting privileged treatment to particular interests[12] and, thus, are bound to be plagued by the problems that modern public choice theory has discussed under the rubric of "rent-seeking."

The above arguments are implied when Hayek (1960:221) insists that "the method of specific orders and prohibitions" is ruled out as a matter of principle by the liberal concept of the market order, and that "direct control of prices by government is irreconcilable with a functioning free system" (ibid.:227).[13] He also insists, however, that the same cannot be said about government *regulation by rules*.[14] He hastens to add that recognizing the need to distinguish in this regard between the two kinds of governmental measures does by no means imply that one need not worry about regulation by rules. To the contrary, he suspects that "many such measures will, of course, still be undesirable or even harmful" (ibid.:222), and that we may often have good reasons for considering them "inexpedient, either because they will fail or because their costs will outweigh the advantages" (ibid.:221). Yet, as he puts it, "so long as they are compatible with the rule of law, they cannot be rejected out of hand as government intervention but must be examined in each instance from the viewpoint of expediency" (ibid.).[15] In this context he makes it unambiguously clear that he sees no merit in downplaying the difference between rejecting certain kinds of governmental measures as incompatible with the very principles of market coordination and faulting regulatory provisions on grounds of expediency: "The habitual appeal to the principle of non-interference in the fight against all ill-considered or harmful measures has had the effect of blurring the fundamental distinction between the kinds of measures which are and those which are not compatible with a free system" (ibid.).[16]

Admittedly, the distinction between *regulation by specific orders* and *regulation by rules* that is alluded to by Hayek and that I wanted to draw attention to in this section may not provide us with a perfectly sharp demarcation line in the sense that all conceivable instances of regulation can be unambiguously assigned to one side or the other. There may well exist "gray areas," and ambiguities may arise from the fact that, as a matter of linguistics, "specific orders" can be translated into suitably phrased "general rules." This should not distract, though, from the fact that, conceptually, the distinction is both meaningful and significant. Where governments regulate by command, they tell market-participants how they are to play the game of catallaxy, and such interference in the *playing of the game* is in apparent conflict with the very purpose of the game. Where governments regulate by rules, they

redefine the terms under which, or the framework within which, the game is played. Such interference *at the level of rules* may well be inexpedient in the sense of causing the game of catallaxy to exhibit less attractive working properties than would otherwise be the case. However, it cannot be said to be in principle contrary to the purpose of playing a game.

3. Regulation by Rules and the Market as a Constitutional Order

For the remainder of this paper, I shall concern myself only with the issue of *regulation by rules*. As far as the issue of *regulation by specific orders* is concerned, there is no disagreement between the unhampered-market approach and the constitutional approach. Both are critical of such intervention, for the same reasons. The differences that separate the two outlooks at the liberal order come to the surface, though, as soon as we seek to specify the systematic criteria on which a liberal critique of *regulatory rules* (as opposed to regulatory commands) can be based.

The formula of the unhampered market can surely not be meant to imply the notion of a market without any rules. That the market order is a rule-based order, and different from the "everything-goes-game" of pure anarchy, is certainly not controversial. The market simply cannot be described as the game of catallaxy without reference to the rules of the game. Though we can, of course, imagine (and consider desirable) a market without any interference by specific orders, we cannot imagine (and consider desirable) a market without any framework of rules and institutions.[17] If advocates of the concept of the unhampered market acknowledge the fact that there can be no market without framing rules, they cannot avoid specifying in substance which rules they consider to be constitutive of the unhampered, unregulated market, in contrast to a hampered, regulated market.

Without explicitly using the term unhampered market, Kirzner (1994) specifies in a more recent contribution his own understanding of this concept in a manner that explicitly refers to "the institutions upon which markets must rest for their very existence" (ibid.:107),[18] and that acknowledges the fact that the "function of the market . . . can be defined only in the context of a given pattern of individual rights" (ibid.:105), a context that, obviously, may vary among different societies. "Within such a context," Kirzner (ibid.:105) notes, "it is the function of the market to promote mutual discovery . . . , encouraging fullest exploitation of *all available opportunities* for mutually gainful exchange" (ibid.), where "available opportunities" is to be understood *relative to the "given rights system*."[19] In this understanding, it seems, for a market to be considered unhampered means that government does not interfere in the market discovery process as it unfolds *within the given rights framework*, it does not imply a judgement on the nature of that framework *itself*. And, in fact, in critique of standard market-failure arguments, Kirzner explicitly stresses the need to distinguish sharply between the issue of the successful working of the market process within a given institutional framework, and the issue of the suitability of that very framework. As he describes his own view: "If market outcomes, resulting from externalities, are deemed somehow unfortunate, this is seen immediately as attributable not to the failure of the market to coordinate with respect to the given rights system, but to the pattern of rights which the system has, rightly or wrongly, taken as its initial framework" (ibid.:108f.). While this interpretation may give an unambiguous meaning to the notion of an unhampered

market, it raises, of course, the question of how we are to escape the institutional relativism that appears to be implied if the "given rights system" were the unquestioned starting point of our inquiry into the functioning of the market process. Should we abstain from judging alternative frameworks, or, if not, what is the criterion that we may employ to pass judgment?[20]

The approach that I propose to call *constitutional liberalism* starts from the very premise that the market order, as defined by its institutional framework, is a matter of, and is subject to, (explicit or implicit) *constitutional choice*. It assumes that the working properties of market processes depend on the nature of the legal-institutional framework within which they take place, and that the issue of which rules are and which are not desirable elements of such frameworks ought to be judged as a *constitutional issue*, i.e. in terms of the relative desirability of relevant constitutional alternatives. In the same manner the case for the market order in general, by contrast to centralized types of economic systems, is to be argued at the *constitutional level*, i.e. in terms of its desirability in comparison to economic constitutions of the central planning type.[21] This is the paradigmatic essence of the constitutional outlook at the liberal market order that Walter Eucken and the Freiburg School developed and that is implied in modern Constitutional Political Economy, as founded on the work of James Buchanan.[22]

Different from a free-market liberalism that uses the concept of the unhampered market not only in the limited Kirznerian sense but as a standard against which the institutions that frame markets can themselves be judged, the constitutional approach does not claim to provide us with a universal criterion that allows for a straightforward and a priori answer to the question of which rules are to be recognized as constitutive of a desirable market order and which rules are to be rejected as hampering regulations. Instead, it requires us to take on the task of comparative analysis and evaluation of constitutional alternatives, a task that we should approach, of course, in light of our general theoretical knowledge and available empirical evidence, but that we cannot circumvent by merely referring to the universal standard of an unhampered market. In fact, the body of research on the practice of regulation to which I referred in the introduction of this paper provides important contributions to the very task of comparative institutional analysis and evaluation that the constitutional approach calls for. To the unhampered-market approach such research is of little systematic significance. It reaches its relevant conclusions beforehand.

If the concept of the free, unhampered market is claimed to provide the appropriate standard for judging, what could be its criterion for distinguishing between the rules of an unhampered market and regulatory rules that interfere with it? One obvious criterion may seem to be provided in the concept of private property. If "the institution of private property" (Mises 1985:30) can be said to provide the essential institutional foundation of a market economy,[23] we can conclude that private property rights define the constitutive rules of the game of catallaxy. Accordingly, interference with these rights seemingly provides an unambiguous criterion by which regulatory rules could be distinguished from the rules of the unhampered market, as well as a criterion on which they could be critically judged from a liberal perspective.[24] Yet, here again, the need for further specification becomes apparent as one examines the issue more closely.

When we speak of the role of property rights, two separable, though interconnected, issues are involved. The issue of *assigning* rights, i.e. the question of "who owns what?", and the issue of *defining* rights, i.e. the question of "what does it mean to own something?" In their *rights-assigning role* property rights determine the allocation of entitlements, while in their *rights-defining role* they determine what the rules of the game are.[25] In light of this distinction it is not entirely unambiguous when regulations are said to "restrict the use of the property."[26] Regulations can restrict private property in the sense that they *reassign* property rights from private persons to the public or the state. In doing this, regulations shift the dividing line between privately held rights and communal rights, as, for instance, in the case of regulations that require the owners of ocean front property to allow for public access to the beach.

Yet, when regulations are said to restrict private property this can also mean that they *redefine* property rights in the sense of changing the restrictions to which property holders are subject in using their assets. In doing this, regulations redefine the rules of the game for all property holders, i.e. they redefine what it means to own something, as, for instance, in the case of environmental regulation that sets certain general standards for permissible emission.[27]

To be sure, demarcating the two types of restrictions is not always an easy task and it may by no means be obvious exactly where the dividing line is to be drawn. Yet, these difficulties do not make the conceptual distinction meaningless. Nor should they make us overlook the fact that the kinds of arguments that one may advance against regulations which reassign property rights cannot be simply extended to regulations which redefine property rights, even though, of course, the latter are by no means immune to objections either. There are relevant differences between the two types of regulatory restrictions and our interest in "providing a bulwork against excesses of government power" (Epstein 1985:95) need not be best served by glossing over these differences.

The issues raised by regulations that shift the dividing line between the private and the public domain by "partial taking" of property from private holders appear to be the principal focus of Richard Epstein's critique of the regulatory state, when he charges that "there is no sharp dichotomy between government regulation ... and government ownership" (Epstein 1995:XII), and when he comments on his notion of regulation as *partial taking*: "Regulation takes certain elements from the owner's bundle of rights and transfers them to the state, where they again fall prey to the same difficulties that arose when central planning was defended on a grand scale" (ibid.:XIIf.). Even though such statements seem to be clearly concerned with the issue of reassigning rights from the private to the public domain, Epstein's apparent claim is that no sharp dividing line can be drawn between the taking of private property and general economic regulation. As he puts it: "All regulation, all taxes, and all modifications of liability rules are takings of private property prima facie compensable by the state" (1985:95).[28]

Epstein's analysis is concerned with the issue of the legal status and the functional role of "the constitutional standard of just compensation" (Epstein 1986:11). I need not question in the present context whether, with regard to this issue, he is right in insisting that there is a "tight, logical connection between taking private property and general economic regulation" (ibid.:8). Yet, while the distinction suggested above between regulations that *reassign* and

those that *redefine* property rights may be irrelevant for Epstein's purposes, it cannot be ignored when the task is to examine the logical foundations of the liberal critique of the regulatory state.

Regulations that shift the dividing line between privately held property rights and communal rights in favor of the latter clearly decrease the domain within which market forces can work and they are, accordingly, subject to the battery of liberal arguments that spell out the reasons why a system of private property rights promises to be superior—i.e., more attractive to all parties involved—than a system of communal rights. The logic of these arguments applies wherever property rights are transferred, in total or partially, from private holders to the state. To be sure, these arguments do not allow for the conclusion that communal ownership can never be preferable in the sense noted to private ownership. Yet, they point out why this can be expected to be true only under certain, limited circumstances. When the "rationality" of regulatory reassigning of rights from private holders to the state is concerned, the critical issue is whether communal control can be expected to be, overall, socially more beneficial than private control. And the central message of the liberal paradigm is, of course, that "taking well-defined rights away from individual owners, and placing them in a new common pool" (Epstein 1985:203) will, as a rule, be a welfare-reducing rather than a welfare-improving recipe.[29]

Regulations that change the general rules of the game by redefining what it means to own something may well reduce the scope of permissible uses that private owners of assets may engage in, but they cannot be said in the same sense as rights-reassigning regulations can to decrease the domain of the market in favor of communal rights. Regulations of this sort respond, in V. P. Goldberg's (1976b:445) terms, "to such questions as: how should X's right to breathe clean air be protected from Y's productive activity which pollutes that air?" That is, their principal concern is with how, according to which rules the market game is to be played, rather than with the issue of where the line between the private domain and the public domain is to be drawn. To be sure, there may often be difficulties in separating these two aspects, and what appear to be redefining regulations may often be instruments for transferring rights from private holders into common pools. Yet, the issue of whether it can be desirable to shift the line between privately held rights and communal rights in favor of the latter must surely be distinguished form the issue of whether it can be desirable to redefine the general restrictions to which the use of private property is subject.

The private property rights that constitute markets are inevitably "restricted" rights in the sense that they define socially sanctioned limits to what the owner of an asset is entitled to do, and which uses of his property are prohibited in order to protect the interests of other players in the game of catallaxy. In other words, the question of the desirability of regulation cannot be an issue of unrestricted versus restricted rights, because a market based on literally unrestricted rights is unimaginable. It can only be an issue of which *kinds* of restrictions are overall more beneficial, i.e. promise to make the game of catallaxy a more attractive game for all players involved. This issue can only be approached by comparing the observable and/or predictable working properties of alternative property-rules.

There is no pre-defined, immutable standard for what the content of "well-*defined* private ownership" (Epstein 1986:15) must be, nor does the formula of "the full bundle of rights" (ibid.:8) inherent in "the original common law bundle" (ibid.:14) seem to provide a substitute

for such a standard. Property rights are socially defined,[30] and in a constantly changing world it is hard to deny the need "for adjusting legal relationships over time in an ongoing evolving social system" (Goldberg 1976a:886).[31] The common-law process as well as the legislative process serve to bring about such adjustment.[32] Both processes may be analyzed and compared with regard to their general capacities to serve that function in the interest of all parties involved, contingent on the rules of the game to which they themselves are subject. And the specific modifications in rules that they produce may be analyzed in terms of their prospects of improving the game of catallaxy. Yet, it would clearly be misleading to suggest that the liberal paradigm can spare us the trouble of such comparative analysis by providing an immutable standard against which the "malleable" rights of common law and legislation could be directly judged as to their appropriateness.[33]

Hayek has been very clear in these matters when in his address to the inaugural 1947 meeting at Mont Pelerin he noted,

> That a functioning market presupposes not only prevention of violence and fraud but the protection of certain rights, such as property, and the enforcement of contracts, is always taken for granted. Where the traditional discussion becomes so unsatisfactory is where it is suggested that, with the recognition of the principles of private property and freedom of contract, which indeed every liberal must recognize, all the issues were settled, as if the law of property and contract were given once and for all in its final and most appropriate form . . . It is only after we have agreed on these principles that the real problems begin (Hayek 1948:110f.).[34]

To argue that, for the reasons stated, rights-reassigning regulations must be distinguished from rights-redefining regulations is, of course, not at all the same as saying that the latter give no cause for concern from a liberal perspective. Legislative changes in the rules of the game, in particular, are subject to severe knowledge problems as well as incentive problems that can easily cause well-intended initiatives to result in welfare-reducing rather than welfare-improving reforms.[35] The knowledge problems that Hayek has stressed must, therefore, be understood as a serious warning against lighthearted experimentation in these matters. And the incentive problems that have been amply discussed in the literature on *rent-seeking* must always be kept in mind as warning against the danger that the legislative process falls prey to the pressures of special interest groups who seek legislative privileges under the pretence of advocating generally beneficial rule-changes.

As important as such warnings unquestionably are, they do not provide an argument against rule-adjustments per se. Instead, they serve to remind us that the processes through which such rule-changes take place should be properly constrained such that the noted knowledge problems and incentive problems are sufficiently checked. The most important role that, in this regard, the *generality constraint* plays has been a central theme of the liberal paradigm throughout its entire history, i.e. the constraint imposed on legislation by the requirement to operate in terms of non-discriminatory general rules only.[36] Even though he points to the fact that the generality-constraint, even if it were in place, could not provide a perfect safeguard against discriminatory regulatory taking,[37] Epstein (1985:195f.) explicitly acknowledges that the issue of generality may indeed mark a relevant differ-

ence between the two kinds of regulations that I have sought to separate here when he argues,

> Many large-number takings are in the form of regulation, taxation, and modification of liability rules. In these instances, the problem of assessing the impact of the taking, no matter what its form, on each person can be divided into two inquiries. The first asks to what extent the government action limits the person's possession, use, or disposition of property and hence operates as a taking. The second asks to what extent the restrictions imposed by the general legislation upon the rights of others serve as compensation for the property taken. . . . These benefits are more likely to take place under statutes of general application because a large number of persons will be both benefited and burdened by the same rule. . . . Each person whose property is taken by regulation receives implicit benefits from the parallel takings imposed upon others. . . . The landowner who cannot erect a large sign is assured that his neighbor cannot put up a sign that will block his view.

As will be shown below, this Epsteinian outlook at general regulation comes quite close to the notion of "*constitutional exchange*" that is central to what I call *constitutional liberalism*.

4. Regulations and Freedom of Contract

At the root of the liberal preference for markets over communal arrangements is the concept of the market as an arena of voluntary choice and voluntary contract. The free society, Rothbard (1970:71) notes, is "a society based on voluntary action, entirely *unhampered* by violence or threat of violence"; in the free market "individuals deal with one another only peacefully and never with violence" (ibid.:765).[38] In fact, the ideal that voluntary agreements among individuals should be, to the largest extent possible, the principal method of social coordination can be said to be the essential normative premise of the liberal paradigm. This ideal is equally foundational to the two approaches, free-market liberalism and constitutional liberalism, the comparison of which is the theme of the present paper. Where the two perspectives differ is in their more specific interpretations of this ideal and, as I shall seek to substantiate in the remainder of this paper, it is the constitutional perspective that provides the interpretation that appears to be more consistent with the inherent logic of the fundamental liberal ideal.

If one approaches the regulation issue in light of the notion of the market as an arena of *voluntary cooperation*[39] it would seem natural to suppose that the principle of *freedom of contract* may provide the criterion for judging which general regulations are and which are not compatible with a liberal order. Accordingly, those regulations ought to be rejected that interfere with the process of voluntary contracts among market participants, i.e. regulations that prohibit transactions that market participants would otherwise voluntarily enter into. The obvious rationale behind such judgement would be that prohibiting voluntary transactions means to prevent the realization of mutual gains that the contracting parties expect to get, as indicated by their voluntary agreement. Accordingly, regulations that prohibit voluntary transaction between market participants could be said to be welfare-decreasing and in this sense "irrational."

Again, it is Hayek who reminds us that the issue may be more complex than it initially appears. In his 1947 address he argued,

> We cannot regard 'freedom of contract' as a real answer to our problems if we know that not all contracts ought to be made enforceable and in fact are bound to argue that contracts 'in restraint of trade' ought not to be enforced. . . . A legal system which leaves the kind of contractual obligations on which the order of society rests entirely to the ever new decisions of the contracting parties has never existed and probably cannot exist. Here, as much as in the realm of property, the precise content of the permanent legal framework, the rules of civil law, are of the greatest importance for the way in which a competitive market will operate (Hayek 1948:115).[40]

One question that the liberal ideal of voluntary cooperation raises concerns the role of coercion in providing the pre-conditions that must exist for the market to be viable as an arena of purely voluntary cooperation. In order to assure that, indeed, market participants employ only non-violent or non-coercive means in their dealings with one another the use of such means has to be effectively prevented, and this can ultimately not be done by other than coercive means. This question can be answered by invoking the protective state as the agency that provides and secures the institutional framework within which the market can function as an arena of voluntary cooperation. Even though the state itself is a coercive apparatus, and as such in contrast to the liberal ideal of voluntarism, it is a necessary prerequisite for that liberal ideal to be realized at all.[41] The protective state can be said to be welfare-enhancing as a facilitator of trade by creating conditions that enable people to realize gains from voluntary cooperation.

The critical issue concerns regulatory provisions that employ the coercive power of the state beyond its necessary role as protective agent. In essence, the issue is whether regulations that reduce the scope for voluntary transactions, by prohibiting certain types of contracts, can ever be "rational" or beneficial in the sense of making all persons involved better off. From the perspective of a free-market liberalism the answer to this question must, it appears, clearly be "no." The diagnosis that such regulations prohibit mutually beneficial voluntary transactions would seem to lead inevitably to the conclusion that they cannot be but welfare-reducing.[42]—The question that needs to be examined, however, is whether this conclusion necessarily follows from the fundamental liberal ideal of voluntary cooperation. From the perspective of a constitutional liberalism this is not so.

The constitutional approach insists that the questions of "what the specific content of the law of contract ought to be" (Hayek 1960:229) and "what contracts should be enforceable" (Hayek 1948:113) are *constitutional* questions. They concern the rules of the game under which the game of catallaxy is to be played. What kinds of restrictions the "freedom of contract" should be subject to is a matter of *constitutional choice*, and which among potential alternative "regulations" are preferable is to be judged against the *constitutional interests* of the respective constituents, i.e. in terms of the constituents' preferences concerning the kind of constitutional order under which they want to live. It is a question that cannot be decided by looking only at whether the respective contracts provide mutual gains to the contracting parties. Instead, it has to be decided in terms of whether or not generally allowing for certain kinds of contracts makes the socio-economic game more attractive to all participants than it would be if the respective contracts were prohibited.

Central to the constitutional approach is the explicit distinction between the *constitutional level* at which the rules of the game are defined, and the *sub-constitutional level* where the players choose their strategies for playing the game, within the limits set by the rules. The core notion is that individuals may exercise their freedom of contract at both levels, that they may seek gains from voluntary cooperation not only at the sub-constitutional level, but at the constitutional level as well. People may seek to realize "gains from voluntary cooperation" not only by engaging in mutually beneficial market transactions, but also by jointly submitting to mutually beneficial constitutional constraints. While the free-market approach tends to limit its attention to the sub-constitutional level of voluntary contracting in the market arena, the constitutional approach accounts for the fact that people may choose to enter into *constitutional contracts*, the very purpose of which is to jointly restrict their freedom of contract at the sub-constitutional level, with the purpose of realizing mutual gains that they expect to flow from such mutually accepted restrictions. The very purpose of such contracts of joint commitment, or *constitutional contracts*, is to specify the terms—or the rules of the game—to which transactions on the sub-constitutional level are subject.

The distinction between the constitutional and the sub-constitutional level is, of course, not limited to the case where just two levels of contracting exist. It can be generalized to account for multi-level systems of contracting where the distinction between constitutional and sub-constitutional contracts can be applied to any two adjacent levels, and where the freedom of contract at any level may be subjected to mutually beneficial constraints that are the subject of a constitutional contract at the next higher level. Within such multi-level systems of contracting people may exercise their freedom of contract at every level, and the question of whether contracts at any level are desirable or "rational" cannot be answered by looking only at whether they restrict the freedom of choice at a sub-constitutional level. Their "rationality" has to be assessed in terms of their overall consequences as constitutional constraints compared to relevant alternatives.—Looked at in this manner, regulations that limit the freedom of contract at the level of market transactions can be interpreted as constitutional contracts, the rationality of which cannot be simply questioned because they prohibit voluntary transactions that otherwise would occur. Instead, their rationality must be judged in terms of whether or not they make for a better game, "better" in terms of the preferences of the relevant constituency, i.e. of the group of individuals on whose behalf the respective regulations are chosen. While to a free-market approach it is enough to show that regulations limit the freedom of contract in order to conclude that they are undesirable, a constitutional liberalism cannot reach such conclusion without considering the constitutional interests of the persons concerned.

I have noted above that a free-market liberalism and a constitutional liberalism differ in their respective interpretations of the liberal ideal of voluntary cooperation. In light of what has been said above, the critical difference between the two perspectives can be seen in the fact that the constitutional approach *generalizes* the concept of voluntary contract and voluntary cooperation so as to include constitutional contracts and, thus, to account systematically for the fact that people may seek to realize mutual gains by jointly submitting to constitutional constraints. By contrast, the free-market approach tends to focus on voluntary exchanges in the market as the principal vehicle of voluntary cooperation[43]

and, accordingly, tends to view any restrictions on voluntary market exchange as welfare-reducing limitations of the freedom of contract. The constitutional approach, in other words, employs a more general concept of voluntary exchange than does the free-market approach. It includes within that category the kinds of mutually beneficial *constitutional exchanges* that are exemplified by the case of the landowners mentioned in the above quotation from Epstein. Since it would seem arbitrary to limit the liberal ideal of voluntary cooperation to one level of contracting only, the constitutional interpretation of that ideal may be claimed to be more coherent than the free-market interpretation.

To say that the free-market approach concentrates only on exchange contracts and overlooks the role that constitutional contracts play in voluntary cooperation is, in fact, not entirely correct. Advocates of a free-market liberalism at least implicitly account for what may be called *private* constitutional contracts, i.e. mutually constraining contracts voluntarily entered into by market participants. They recognize the fact that, as V. P. Goldberg (1976b:428) puts it: "Entering into a contract will generally entail placing restrictions on the contracting parties' future options. Freedom of contract is the freedom to impose restrictions on one's future behavior."[44] In other words, they acknowledge that "voluntary cooperation" may include, beyond ordinary market exchange transaction, the voluntary joint submission to restrictions on the parties' future freedom of contract, as they occur in various kinds of relational contracts that can be observed in the market.[45] What they fail to recognize is that internal consistency would seem to require a liberal approach to extend to public constitutional contracts the very same logic that it applies to private constitutional arrangements, i.e. that the "social contracts" that define the constitutions of political jurisdictions or polities should also be looked at as potential instruments by which people can realize mutual gains from voluntary cooperation.

To be sure, there are significant differences between private constitutional contracts concluded in a market context and public constitutional contracts. The very purpose of the institutional framework of the market is to insure *voluntariness* in contracting, and to the extent that this purpose is achieved we can suppose that the private constitutional contracts concluded in the market are based on voluntary agreement of the parties involved. The voluntary nature of public constitutional contract is a much more uncertain matter, and the question of how, at this level, voluntariness may be secured, is by no means easy to answer. Yet, that these differences exist can hardly mean that we should not seek to provide, from within the liberal paradigm, a systematic account of public constitutional contracts, nor can it mean that, in approaching these types of contracts, we ought to employ different explanatory and normative principles than the ones that we apply to private constitutional contracts. To the extent that they can, in fact, be said to command voluntary agreement of the members of the relevant constituency, public constitutional contracts must be judged, from a liberal perspective, no less "efficient" than private constitutional contracts that are concluded in a market context.

An issue that can serve to illustrate the difference between a free-market and a constitutional outlook at regulations that restrict the freedom of contract is the case, mentioned in the above quotation from Hayek, of contracts 'in restraint of trade.' From the perspective of his notion of the unhampered market Rothbard sees no reason why one should object to such contracts. "The whole concept of 'restricting production'," he argues, "is a fallacy

when applied to the free market" (Rothbard 1970:568). As he sees it, in the free market "consumers and producers adjust their actions in voluntary cooperation" (ibid.:566) and that includes the freedom of producers to seek to maximize their income by "producing where their gains are at a maximum, through exchanges concluded voluntarily by producers and consumers alike" (ibid.:571). Cartel agreements are, from his perspective, nothing but voluntary contracts among producers, equally legitimate as voluntary exchanges between producers and consumers. As he puts it: "To regard a cartel as immoral or as hampering some sort of consumer sovereignty is therefore completely unwarranted. And this is true even in the seemingly 'worst' case of a cartel that we may assume is founded solely for 'restrictive' purposes" (ibid.:570).[46]

From a perspective that looks at the issue of contracts in restraint of trade only in terms of an unqualified principle of freedom of contract, it must indeed seem implausible to treat voluntary cartel agreements among producers different from other voluntary agreements among market participants, and the appeal to the principle of consumer sovereignty may appear as an arbitrarily limited interpretation of the principle of "individual self-sovereignty" (Rothbard 1970:560) that is constitutive of the free market and that covers individuals in their capacity as producers no less than consumers.[47] Accordingly, one might conclude, as Rothbard does, that a consistent interpretation of the ideal of self-sovereignty implies that the appropriate normative standard for judging the performance of the free market should not be the service to consumers alone, but the "principle of maximum service to consumers and producers alike" (ibid.:657).

The issue appears in a quite different light as soon as one looks at it as a constitutional issue, i.e. when the prohibition or non-enforceability of contracts in restraint of trade is treated as a *constitutional constraint* on the freedom of contract and when consumer sovereignty is treated as a *constitutional ideal* for how the game of catallaxy should function. At the constitutional level the relevant question is whether this game can be expected to be more attractive for all players involved if cartel agreements are generally prohibited, or at least not enforced, compared to how it would function in the absence of such a constraint. Whether this is in fact the case is, of course, a debatable issue. Yet, debating the issue of cartel agreements as a constitutional issue is an entirely different matter than discussing it in terms of whether or not the principle of freedom of contract per se allows for treating such contracts among producers differently from other voluntary contracts among market participants. That it can only adequately be discussed as a constitutional issue has been insisted upon by the founders of the Freiburg School who argued that the freedom of contract on the sub-constitutional level cannot include the right of the players to abrogate the rules of the game that are established at the constitutional level.[48] J. M. Buchanan approaches the issue in essentially the same manner from his constitutional economics perspective when he chastises "the libertarian blunder of extending the defense of the liberties of individuals to enter into ordinary voluntary exchanges to a defense of the liberties of individuals to enter into voluntary agreements in restraint of trade."[49] And, at least implicitly, authors like R. Epstein[50] or H. Demsetz[51] seem, at places, to adopt similar views.

As a *constitutional ideal* the principle of consumer sovereignty postulates that the rules of the game of catallaxy should be such that they ensure maximum responsiveness of producers to consumer interests. The rules of the game should be such that better service

for consumers is, ideally, the only route to business success.[52] This ideal is, it would seem, what Adam Smith had in mind when he criticized the rules of the game of the mercantile system:

> Consumption is the sole end and purpose of all production; and the interest of the producer ought to be attended to, only so far as it may be necessary for promoting that of the consumer. The maxim is so perfectly self-evident, that it would be absurd to attempt to prove it. But the mercantile system, the interest of the consumer is almost constantly sacrificed to that of the producer (Smith 1981:660).

Smith's claim was clearly that the rules of the game of what he called the "obvious and simple system of natural liberty" (ibid.:687) allows for a more attractive game than a mercantilist economic constitution for all players involved and in all their capacities as consumers as well as producers.[53] It is apparent that W. H. Hutt too, who is the target of Rothbard's critique,[54] had the constitutional dimension in mind when he used the concept of "consumer sovereignty"[55] to capture the Smithian ideal.[56]—One can, of course, question whether the principle of consumer sovereignty is, in fact, a desirable constitutional ideal, in terms of the inclusive preferences of the respective constituents. Yet, as a constitutional matter this issue has to be discussed in different terms than those employed by a Rothbardian free-market approach. It is, of course, also open to debate what specific rules of the game ought to be recommended if consumer sovereignty is adopted as a constitutional ideal, and one may even question whether, as a matter of fact, this ideal would be served by prohibiting cartel agreements.[57] Yet, again, discussing these matters as constitutional issues requires us to go beyond the logic of the free-market approach.[58]

5. Constitutional Liberalism: Generalizing the Concept of Voluntary Contract from the Market Level to the Constitutional Level

When Rothbard argues that the "sovereignty of the individual" rather than the sovereignty of the consumer must be considered the fundamental normative premise of the liberal paradigm he is right. And, as noted before, there is no disagreement in this regard between his free-market approach and a constitutional approach.[59] He is wrong, however, when he concludes that, *therefore*, voluntary cartel agreements among producers cannot be considered illegitimate. He is wrong because he fails to appreciate the distinction between the constitutional and the sub-constitutional level. He ignores the fact that individuals may exercise their sovereignty at both levels, and that in exercising their sovereignty at the constitutional level, they may voluntarily agree to impose constraints on their sovereign choices at the sub-constitutional level. Sovereign individuals may, in this sense, have good reasons to agree, at the constitutional level, to an economic constitution that seeks to implement the principle of consumer sovereignty, and, in fact, much of traditional liberal teaching is about why there are good reasons for people to enter into such a constitutional contract.

The failure adequately to appreciate the relevance of the distinction between the constitutional and sub-constitutional level is, I suppose, a general shortcoming of the free-market approach to the issue of regulation. The research program of the Freiburg School must

be credited with having focused its attention on the constitutional dimension of the liberal paradigm, as well as for having made explicit that the liberal ideal of a free society is a *constitutional* ideal, that it has to be specified in constitutional terms, i.e. in terms of the specific rules of the game that it advocates, and that it has to be argued for in terms of its attractiveness as a constitutional regime. In advancing his proposals for the constitutional order of a free society the liberal must ultimately appeal to people's constitutional interests, and his claim is, in the final analysis, that these interests are better served by such an order than by feasible alternative regimes.

In launching the research program of constitutional political economy J. M. Buchanan has, independently of the Freiburg School and with a somewhat different emphasis, in essence argued along similar lines. The particular significance of his contribution, though, must be seen in the special emphasis that he adds to the constitutional theme, namely his insistence that a consistent liberalism cannot confine its normative principles of individual freedom of choice and voluntary contract to the sub-constitutional level of market transaction, but must extend them to the level of constitutional choice and constitutional contracting as well.[60] In other words, his emphasis is on the very simple but fundamental argument that the consistent liberal must allow individuals to be sovereign at the constitutional level no less than at the market level. It is Buchanan's singular merit to have generalized the liberal ideal of voluntary cooperation from market choices to constitutional choices, from exchange contracts to social contracts, and to have shown thereby how a free-market liberalism can be consistently generalized into a more inclusive constitutional liberalism.

The fundamental normative principle of the liberal paradigm, what Rothbard describes as "individual sovereignty" and what Buchanan calls "normative individualism," is an *internal* as well as a *procedural* standard. It is internal in the sense that its measuring rod for what is desirable or rational in social matters is, ultimately, to be found in the subjective preferences or interests of the individuals themselves who are involved in the respective social arrangement, by contrast to external standards of goodness that ignore what the actors themselves consider desirable. It is procedural in the sense that it does not judge social outcomes per se, in terms of the attributes that they exhibit, but in terms of the nature of the process by which they have been brought about. The question it asks is whether social outcomes can be reasonably said to have emerged from voluntary choices of the parties concerned, and it considers desirable whatever results from voluntary exchange or cooperation among individuals.—This is the basic logic that the free-market approach applies to market transactions. The constitutional liberal only insists that the same logic be applied at the level of constitutional contracting. Accordingly, he concludes, that at this level too the liberal normative standard cannot be but *internal* and *procedural*. Its ultimate point of reference are the subjective constitutional preferences or interests of the persons concerned and their voluntary agreement to the constitutions under which they live.

The constitutional approach implies that we need to distinguish between the issue of voluntariness of agreements *within rules*, i.e. at the sub-constitutional level, and the voluntariness of agreements *on rules*, i.e. at the constitutional level. The voluntariness of market transactions is *voluntariness within the rules of the game* that define the constitu-

tion of the market. Whose *explicit* voluntary agreement is required for a transaction to count as a voluntary market exchange (or a voluntary private constitutional contract) depends on how the rules of the game of catallaxy are defined. If private property rights are defined so as to include a landowner's right to erect a large sign on his property, a voluntary contract between him and a construction company for erecting such a sign qualifies as a perfectly voluntary market exchange, even if his neighbor, whose view is blocked by the sign, is strongly opposed to such action and does not voluntarily agree to it at all.[61] If the rules of the game do not give a landowner the said right, his voluntary agreement with a construction company would not be sufficient to make the transaction a legitimate market exchange, in the absence of his neighbor's explicit agreement to the transaction.

How the rules of the game should regulate such matters has, of course, to do with the externality issue. How property rights are defined decides, in effect, which of the ever present externalities of transactions third parties simply have to tolerate and against which of such externalities they enjoy the protection of the law. Where this line is to be drawn is a matter of *constitutional choice*,[62] and this means, it is a matter of the constitutional interests of the persons involved and their voluntary agreement to the rules under which they want to live.[63] The consistent liberal cannot appeal to any a priori, external criteria for how the said line is to be drawn, criteria that would apply independently of what the members of the relevant constituencies themselves consider desirable. It is misleading to suggest that the liberal paradigm provides us with timeless, objective standards for what kinds of external effects constitute "molestation" and should, therefore, considered incompatible with the "free market."[64] And it is misleading to suggest that the question is answered by saying that the externality problem is only a problem of "insufficient defense of private property against invasion," since the real issue is to define what counts as invasion.[65]

The free-market liberal may readily agree that the distinction between the issue of voluntariness in agreements *within rules* and the issue of voluntariness in agreements *on rules* applies to *private* constitutional contracts, such as contracts that govern employment relations or relations among the members in a partnership. The constitutional liberal insists that it must be extended to *public* constitutional contracts as well, and that it applies equally to the rules of the market itself.[66] What legitimizes the market as a constitutional order is, in the last resort, its voluntary acceptance as a constitutional order, and that legitimacy is not provided by the voluntary transactions that are carried out *within* the market order. That there is a distinction to be drawn here between sub-constitutional and constitutional agreements is overlooked by authors who, like Rothbard, suggest that, since each and every market exchange is a voluntary transaction, the market order itself can be said to be unanimously approved.[67] As much as the constitutional liberal agrees with the claim that the game of catallaxy provides benefits, and is attractive to all participants, he cannot agree that this claim is proven by the voluntariness of market transactions. The ultimate test for the attractiveness of the market order can only be its attractiveness and voluntary acceptance as a constitutional order. Even if this distinction may seem to border at sophistry, it is a distinction with important implication for how liberals argue their case for the market order to their fellow citizens. It implies that, ultimately, the liberal argument for the market order

must appeal to individuals' constitutional interest and cannot bypass the individuals' own judgement of what is desirable at the constitutional level. Ludwig von Mises (1985:30) may have had this in mind when he said about the liberals: "If they considered the abolition of the institution of private property to be in the general interest, they would advocate that it be abolished."[68]

If we extend, as a constitutional liberalism requires, the fundamental normative principle of voluntary choice and voluntary contract to the constitutional level, the question arises of what meaning the concept of voluntariness can be given at that level. As noted, when we speak of voluntary market transactions we do have a fairly clear understanding of what "voluntary" means. It is defined in terms of the rules that constitute the market as an arena of voluntary cooperation. To be sure, what voluntary choice and voluntary agreement in constitutional matters can mean is a much more complex issue. But the complexity of the issue can surely not be an acceptable excuse for ignoring it. In examining this issue we have to inquire into the nature of the processes in which constitutional rules are generated and reformed, and we have to inquire into how these processes may themselves be subjected to rules such that voluntariness in constitutional choice can best be secured.

That the political processes in modern democracies, not to speak of other regimes, have grave deficiencies is widely acknowledged and has often been criticized from within the liberal paradigm. Where the liberal research agenda has remained comparatively underdeveloped, is in regard to the *positive* question of how the political process might be structured so as to implement the principle of individual sovereignty at the constitutional level, accounting for the specific difficulties that the nature of things poses at that level.[69] Suggestions for how the political process might be reformed with that purpose in mind have been spelled out by Hayek in his work on constitutional reforms of modern democracy, and the general issue of such reforms is a major item on the research agenda of Buchanan's constitutional economics. His enterprise of developing a theoretical approach to "the state as a voluntary institution" has nothing to do with "Hegelian mysticism," as Rothbard charges,[70] but is an attempt to systematically and consistently extend the fundamental logic of the liberal paradigm from the level of market choices to the constitutional level.

Beyond options for reforming the political processes through which constitutional rules are collectively chosen by the members of jurisdictions, or by their representatives, the more effective means of enhancing and securing voluntariness in constitutional choice will be found in provisions that enable the individual to choose individually and separately among alternative constitutional regimes. As a conceptual benchmark one may choose Robert Nozick's liberal utopia,[71] an imagined world where individuals are perfectly free to adopt within consenting groups any kind of constitutional order they like, and where everybody is perfectly free to move between the alternative constitutional orders that exist. Yet, the difficult pragmatic task begins when it comes to examining how, by what provision and by what forms of political organization, the options of individuals to freely choose for themselves among constitutional alternatives can be improved in the world in which we live. Important contributions to this issue have been made in such research areas as the theory of competitive federalism and in other areas,[72] but there remains much to be

done. To take on this task could be an important part of our efforts in expanding the liberal paradigm.

Notes

1. In 1975 R. H. Coase (1975:183f.) reported: "There have been more serious studies made of government regulation of industry in the last fifteen years or so, particularly in the United States, than in the whole preceding period. . . . The main lesson to be drawn from these studies is clear: they all tend to suggest that the regulation is either ineffective or that when it has a noticeable impact, on balance the effect is bad."
2. For an overview of the history and the teaching of the Freiburg School see V. Vanberg 1998a.
3. W. Röpke's (1961:10f.) brief report reads: "Es kam zu Zusammenstößen, unter denen derjenige besonders schwer und eindrucksvoll war, der sich zwischen Walter Eucken und Ludwig v. Mises ereignete. Auf den von dem letzteren erhobenen Anspruch, in seiner Person den allein maßgeblichen Liberalismus zu repräsentieren, war Eucken die Antwort nicht schuldig geblieben. Und so wäre es denn nicht leicht gewesen, einen halbwegs versöhnlichen Ausgang zu erreichen, wenn nicht Ludwig v. Mises mit seiner Ritterlichkeit eingelenkt hätte. Jene Diskussion, in der es vor allem um das Monopolproblem und um die dem Staat und der Rechtsordnung dadurch zufallende Aufgabe ging, ist symbolisch für einen Richtungsstreit im liberalen Lager geblieben, der innerhalb der Mont-Pèlerin-Gesellschaft immer wieder hervortrat."
4. In Max Hartwell's (1995) history of the MPS the incidence is not mentioned.
5. L. von Mises (1949:238f.) defines: "The imaginary construction of a pure or unhampered market economy . . . assumes that the operation of the market is not obstructed by institutional factors. It assumes that the government . . . is intent upon preserving the operation of the market system, abstains from hindering its functioning, and protects it against encroachements on the part of other people." (On the "method of imaginary constructions" Mises [ibid.:237] notes: "An imaginary construction . . . is a product of deduction, ultimately derived from the fundamental category of action. . . . In designing such an imaginary construction the economist is not concerned with the question of whether or not it depicts the conditions of reality which he wants to analyze.")—As Mises (ibid.:239) notes: "The classical economists and their epigones used to call the system of unhampered market economy 'natural' and government meddling with market phenomena 'artificial' and 'disturbing.' But this terminology also was the product of their careful scrutiny of the problems of interventionism."
6. As Kirzner (1985:141) puts it: "Nothing within the regulatory process seems able to simulate even remotely the discovery process that is so integral to the unregulated market."
7. In a more recent contribution Kirzner (1994) explicitly distinguishes between governmental enforcement of what he calls the "outer limits of the market" and governmental "suspension of or interference with the market" (ibid.:108). By "outer limits" he means the "institutional pre-requisites for the very existence of the market" (ibid.:101) or "the rights system" (ibid.:108) that constitutes the institutional framework within which market activities take place. This "rights system" Kirzner sees based on society-wide "shared ethical perspectives" (ibid.), and he states that it is "only in the context of a given pattern of individual rights" (ibid.:105) that "the function of the market" (ibid.) can be defined. In this context, government intervention is then to be understood as interference with the process of voluntary coordination of individual activities as it unfold within this framework *of a given rights system*.—I shall return to Kirzner's argument in section 3.
8. The liberals claim, Mises (1949:240) says, "that the operation of an unhampered market . . . brings about more satisfactory results than the decrees of anointed rulers."
9. Hayek (1976:115): "It is a wealth-creating game (and not what game theory calls a zero-sum game), that is, one that leads to an increase of the stream of goods and of the prospects of all participants to satisfy their needs."
10. Hayek (1976:129): "The particular results that will be determined by altering particular actions of the system will always be inconsistent with its overall order: if they were not, they could have been achieved by changing the rules on which the system was henceforth to operate. Interference, if the term is properly used, is therefore by definition an isolated act of coercion, undertaken for the purpose of achieving a particular result, and without committing oneself to do the same in all instanced where some circumstances, defined by a rule, are the same."

11. In this sense Kirzner (1985:139) justly asks: "But what is the likelihood that government officials . . . will know what imposed prices, say, might evoke the 'correct,' desired actions by market participants? . . . How do government officials know what prices to set (or qualities to require, and so forth)?"
12. Hayek (1976:129): "Every act of interference thus creates a privilege in the sense that it will secure benefits to some at the expense of others, in a manner which cannot be justified by principles capable of general application."
13. Hayek (1960:228): "Strictly speaking, then, there are two reasons why all controls of prices and quantities are incompatible with a free system: one is that all such controls must be arbitrary, and the other is that it is impossible to exercise them in such manner as to allow the market to function adequately."
14. Hayek (1944:37): "Any attempt to control prices or quantities of particular commodities deprives competition of its power of bringing about an effective co-ordination of individual efforts . . . This is not necessarily true, however, of measures merely restricting the allowed methods of production, so long as these restrictions affect all potential producers equally . . . To prohibit the use of certain poisonous substances or to require special precautions in their use, to limit working hours or to require certain sanitary arrangements, is fully compatible with the preservation of competition. The only question here is whether in the particular instance the advantages gained are greater than the social costs which they impose."
15. Hayek (1960:225): "But if, for instance, the production and sale of phosphorous matches is generally prohibited for reasons of health or permitted only if certain precautions are taken, or if night work is generally prohibited, the appropriateness of such measures must be judged by comparing the over-all costs with the gain; it cannot be conclusively determined by appeal to a general principle."
16. Hayek (1960:222) suggests "that the rule of law provides the criterion which enables us to distinguish between those measures which are and those which are not compatible with a free system. Those that are may be examined further on the grounds of expediency."
17. When, as quoted above, von Mises (1949:238f.) says about the operation of the unhampered market that it is "not obstructed by institutional factors" he cannot mean to imply that in the unhampered market any institutional factors are absent.—As K. R. Popper (1977:312) has remarked in critical reference to von Mises: "(I)n a complex society, anything approaching a free market could only exist if it enjoyed the protection of laws, and therefore of the state. Thus the term 'free market' should always be placed in inverted commas, since it was always bound, or limited, by a legal framework and made possible only by this framework."
18. Kirzner (1994:101): "We wish to emphasize the insight that, for its very emergence and existence, the market must rely on the presence of extra-market institutions, without which the idea of a market process must be a mere dream."—"The uniquely valuable character of the spontaneous forces of the market process rests entirely on non-market-generated institutions which frame the market" (ibid.:109).
19. Kirzner (1994:106) speaks of "opportunities inherent in the given set of rights."
20. From a passing reference one may conclude that Kirzner considers "citizens' preferences" (1994:105) as a criterion. He explicitly refers to "shared ethical perspecitives" as a criterion when he notes: "Our affirmation of outer limits to markets should drive home the need for society-wide acceptance of shared ethical perspectives (and most likely, for governmental, extra-market enforcement of the rights system implied in such shared ethical perspectives" (ibid.:108).
21. The fact that opting for the market system is a matter of *constitutional choice*, a choice that can be recommended because of its attractiveness compared to alternative arrangements, is obfuscated by some of von Mises' arguments that make it appear as if there is no choice. Under a chapter heading "Capitalism: The only Possible System of Social Organization"" Mises (1985:88f.) argues, for instance: "Liberalism is derived from the pure sciences of economics and sociology, which make no value judgements. . . . (T)hese sciences show us that of all the conceivable alternative ways of organizing society only one, viz., the system based on private ownership of the means of production, is capable of being realized, because all other conceivable systems of social organization are unworkable.*ldots* (E)very system of social organization that could be conceived as a substitute for the capitalist system is self-contradictory and unavailing."
22. As Buchanan (1977:5) notes on the "market economy": "But the economy cannot function *in vacuo*, it must be incorporated in, and must be understood to be incorporated in, a structure of 'laws and institutions.' Modern economists have grossly neglected the constitutional-institutional or framework requirements of an economic system."
23. Mises (1949:678): "Private ownership . . . is the fundamental institution of the market economy."

24. Mises (1985:88): "One may undertake to modify one or another of its (the market system's, V.V.) features as long as in doing so one does not affect the essence and foundation of the whole social order, viz. private property."
25. It is not entirely clear which of the two aspects is referred to in statements like: "The function of the market process can be defined only with respect to some given initial set of endowments" (Kirzner 1994:108).
26. R. Cooter and T. Ulen (1995:153): "Regulations restrict the use of the property without taking title from the owner."
27. That property rights are always circumscribed in some manner is, of course, one of the basic premises of the economics of property rights. As P. Milgrom and J. Roberts (1992:289) note: "For economic analysis, it is often useful to interpret 'owning an asset' to mean having the *residual rights of control*—that is, the right to make any decisions concerning the asset's use that are not explicitly controlled by law or assigned to another by contract."
28. R. A. Epstein (1985:93): "Taxation, regulation, and modifications of liability rules ... cannot be kept in a watertight compartment separate from takings of private property."—About "government's efforts to regulate the possession, use, and disposition of private property" Epstein (1985:100f.) says: "Some regulations require owners to allow others to gain access and entry to their property. Land use regulation can limit land to residential, commercial or industrial uses; ... it can prohibit certain types of activities ... Regulations limit the goods that can be sold in commerce and the prices charged for them. The differences between these various forms of regulation are sure to be important in any assessment of their economic consequences or their legal justification. Yet these protean forms of regulation all amount to partial takings of private property."
29. Epstein (1986:15): "When resources, which are subject to well-defined private rights, are placed into common pools, then the presumption is that their value diminishes."
30. Epstein (1985:96): "That the common law is malleable is, within important limits, correct. ... Ownership is a social concept. ... The basic rules of ownership state in general form the types of actions by others that constitute wrongs."
31. Goldberg (1976b:429): "Conceptually, we can treat judges and legislators as agents enforcing and revising the rules under which individual transactions take place."
32. Goldberg (1976b:429): "The common law is embedded in a social contract which establishes a procedure for adjusting the specific terms of the contract over time."
33. In his distinction between the "catallactic notion of ownership and property rights" and "the legal definition of ownership and property rights as stated in the laws of various countries" Mises (1949:678) may seem to suggest that such an immutable standard can be defined. Yet, at least with regard to the notion that the "natural law" may provide for such a standard he flatly states: "There is, however, no such thing as natural law and a perennial standard of what is just and what is unjust."
34. Hayek (1948:113): "As far as the great field of the law of property and contract are concerned, we must ... above all beware of the error that the formulas 'private property' and 'freedom of contract' solve our problems. They are not adequate answers because their meaning is ambiguous. Our problems begin when we ask what ought to be the contents of property rights."—Hayek (1960:229): "The recognition of the right of private property does not determine what exactly should be the content of this right in order that the market mechanism will work as effectively and beneficially as possible."—See also Hayek (1960:231; 1944:38).

    Hayek's remarks imply that further specification is needed when, for instance, Kirzner (1994:106) notes on his concept of the "outer limits of the market": "Without these institutional prerequisites—primarily, private property rights and freedom and enforceability of contract—the market cannot operate."
35. Epstein (1986:11): "The zoning ordinance that masquerades as an antipollution device could easily be an effort to prevent (legitimate) competitive injury."
36. Hayek (1944:IX f.): "The essence of the liberal position, however, is the denial of all privilege, if privilege is understood in its proper and original meaning of the state granting and protecting rights to some which are not available on equal terms to others."—For a general discussion on the role of the generality constraint see Buchanan and Congleton 1998.
37. Epstein (1985:211): "Government action may be very general in its articulation and application, but it may impose all of the burdens on one class and all of the benefits on another, imposing uncompensated takings of private property on a grand scale."

38. M. N. Rothbard (1970:77): "A society based on voluntary exchanges is called a *contractual society*. . . . (T)he contractual type of society is based on freely entered contractual relations between individuals. . . . It is the society of the unhampered market."
39. Rothbard (1970:84): "The contractual society of the market is a genuinely *co-operative society*."
40. Hayek (1960:229f.): "The decision to rely on voluntary contracts as the main instrument for organizing the relations between individuals does not determine what the specific content of the law of contract ought to be. . . . There is indeed a sense in which freedom of contract is an important part of individual freedom. But the phrase also gives rise to misconceptions. . . . No modern state has tried to enforce all contracts, nor is it desirable that it should. Contracts for criminal or immoral purposes, gambling contracts, contracts in restraint of trade, contracts permanently binding the services of a person, or even some contracts for specific performances are not enforced."
41. Mises (1949:258): "There is in the operation of the market no compulsion and coercion. The state . . . does not interfere with the market and with the citizens' activities directed by the market. It employs its power to beat people into submission solely for the prevention of actions destructive to the preservation and the smooth operation of the market economy. It protects the individuals' life, health, and property against violent and fraudulent aggression on the part of domestic gangsters and external foes. . . . Thus the state creates and preserves the environment in which the market economy can safely operate."—There are, of course, a number of libertarian authors who seek to avoid the conclusion that "the protective state" is a necessary institution for securing the market as an arena of purely voluntary cooperation. For a discussion of this literature see G. Habermann 1996.
42. Rothbard (1970:766): "Intervention is the intrusion of aggressive physical force into society; it means the substitution of coercion for voluntary actions."
43. Rothbard (1970:72): "The major form of voluntary interaction is voluntary interpersonal exchange." And (ibid.:152f.): "Contract must be considered as an agreed-upon exchange between two persons of two goods, present or future."
44. About the types of contracts that I call *constitutional* contracts Goldberg (1976b:428) says that they are concerned with "the establishment, in effect, of a 'constitution' governing the ongoing relationship."
45. Kirzner (1994:105f.): "Where cooperation is of a real or imagined mutual benefit to a group of individuals, the market will of course provide scope for such cooperation. The market does, as has often been recognized, make it possible for groups within it to organize themselves in communes or other organizations on strictly socialist principles, if they choose (This, let us not forget, is how capitalist firms come into existence.)."
46. See also on this issue Rothbard (1956:255).
47. Rothbard (1970:560): "Rather than 'consumers' sovereignty,' it would be more accurate to state that in the free market there is a *sovereignty of the individual: . . . individual self-sovereignty*."
48. For more details see Vanberg (1998a:176).—To the Freiburg scholars the constitutional choice in favor of market competition implies a commitment to submit to the constraints of competition, and they considered it incompatible with such constitutional choice to allow the players in this game to seek to exempt themselves from these constraints by private contracts. They would have strictly disagreed with the statement of B. R. Tucker that Rothbard (1970:584) quotes approvingly: "The right to cooperate is as unquestionable as the right to compete; the right to compete involves the right to refrain from competition . . . To assail or control or deny this form of cooperation (cartel, V.V.) on the ground that it is itself a denial of competition is an absurdity."
49. Buchanan (1991a:112, ; 1991b:125ff.; 129).—The issue of the relation between "private" and "public" constitutional contracts is raised when Buchanan (1991b:129) notes: "The libertarian who defends private, cartel-like agreements among contracting parties on the same side of the market, as long as such agreement is voluntary, must have difficulty arguing against politically orchestrated cartel-like restrictions in particular markets."
50. Epstein (1985:202) clearly appears to argue in this sense when he places "antitrust laws, which prevent monopoly and foster competition" in the class of regulations that potentially make for a "positive-sum game." As he puts it: "Monopoly therefore can be understood as a negative-sum game which the antitrust laws, at least in their prospective application, are designed to overcome."
51. H. Demsetz (1995:157f., 166).
52. Mises (1949:310) appeals to the very same performance criterion when he notes: "So far as the operation of the market is not sabotaged by the interference of government and other factors of coercion, success in business is the proof of services rendered to the consumers."

53. As for the rules of the "system of natural liberty" Smith (1981:308) noted that the "obligation of building party walls, in order to prevent the communication of fire, is (not) a violation of natural liberty."
54. Rothbard (1970:562) criticizes as "inconsistent" Hutt's appeal to "'consumer's sovereignty' as an *ethical ideal against which the activities of the free market are to be judged*."
55. Rothbard (1970:561) credits Hutt for being "the originator of this concept."
56. On Hutt's concept see also Vanberg (1998b:639).
57. Indeed, Rothbard's reasoning is in this regard not entirely unambiguous. On the one hand his claim seems to be that the concept of consumer sovereignty is not the adequate "ethical ideal against which the activities of the free market are to be judged" (Rothbard 1970:562). On the other hand it seems as if he accepts the ideal, but wants to argue that, as a matter of fact, cartel agreements are not obstacles to the capacity of the "free market" to work for the benefit of consumers (see ibid.:76, 574, 578, 581f.).—My concern here is not with the second but only with the first claim.—It may be noted as an aside that Rothbard (ibid.:620) does not extend his sanguine view of cartels to unions: "It is clear that while cartels, to be successful, must be economically more efficient in serving the consumer, no such justification can be found for unions."
58. The issue of whether "voluntary enslavement" should be permitted may also be used to illustrate the difference between a free-market approach and a constitutional approach. To the latter this question cannot be answered in terms of the abstract principle of freedom of contract, and the fact that the parties to such contracts would indicate, by their voluntary agreement, that they expect to be made better off, does not provide a sufficient argument for permitting such contracts. Instead, the issue has to be examined in terms of the working properties of a constitutional order within which such contracts are permitted, compared to one where they are prohibited. And the relevant criterion of evaluation in this comparison are the interests of the constituents of the jurisdiction for which such constitutional choice is to be made.
59. See Buchanan (1991c).
60. For further discussion see Vanberg 1998c; 1998d.
61. He can only be said to implicitly agree, given the rules of the game, if he chooses not to pay his neighbor for not putting up the sign.
62. See on this issue Buchanan and Vanberg 1988.
63. For a detailed discussion of this issue see Buchanan 1985.
64. That there is such a standard seems to be implied when Rothbard (1970:653) describes the "purely free market" as the arena "where the individual person and property are not subject to molestation," and when he defines: "'Free' . . . is used in the interpersonal sense of being unmolested by other persons" (ibid.:581).
65. Rothbard (1956:259fn.): "The famous 'external diseconomy' problems (noise, smoke nuisance, fishing, etc.) are . . . due to insufficient defense of private property against invasion. Rather than a defect of the free market, therefore, they are the result of invasions of property, invasions which are ruled out of the free market by definition."—See also Rothbard (1970:156) and Mises (1949:653).—Hayek (1960:229) comments on this issue: "Though the principle of private property raises comparatively few problems as far as movable things are concerned, it does raise exceedingly difficult ones where property in land is concerned. The effect which the use of any piece of land often has on neighboring land clearly makes it undesirable to give the owner unlimited power to use or abuse his property as he likes." See also Hayek (1944:38f.; 1948:113).
66. That we need to distinguish between the transactions carried out within markets and the social processes that shape the institutions that frame markets is explicitly stressed by Kirzner. He speaks of "the sharp difference . . . separating the character of market processes from the character of the processes leading up to the crystallization of the institutions upon which markets must rest for their very existence" (1994:107).—He comments: "The institutions upon which the market must depend must have been created or have evolved through processes different from those spontaneous coordinative processes which we have seen to constitute the essence of the market's operation."
67. Rothbard (1956:250): "Such an exchange is voluntarily undertaken by both parties. Therefore, the very fact that an exchange takes place demonstrates that both parties benefit . . . from the exchange. . . . The free market is the name for the array of all the voluntary exchanges that take place in the world. Since every exchange demonstrates a unanimity of benefit for both parties concerned, we must conclude that the *free market benefits all its participants*."

68. Mises (1985:68): "Governments must be forced into adopting liberalism by the power of the unanimous opinion of the people."—See also (ibid.:46).
69. Mises (1949:271) points to the symmetry between the issue of "the sovereignty of the individual" in the market and in the political arena when he notes: "It would be more correct to say that a democratic constitution is a scheme to assign to the citizen in the conduct of government the same supremacy the market economy gives them in their capacity as consumers. However, the comparison is imperfect. . . . (O)n the market no vote is cast in vein."— See also Mises (1985:xvi).
70. Rothbard (1956:260).
71. See part three of Nozick (1974).
72. Vanberg and Kerber (1994).

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