Markets, Crises and Policies

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Abstract

To analyze how states influence the building of institutional frameworks, we contrast behavior-establishing institutions (BEI) with rights establishing institutions (REI). The former prescribe agents' behaviors, while the later allows them to make decisions. Outcomes of BEI are monitorable, while outcomes of REI are difficult to anticipate due to freedom of choice, strategic interactions, and complexities in aggregation of individual actions. REI are economically superior to BEI because they decrease the cost of innovation and of organization. However, they can lead to critical discrepancies between observed distribution of wealth and power and expected one, which ends up in a crisis: a socially non acceptable result that leads agents either to claim for the intervention of the state. State intervention can be called either for correcting the distribution of wealth, or for redesigning components of the institutional framework. We highlight a cumulative process where BEI and REI develop successively: a phase of liberalization generating processes of regulation and vice versa. This allows understanding why "open access societies" combine open competition with a considerable body of regulation and a high level state intervention. Our framework also points out possibilities of bifurcations due to the choices made when disequilibria and crises occur. We then propose explanations for the emergence and evolution of alternative socio-political models.

1. Introduction

A broad-brush comparison of economic and political systems, across centuries and societies, may raise a remarkable paradox. Whereas despots or autocrats can wield extreme, possibly lethal powers against *individual* agents, they typically have a most limited capacity to influence decentralized behaviors *in general*. That is, they cannot affect much the outcomes of day-to-day social interactions, whether one thinks at market transactions or at collective behaviors regarding public health, working conditions, or the environment. In this sense, the most successful despots may have build empires and palaces, and they may have left their names in textbooks for centuries, but their capacity to govern societies, or to shape or influence the division of labor, is comparatively limited.

To the opposite, modern or liberal governments typically have no interaction whatsoever with individual citizens as such, i.e. with all their own, idiosyncratic, personal characters. But these regimes have a most extended, diversified, possibly invasive capacity to normalize individual action *in general*. That is, they affect individuals (or classes of individuals) through impersonal, abstract, universal rules and instruments. And from there on, they have a unique capacity to bear ex ante on behaviors, so as to shape ex post social outcomes. This is actually what modern policymaking is about, whether one thinks to monetary policy, poverty-reduction programs or cap-and-trade mechanisms against climate change. Think also to the incredible mass of social demands and regulatory challenges directed at governments by the present international financial crisis.

For sure, there is also the sense, very present these days, which some medium-term balancing can be observed between public regulation and private autonomy. Still, this trade-off is observed in social, institutional and political orders where unique normative and organizational capacities come together with an as well uniquely extended individual franchise. The notion of a way-and-back cycle also under weighs the cumulative or evolutionary dimension of these movements. In this contribution we discuss this puzzle and try to understand (slightly) better the working of the modern policy-making state and its interaction with an open-access, entrepreneurial society.

More precisely we show that the drivers of the raise of the modern state is the call for policies that necessitate the development of policy-making capabilities. This development is framed by the tensions between the will to control and frame behaviors and the call for enfranchisement, which complex combination can explain the development of alternative forms of liberal/social-democrat models.

Section 2 introduces and discusses the opposition between Rights Establishing Institutions (REI) and Behavior Establishing Institutions (BEI) and presents our analytical framework. Section 3 then articulates REI and BEI to the opposition between Despotic and Liberal orders, as developed in Brousseau, Schemeil and Sgard (2009). Whereas in the former case BEI are overwhelming, and REI tend to be fractured and fragmented, the liberal case corresponds to a reverse relation: BEI are subsumed to REI, which provide the ultimate, overall regulatory principles. We then show (in section 4) how this later, liberal interaction rule can account for the development of public, policy-making capacities. Typically, States that are confronted to the unanticipated, adverse consequences of free individual action (i.e. to a crisis) may react in four different manners. They may enforce rules and support the private endogeneisation of external costs; they may socialize some of those costs; and they may erect boundaries to individual action; and they may attempt to directly monitor behaviors to avoid the repetition of the same "crisis". In section 5, we argue that these responses may in turn have adverse social consequences if policy-makers are not restrained when relying upon them. This is ultimately why cyclical movements can be observed. Section 6 concludes and highlights path dependency phenomena in the development of policy-making states.

2. Disequilibrium and the logic of public policies

2.1. Rights vs. Behaviors Establishing Institutions

To analyze how states influence the building of institutional frameworks, we contrast behavior-establishing institutions (BEI) with rights establishing institutions (REI). The former prescribe agents' behaviors, while the later allows them to make decisions and, therefore, do not impose them a specific behavior. Of course these two analytical categories are the extrema of a continuum. However, many regulations and standards of quality tend to be BEI. In agro-industries, for instance, many public or private labels of quality — think at "Appellation d'Origine Contrôlée" for wine in France, at fair trade or biological agriculture labels for consumers product, at EU regulations concerning dairy products, etc. — do not only establish standards for the output of the production process (weigh, color, composition, etc), they also state the mode of operations to be followed by the producer. To the opposite, a standard property right on land is a typical REI in the sense that the owner can use it in very different ways. Of course, rights can be bounded by obligations such as urbanism regulations that de facto reduce the scope of the freedom of use of land and building owners, hence the idea of a continuum.

To a large extent our categories reflect the classic opposition in political theory between prohibitions and "rights of action", sometimes also summarized as "negative" and "positive" rights. Therefore, we do not pretend to invent anything new: we just summarize the main characters of two basic forms of social normalization, or regulation. While REI typically empower agents and bring public guarantees of execution beyond their private endeavors, BEI exclude a number of possible options from the realm of legally-admitted action. The French *Code Civil* (1804) — which article 544 states: "Property is the right to enjoy the use and to dispose of things in the most absolute manner, provided those uses are not prohibited by the statutes and the regulations" — illustrates how the lawmaker states a general principle, which establishes a default rule, i.e. a REI, and then opens the door to the possibility of a multitude of specific, qualifying BEI. Balancing both legal strategies is the primary, defining trade-off that all lawmakers have to address in their day-to-day activity. Combinations of REI and BEI generate a continuum: building REI can lead to the obsolescence of REI; just as BEI can fully erode the empowering potential of REI. Most clearly, social orders exclusively built on one or the other probably never existed.

These two types of normative institutions then differ in how they are implemented. Because REI provide agents with open, discretionary rights they primarily have to be enforced on behalf of beneficiaries. For this reason, monitoring the enforcement of REI (like property rights to start with) is primarily decentralized and should come from citizens, which rights might be infringed by third parties (fellow citizens or the state). Courts should then adjudicate conflicts that arise from the competing private uses of REI – for instance the capacity of agents to enter incomplete associations or business contracts. BEI on the other hand call primarily for strict compliance to normative rules of behavior. This may rely more extensively on some centralized form of monitoring. In a modern setting BEI typically regulate negative externalities, i.e. the adverse consequences of individual actions that are not accounted for, or endogenized by agents. Local communities may certainly rely upon mutual control, as when neighbors spontaneously enforce a ban on smoking in restaurants. However, the extended division of labor that characterizes modern societies inevitably calls for more formalized mechanisms, i.e. for institutionalization (See Brousseau and Raynaud (2009) on the drivers of formalized and centralized institutional settings).

2.2. The contrasted outcome of BEI and REI

The collective outcomes of behavior establishing institutions (BEI) are more easily monitorable, than those of rights establishing institutions (REI). This is true for three reasons. First, by definition REI frame but do not set individual behaviors. As a consequence these behaviors result from the exercise of individual freedom. Second, the aggregation of individual choices is subject to strategic interactions and to potential cumulative effects. It is likely that several equilibria or paths of evolution exist. It is therefore difficult to anticipate the outcome of a REI. Because individual actions are directly managed by the designer of a BEI (if any), this later can control the collective outcome, if he is able to figure out the aggregation process. Third, enforcement is easier to implement in a BEI than in a REI. If a behavior is required, it is easier to control compliance, than if a set and a scope of choices is open. In that later case, any behavior has to be observed, interpreted and assessed, which is much more complex and costly.

When we come to institutions that are designed, and therefore that are intentionally drawn to achieve a certain purpose, then discrepancies between objectives of the designer and the observed outcome is more likely to occur in case of REI than in case of BEI. This is due to what has just been written about the relative monitorability of collective outcome of BEI as compared to REI. This is also due to the scope of the games around the rules that are open under the two realms, which influence innovation. Systems of rules are never fully complied with, in the sense that the agents have always some slack when they face constraints and norms of behaviors. Being costly, enforcement is never perfect. Moreover, rules can have some margins of interpretations. Agents thus tend to play with the rules. First, they can formally comply with them, while pushing interpretation to the limit. Second, they can decide not to comply. Third, they can innovate and adopt behaviors that are neither authorized, nor forbidden. Facing a BEI agents have the choice between the two first options only, while REI open the three options. Not only, REI are more open systems because they let more freedom to individuals to act and decide, but also they allow decentralized design and adoption of innovative behaviors (including innovative methods of coordination). This is not the case for BEI.

REI are more likely to generate innovation for the better and for the worst. On the one hand, REI facilitate individual innovation, but also their test and decentralized negotiations to adapt new models and foster their adoption, then benefit from spillovers, and cumulativeness. On the other hand, everything equal decentralized innovation has a collective costs. Innovation accelerates depreciation of past investments (including human capital and organizational design) and might result in negative outcomes (when benefits are inferior to costs). Decentralization of innovative efforts can result in duplication of efforts and over-spending of resources in a competitive race.

REI are also more likely to favor efficient coordination in the economy, since more freedom will lead agents to design, or adapt, or adopt, coordination solutions fitting their coordination needs. This might have however a cost in terms of redundancy of efforts, misfits among decentralized coordination solution, and potential disorder (i.e. the standard analysis of the costs and benefits of centralized vs. decentralized coordination; cf. Brousseau and Raynaud, 2009).

Beyond the controllability of the outcome, then, REI and BEI, have different balances in terms of benefits and costs of collective coordination. REI tend to favor efficient organization of production and exchange and to foster innovation, to the costs of excessive decentralization and disorder. BEI favor systemic consistency, foreseability and stability to the cost of adaptation to specific needs and of innovation.

Beyond these elements BEI and REI, both, are characterized by inherent fundamental limits due to information and knowledge requirements when dealing with coordination within a large set of individuals. REI results in social models that are inherently in disequilibrium, since individuals have neither incentives nor informational or knowledge capabilities to deal with externalities. The dynamic of innovation and self-centered individual action may bring about large negative externalities, with further distributive stakes. On the other hand, under BEI-dominated orders, the main internal risk of resource waste (hence systemic decline) arises not so much from externalities, but from inefficient design. An efficient design of a BEI requires a high knowledge on the need of agents and a capability to manage enormous amount of information as nicely pointed out by Hayek in his arguments against planed economy and “designed” institutions. While an organization like the state à la Weber allows and is required to accumulate the relevant knowledge and process the necessary information, decreasing returns can be expected (with the size of the organization, with the enlargement of the scope of its activity). They lead to inefficient design and to the corollary raising costs enforcement necessary to reply to the incentives agents have to bypass the system of mandatory rules.

The overall set of opposite characters between REI and BEI is summed in the following table 1.

Table 1: Rights versus Behaviors Establishing Institutions

	REI	BEI
Character of the norm	Right of action	Prohibition
Monitoring/Enforcement	Decentralized	Centralized
Effect on agents	Empowerment	Security
Effect on social game	Support innovation and Self-organization	Ensure collective consistency and decrease level of risks
Socio-economic outcome	Multiple Equilibria	Linear, pointed aggregation
***Ex ante* predictability**	Low	High
Internal source of decline	Large negative externalities; costs of decentralization	Inefficient design (maladaptation) ; cost of enforcement

2.3. Disequilibrium and Public Policies

Of course, an institutional framework is made of a combination of designed and spontaneous institutions. Since we are dealing with institutional policies and focusing on the interplay between citizens and the state, we focus here on designed institutions. While they result from complex process of bargaining among the different layers of the society and between citizens/subjects and the sovereign (see Brousseau, Schemeil, Sgard, 2009), let us assume that institutions are the result of processes of acceptation/adhesion to a common order that benefit (even unequally) to all. The set of designed institutions establishes rights, hence individual and collective capabilities, and therefore the ability to produce both private and public goods; the infrastructure for exchange of private goods being one of the essential public good provided by the institutional framework. Adhesion and acceptation of an institutional framework by agents is partly linked to expected return under the form of a certain provision of public and private good, and, eventually, expectation about their distribution. Indeed, agents have preference in terms of level of inequality.

If agents dislike the outcome of an institutional setting, they then call for institutional transformation. As pointed out in Brousseau, Schemeil, Sgard (2009), this may take the form for a call for reform, but most of the time it is driven by call for extension and modification of their rights. There is however another driver of institutional change that is driven by a call for public policies. To make the point, let us assume that there is a consensus in the society, or at least a general agreement, about a given institutional setting. Given (political, economic, societal, etc.) constraints, agents agree that the current institutional setting is satisfying. They expect therefore a given provision and distribution of public and private goods[1]. The fact that agents play with the rules can lead to critical discrepancies between observed distribution of wealth and power and expected one, which ends up in a crisis: a socially non acceptable result. Disequilibrium between accepted (even unequal) outcome and the one that result from the interactions of agents create a demand for state intervention. Indeed, the sovereign/state is the guarantor of the constitutional pact, when there is one (BSS, 2009). By this pact, agents accept a given order in exchange of the guarantee of their rights that ultimately secure access to a set of public and private goods. When the result of the social game no longer guarantee this access agents can call for the intervention of state, either to reconcile the outcome with the social/aggregated individual preferences, or for reshaping the social order by modifying the set of rights guaranteed to agents and the rules framing the exercise of these rights. The threat point of individual agents/citizens in this bargaining with the state is their ability to bypass what they consider as no longer legitimate governance, or their ability to build coalition to break the established order. Of course, in both case, one can expect this ability to be proportional to the number of dissatisfied agents in the society and to the magnitude of their discontent that should be correlated with the gap of the expected outcome of the social game and the realized one. A strong correlation should therefore exist between the magnitude of the disequilibrium, and the strength of the call for state intervention.

2.4. Four types of policies

State intervention into the social game, and specifically into markets, can take different forms. These forms correspond to an increasingly deep intervention in the economy and the society. State intervention can be punctual and aimed at fixing/correcting temporary and localized problems of dysfunctioning. To the opposite, state intervention can lead to a reshaping of the social order by modifying in the long run the system of rights and rules framing agents' behaviors. We contrast four modalities of state intervention, resulting from contrasted diagnosis of the source and magnitude of the disequilibrium/crisis that the state is called to cure. First, the disequilibrium and the disorder might be considered caused by non-compliance with the existing systems of rules, which is not challenged because considered as efficient. The cure is then to reinforce repression by developing/mobilizing enforcement capabilities; both to ensure non-infringement of rights (for REI) and compliance with

[1] It is either because they have established preferences that can be aggregated, or because they share standards of fairness or social justice (See Binmore)

regulation (for BEI). Second, the disequilibrium is considered as due to a combination of causes, which joint occurrence is very unlikely. The crisis is therefore an accident, which consequences should be collectively managed, but which doe not call for a transformation of the system. The solution is therefore to redistribute revenues, especially to compensate losers. This can be done either by taxing/subsidizing or by imposing prices to monitor transfers of values among categories. Third, the observed discrepancies can be considered as due to too wide margin of maneuver of agents, resulting in coordination and market failures. Fundamentally however the existing set of rules is not questioned. The state then regulate at the fringe by closing or reducing the contracting capabilities of agents. Lastly, the crises might be considered as systemic in the sense that the outcome of the social game in the given institutional setting leads to consequences that are considered both as highly costly and difficult to control. The institutional setting is in question and it is admitted that the state should reshape it by favoring the in depth modification of rights and rules to affect the logic and the dynamic of the social game. These four logics of intervention are not mutually exclusive. They can be combined. However they are clearly ranked and linked to different (collective) diagnosis on the nature of the disequilibrium to be dealt with.

These four policies can apply either to BEI or to REI, even if disequilibria are more likely to occur in a REI regime (as pointed out above). Also, some policies tend to better fit to the nature either of BEI or REI. If a crisis occurs in a BEI regime it is either because there is a too high level of non-compliance or because the system of rules is inadequately designed. The solution is then either to intensify repression or to reestablish norms. In a pure REI regime, non-compliance is very unlikely to be the cause of major crises. This is rather the too high level of freedom of agents that result in coordination failures. This call either to bind the freedom of maneuver of agents, or to impose them norms of behavior (then BEI). However, imposing norms of behavior change the logic of the institutional system since it is a move toward an institutional system more intensive in BEI, which impact on the dynamism and efficiency of the economy and society. Thus the two policies that are the more likely to be developed are the compensation policies if the systems of rights and rules are considered as satisfactory, and the closing/reducing of contracting capabilities, if the institutional framework is questioned. Huge crises can however lead to consensus to increase the intensity of BEI. These ideas are summarized in the following table 1.

Table 2: Public Policies and the Nature of Institutions

Possible action by the state in case of discrepancy between expectations and outcomes	BEI	REI
Repression for non-compliance	If discrepancies result from non compliance	If discrepancies result from non compliance (which is by definition quite unlikely in a regime of pure REI)
Compensation	Can be implemented but would be more relevant to change the rules	If the crises is considered as temporary or if regulatory remedies are worse than coordination failures (i.e. because incompetent/corrupted regulator)
Closing/Reducing Contracting Capability	If discrepancies result from too loose norms of behavior	If discrepancies result from too difficult to monitor innovation or biased incentives for players (e.g. traders' bonuses)
Establishing Norms of Behavior	"Natural" solution driven by the clear accountability of the ruler	If discrepancies result from unavoidable systemic risks resulting from the combination of individual rational/strategic behavior (hence switch toward more BEI regime)

2.5. The Pendulum movement between enfranchisement and regulation

We thus propose an analytical framework aimed at understanding the call for/legitimacy of public policies. State intervention can be called either for enabling the market to perform (market failure) or for aligning the economic distribution of wealth and market power on social preferences; i.e. for economic/technical reasons or moral/civic motivations. In a given institutional setting characterized by a socially accepted balance between REI and BEI — or rights and regulations — agents play games around the institutional framework. In case of significant discrepancies between the expected outcome and the observed one, state intervention can be called for. Crises in particular will lead to the adoption of an institutional framework more intensive in BEI. This however impacts upon the ability of agents to innovate, trade, and self-organize. A call for enfranchisement will follow. As pointed out by BSS (2009) this lead to a slow but pervasive process of liberalization; resulting in a more REI intensive institutional framework. This later, however, may experience crises, which will move back the pendulum toward a call for a more BEI intensive framework.

According to us, this pendulum movement between phases of liberalization and phases of regulation/direct public intervention does not result in a pendulum movement of the institutional system itself around a given quantity and balance of BEI and REI. Rather, the process of institutional building is cumulative, and most BEI and REI are built on the existing set of institutions. Alternative institutional regimes are thus characterized by the level of development of formal institutions and the balance between REI and BEI within it, than only by the balance. This framework allows understanding why open access societies combine open competition with a considerable body of regulation and a high level state intervention, and why different open access societies experience different relative balance between REI and BEI.

3. Alternative Constitutional Orders and the Hierarchy between REI and BEI

Pure REI or BEI based society do not exist and never existed. What characterize contrasted social model in the perspective of the contrast between BEI and REI is first the hierarchy between the two type of institutions; i.e. whether agents are granted before all with rights that are then bounded for various reasons like the management of externalities; of whether individuals are struck in a dense network of obligations, from which they are able to partly enfranchise. Second, the question is whether the system of rights and obligations is uniform across the society or not. BEI may prevail over REI in a society, while various groups benefits from different rights and obligation, resulting in a highly fragmented society. The same for REI. Discussing policy making and considering the dynamic of the development of REI and BEI requires therefore to go beyond the contrast highlighted in the first section, and to combine it with an understanding of alternative socio-political models. Indeed, European medieval societies and XXth century socialist state are both characterized by the prevalence of BEI over REI. But the social order is less fragmented in the second case than in the previous one, resulting in contrasted socio-economic properties.

Brousseau, Schemeil and Sgard (2009a&b) differentiate Despotic and Liberal orders from how they structure individual rights – whether formal or informal, economic and politic. In the former case these rights are mainly personal, differentiated and unequal, while under Liberal constitutions the fundamental rights of citizens are defined as equal and impersonal. Moreover, under a Despotic regime, delegation of normative powers and resources to the ruler is typically limited: first he does not offer much in reverse; second he keeps huge discretion when leveraging his capacities, so that he may easily coerce or expropriate individuals. The result is a “low-powered bargain”, where limited constitutional guarantees cause widespread resistance to centralization, and therefore large underlying normative and social fragmentation. Then the definition and enforcement of the most important rights and the provision of the related public goods, like security and property establishment, are primarily local; that is, they remain very much anchored into closed communities. Symmetrically, the political process at the centre is typically limited to tiny elite groups (see North, Wallis and Weingast, 2009). Beyond the establishment of a minimally peaceful civil order, governments then tend to be limited to two main functions. The monarch may adjudicate some civil conflicts and punish delinquents, with the help of a more or less extended judicial apparatus. And he may invest into a more or less extended public infrastructure, like transport or irrigation. Both require that he extract a fiscal tribute and possibly built, for this purpose, a specific organizational apparatus. Think at the medieval monarchies in England, France or Spain, or to Ancient empires. What is left out of the realm of policy-making – an anachronism, here – is comparatively large: in fact government action is much more about policing than policies.

Despotic social orders are therefore characterised by the prevalence of Behavior Establishing Institutions. BEI are indeed congruent with differentiated, personal rights that exercise considerable direct constraints on individual action as on integration across communities. Selling or mortgaging land is difficult, entry into professions is tightly regulated, technological innovation is repressed, and price bidding is bounded. Last but not least, movements and transactions across local jurisdiction are typically difficult. Note also that, in this context, BEI should not be conceived exclusively as top-down prescriptions that would reflect an intention or interest by the rulers in controlling society and allocating rents. BEI are also part of how local communities are built and how they define legitimate, socially-enforced behaviors.

Twentieth century highly corporatist or socialist regimes offer a comparable normative pattern, although on the background of an obviously different underlying sociology – social individualism is more widespread, the division of labor is more extended, growth potential is probably higher. Most often the notion of a forward-looking “development project” is also a key element in legitimizing the political order and in mobilizing individuals and resources; think at Soviet Union, at least for a while. These contemporary social models share with previous despotic ones a strong reliance upon BEI, but in a context in which the development of a state apparatus enabled the rulers to impose a much more integrated order than in traditional societies with weak state. As it will be pointed out in the next section, the combination of BEI dominance and uniformity explain why these societies experienced major difficulties in evolving and adapting after a first phase of rationalization and unification.

Both the traditional and the contemporary despotic models are characterized by their capacity, or at least their pretension to deliver an ex post state of the world that closely reflects what was put ex ante in the determinants of individual and collective action (whether norms or objectives). Correlation, therefore predictability, between statements, behaviors and social outcomes is strong and contributes decisively to how legitimacy is defined and obtained. Mastery of the future and the reduction of the unexpected is decisive in these societies, whether the aim is Progress of Mankind or the reproduction of traditions and steady states. In the economic sphere, for instance, actual performances may not reach the expected levels and managers may not act according to plan. But "market surprises" are rare, as far as they arise from the discrete exercise of individual, guaranteed statutory rights as from the unexpected results of their dynamic interactions – like in the case of a financial or environmental crisis.

Because under a liberal order citizens benefit from the prevalence of their rights, both in the economic and the civic spheres, they have a much larger capacity to invest, innovate, take risk and speculate, while remaining within the state-sanctioned rules of the game. They may for instance launch a political party, a new literary journal, an NGO, a revolutionary software, or new market-traded, financial contracts. This does not suggest that liberal societies are run by freewheeling individual arbitrariness. On the contrary, few social orders are more rule-based than modern societies and markets. The point is that rules and sanctions are not distributed the same way as under a despotic order. Typically: they are enforced impersonally, individual discretion is considerably larger (less micro-management), and much more takes place ex post, i.e. when the results of action or enterprise are observed. This is indeed a reflection of the prevalence of REI over BEI.

A major implication of Liberal constitutions being founded on equal fundamental rights is that a powerful principle of centralization is being put at work: equal rights among citizens and merchants imply that the authority and legitimacy to establish and enforce them is transferred from local communities to a new, powerful sovereign. Both vertical and horizontal differences among them will be reviewed while considerable powers are delegated to the ruler. Provided citizens obtain symmetric reverse-guarantees against coercion and extortion, they may derive large-scale benefits from such "high-powered contract". Their rights will be defended much more strongly across the country, and because of the impersonal, universal character of those rights, the circulation of persons, ideas, goods and factor will become much easier. This will support the division of labour and innovation. Political participation and economic growth would be the most telling outcomes, as entrepreneurship or local self-organization find a much more supportive environment than in the segmented, opaque world of despotism. In other words, and in historical retrospect, liberal orders are defined by a high degree of centralisation in the definition of norms and rules, and altogether by a high predictability of enforcement. This specific character is primarily articulated to the establishment of REI that include and enforce wide-ranging individual discretion in the way individuals can actually seize and instrumentalize those rights.

The main implication of this unique, law-based habitat of modern societies and economies is that the division of labour is much more dynamic and intrinsically in disequilibrium. As REI are extended, innovations, speculations and aberrations are doomed to become more common so that the dynamic of the division of labour will become less predictable, and possibly less satisfactory. Sometimes, some outcomes will substantially diverge from the common understanding of social efficiency or from accepted norms of justice, or fairness.

This instability pattern of REI-based order was at an early hour ignored by Adam Smith and Leon Walras (arguably after Mandeville and some others) who concentrated on demonstrating that a BEI-free society could be viable and even could be a model of optimal social order. Of course, the ideal-typical character of these models can then be traced to a set of underlying hypothesis that makes them formally consistent. A good example is the neo-classical premise that economic agents actually fully endogenize their payment (or budget) constraints. Hence, really bad market surprises are ex ante excluded, because agents, by construction, always fulfil their commitments. This model of social order is therefore the exact opposite to the ideal-type of the BEI-heavy, despotic order proposed by Socialist thinkers, since Karl Marx, as the necessary alternative to a social order founded on the limited self-interest of individual, which prove to be not only unjust but also inefficient. The superiority of socialism, in their view, was not only predicated on ethical or political principles: this would also be more rational social order, because of its capacity to take in charge the true common interest of society, over and above that of (alienated) private maximizers. Of course, as pointed out by Hayek and many others, the proposed alternative model was doomed to failure because relying also on oversimplifying assumptions about individual motivations and human cognitive capabilities.

Between these two polar cases – the Hidden Hand and the Plan - a number of other, possibly more interesting options have been proposed. Social libertarians or fiscal federalists, for instance, have underlined the role of locally-organised communities that may help endogenezing the intrinsic costs and collective risks of a freewheeling market economy. With a somewhat comparable view, social conservatives build values or moral imperatives into the social fabric, as a counterweight to the destabilising effects of market opportunism or individual anomy. Family and community life would then be governed by traditional BEI, while the economy would run mostly on REI. 1970s New Agers possibly proposed the exact reverse option. Lastly comes the case we are most interested in, in this essay: that of social engineers, or technocratic policy-makers who, historically, have been primarily interested in finding new ways to articulate the open-ended, enfranchising character of REI, with BEI that would ex ante control the risk that some inefficient or unfair outcomes may emerge.

4. Crises, and Policy making

Whereas despotic orders, traditional or modern, are founded on the prevalence of BEI, that direct resources and actions, liberal orders on the other hand require that REI come first. The benchmark is empowerment, although qualifications and regulations may then extend on a large scale, implying costs or, resistance to competition and to risk taking. REI, in these frameworks, are the default option, as the *Code Civil* established; and in so doing they offer the first principles along which the overall hierarchy of norms is regulated and its coherence preserved. The principle of a binding hierarchy of norms is the instrument extending and preserving open access and equality of rights, in each sub-field of the social arena. Lastly, because this rule extends enfranchisement across society and markets, it also creates the ground for open-ended, multiple equilibria social dynamics that may deliver adverse outcomes. Let's take the paradigmatic case of debt contracts so as to illustrate the different interplay of REI and BEI in a despotic and a liberal setting respectively.

When addressing the implied risk or default and insolvency, traditional or illiberal societies typically put much weight on ex ante, supply side rules that prevent agents from accumulating too much debt. Usury law is the classical example, but many other comparable institutions can be observed across the world.[2] These risk-limiting rules are then often balanced by a harsh, exclusionary treatment of failed debtors, if they overpass safeguards. In fact, in a BEI-dominant regime, debtors would have not only broken their contracts, they have also violated a public rule, i.e. both a private dispute and a public offence. In early modern Europe, open-

[2] The Indian Damdupat is a functional alternative (Swamy 2007). Brockman (1980) also describes contingent clauses written into Taiwanese future rice contracts that split excess price fluctuations between the two parties so as to limit the risks of destabilising wealth transfers.

ended prison for debt was a most common practice that may be seen as the standard ex post counterpart to usury law, although public humiliation, excommunication and banishment came to the same effect. Then are also the many possible forms of debt slavery, coolie labor or debt peonage. Alternatively, liberal or REI-based orders are characterized by a wholly different regime as regard the economics of debts and defaults. First, ex ante restrictions on access to debt-markets and on pricing are much more limited: the default rule is that agents should assess and assume the level of risk they take. BEI rules may then be added, but in principle they would only qualify and adjust the default rule, so as to eschew some socially averse outcomes. The standard ex post rule, when default and insolvency occur, then takes the form of a bankruptcy law: that is, in its modern form, an exclusively civil, judicial procedure that divides the debtor's assets among its creditors and then offers him a "fresh start". In other words, breaking one's contracts can have severe consequences though not penal ones – as long as the law has been respected. The overall logic of the institution is indeed to support a rapid return of assets and debtors into market exchange and make sure that, again, entrepreneurs will invest, innovate, take risk and speculate. And of course some will again fail and, on the aggregate level, some social outcomes may diverge substantially from the common understanding of social efficiency or from accepted norms of justice. This is the reverse pattern of that observed in BEI-based orders that very much write the expected social outcomes in the ex ante rights and norms, so that the predictability of outcomes is high. Actual performances may not reach the expected levels and managers may not act according to plan; but "market surprises" are rare, as far as they arise from the discrete exercise of individual statutory rights as from the unexpected results of their collective dynamic interactions.

Financial crisis are the typical market surprise. First, liberalization endows market operators with much extended rights in terms of the type of contracts they can write, the market segments they can enter, the downside risks they can assume, the information they are supposed to transfer to clients or third-parties, or the way they estimate their equity capital requirements. Second, they exploit these new possibilities to compete and extract profit, while de facto following a diffuse, market-based measure of risks and its remuneration. As we know, informational asymmetries, mimetic behavior but also monetary policy may bear a lot on this trade-off, which ultimately reflects market liquidity. Thirdly, it regularly happens that within a generation of financial contracts a substantial proportion fails and possibly causes a systemic market failure. Moreover, the experience also tells the large-scale brake-up of financial contracts may rapidly cause disastrous externalities, which might be further increased by inadequate response from the policy-makers. Eventual costs may take the forms of a massive reallocation of private wealth, macroeconomic recession, large undue failures by viable firms, an extended credit crunch, the transfer of a large public debt to future generations.

Many other comparable examples could be put forward. Economic crisis, like flu outbreaks, floods or daily congestion crisis on network infrastructures, all share one point in common: they all raise the spectre of a tragedy of the common and call for some clear, identifiable, effective response by public authorities. And if the rulers are not credited with an adequate answer, loss of legitimacy can be large and enduring.[3] Less predictability in social outcomes and the probability of negative consequences is indeed where policy making arise from. If all market or social equilibria were satisfying both from an economic efficiency and a social fairness viewpoint, why would government intervene? In the reverse case, then, what can be done in front of a "crisis" or a bad market surprise? How can governments react to such events that brings back to the fore the constitutional interaction around common goods between the governed and the governments? We propose that they may take main directions that are less differentiated in terms of substantive results, than principle of public intervention vis-à-vis the on-going division of social and economic labor. Our four models of policy reactions can be articulated with our two models of society/constitution as follow.

Enforcement and private endogenization is the default response to any un-anticipated outcome under a rule-based, REI-dominated regime. Agents are supposed to respect both the law and their commitments and take full responsibility of disappointment and failure: this is the counterpart to the unique franchise they benefit from as, more generally, from the flexibility that is expected from civil society. This can take the form of the individual absorption of shocks on income and wealth, local community-based solidarity, charity, or private markets (like insurance contracts, precautionary savings, or private pension schemes). Any withdrawal from this requirement is doomed to raise problems of moral hazard and to reduce both the incentive to respect commitments and to innovate. Enforcement, therefore, is first social and decentralized, and then possibly supported by adjudication in civil courts. This is where the example of bankruptcy comes in, although tort law and rules of liability are comparable paradigms. A separate class is repression, in the case when agents have not only

[3] Framing the problem in these terms, however, should not suggest that crisis management would be essentially more relevant than other mode of policy making. Neither should leadership and clear-sightedness in front of urgency be considered the ultimate test of governments.

been able to endogenize on their own the un-expected consequences of their action, but when they also abused the limits of their franchise. Still today, the dividing line between the civil and the penal enforcement of wayward or speculative economic behaviors remains hotly debated - in the courts, in the media and in the Parliaments. This is partly a reflection of the ever-unstable balance between BEI and REI, within open, liberal societies: breaching the former rather calls for penal sanctions, whereas conflicts over the latter lead more to adjudication.

What the experience tells, however, is that there is a limit to complete endogenization by private agents and local communities. Well before modern states took charge of the provision of a number of growth-supporting public goods, they were politically founded on the principle that there are basic non-rival, non-exclusionary public goods that have to be provided by a single producer to the society as a whole. In case of failure, a tragedy of the commons may arise, where the large majority would loose, so the social division of labor and civil order may crumble. This indeed brings back to the basic Hobbesian or Lockean social contract, which failure can indeed be observed in society experiencing low-level anarchy or open civil war.

Socialization is the opposite answer to crisis: private endogenization as a default rule is suspended: part of the losses, i.e. some wealth, is shared with agents that did not have a direct stake in the failure. Social Security systems, the subsidizations of enterprises, the public guarantee of banking operations or recapitalization are straightforward examples that call for a precise identification of who is being bailed-out (managers, equity holders, bond investors, depositors?). Lender of last resort operations may also come in this category even though, in principle, they should not reallocate wealth. But the mere fact that the Central Bank acts in this way reflects the emergence of a crisis of decentralized transactions that agents are fully unable to address on their own – that is, it cannot be endogenized privately. The two standard policy instruments at stake – money and budget – have also become forward-looking ones, since sometimes between the late 19th century and the 1930s. Macroeconomic policy is indeed about mitigating the risk that aggregate cycles would be too large and would cause undue, permanent costs on the economy, therefore on welfare.

Socialization however is highly diverse and may be either based on explicit social pact, as most of the above-mentioned examples, or less so. Think at post-tsunami first help, unilateral debt moratoria, or the suspension of the banks solvency norms. De facto the open-ended, unstable character of market dynamics has regularly infirmed the expectation that purely-rule based approach, with no exit option, may be sufficient. The problem, of course, is that expectation that socialization might happen can always create a risk of moral hazard, whether there is a contingent clause or whether the public authority opts for a strategy of strategic uncertainty. Moreover, while modern states have developed sophisticated, rule-based instruments of socialization, loss-sharing can also be very messy and non-institutionalized. Suspending monetary rules and spending (or printing) money freely is not very costly ex ante: high inflation and public defaults are always manufactured by policy-makers. Both may cause huge costs on society, as wealth is typically redistributed on a large scale while the division of labor crumbles.

Reshaping Regulation is the third approach to policy-making, after private enforcement and socialization. While the latter mostly address the distribution of ex post costs, regulation exclusively addresses future behaviors or contracts and tries to shape them. Again, bank regulation comes out as a good example, where post-crisis regulation (now or in the 1930s') clearly balanced between two strategies: lawmakers can close some markets or the capacity to operate simultaneously in different market (like the Glass Steagall Act); or they can affect the underlying trade-off of banks and ask them to put forward more or less equity capital, depending upon the type of market, or assets, they deal with. However, a continuum is now observed between regulatory interventions that belong to BEI and those that de facto redesign existing REI. The aim of regulation in the strict sense is to fine-tune the franchise written into REI and shape behaviors so as to bound some classes of strategies and exclude the outcomes which are considered socially ineffective or inequitable. The limit of this approach to crisis management is straightforward: less aggregate risks will imply less innovation and less growth. In this sense, the critics of the regulatory state are right, although the common suggestion that a regulation-free market is an option is obviously misleading. The micro- and macro-level trade-off between risk and reward is therefore intrinsic to modern, rule-based liberal economies, not a side-cost.

Administrating Behaviors is the name that can be given to reforms that de facto redesign the basic rules of the social game and, specifically, in the economic field, the freedom of decision of agents. Typically the contracting capabilities of agents can be thoroughly closed in a reform that does not aim anymore at incremental adjustment. The ex ante options opened to actor are clearly reshaped so that a whole of possible outcomes is now excluded. The New Deal reforms of the 1930s' clearly fall into this category. Control and liberalization of capital movements across the balance of payment are a sub-case, although with large potential consequences. Other examples are the nationalization of public utilities: in most Western

European countries for instance, railway network were developed at first on a mostly private basis (though with a fair amount of regulation) and then shifted to public ownership and management, between the 1920s and the 1940s'.

Of course, the reshaping of the "formal rules of the game" can be radical the other way (toward a regime intensive in REI). Think at Supply side policies of the 1980's, privatization of publicly owned corporations and even civil services of the 1990's. Eventually, brutal back and forth movements may develop and characterize a socio-political regime. Think to Russia that abandoned forced labor in the 1880s, then fell back into non-market management of the labor force during the 1930s', and took again the reverse road during the 1990s – although with difficulties. Indeed when political authority and power are strong enough to reshape the division of labor between contract-based interactions and hierarchy in the all society, it can play both ways.

Our theory, however, is that enfranchisement is mostly the result of specific interactions between the rulers and the governed, leading to a very gradual process of enfranchisement and equalization of rights. We recognize, nevertheless, that highly failing social orders and economies may favor the emergence of political "window of opportunity" during which formal BEI can be replaced by REI overnight. It happened in Eastern Europe and former USSR in the 1990's. This did not prevented, however, the development of regulations de facto bounding these rights, and these regulations have been largely developed to respond to crises in line with our analysis.

Table 3 – Four types of policy responses to crises

	Endogenization	Socialization	Reshaping Regulation	Administrating Behaviors
Instrument	Courts, markets, local communities, self-help Repression	Fiscal policy Money	Regulation, Law	Constitutional Change, Law, Nationalization, Regulation
Time horizon	Ex post	Ex post and ex ante	Ex ante	Ex ante
Effect	Enforcement of contracts, individual responsibility	Diffusion of impact on larger community	Shape future contracts	Substituting hierarchy to contract / Mandatory contractual conditions
Constitutional/ rule of law requirements	Low	High	High	Low (Political strength/legitimacy prevails)
State Organizational resources	Low	High	Very High	High
Degenerative form	Civil disorder, failed state	High inflation, default	Regulatory Laffer Curve	Planned economy

5- Constitutional logic and the dynamic of policy making

Four basic policy responses to unexpected negative social outcomes have now been clarified: enforcement, the socialization of losses, regulation, and the administration (even partial) of the economy.

However, if we fall back on the previously discussed contrast between Despotic and Liberal orders, the formers can now bee characterized by their primary reliance upon the first and fourth forms of policy responses to perceived disequilibria or crisis. Despots may either let society absorb the shock and recover as it can, on the basis of its resources and capabilities. Or they may rely upon direct, command-and-control allocation of resources. In both cases, institutions and their capacity to react to shocks are then typically limited so that the state does not endogenize much. Ulterior institutionalization of experiences and processes is therefore weak. In very schematic terms, these two options also reflect the polar cases of anarchy and dictatorship, envisaged as the two paradigmatic alternatives to law-based government.

Symmetrically, modern liberal states can be characterized (still in utterly schematic terms) by their primary reliance upon the two central strategies. Both represent de facto some form of dilution, or mellowing of the alternate, polar rules: first, socialization explicitly aims at diffusing the individual impact of market outcomes on a larger part of the population; second, provided BEI qualify or incrementally adjust REI, they also limit the full leveraging of their empowerment potential. First are budgetary and monetary policies as instruments that help socializing the cost of crisis, though most of the time they aim at controlling, on an ex ante basis, the risk of future, negative aggregate evolutions. Second is regulation through the graduated adjustment of the legal environment within a framework of REI that, in principle, changes rarely. Of course, this does not mean that the two other roads are closed: modern liberal societies show under many respects an exceptional autonomous capacity to adjust and respond to crisis; and obviously these societies also have a political capacity, or potential, to rewrite the basic rules of the game. This brings back to the question raised at the beginning of this paper: modern or liberal governments have an exceptional capacity to normalize or organize individual and collective action, while generally preserving individual franchise.

If we now try to identify what allows states to operate like this, complex requirements come to the fore that ultimately reflect the constitutional bargain between citizens and rulers. First, states acting through macroeconomic policies and regulation require large organizational resources: human capital, capacity to collect and process information, sophistication of the internal bureaucratic division of labor, capacity to interact constructively with private actors, or with different levels of governments, etc. Then comes the second key input: constitutional guarantees and the overall hierarchy of norms and jurisdictions that derive from the former and support the integration and consistency of the overall rules of the social game.

First, economic theory and history are positively replete with arguments and models that establish why fiscal and monetary policies should be in the hands of institutions, like public debt managers and central banks, which independence should be founded on powerful constitutional guarantees. Because their efficiency is conditioned by their capacity to commit themselves to long-term rules of sustainability, they should be strongly protected against outside, special interests that may pressure for relaxation. And in both cases, the main threat is undue, i.e. informal transfers of wealth, or informal socialization, under the form of either inflation or debt default. Both the Glorious Revolution paradigm, as interpreted by North and Weingast (1989), and the more recent model of the "independent, conservative Central Bank", are founded on the principle that insulation from special interests is the pre-condition for producing the public good they are in charge of – respectively a capacity to rise large debt at a low interest rate, if necessary, and a credible, non-inflationary money. However, recent experiences tell that establishing those rules may be quite difficult. Sovereign states have defaulted en masse on their debt during both the 1980s' and the 1990s', at a time when the anti-inflationary credentials of most central banks, including in the developed world, were at best partial.

But that is not all. The proper operation of a deep and liquid public debt market, like the smooth operation of a central bank both call for the establishment of that most complex institutional and contractual framework – a functioning financial system. This requires altogether powerful public bodies in charge of regulation, then a complex mix of subordinated public and private rules, or orders, and finally private organizations that trade actually contracts – like banks and funds, and the endless variety of possible financial contracts, toxic or not, now traded on modern exchanges. The modern analysis of the channels of transmission of monetary policy is actually contingent upon such a highly complex regulatory environment, where solvency and liquidity constraint are observed and made binding, while also allowing for open, free-wheeling competition.

The case of regulatory policies underlines comparable institutional constraints. Again the case of financial markets underline the key role of prudential regulation and supervision in allowing for both a large and dynamic supply of financial services, while also controlling the risk that aggregates strategies eventually delivers non-sustainable or sub-efficient social results. Beyond, the regulatory response to crisis, or market surprises, is also conditioned by a working hierarchy of norms. It was said above that this complex institution should regulate both the actualization of fundamental rights, that support equality and competition, and the private law dimension of the division of labor, that reflect the contractual autonomy of agents. A third driver of judicialisation now emerges from the intrinsically unstable character of market and the need for governments to address adverse outcomes on an ex ante basis, that is with the aim of shaping behaviors and contracts so as to avoid the largest damages. Because the Invisible Hand may sometimes shake, or let the dynamic of aggregation slip out of control, a huge body of ex ante rules has been accumulated in developed market economies that actually try to control the most important risks: those that may call for the large-scale, ex post reliance upon private enforcement and socialization. While the two first drivers belong to the world of REI and empowerment, the third one reintroduces prescriptions. It aims at controlling the externalities that may arise from freewheeling interaction between individuals, which emancipation inevitably implies that, when optimizing under constraints, they will not spontaneously take into account broader sustainability constraints – whether social or environmental. Here is most clearly where prescriptions and prohibitions, i.e. BEI, come back into the complex, evolving structure of open liberal societies. In other words, the hierarchy of norms, that is regulated by the constitution and a supreme court, is the institution were the multiple trade-offs made by society (or its lawmakers) are formalized and integrated: first equality and integration; second individual and collective autonomy; third the need to re-endogenize within the rules of the game, the externalities that arise from individual autonomy.

6- Path-dependency

If we now consider together all four models of policy responses, combination of them can be readily identified, because of their being mutually compatible. Tsunami-like crisis for instance would typically be addressed with a mix of endogenization and more or less ad hoc socialization: building large-scale institutional capacities in order to address rare though high costs crisis would not make budgetary sense – hence the tendency to rely upon generic, non-specialized instrument like the army or the police. Large, contemporary financial crisis typically lead to all four types of policy-responses: first a bit of private endogeneization (think to bankruptcy and wealth losses), then a large spectrum of socialization mechanism. Beyond, all such crisis immediately raise the question of what to do in order to avoid the repetition of such event. And in turn, incrementalist reformers may have a fight with more radical reformers who would typically argue that the social benefits of open, free-wheeling markets, when they function correctly, is not worth the costs of eventual collapses. Or you may over-tax cigarette consumption and at the same time forbid smoking in specific places.

However, as responses to crisis vary along the four policies axis, they should leave enduring marks on institutions, expectations and actual behaviors.

i. Moral hazards, reputation costs or adaptative expectations are well-known, straightforward micro-level examples. For instance, populations that have already been exposed to large foreign exchange or banking crisis tend to react much more rapidly to incoming signs of distress – self-fulfilling prophecies may realize much more rapidly. By the same token, the experience of large bailouts obtained by “too-big-to-fail” financial institutions may also shape expectations and strategies, as well as possible regulatory responses.

ii. Path-dependency may also take a more institutionalized character, as when the collective experience is institutionalized in permanent operational procedures that shape organizations, coordination rules and expectations. The Original Sin theory is another example in the field of sovereign debts: countries that have defaulted or monetized their debt in the past may have an enduring difficulty to raise debt in their own currency. Quite clearly, this is reflected in the structure of their public finance, of their financial system and therefore the operation of the Central Bank. A comparable experience is that of a population that abandons its own currency over the course of an inflation crisis and then re-coordinates around an alternate one, typically the dollar. The experience tells that, after such experience, moving back to the national peso or rupiah may be extremely difficult. In such cases, the supply of services by the financial system (including credit and deposits contracts) will evolve very differently and shape the evolution of private firms as well.

iii. Redistributive issues may add a further degree of inertia. Western European socialized pension and system and unemployment insurance were all founded in the shadow of the 1930s' crisis: at that time, support to the unemployed had to be more or less improvised, and the private pension funds industry was de facto bankrupt by the crisis. Once such institutional framework is in place, of course drastic change rapidly become difficult: reform would imply a redistribution of revenue and risk, and, moreover, such mechanism are generally part of a very cohesive, integrated social compact that have endorsed a large array of special interests.

These three axes can be qualified, respectively as changes in mental models (i), as building/destruction of capacity and credibility in governing (ii), and establishment/reshaping of social compromises (iii).

There is however another type policy responses with enduring consequences. Beyond the redesigning of the four-angle policy framework, immediate policy responses may also set the overall social order on a diverging path that may lead to profound, possibly high cost trajectory. Indeed, it was mentioned that all four types of policies do reach declining return. They may even experience negative absolute return if self-controls or feedback don't work. Beyond threshold points, private endogeneization, socialization, regulation and market closure can all affect the long-term growth and innovative potential of the division of labor. Social breakdown and state failure may lead to strategies of relative withdrawal from social and economic participation; hyperinflation can redistribute wealth on a large scale and impose huge costs on the long run growth of developed economies; over-regulation can become highly inertial if vested interest take control of regulatory institution and progressively develop a secondary, rent-based redistributive economy; lastly, large-scale socialization of production factors clearly do not have the same economic consequences as the socialization of revenue and losses. An example of this type of dynamic is given by the various models related to the political economy of stabilizations: models of war of attrition typically formalize how polarized interests may delay the emergence of the minimal redistributive compact on which hyperinflation should be founded (Alesina, etc).

What is specific with these diverging trajectories is that they affect altogether the distribution of wealth, the capacity to extend the division of labor on a decentralized, contractual basis, and ultimately the empowerment capacities of REI. For this reason, these experiences do not solely impact how the market economy and a liberal civil society are governed, and how they produce public goods and solve their coordination problems. These experiences may also restructure the more central interactions rules between REI and BEI, that is the balance between private rights and prescriptions.

(…)