

THE ORIGIN OF FREE MARKET. AN INSTITUTIONAL PERSPECTIVE FROM A NON-INSTITUTIONAL POINT OF VIEW

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There are many factors which explain the origin and existence of institutions. One such factor refers to controversial human nature and also to the idea that each individual is a sum of pluses and minuses, of challenges and opportunities. Additionally, it is well-known that due to human nature, a strong negative tendency at the personal level cannot be neglected. Is there a solution to the undesired negativity which is within us? Adam Smith found it! It is the free market. Mises, Hayek, Kirzner, Buchanan, Hazlitt and others offer similar explanations; as well as all advocates of new institutionalism. The paper discusses the non-institutional contribution to this issue.

Key words: institution, market, human nature, division of labour.

Theoretical background

Institutions generally appear as and with a role of rational mechanism in order to comply with the market imperfections, informational disorder, uncertainty, risks and transactional costs. Thus, they appear as instruments which are employed to make a decent living in an imperfect world. Remaining within the realm of institutional phenomenology but getting into further detailing of the general factors, we could say that institutions appears as **a solution to undesired negativity but existent in human behaviour**.

North follows Adam Smith in explaining the origin of institutions defining the innate negativity of human nature.⁵⁴ He includes the institutional construction to his view on the nature of human cooperation. His chapters entitled *Cooperation: the theoretical problem* or *The behavioural assumptions in a theory of institutions* aim at showing the fact that cooperation between people without institutions is possible only in a society formed of angels, in other words, without any constraint.⁵⁵

If *constraint* is the key term used by North when he talks about origin of institutions, then his philosophy echoes what Thomas Paine thought when he wrote that government is the ‘product of our meanness’. We do not believe that what we have here is a sign of a limiting and revenging necessary meanness which is a characteristic of any governance⁵⁶, but of something necessary as to intervene as to show the way and separate difficulties from opportunities or to make visible and notice what is unseen: general rules which are created for everybody and each of us (in hayekian sense) or, in one word, of that something necessary to create concordia and equilibrium.

The philosophy of ‘necessary evil’ used to explain the origin of institutions takes us to “philosophy of the wall” envisaged in the famous poem *Mending Wall* by Robert Frost.

Silent dialogue between neighbours separated by the wall offers indirectly the meaning of it and, thus, of any constraint, named institution in a world populated by people. Arguments in favour (a solid wall offers protection and safety) and against (any wall separates and limits freedom, and not only in terms of space) could be very well used to explain origins of any institutional constraint. We know that our existence not being similar to that of Robinson Crusoe, the place where we produce and consume needs resources for functioning. Referring to this truth, our attitude to law as to that of tax evasion is contradictory. We feel comfortable and safe when we realise that such a rule forces everybody to common contribution for the benefit of the entire community; the benefit which offers common goods and services (roads, schools, hospitals, etc). As taxpayers, we are not as happy about tax deadlines or penalties, when we have to prove our obligations as members of community by paying taxes and fees. Something in us (the human

behaviour) tells us that we could interpret law and have a lower level of rent or income disclosed to authorities.

The same human qualities as described by Smith contributed to the negative image attributed to tax agents and official receivers. Rules still apply and are obeyed. As old English saying “good fences make good neighbours” points out, similarly, good rules make the cooperative effort possible and our whole existence and especially the economic one.

In conclusion, rules also appear as to balance evil character of people, as to stop the exaggerated drive towards evil, selfishness and individualism. The awareness of evil, in a way, solves the problem. Obeying rules, we behave as the two neighbours that need the wall even though they are ready to respect each other’s property.

A special case. The origin of competitive market

Without ever pretending to be the creator of any theory on how and why market appeared, Adam Smith, followed by the same tradition by Mill and Ricardo, is still a genius in his inspiration to look for origin of this fundamental institution within man’s behaviour. Adam Smith did not dedicate any special chapter to this issue. His philosophy on rational self-interest and existence of free market – can be followed in his entire work, especially from *The Theory of Moral Sentiments* and *The Wealth of Nations*. He starts from natural order and individual. Smith keeps from physiocrats the natural order with its non-contractual meaning. The natural order refuses to be organized as it is more in the nature of things. Its “invisible hand” intervenes to help human nature. This is where the problem appears. Human nature is not composed just of a set of qualities, pluses, but a set of contrasts. The desire to work is intertwined with idleness, accumulation with selfishness and affects generosity and altruism. Smith finds a solution. As a professor of the History of Moral Thought he was aware of the tendency towards evil, a tendency of the individual more towards bad than good. He offered one solution to individual – market competition which forces individual in developing just his good side in order to survive. Competition forces him to be rational and efficient, obey contractual obligations and follow the rules established by competitors. Even if, affectively he does not enjoy it, the individual is sent to market **instinctively** and **objectively**. This happens because man always needs help of other people’ (Smith, 1962, p. 13). He is forced to accept that there is a natural division of labour, that he cannot do everything and need others for survival.

Thus, he needs the products of other people’s work and vice versa. „Anybody who offers to somebody something needs to do the following: give me what I want and I’ll give you what you want. This is the meaning of any offer of this kind and, thus, we get from each other best services for what we need” (Smith, 1962, p. 13). The example of needle manufacturing is famous for emphasizing the role of labour division in increasing productivity and satisfying needs at the highest level. Smith’s conclusion is valid even today. A good answer to the question: What should be done for better living? We should use our skills in fields and places where we could use them better. And where else but on the market. The competition market stratifies socially and put everybody where he or she belongs under the work efficiency criteria. Market gives compensation to those who deserve it and punishes idleness, failure, bankruptcy and lack of initiative. Smith still inspires modern approaches to economic analysis of the origin and role of institutions. The Austrian school still follows his model. Mises, Hayek, Kirzner regard market in new terms but still in Smith’s tradition. Buchanan follows the same line of thought as well as Henry Hazlitt with the principle of “invisible hand” which, in his view, leads to spontaneous market order.

If we start with Mises, with his work *Human Action*, he tells us that human action under labour division is the source of human cooperation, as without cooperation, life itself is an empty metaphor (Mises, 1985). He starts from labour division, as Adam Smith, in which he sees „a fundamental institutional arrangement” determined by both natural factors and societal. All these factors, establish both seen and unseen rules as to allocate a definite place for everybody in the machinery of human energy. The fact that each person does something else forces people to cooperation. Only within this framework, human effort could flourish. Even if human action is individual, it is socially recognised. Work is individual but it needs other people’s work and vice versa. The role of exchange is a necessary aim and the market appears to coordinate this complex and contradictory phenomenon where independence of individual movement is conditioned by the effort of the others.

Even to Buchanan, market is „the institutional process by which individuals cooperate voluntarily (as a result of individual, separate aims)” (Buchanan, 1986, p. 87). Cooperation is, thus, fundamental; the market

is its expression. It is worth noticing the contradictory meaning of this institution. Along with private ownership and free association, market defines free world and is one of its main pillars. At the same time, as an institution, it also has a normative component; it is created to ensure coordination of human activity.

Conflicting reality of the market is not irrevocable. Society would cease to exist if such a conflict did not have a solution (Hazlitt, 1988).

In Austrian tradition, Hayek presents the market as the main institution of a free society, and the only one meant to optimize human action. Passing from archaic world based on 'precise rules' to civilized world of "Great Society" based on „abstract rules” was an objective process. This happened not because precise rules weren't good, but because life had become too complex to be depicted by simple, visible rules. Market is the only institution capable of adjusting individual action by feed-back. These „abstract rules” were seen by Hayek as an alternative to planning. Accepting the role of market in coordinating individual human action, Hayek refused, even a complementary role, of macro planning (Hayek, 1990).

Surely the image of market as abstract synthesis of a network of relations which condition human activity could be criticized. We refer here especially to the Hayekian affirmation that the market is the only institution with the role of optimization. Specialized literature offers critical opinions (Lachmann, 1986; Ege, 1992). It is true that L. Lachman, one of the critics, is correct when he sustains that we talk about "types of market", market producers and consumers, market with perfect competition or monopoly; local or regional, national market, etc. Generally, we refer to market, an institution with a set of rules. Once they have been respected, cooperation and valorisation of human effort, becomes possible. It is also true, that only in an illusory perfect competition market gets closer to Hayekian optimizing ideal. It still has its imperfections, recognized by the most fervent advocates of free market economy. With all its shortcomings, compared with centralized planning, it is a solution. We do not know whether it is the best one but till now humankind has not invented anything better. Hayek has foreseen it and those who have had the experience of planned economy know that he was right.

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