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The Concept of a World Economic Order

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Abstract: This paper studies the concept of an international economic order, i.e. an institutional arrangement of international rules. Such rules emerge from negative experiences – historical disasters – that inflict severe hardship on people. A taxonomy for rules reducing transaction costs is developed, for instance through decentralization of decisions, property rights, territoriality and the internalization of border-crossing negative externalities and mechanisms for global public goods. Some aspects of the rule system are studied including the process of ceding sovereignty and philosophical thoughts on international rules.

Keywords: International rules, transaction costs, welfare gains of rules, property rights, hierarchy of rules, concept of order, Freiburg school, philosophical ideas.

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The Concept of a World Economic Order

Horst Siebert

Institutional arrangements, including informal norms of behavior, the law, property rights for using land and resources as well as nature and the environment, can be interpreted as a set of rules and procedures which humankind has introduced for the governance of society and the economy on the basis of historical experience. The origin of these rules is: learning from experience, mostly learning from mistakes. In a broad sense, institutions - not to be confused with organizations - are the way things are done in a society.

In the domain of economics, institutional arrangements assign the benefits and opportunity costs of an economic decision to individuals or other subunits of society, for instance to individual households which consume goods and supply labor and savings, to firms which produce and invest, to the private sector or to governments and its different layers (Siebert 1996). In assigning benefits and opportunity costs, institutional arrangements define the incentives for the economic agents, and these incentives in turn determine the performance of the economy, for instance its growth and employment. Rules take the place of ad hoc solutions and discretion (Kydland and Prescott 1977).

Global rules refer to the institutional arrangements among states. In specific areas and to a certain extent, sovereign states cede sovereignty. The multilateral rule system that is established in this way binds sovereign states and their citizens in their behavior. In the economic sphere, the institutional set-up relates to all aspects of international interaction and interdependence, including the allocation of goods and resources, the flow of capital, the diffusion of technology, the movement of labor and human capital as well as global environmental scarcity. In addition, a rule system does not only refer to the international interaction and interdependence on the real side of the economy but also to international relations on the monetary side. Using the word "order" in the tradition of the Germany Freiburg School (see Eucken 1940; p. 238), we can speak of a world economic order.

As with norms in a nation state, rules for a world order can be based on ethical grounds, and a theologian or a philosopher may attempt to construct a rule system in a constructionist "top-down" process, starting from one or some basic axiomatic ethical norms given by religious values, natural law or philosophical principles, such as the Kantian Imperative. He may then derive specific and concrete implications for the behavior of economic agents from these principles. Such a constructionist approach, however, is not likely to succeed in deriving precise rules for economic decisions, since ethical principles allow a wide range of human behavior in specific situations.

Reduced transaction costs as a measure of welfare gains

I here use a different approach (which is in line with economics). The emergence of rules is the result of learning from experience. Most importantly, negative experiences that inflict severe hardship on people, - historical disasters - become the underlying origin of a new rule. Rules arise from the attempt to prevent human tragedies in the future. For the economist, hardship can be interpreted in terms of transaction costs. These are defined as resources used in human exchange in a broad sense and are here understood in the interpretation of Coase (1937; 1960). Costs mean opportunity costs, i.e. the costs of an opportunity forgone. When a resource is used for one purpose this means renouncing on its use for another purpose. Opportunity costs are thus defined by the welfare lost by not being able to use a resource for a forgone alternative. If fewer resources are needed for transaction they can be used for other purposes, for instance in production. Hardship or human tragedy goes together with high transaction costs. Examples are wars between nations, internal civil wars in countries, border-crossing negative externalities, for instance acid rain, but also opportunistic behavior of one nation to the detriment of another in the international division of labor. Many rules, especially in institutional arrangements relating to the economic sphere, can be explained as serving to reduce transaction costs. We therefore speak of a transaction costs approach or an experience approach to rules.

Transaction cost reduction is visible in a whole set of phenomena: lowering transportation costs, reducing market segmentations, decreasing uncertainty from all sorts of distortions and disruptions, for instance those arising from internal or cross-border political turmoil, and internalizing the negative effects of one nation’s action on others, i.e. internalizing negative externalities. According to this approach, the rule system for the world economy can be interpreted to have evolved in a bottom-up process of learning from experience, starting from subsidiary national rules. Whenever severe international transaction costs of national arrangements became apparent because new interdependencies arose or because unexpected opportunity costs of existing rule systems reveal themselves, new institutions evolved.

Ethical norms and ethical values can be viewed as a restraint to such rules. They limit the rule space that can be established nationally and globally. If ethical values differ markedly between nations, the potential global rule space becomes limited. For instance, if the values and goals of a specific group consider the destruction of other groups as their core aim, global rules cannot be established. Examples for this are the credo of Islamic terrorists or the ideology of the Nazis. An international rule system may fall apart, when values in different nations and cultures start to diverge significantly. If, however, ethical values are universal, there is more scope for an international institutional arrangement.

Ethical principles may be interpreted as being completely independent from economic institutional arrangements. However, institutional set-ups influence human interaction and are vital in the creation or prevention of new economic options. In turn, economic activities and interdependencies may then affect ethical values, for instance by showing the implications of behavior and the opportunity costs of norms. In this view, ethical principles are not completely autonomous from institutional arrangements. With the long-run impact of ethical norms being revealed by reality, the institutional arrangement reflects, at least to some extent, the experience made with ethical norms.

The transaction cost approach has the advantage that it does not motivate rules by a rosy concept of the welfare of the world that might be easily determined by a politburo, by a dictator or some other organization but is impossible to be defined in free societies with different preferences of individuals. The approach also does not start from the preferences of a subgroup of society, for instance the ideas of some NGOs that are shared by their supporters but are not accepted outside the group by other members of society. In contrast, under the transaction cost approach, the benefit of rules is assessed according to the concept of reduced costs, and these costs can be defined in a decentralized way by individuals according to their preferences and by nation states according to their goals.

Apparently, we need an agreement or understanding on the procedure how transaction costs are determined since this is vital for the emergence of rules in a society. In the transaction cost approach, the reduction of transaction costs can be revealed either through a market process that brings to light lower costs or through explicit political mechanisms through which preferences of society are aggregated. This means that the transaction cost approach assumes a competitive process, an open society and democratic structures. Under these conditions, if a country accepts a rule, it is likely to find it advantageous, unless it is coerced to obey the rule. By agreeing on rules voluntarily, the cost reductions are revealed implicitly. If, however, economic transactions are locked in by market monopolies or by political power of specific groups, there is no or only a limited scope for reducing transaction costs through new rules.

An example is existing distortions between countries, for instance when free market access to foreign countries is not agreed upon and when market access is prevented through regulations or subsidies protecting domestic producers.

The concept of opportunity cost clearly varies with preference shifts in time. A case in point is that opportunity costs for future generations may become more relevant in the utility functions of individuals or in the goal functions of governments, as for instance with respect to environmental degradation in Europe since the 1970s. In such preference shifts, NGOs and new political parties as the Greens in Europe can be a forerunner or a prime mover of future values which eventually make their way into society. This is especially relevant since preferences shift occur with intergenerational change, i.e. with new young cohorts entering the population. In this interpretation, subgroups of society can indeed play a role in determining the political preferences of society. Another example is that the utility function of individuals begins to include argument variables that extend to a wider space than the nation state, including phenomena in other countries. Thus, the Tsunami that hit Thailand and other parts of Asia and India in 2005 was of concern to individuals in Europe and North America.

The gains for individual countries from accepting a rule need not be identical. Some countries may derive a larger gain from the rule system than others. Take the case of preventing a war through a rule system. In that case, it is difficult to determine whether the benefits of such a rule system are identical to all countries. It is then more important to have an effective rule preventing wars than to discuss who gains most. However, if the benefits of a rule system are visibly one-sided or if they diverge very much, the stability of a rule system will most likely be put into question.

Admittedly, the approach described here is rather functional and rationalist, being founded on historical experience. It corresponds to approaches discussed in the age of enlightenment, for instance by Kant. For many people and for many NGOs, the transaction costs approach may appear to be not compassionate enough, not showing sufficient empathy and not having a heart and a soul. But it is dependable. It is more important to have a reliable rule system than to be at the mercy of bloomy feelings and the intentions of do-gooders. Good intentions are not sufficient for an international order.

Lowering Transaction Costs through International Institutional Rules

International rules, representing norms of behavior for governments, firms and citizens, reduce transactions costs.

First, the practice of decentralizing economic decisions, made possible by a framework of rules, represents a method of lowering transaction costs. This practice can be interpreted as an informal agreement corresponding to the subsidiarity principle which is mostly applied to the different layers of national governments in federal states, but is also relevant for the institutional set-up of regional integrations such as the European Union and also of multilateral arrangements. This principle is based on the experience that the decentralization of decisions is, in many areas, more efficient than the centralization of decision-making, one reason being that on lower levels of organizations information is more readily available and preferences can be expressed more easily. As a matter of fact, explaining rules through the lowering of transaction costs is implicitly based on the concept of decentralized decisions.

Second, relying on markets is a specific form and an essential way of decentralizing decisions and implementing the subsidiarity principle. Markets represent an institutional mechanism that aligns the production of private goods with the willingness to pay, determines consumption, saving and investment from individual choices and allocates scarce resources towards competing uses. The core function of markets is to convey the benefits and opportunity costs of economic decisions to individual agents. This means that markets express economic constraints and signal scarcity in the form of prices to economic agents – a role most relevant globally. Thus, global resource constraints are indicated by scarcity prices. New demand (of emerging countries) can drive out old demand (of developed economies) in a peaceful way. [1]

How efficient markets are in allocating resources could be observed after the transition of property rights from the large oil companies to the resource countries prior to the first oil crisis in 1973. The allocation in the hierarchical vertically integrated main oil companies including upstream and downstream activities – the Seven Sisters – was replaced by spot and future markets. Prior to this change, the Seven Sisters controlled oil exploration and oil production in the upstream activities as well as refining, transportation and distribution in the

[1] For instance, Chinas share of world imports is 46 percent for iron ore, 36 percent for cotton, 23 percent for copper ore, 21 percent for pulp and paper, 20 percent for rubber and 6,2 percent for crude oil. For comparison: China's share of world output was 5 percent (data for 2005). In 1993 China did not need oil imports.

downstream activities. Concession contracts, often valid for a period of 50 to 70 years, guaranteed their access to the natural resources, also to the undiscovered resources of the resource countries. When extraction rights shifted to the resource countries, the vertical integration of the enterprises was broken up; spot markets (for example, in Rotterdam) and forward markets replaced vertical integration. Moreover, long-term resource contracts between governments - the result of political negotiations – became unattractive, as soon as spot and future markets for crude oil had developed. Note that a firm can be interpreted as a network of explicit and implicit contracts that combines different production factors. Following institutional economics, a firm can also be defined as an organizational unit with lower transaction costs than on markets: a transaction will be carried out within a firm if the transaction costs within the firm are lower than on the markets. The dividing line between firms and the market therefore is determined by the level of the transaction costs.

The reduction of market segmentations is an important vehicle to reduce transaction costs. Over time, new options of reducing market segmentations arise, for instance technological progress in transportation, new property rights in network industries and institutional harmonization, as in regional integrations.

Third, property rights represent a crucial condition for decentralization. A property right can be defined as a set of rules specifying the use of scarce resources and goods (Furubotn and Pejovich 1972). The set of rules includes obligations and rights; the rules may be codified by law, or they may be institutionalized by other mechanisms such as social norms together with a pattern of sanctions.

Property rights may be defined over a wide range of specific uses. Dales (1968) distinguishes four types of property rights: A first category are exclusive property rights, covering the right of use, notably the right of sale and the right of disposal, even the right to destroy the good or the resource. However, an exclusive form of ownership is controlled by a set of restraints which protect other individuals or maintain economic values. For instance, according to national regulations, a homeowner may not destroy his house. Zoning rules and criminal law are examples of restrictions on exclusive property rights. A second type is status or functional ownership, referring to a set of rights accorded to some individuals, but not to others. In this case the right to use an object or to receive a service is very often not transferable. Examples of this type of right include the access to services of party officials in communist systems, licenses to notarize documents, and, during the Medieval Times, the right of admission into a guild. A third class are rights to use a collective good such as a highway or have access to a school or to a public good (health protection against contagion) for a specific purpose. A fourth kind are common-property resources such as the commons represent de facto a non-property because nearly no exclusion is defined.

Property rights represent a mechanism that reduces conflict. Accepting property rights means that people renounce on brute force. Without accepted property rights people would turn to violence and dash out each other's brain. This holds for individuals within a society and it also applies to nations. This latter application is the more relevant issue in out context.

In the past, common properties or free access goods and free access resources have been turned into private properties or, in an international context, into national properties. Thus, the high sea was interpreted as "*res nullius*" in the times of Hugo Grotius in the 16th century, not belonging to anyone. Meanwhile, we have established rules for using the seas. Since the 18th century up to the mid 20th century, the territorial waters where a sovereign state had complete jurisdiction were three nautical miles. At the end of the 20th century, this zone was extended to twelve nautical miles (1982 UN Convention of the Law of the Sea). In a contiguous zone, up to 24 nautical miles beyond the territorial sea of 12 miles, a coastal nation can prevent infringement of its customs, fiscal, immigration or sanitary laws and regulations. In addition, an exclusive economic zone extends for 200 nautical miles, with control of all economic resources, including fishing, mining, oil exploration, and any pollution of those resources. Thus, a coastal country has a differentiated control on its coastal waters.

In terms of the property-rights approach, the basic question of economics can be posed: How are property rights to be defined so that the economic system generates "optimal" results? The meaning of "optimal" may be manifold, encompassing quite a few criteria, such as freedom of the individual and correct incentives to produce and to invest, to find new technologies, search for new resources, and to supply the resources he owns (for example, capital, labor and minerals). Also we can ask whether property rights can be defined in such a way that externalities are internalized.

A most important issue in property rights is who can use land. Property rights assign the use of land to those who have a title to it. This question is also relevant for the use of the land of a country. Historically, respecting the integrity of other countries, i.e. following the principle of territoriality, can be interpreted as a national property right that prevents war as a means to conquer space. Territoriality is an international principle by which nation states agree on respecting the other nation's autonomy, in my interpretation their property rights. This gives legal authority for a state to exercise jurisdiction within its borders, not beyond. Most importantly, it relates to the nation's right to decide on using its resources and organizing its economy and its affairs as well as its political system.[2] In that sense, a nation can be understood as a resource machine that allocates resources and the power to decide on the use of resources.

Territoriality finds its limits in international public law, especially in the violation of its principles. Figures like Milosevic's, Pinochet and Hitler cannot be allowed to motivate their decisions with the principle of territoriality. Thus, the violation of "natural" law and human rights is not covered by the principle of territoriality.

Territoriality is overcome by international agreements, for instance in ceding sovereignty to a supra-regional level in regional integrations (like the EU) or in international treatises like the Kyoto Protocol. The principle of territoriality also loses importance if the utility functions of individuals include more and more argument variables from other countries. International courts such as the Court of Justice serve to implement these agreements and to solve disputes.

Fourth, international rules reduce uncertainty in transactions. Such uncertainty arises many courses, for instance from opportunistic behavior of national governments and of market participants in the fulfillment of contracts by private market participants, e.g. in the interpretation of contracts. Rules take the place of ad hoc negotiations between governments in the case of disputes. If rules do not exist, ad hoc negotiations are needed to solve disputes over the behavior of governments or in the fulfillment of contracts by private market participants, for instance to prevent cheating, finagling and double-dealing. Uncertainty is likely to arise when states of nature change so that contingent contracts are imperfect. The reliability and certainty of an international institutional framework can be considered to be a public good, enhancing the welfare of nations.

Fifth, international rules set limits on strategic behavior of national governments. This refers to governments with political power or market power who might use policy instruments to increase their national gains from the international division of labor to the disadvantage of other countries. Potential conflicts between different national interests are thus eased. Countries who find their own advantage negatively affected by such strategic behavior are bound to object to such rules. In this role, international institutional arrangements can be interpreted as public goods.

[2] See Langewiesche (2007) who explicitly mentions power resources, "the access to culture" and the distribution of "what has been commonly produced" (Translation of author).

Sixth, by joining an international rule system, states self-commit themselves, limiting national governments' choice of actions in the future. We can speak of a 'negative catalogue', a restraint on government behavior. It protects the international division of labor against the interest of national governments. The self-commitment of states is also a shelter against the power of protectionist groups in national economies. It helps against political cycles, for instance against a protectionist leaning of a government in order to win votes in a national election. It also shields against the shift of political preferences in a country, for instance when a government comes into power with completely different preferences.

Seventh, a rule system can lead to cooperative behavior among states, which makes it possible to increase the total benefits from the international division of labor to all countries (the distribution of the increased benefits is another story). Without cooperative behavior, countries find themselves in a prisoners' dilemma, unable to reduce their protectionist measures or capitalize on potential gains. Cooperative behavior is more likely in repeated games in which economic agents have to deal with each other over time. Rules then are embedded into a relational contract (MacNeil 1978). Transaction costs would be higher with non-cooperative behavior.

Eighthly, rules can internalize negative externalities between states (negative spillovers) and thus reduce transaction costs. Negative externalities are interdependencies between economic activities that exist not through market mechanisms but that follow non-market systems or technological systems. For instance, national economic activities are interdependent through border-crossing groundwater or river systems, through atmospheric systems or the bio-chain. Contagion in a currency crisis through communication systems, social or "psychological" systems is such another example of economic interdependency. In a broader interpretation, a war started by one country can be considered as an extreme form of negative externality. Rules may hopefully be able to prevent this super externality. Contrary to negative externalities, also positive externalities, for instance the supply of biodiversity by a country, can be internalized among states.

Ninthly, global public goods require specific rules in order to reduce transaction costs. Public goods are goods that are consumed in equal amounts by all (Samuelson 1954). There is no rivalry in consumption and, technically, users cannot be excluded. In our context, public goods have a global dimension, for instance, the earth's atmosphere in the case of global warming or the depletion of the ozone layer. Such public goods can be interpreted as a special case of negative externalities, but public goods are an important case of its own right in the taxonomy of interdependencies. How much of a public good we want to have cannot be determined by decentralized market decisions; this would lead to an under-provision of the public good and transaction costs would be too high. Instead, the optimal provision of a public good must be determined by the aggregation of countries' preferences in a bargaining solution between states. Institutional arrangements are needed for the process of establishing the desired quantity of the public good, i.e. for aggregating national preferences. Putting it differently, an international agreement is needed on how much deterioration in the quality of the public good is acceptable, for instance how much global warming is tolerated. Agreement is also needed on how the costs of the desired quality of the public good are allocated to individual countries and how free rider behavior can be prevented.

This taxonomy represents nine categories in which transaction costs can be reduced. One may look at these cases as international market failures that lead to too high transaction costs. The international rule system can then be interpreted as a correction of subsidiary national rules and of international market failure. Multilateral rules can thus be interpreted as an expression of the subsidiarity principle. Only when national rules lead to undesirable results with high transaction costs, do multilateral rules come in. However, it is well known that the correction of market failure by bargaining and cooperation is not free from policy failure. Only if the costs of policy failure are lower than the benefits of correcting market failure will transaction costs be reduced.

Note that the taxonomy presented here differs from the theory of fiscal federalism which applies when communality applies as a common interest, for instance in the form of a national identity in culture and language and where usually at least a weak institutional arrangement exists. The conditions given for fiscal federalism, as presented by Ahearne and Eichengreen (2007), namely similarity of tastes and economies of scale do not apply to multilateral arrangements. Similarity of tastes should not be confounded with the utility function including phenomena in other nation states. Economies of scale seem to be a narrow concept applying to existing organization units.

A Hierarchy of Rules

The rule system consists of a complex net. Most rules have a spatial dimension: some are local, others are regional, a good number of rules are national; some apply to regional integrations or pertain to border-crossing interdependencies, and finally various rules relate to global phenomena. In this interpretation, rules follow the subsidiarity principle: rules are relevant for the organizational layer, for instance households, firms and organizational strata of governments, where they fulfill their function in the best way. Thus, local rules make sure that information on problems is easily available and that preferences of local people can be straightforwardly expressed. Therefore, quite a few rules can be decentralized. When spillovers occur, the dimension of rules needs a larger scope. In this interpretation, rule systems have a vertical structure. With globalization and increasing independencies, institutional arrangements become more global.

In contrast to this vertical structure of rules according to the subsidiarity principle, some rules are universal. This characteristic applies to ethical norms, religious values and principles of natural law. Such universal rules cut through the network of hierarchical rules. Thus, the rule system is a complex matrix containing many dimensions: it is defined over space; with space it has a vertical structure; it applies to different walks of live, also having a spatial dimension; and it contains universal rules.

The Process of Ceding Sovereignty

Historically, it has been a long process in which nation states ceded sovereignty to multilateral arrangements, with many accomplishments and also many setbacks. Abandoning national decision power went along with poor historical experiences made and the arrival of new interdependencies becoming apparent. An example is the increased awareness of environmental degradation, going hand in hand with industrialization and affecting not only national environmental systems but also global media such as the atmosphere. Another example is the experience with the disintegration of the world economy in the 1930s and of World War II which then lead to the founding of GATT, the IMF and the World Bank.

The transaction costs approach to rule setting relies on rules being found by voluntary decisions because rules are expected to bring advantages. This is the approach that fits a multipolar world. Historically, rule systems have been strongly influenced by a hegemon as were the Bretton Woods institutions after World War II by the US. In other times, the rule system was imposed by the dominant power; witness the Pax Britannica or the Pax Romana. Such rule systems collapsed when the dominant power went under. Then rule systems had to be invented anew. This is the moment when the transaction cost approach is in demand again. Consequently, in a long-run historical analysis, the transaction cost approach holds.

A rich practice in ceding rules exists in the European Union where the process of giving up sovereignty is now going on for nearly sixty years, having started with the European Coal and Steel Community in 1951. The original group of Six now has grown to 27 members, through four consecutive steps: northern enlargement, southern enlargement, enlargement by the neutral states and eastern enlargement. The ceding of sovereignty also included policy instruments in substance, such as the single market, the control of national borders and monetary union. The process of ceding sovereignty embraces many other mechanisms, for instance an informal meeting of constitutional court judges of the EU countries to discuss inconsistencies between national constitutions and the European basic treaty.

As concerns the extent to which rules are ceded, unconditional delegation to a supranational agent, supervised delegation and coordination can be distinguished (Coeuré and Pisani-Ferry 2007, p. 29). Unconditional delegation is unusual. As examples, monetary policy in the euro area and EU competition policy are used where the agents have full authority to take decisions (although the EU member states remain the master of the EU treaty). The term unconditional delegation is more fitting inside nation states. Supervised delegation also is unusual internationally. Again in the EU, trade policy may be considered as illustration where a committee made up of trade officials nominated by the member states monitors the negotiation process (ibid, p. 30). Coordination means that states cooperate, in taking into account the conditions existing and the instruments chosen elsewhere as well as the interest of other countries.

As concerns the rules ceded, they apply to different areas (see the following Chapter) and represent different intensities in which rules are relinquished. For instance, Stiglitz and Charlton (2005, p.133) distinguish a descending order of transparency-enhancing obligations on firms and countries, co-operation between jurisdictions and putting in place enforceable international rules.

A Political Order as Precondition

A necessary frame of reference for the transaction cost approach is some international political stability, i.e. a political order in which rules are respected. At the same time, the rule system may contribute to political stability. Such a rule system may be provided by a hegemon, assuming that the hegemony is not selfish. It may also be developed by a group or all nations in a pluralistic approach in a multi-polar world. This is our frame of reference.

However, the political order often does not represent a stable equilibrium. Imperiousness, ideological dominance, political supremacy and strategic behavior have the potential to harm existing international rules.

As a warning, the Communist systems and the National Socialism experience remind us, that rules, even agreed upon within a country and between countries, may be fragile. Dictators may appear, governments or political systems may turn authoritarian, populists may seduce people, institutions may fall into the hands of lunatics and political preferences may vary over time. Our experience tells us that the transaction cost approach is not immune against ideologies and religions that want to destroy other ethnic groups or the people of other religious beliefs. It is also not resistant against terrorism. We, especially the generation that has not seen a war in Europe in the last sixty years, cannot be sure that rules will not be reneged, forgotten or thrown into the waste basket of history. Unfortunately, man has only a short memory. Sometimes, man is only one generation away from the Stone Age. As a consolation, the possibility of overthrowing the rule system becomes smaller the more integrated the countries are in the world order; then the international community has a strong interest to prevent a country from deviating.

Historically, shifts in the balance of power have been periods of disruptions in international rules. Witness the rise of Germany after its unification in 1871 and the two world wars that ensued, to a large extent as a consequence of the shift in the balance of power between European nations. A case for the future will be the shift of power in the coming decades from the US to China. For such shifts, it is essential to have a rule system that accommodates the rising powers and to have effective forms of mediation that can be used.

Philosophical Thoughts on International Rules

International rules have been studied by philosophers since a long time. Especially the age of enlightenment has seen many proposals looking into the issue how rules can be found. A common feature is the principle of rationality and the analysis how such a rule system may function.

Adam Smith (1757), the founder of economics, in his work “The Theory of Moral Sentiments” explained rules by a combination of sentiments and experience. As stated in the opening sentence of his book, moral sentiments, called sympathy by Smith, are feelings or emotions of approval, disapproval, gratitude, resentment: “How selfish so ever man may be supposed, there are evidently some principles in his nature, which interest him in the fortune of others, and render their happiness necessary to him, though he derives nothing from it except the pleasure of seeing it.” (p. 1). Sympathy means feeling with another person, imagining oneself in another’s place. By observing the behavior of others and feeling or expressing approval or disapproval, the rules are revealed. “Our continual observations upon the conduct of others, insensibly lead us to form to ourselves certain general rules concerning what is fit and proper either to be done or to be avoided. Some of their actions shock all our natural sentiments. (p. 265). “We thus naturally lay down to ourselves a general rule, that all such actions are to be avoided, as tending to render us odious, contemptible, or punishable, the objects of all those sentiments for which we have the greatest dread and aversion.” (p. 265) In this way, a general rule is established upon experience of which actions are approved or disapproved. These general rules are universally acknowledged and appealed to as standards of judgment.

In contrast to Adam Smith, Immanuel Kant provides a rationalistic foundation of international rules, reason being the basis of rules, for instance of an institutional arrangement to prevent war: "Nonetheless, from the throne of its moral legislative power, reason absolutely condemns war as a means of determining the right and makes seeking the state of peace a matter of unmitigated duty. But without a contract among nations peace can be neither inaugurated nor guaranteed. A league of a special sort must therefore be established, one that we can call a league of peace (*foedus pacificum*), which will be distinguished from a treaty of peace (*pactum pacis*) because the latter seeks merely to stop one war, while the former seeks to end all wars forever." (Kant 1795, p.117)

Karl Marx (1867) proposed a system of rules for organizing society with public ownership of the means of production. Meanwhile, we have gained experience with Marxist societies and economies, especially in Europe. Communist economies were centrally planned; nearly all sectors of the economy were nationalized. Private ownership was reduced to a minimum. Individuals were deprived of economic and political freedom, access to information was limited, freedom of expression prohibited. One political party controlled all political processes and all educational and cultural activities. Society was organized according to the principles of constructive rationalism with the communist ideology as the underlying approach. Self-correcting mechanisms were lacking. Gulag Archipelago was an inherent result of this approach and cost many millions of lives. Residents were walled in. Although the system clearly failed and citizens walked away from it when the iron curtain fell, the disaster of its historical performance is fading in the perceptions of young generations and Marxist principles are receiving attention again in the intellectual circles of Europe.

Another immoral orientation with a devastating impact for the world and for the international institutional arrangement was National Socialism or Nazism in Germany; this also holds for Fascism in Italy. Again, power was centralized, political freedom and democracy were abolished, one party had all the power, decisions were taken by the "Führer" and its immediate environment and nationalistic emotions were appealed to. The laws of the state and social behavior were brought in line – all ending in a terrible World War II.

The historical experience of Communism and National Socialism was the origin of social philosophers whose intention was to understand why such aberrations were the inherent necessary consequence of poor institutional arrangements. They also searched for conditions that would prevent the recurrence of such anomaly and to look for principles on which superior rules could be based.

Germany's Freiburg School, most prominently Walter Eucken (1952), developed the concept of the competitive order and its constituting principles: Open markets, nowadays the most important ingredient of the concept of contestable markets, are a prerequisite for competition. Private ownership is both a guarantee of individual liberty and an incentive to minimize costs and reveal truly economic information. Freedom of contract is conducive to competition. Liability ensures that social costs are internalized. The constancy of economic policy helps to prevent a misallocation of resources over time, and price level stability is a *sine qua non* for the price mechanism to operate. All this feeds into the competitive order which Eucken considered as the very basic principle. The ordoliberals took the view that the competitive order is instrumental in allowing individual liberties. Decentralization permits personal choice and provides options. How the institutional set-up affects the behavior of the individuals and firms was a central issue for the ordoliberal thinkers of the Freiburg School – to think in terms of an order, i.e. in terms of incentives, was a central demand of the ordoliberals. Their thinking became the foundation of German's concept of social market economy.

Karl Popper (1945) developed his concept of the open society as a counter position to a closed society in which inheritance, tradition, party membership and status decide on an individual's options and in which measures and hierarchies cement social structures, limit entry and hold down vertical income and social mobility. According to Popper society should not be "closed", but it should be an open society, "in which individuals are confronted with personal decisions" (2003:186), "in which institutions leave …room for personal responsibility"

(2003:185) and “which sets free the critical powers of man.“ (2003: xvii). This concept of the free society implies "competition for status among its members" (2003: 186).

Hayek (1944, 1971, and 1973) developed the concept of a “spontaneous order” which evolves from the interaction of the multitude of decentralized agents. Many rules and institutions have evolved in a historical process and were refined by selection. The institutional arrangements for the different spheres of human life - economic, political, educational, cultural, and religious - are partially separate. They are so complex that it is impossible that any individual could know all the facts which are relevant to the functioning of the rules. The rules are not "designed" nor can they be "designed" by a social planner, they "emerge" spontaneously from a seemingly complex network of interaction among agents with limited knowledge. Instead of constructive rationalism “from above”, rules and institutional arrangements are the outcome of evolutionary rationalism. The subsidiarity principle is part of the institutional arrangement. Self-correcting mechanisms for amending errors and improving malfunctioning are essential. Market prices are important information signals to bring about adjustment to changed conditions. Governments must create a legal framework - including laws of property, contract and tort - which allow the market order to function.

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