

Wisdom, Alterability, and Social Rules^{*}

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Abstract

This paper uses cost-benefit analysis to evaluate the relative efficiency of three competing sources of social rules: legislation, norms, and private rules. On the benefit side we consider the “wisdom” and “alterability” of social rules produced under each source. Wisdom refers to the extent to which social rules reflect society members’ rule demands. Alterability refers to the ease with which society members can change social rules when their rule demands change in response to changed conditions. On the cost side we consider the production and external costs associated with producing social rules under each social-rule source. We find that legislation is relatively alterable but unwise. Norms are wiser but unalterable. Private rules avoid the wisdom-alterability tradeoff. They’re both wise and alterable. However, private rules have higher external costs than legislation. And they have higher production costs than norms. Many societies may be able to produce more efficient social rules privately.

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1 Introduction

Social rules are proscriptions and mandates that regulate interpersonal interactions. These rules may be formal codes or informal conventions. This paper analyzes three competing sources of social rules: legislation, norms, and private rules. Most societies use legislation and norms to produce social rules. We argue that many might be able to produce more efficient social rules privately instead.

We provide a cost-benefit analysis of competing sources of social rules. On the benefit side we examine two features of social rules that are critical for social rule effectiveness: “wisdom” and “alterability.” Wisdom refers to the extent to which social rules reflect society members’ rule demands. Social rules are wiser when they incorporate a larger number of citizens’ rule demands and reflect those demands more closely. Wisdom is important for effective social rules because it ensures congruence between the rules individuals require to achieve their ends and the rules that actually exist.

Alterability refers to the ease with which society members can change social rules when their rule demands change in response to changed conditions. Social rules are more alterable when they can be more quickly and cheaply modified to suit changing citizen demands. Alterability is important for effective social rules because individuals’ needs change. The rules that are wise today may not be wise tomorrow.

Each social-rule source has different rule producers. Legislators produce legislation. Human interaction produces norms “spontaneously.” And private, for-profit producers produce private rules. Each class of social-rule producers faces different incentives and constraints. Those incentives and constraints crucially shape resulting social rules’ wisdom and alterability and thus their effectiveness.

To analyze the effectiveness and thus benefit of the social rules produced by each of our social-rule sources, we ask three questions: (1) What incentives do social-rule producers under a particular social-rule source have to produce rules whose substance reflects society members' rule demands? (2) What information do social-rule producers under a particular social-rule source have about the substance of rules society members demand? (3) What incentives and information do social-rule producers under a particular social-rule source have to modify the substance of existing rules to reflect changes in society members' changing rule demands?

On the cost side we examine two features of social rules that critically determine the cost of using a certain social-rule source for producing social rules: production costs and "external costs." Production costs are the costs entailed in producing social rules. External costs are the cost social rules may create when they're not uniform over a given geographic area—the costs citizens must incur to interact with citizens governed by different set of social rules.

To analyze the costs of social rules produced by each of the social-rule sources, we ask three additional questions: (1) What kind of production costs do social-rule producers under a particular social-rule source confront and how high are they? (2) What incentive do social-rule producers under a particular social-rule source have to minimize those costs? (3) How extensive are the external costs a particular social-source creates?

The answers to these six questions allow us to evaluate alternative social-rule sources' comparative efficiency. We find that societies that use legislation or norms to produce social rules confront a wisdom-alterability tradeoff that undermines their effectiveness and thus depresses the benefit side of these social-rule sources. The social rules legislation creates are easy to alter. But they're relatively unwise. The social rules norms create are wiser. But they're difficult to alter.

In contrast, the social rules private rules create avoid the wisdom-alterability tradeoff. Private rules are both wise and alterable. Thus private rules are more effective than legislation or norms. The benefit side of this social-rule source is maximal.

Despite the greater effectiveness and thus benefit of private rules, this social-rule source involves higher external costs than legislation and higher production costs than norms. Thus there's no universally efficient social-rule source. Our analysis suggests that different social-rule sources may be appropriate in different contexts. However, given that the wisdom and alterability benefits of private rules are much greater than those of both legislation and norms and, further, these benefits likely weigh more significantly in citizens' cost-benefit calculus than the potential costs associated with social rules, many societies currently governed by legislation and norms may be governed inefficiently. In such instances it would be more efficient to move to a social-rule source based on private rules.

To gain analytical traction we treat each of our three social-rule sources as an "ideal type." In practice these rule sources may overlap and blend. They may also exhibit variation across societies due to differences in procedural specifics. Such overlapping, blending, and variation may attenuate or exacerbate the costs and benefits we identify associated with each ideal type.

Despite this, the defining features of each social-rule source's ideal type are analytically distinct. Our analysis therefore focuses on those features. Private rules are produced for profit. Legislation and norms aren't. Legislation is produced by a monopoly, governmental, social-rule producer. Norms and private rules aren't. Finally, norms are unintended social rules. Private rules and legislation aren't. Thus, while in practice a private-rule producer might introduce a rule-making body that in important respects resembles and functions like a legislature, this

doesn't change fact that the resulting social rules' source is private rules, since those rules' are produced for profit and the social-rule producer lacks a monopoly on social-rule production.

This paper is most closely connected and contributes to two strands of literature. First, we contribute to the literature on social norms and economic and legal institutions (see, for instance, Koford and Miller 1991; Cooter 1998; Kahan 1998; Kuran 1998; R. Posner 1998; E. Posner 1998, 2002; Pildes 1998; Zasu 2007; Leeson 2008). Ellickson (1998) notes that law-and-economics scholars have tended to exaggerate legislation's role in facilitating social cooperation. Our study contributes to a deeper appreciation of alternative social-rule sources by exploring the relative efficiency of three different sources of social rules. If scholars have tended to downplay norms' importance regulating social conduct, they've ignored private rules' importance toward that end almost entirely.

Second, this paper contributes to the literature on private legal systems (see, for instance, Benson 1989a; Dixit 2004; Leeson 2007a, 2009). We extend this literature by clarifying private rules' comparative effectiveness and, in many cases, efficiency. In particular we show how this social-rule source avoids the wisdom-alterability tradeoff that legislation and norms confront.

2 Legislation

2.1 Examining the Benefit Side of Legislation

Legislatively produced social rules are social rules produced by government officials who legally monopolize social-rule production. A deliberative political body creates and may undo such rules with the stroke of a pen. Because of this, legislation is relatively easy to alter. Change is possible

provided legislators follow the procedural rules in place. This could range from decree under a single sovereign to a more complex process under democratic systems.

While legislation is highly alterable, it tends to be unwise. The reason for this is simple. Legislators face a classic “planner’s problem.” The planner’s problem is an information problem. Legislators’ ability to accumulate, let alone appropriately aggregate, citizens’ information about the differing problem situations they confront and the kind of rules that would help them negotiate those problem situations is severely constrained. As Hayek (1945, 1973) pointed out, that information is “dispersed.” It’s held individually in bits and pieces by each member of society who has particularized, local knowledge of “time and place.” In centrally planning social-rule production, legislators are unable to draw on citizens’ dispersed information. This significantly hampers legislators’ ability to produce social rules that reflect citizens’ demands.

Legislators also face an incentive problem. They have weak incentives to produce social-welfare maximizing social rules. To see why, consider the well-known principal-agent problem. This problem arises when ownership is separated from control. In such instances the agents (those hired to represent the interests of the principal) have incentives to exploit the principals (the owners) rather than to faithfully serve the principals’ interests. In the context of our analysis, citizens are the principals. Legislators are the agents.

The principal-agent problem can be overcome, or at least significantly mitigated, if the principals can effectively monitor the agents. Thus the question is whether appropriate monitoring and feedback mechanisms exist for legislators that might align their interests with citizens’, leading legislators to produce social rules that reflect citizens’ rule demands.

In the case of a single sovereign who controls his citizens’ movement, there’s but one potential mechanism that might perform this function: the threat of revolution. However, this

mechanism is weak because citizens' revolutionary threat is weak. As Tullock (1971) points out, would-be revolutionaries suffer from collective action problems that undermine rebellion. No individual member of society has an incentive to participate in revolution. And no one has an incentive to lead it even if this participation problem could be overcome. These collective action problems largely undermine revolution as an effective check on the agent's exploitation of the principals.¹ Thus the sovereign has little reason to satisfy citizens' rule demands.

The sovereign's residual claimancy on citizens' productivity might provide an alternative channel through which his interests could be aligned with citizens'. But this fails too. The sovereign isn't a residual claimant on the revenues he generates from producing social rules citizens desire. He's a residual claimant on the revenues generated through his citizen's productivity. This gives the sovereign an incentive to maximize his citizens' productivity. But the social rules that maximize citizens' productivity needn't be the ones that maximize citizens' welfare. And these are the social rules citizens desire. The social rules the sovereign will produce legislatively only dovetail with the ones citizens demand in the event that citizens care only about maximizing their incomes. That would, for example, require citizens to value leisure only instrumentally—as a means of making them more productive laborers. This is unlikely.

Even if productivity did exclusively drive citizens' demands for social rules, McGuire and Olson (1996) supply reason to doubt the sovereign would produce rules consistent with citizens' demands. The sovereign's revenue-maximizing tax rate is always higher than the tax rate citizens would choose because the sovereign bears only a small fraction of the deadweight loss his

¹ Tullock points out that revolution suffers from various collective action problems that should, theoretically, preclude revolution from occurring. Of course, in practice, we do observe revolutions. This suggests that individuals are capable of finding solutions to these problems (see, for instance, Leeson 2010). Our point is simply that far fewer revolutions take place than would otherwise be the case were it not for the obstacle Tullock confronts, making rebellion a much less effective, and thus comparatively rarely observed, check on sovereign's behavior.

taxation engenders. Thus, in this case too, legislatively produced social rules will exhibit a dearth of wisdom.

Perhaps unexpectedly, democratically elected legislators confront a similar incentive problem. The voting booth and regular elections would seem to discipline elected legislators, aligning their interest with citizens' and, in doing so, providing legislators incentives to produce the social rules citizens demand (Ferejohn 1986). In eliciting and aggregating the input of society's members about which legislators they would like to produce social rules, democracy even appears to provide a solution to the information problem legislators face. But this intuition about democracy's ability to produce wise social rules doesn't withstand analytic scrutiny.

One of public choice economics' core insights is that principal-agent interactions under democracy are characterized by vote-seeking politicians, rationally ignorant voters, and special interest groups. These features of democratic politics thwart the potentially incentive-aligning features of democracy, ensuring again that legislatively produced social rules will be unwise.

Because the chances of any one vote influencing the outcome of an election are miniscule, citizens are rationally ignorant of legislators' behavior. They have weak incentives to invest in monitoring the specifics of what elected officials are doing.

Voting is also as an ineffective means of eliciting and aggregating citizens' preferences for social rules. Each voter possesses a single vote equal to all other votes. Because of this, voting fails to communicate the strength of citizens' preferences for social rules. Democratic elections also bundle social-rule choices over a wide and disparate range of issues. When a citizen votes, he votes for a social-rule bundle of potential legislation. He's unable to select social-rule *A* on issue *X*, which one candidate promises to produce, and social-rule *B* on issue *Y* that another

candidate promises to produce. This, too, prevents democracy from accurately registering citizens' demands for specific social rules.

Special interests confound democratically elected legislators' incentive to produce wise social rules still further. Special interests are groups of individual voters who act in concert to achieve common goals sought via the democratic process. In contrast to individual voters, special interests have strong incentives to invest in collecting information about legislators' behavior. While the likelihood that a single vote will be instrumental in influencing an election is minimal, a large collection of votes has a higher chance of doing so. Because of this, special interests are able to enter into exchange with legislators whereby they trade their members' support for the production of social rules that benefit their group.

Responding to the incentives this situation creates, elected legislators concentrate benefits on well-organized, well informed special interests, and disperse the costs of the social rules they create for this purpose on the unorganized, rationally ignorant mass of citizens. The resulting social rules are wise with respect to special interests. But they're unwise with respect to everyone else.

In both the case of the single sovereign and the case of democratically elected legislators, legislation produces ineffective social rules because those rules, while easily alterable, are unwise. This ineffectiveness doesn't result from the absence of a residual claimant under legislation, however. In both cases it results from the residual claim attaching to the "wrong" thing. Under the sovereign the residual claim is attached to citizens' productivity instead of citizens' satisfaction with the social rules he produces. Under elected legislators the residual claim is attached to social rules that benefit special interests at the expense of other citizens. In

both cases legislation fails to produce wise social rules because social rules' producers lack incentives to produce the social rules citizens demand.

In the foregoing discussion we've focused exclusively on legislation's effectiveness in the context of static citizen demands. But legislation's ineffectiveness grows stronger still when we consider its ability to meet changing citizen rule demands as the result of changing conditions. Legislation makes it relatively easy to change social rules in the face of changing citizen demands. But this potential benefit goes unrealized because of the information and incentive problems legislation confronts discussed above. It matters little that social rules are highly alterable in the face of changing conditions if legislation producers have neither the information required to know how to change social rules to adapt to those conditions nor the incentives required to actually make such changes when citizens desire them. The information problem legislators confront in particular makes producing wise social rules harder in a dynamic context in which citizens' demands for social rules may change.

2.2 Examining the Cost Side of Legislation

We've come to some rather unhappy conclusions about the benefit side of legislation. Legislation's benefit is low because, though alterable, legislation is unwise. Its producers have weak incentives to produce social rules citizens demand and to modify those rules when citizens' rule demands change.

Legislation fares only slightly better on its cost side. The main potential costs of social-rule creation are the costs of producing such rules and the external costs associated with those rules—the costs citizens incur when they have to interact with citizens governed by different social rules.

Legislation's production cost depends on the type of government in question and the procedures in place from the creation of new social rules. It's much cheaper for a single sovereign to create social rules than it is for democratically elected legislators, since, in the latter case, the approval of a larger number of individuals is needed. Similarly, within democratic systems, a bicameral system, for example, will entail higher social-rule production costs than a unicameral system.

The most significant production cost of social rules via legislation is the social costs of rent seeking. In the case of the sovereign, rent seeking costs may emerge as different groups attempt to influence the production of social rules. However, since the sovereign isn't directly dependent on these groups, he can at least partly insulate himself from these pressures. In the case of democratically elected legislators, rent-seeking costs will be higher. Social-rule producers under this system are subjected fully to the rent-seeking pressures of special interests since they're position as social-rule producers depends on satisfying these groups by producing social rules that cater to them at others' expense.

In terms of the other major, potential cost of social rules—external costs—legislation performs much better. Legislation produces uniform social rules for the territory over which it governs. The social rules its produces apply broadly. They cover everyone in the society in question. This contrasts with the case we'll consider later in which social rules may differ from one part of society to the next.

Legislation's homogeneity contributes to making it unwise and thus operates to depress the benefit side of legislation. Legislation's social rules don't respect variations of "time and place" that produce different citizen demands for different social rules. But that homogeneity has an advantage on the cost side. When social rules vary from one area to the next, it's more costly for

citizens from different areas to interact. When rules are uniform, this cost is minimized. In this sense legislation provides a kind of “economies of scale” in social rules. Where network effects are significant, so is the external-cost minimizing advantage of legislation.

We can summarize our analysis of legislation as a source of social rules with the following propositions: (1) Legislation is alterable. (2) Legislation is unwise. (3) Legislation’s production costs depend on the legislative structure used. However, rent-seeking pressures tend to make these costs high. (4) Legislation’s external costs are minimized.

3 Norms

3.1 Examining the Benefit Side of Norms

Norms are social rules that emerge spontaneously through individuals’ interactions. They reflect a historical trial-and-error process by each of society’s members as he attempts to improve his individual circumstance. Norms are endogenous responses to the specific obstacles individuals confront. They institutionalize the pattern of voluntary behaviors that individuals develop to help them overcome these obstacles. Although they vary across societies, norms are applicable to an array of contexts including property rights, agreements and contracts, notions of fairness, and non-commercial interactions (see, for instance, Lewis 1969; Ullman-Margalit 1977; Sugden 1986; Young 1998; E. Posner 2002; Hechter and Opp 2001; Bicchieri 2006).

Given the historical weakness and absence of governments that might produce social rules through legislation, history presents a multitude of examples of norm-produced social rules. For example, Zerbe and Anderson (2001) argue that norms were central to shaping the rules that miners in the American West relied on in the absence of legislation. Benson (1988, 1989b),

Leeson and Stringham (2005), and R. Posner (1980) analyze how primitive societies have used norms to avoid conflict. Landa (1981, 1994) explores how norms emerged to govern commercial transactions in contemporary Southeast Asia. And Greif (1989, 1993) discusses the importance of norms for 11th-century Mediterranean traders.

Once norms are established they tend to be self-perpetuating. This is because people expect others to follow them (Lewis 1969). In creating shared expectations, norms serve as “focal points” that coordinate the activities of diverse individuals seeking their ends together or independently. Norms accomplish this by defining commonly understood and anticipated behaviors in situations of uncertainty where a range of potential responses—a multitude of equilibria—are possible. By harmonizing expected responses, norms reduce uncertainty in the presence of imperfect information.

Because norms emerge endogenously, they’re wise compared to legislation.² The social-rule production process norms involve is fully decentralized. This permits norm-created rules to reflect the local conditions and contexts in which they emerge. These social rules’ bottom-up emergence ensures that they reflect citizens’ diverse and specialized problem situations when they first emerge. They’re an endogenous response to citizens’ demands for certain social rules and thus exhibit great wisdom, at least as long as conditions, and thus citizens’ rule demands, don’t change.

However, for the same reason that norm-produced social rules are wiser than legislation-produced social rules, norms are costly to alter compared to legislation. Just as norms emerge through a long, evolutionary process, they only change through a long, evolutionary process. Norms are legal fossils. They’re part of culture. Thus they display tremendous inertia. This makes norms difficult to change—even when conditions change that might render them

² On the “wisdom” embodied in norms, see Boettke, Coyne, and Leeson (2008).

undesirable. Indeed, one of the key findings in the literature on norms is that norms persist under changing conditions (see, for instance, Foster and Young 1990; Young 1993; Kandori et al. 1993; Samuelson 1997).

Norms' institutional inertia can be explained by reference to institutional path dependence—increasing returns to existing institutions that tend to lock in particular arrangements that emerged in various places for unique historical reasons (North 1990: 92-96). Several forces may lock in these social rules far beyond their usefulness. For example, there are learning effects associated with norms as people invest effort to understand and learn how to appropriately follow norms. Similarly, there are coordination effects associated with norms, which refer to the lower transaction costs those social rules permit, which raise switching costs. Simple expectations may also produce norm lock-in. As the number of people coordinating around a norm increases over time, so does the expectation that the norm will continue into the future. This expectation can lead the norm to continue into the future in a kind of self-fulfilling prophecy.

Another factor making norm-produced social rules difficult to alter is the fact that they lack a residual claimant. Precisely because these rules emerge “organically” as byproducts of other behaviors, no one “owns” norms and enjoys the lion's share of the benefits—or costs—that these social rules confer on citizens. Because of this, no one has a strong incentive to change norm-created social rules when conditions change and make social-rule changes desirable. Thus, while norm-created social rules exhibit great wisdom upon their emergence, the difficulty of altering them when conditions and citizens' rule demands change renders them unwise dynamically.

3.2 Examining the Cost Side of Norms

Norms' production cost is zero. Since these social rules aren't deliberately produced, but rather emerge endogenously as the byproducts of other behaviors, norms are "free" to produce. Nor do norms involve production costs associated with rent seeking. There's no person or group of persons to whom a rent seeker could appeal to modify or introduce norms for private benefit. No one is "in charge" of norms. And no one has the power to change them unilaterally. Thus norms minimize the costs of producing social rules.

Determining norms' external costs is more difficult. Since norms emerge endogenously, there's nothing to prevent their substance from varying from one place to the next within a given geographic area. Indeed, precisely because norms emerge endogenously in response to individuals' particularized problem situations and citizens' problem situations tend to vary from place to place, norm-produced social rules will likely vary across regions of an even relatively small geographic area. On the benefit side this feature of norms contributes to their wisdom. However, on the cost side it contributes to norms' external costs. Citizens governed by one set of norms in one area who interact with others in a neighboring area will confront different social rules they must learn and adapt to. Differences in understandings about property rights, appropriate behavior, and so on as the result of differing native norm-produced social rules may produce interpersonal conflicts.

That said, norms have an important feature that can, at least in principle, operate to depress their external costs if citizens' problem situations are sufficiently similar across areas. Norms, which have zero marginal cost of production, confront no diseconomies of scale. In principle norm-produced social rules can be extended over an infinitely large geographic territory and

suffer no diminution in their effectiveness. Thus there are no economic forces operating to prevent norm-produced, social-rule uniformity at least in theory.

We can summarize our analysis of norms as a source of social rules with the following propositions: (1) Norms are relatively unalterable. (2) Norms are initially wise. But the difficulty of altering them may make them unwise dynamically. (3) Norm's production costs are minimized. (4) Norm's external costs depend on the variation in individuals' problem situations that give rise to variation in norms' substance.

4 Private Rules

4.1 Examining the Benefit Side of Private Rules

Private rules are social rules that private owners produce for profit in a market. Privately produced social rules are deliberately designed and chosen. But they must pass the "market test" for private producers to select them over alternatives. Citizens' demands for different social rules drive the rules private producers offer.

Private-rule production can be understood in the context of "clubs." Clubs are a way for individuals to provide goods that have public characteristics privately (Buchanan 1965). Club goods are excludable but non-rivalrous until some congestion limit at which point they become rivalrous and diseconomies of scale set in. Club goods are profitable for club owners to supply privately if they can convince enough customers to purchase the goods, or rather membership in the club. The logic of club goods is applicable to a range of goods and services with publicness characteristics, including social rules.

History supplies numerous examples of club-produced private rules. For example, Anderson and Hill (1979, 2004) examine reliance on private rules in the 19th-century American West where government was largely absent. During this time Americans headed West seeking profit through gold mining or claiming unowned land. The absence of legislation meant that Western pioneers confronted significant potential for conflict. Clashes over mining rights, land rights, and problems of theft threatened to plunge the West into chaos. However, Anderson and Hill show that chaos didn't emerge because an array of clubs produced social rules privately, filling the governance gap.³

To establish property rights and adjudicate potential conflicts over land, Western pioneers created claims associations that defined and registered property rights and arbitrated association members' land disputes. Western pioneers also created cattlemen's associations that performed similar functions with respect to cattle. These clubs competed with one another. Members could enter and exit them depending on whether they were satisfied with social rules and the attendant services the clubs provided.

Unlike legislation and norms, private rules don't confront a wisdom-alterability tradeoff. Private rules combine maximal wisdom and maximal alterability. Consider the wisdom of private rules. Clubs rely on the "wisdom of crowds" inherent in markets to inform them about citizens' demands for different social rules. Club memberships are priced in the marketplace. Those prices reflect citizens' intensity of desire for alternative rules that clubs supply.⁴ Club owners are residual claimants on revenues they generate through providing social rules that

³ For other examples of private rules filling the governance gap created by anarchy, see Leeson (2007a, 2007b, 2007c, 2007d, 2009).

⁴ Friedman's (1973) excellent book was one of the first to describe a system of private rules. See also, Leeson (2011).

comport with citizens' desires. Thus private-rule producers have strong incentives to use the information market prices provide them to produce the social rules citizens demand.

Club owners earn profits by attracting and keeping customers. They do this by supplying and enforcing social rules citizens desire. If club owners fail to supply social rules citizens desire, or fail to enforce those rules once they're in place, they lose customers and hence profit. The residual claimancy inherent in the system of clubs aligns the interests of the owners with that of the club members.

The incentive alignment private-rule producers' residual claimancy creates is imperfect. Exiting a club isn't costless. Thus club owners needn't be perfectly responsive to citizens' demands. The costliness of exiting a club creates a range over which club owners can exploit customers without depleting their customer base. However, this situation exists under other sources of rule provision as well. Migrating from one territory governed by one set of norms or legislation to seek superior norms of legislation elsewhere is costly too. Thus costly exit isn't an automatic strike against private rules' *relative* efficiency.

The relevant question is how high exit costs are under a system of private rules compared to a system governed by norms or legislation. The answer to this question depends on how many social-rule alternatives exist in a given geographic area in each of these systems. The more competitive and decentralized the system of social-rule provision, the more of such alternatives exist, and the less costly it is to move from one social-rule system to another, shrinking the range over which club owners might exploit their customers.

A system of private rules minimizes exit costs because there are as many rule-providing clubs as people demand. Further, since there's no institutionalized monopoly on social-rule

creation, the number of competing social-rule producers isn't artificially limited and the threat of a new, private-rule supplier's entrance remains powerful.

In contrast, legislation centralizes and monopolizes social-rule production. The number of social-rule providers is therefore minimized, maximizing exit costs. Even federal systems, which attempt to introduce a degree of competition in legislative rule making, impose limits on the number of potential rule providers that don't exist under a system of private rules. For example, no federal system permits unregulated entry into the social rule-creation "industry." Even under federalism, fewer sub-governments exist than people would demand if given the choice.

Norms are different. These social rules may flourish over small areas or large ones. Whether more potential social-rule options exist under norms compared to private rules is an empirical question. Economies of scale resulting from the network effects discussed above may "naturally" limit the number of clubs and thus social-rule alternatives under private rules. It's unclear whether such economies would similarly shape and constrain the number of norm-produced, rule-alternatives. However, it is clear that diseconomies of scale in private-rule production that result from congestion that eventually sets in within a club as the club grows, limits how few clubs, and thus how few social-rule alternatives, may exist under a system of private rules.

In contrast, as indicated above, there are no clear diseconomies of extending norms over ever-increasing population sizes or geographic territories. Thus, at least in principle, there's nothing that prevents norm-produced, social-rule alternatives from dwindling to very low numbers. At a minimum, there's no obvious reason why we would expect more norm-produced social-rule alternatives to emerge in a given geographic area than private-rule alternatives.

One final reason may be adduced for why private social-rule producers have strong incentives to create and enforce rules in accordance with citizens' demands. Clubs permit a

continual process of self-section. Because citizens can self-select into the social-rule option that best satisfies their demands, clubs consist of people who share the same preferences over social rules. This permits club members to more easily coordinate on the punishment of the social-rule supplier—the club owner—if that owner reneges on the social-rule arrangement citizens agreed to. Multilateral punishment imposes a higher cost on social-rule producers compared to bilateral punishment through exit. This strengthens private-rule producers' incentives to produce and enforce the social rules citizens demand.

Surowiecki (2004) identifies four conditions “crowds” must satisfy to make them wise. First, they must contain a diversity of opinions. Individuals must be permitted to interpret facts as they want, even if others consider those interpretations idiosyncratic. Second, and closely related, crowds must permit their members significant independence. People must enjoy the freedom to form their own opinions. Third, crowds must be largely decentralized. People must be permitted to exploit their context-specific knowledge. Finally, crowds must have mechanisms for turning private opinions into collective decisions.

We can summarize the reasons why private rules tend to be wise by referencing Surowiecki's conditions. The possibility of different clubs offering different social rules, including the possibility of forming a new club or refraining from joining a club altogether, contributes to the existence of a diversity of opinions and independence in opinion formation. Under a system of private rules people are able to form diverse opinions and to self select into clubs that reflect those opinions. Further, as their opinions change over time, they're able to re-select into a new club that better satisfies their preferences.

Club-provided private rules also satisfy the decentralized condition for wise crowds. The possibility of different clubs offering different social-rule alternatives means that the production

of private rules is decentralized. There's no centralized, monopoly body that imposes rules on everyone per legislation. Finally, private rules provide the information aggregation and feedback mechanisms required for wise crowds. As Mises (1920 [1935]) and Hayek (1945) pointed out, prices and profits and loss in markets provide precisely such mechanisms. This is as true for producers of "ordinary" goods and services as it is for producers of private rules.

Private rules are also easily alterable. They have clear producers who consciously create them and can change them as easily as they put them into place. If citizens' demands for social rules change, club owners learn this through declining demand for their products. On the basis of that information, club owners can change their rules to accommodate changed conditions with the stroke of a pen. And they have an incentive to do since their income depends on this.

4.2 Examining the Cost Side of Private Rules

Similar to legislation, the costs of producing private rules depend on the particular procedures private-rule producers use. A club owner might make rules "dictatorially"—offering a pre-set menu of rules to potential members. The production cost of private rules in this case would be very low, corresponding to the low production costs of social rules under legislation when a single sovereign produces them. Alternatively, a club owner might set up "democratic" rule-making and rule-altering institutions within his club, for instance deciding rules by popular support. Producing private rules will be more costly in this club. This would correspond to the comparatively higher production costs of social rules under legislation when elected legislators produce them.

The critical difference between the costs of producing private rules and the cost of producing social rules via legislation is that private-rule producers are profit motivated while

legislators aren't. Thus private-rule producers have an incentive to employ cost-minimizing procedures for adopting and changing social rules. Legislators have no such incentive. *Ceteris paribus*, this means that private rules' production costs are lower than legislation's. Private rules continue to have a positive production cost. Thus they're more expensive to produce than norms. But they're cheaper to produce than legislation.

Private rules also avoid the rent-seeking costs associated with social-rule production. In this way they're similar to norms but contrast again with legislation. Unlike with norms, with private rules there are identifiable individuals who could be lobbied to introduce or modify social rules for the benefit of special interests: club owners. However, unlike legislators, because club owners are residual claimants on the extent to which they satisfy their customers, these owners internalize the costs of introducing or modifying social rules under rent-seeking pressures fully. This provides powerful incentives that prevent them from doing so.

The external costs associated with private rules are this social-rule source's chief potential costs. As discussed above, there are no artificial limits (though there may be economic ones, such as scale economies) to the number of private-rule alternatives that might emerge in a given geographic area. Thus the prospect that citizens will have to interact with others governed by different private rules is maximized. How significant a problem this is, and thus how costly these external costs are to citizens, depends on the strength of network externalities. If private-rule differences are small or citizens find it relatively easy to interact with individuals governed by different rules, these external costs will be small. If rule differences are very large or citizens find it very difficult to interact with such individuals, external costs will be much more significant.

We can summarize our analysis of private rules as a source of social rules with the following propositions: (1) Private rules are alterable. (2) Private rules are wise, statically and dynamically.

(3) Private rules' production costs depend on the procedures rule producers use to produce social rules. But producers have strong incentives to use cost-minimizing, social-rule production procedures. (4) Private rules' potential external costs are maximized.

5 Concluding Remarks

Ideal social rules are wise and easily alterable. Wise social rules are important because they reflect citizens' disparate and evolving demands for rules that facilitate the pursuit of their individual ends. Easily alterable social rules are important because conditions change, leading citizens' rule demands to change. Effective rules must reflect these new conditions.

Legislation is relatively alterable, but unwise. Norms are wise, but relatively unalterable. Private rules face no wisdom-alterability tradeoff. Private rules can involve either production or external costs that either legislation or norms do a better job of economizing on. However, the considerable wisdom- and alterability superiority of private rules relative to these other social-rule sources means that such costs must be very large to render either legislation or norms a more efficient social-rule source than private rules.

Our analysis suggests several conclusions about alternative social-rule sources' comparative efficiency:

Private rules are wiser than legislation and as easily altered. Further, private rules' production cost is lower than legislation's. However, legislation, which produces uniform rules, economizes on external costs relative to private rules—the costs of interacting with individuals who, under private rules, may be subject to different social rules. Thus legislation is more efficient than private rules only when private rules' external costs are large enough to exceed the difference in production costs between legislation and private rules *plus* the difference in

“wisdom benefits” between private rules and legislation. When the gap between the production costs of private rules and legislation is larger (for instance, because rent seeking is rampant), the gap between the wisdom of the social rules produced privately versus legislatively is larger, or private rules’ external costs are smaller, private rules are more likely to be efficient than legislation.

Private rules are as wise as norms statically and more easily altered to reflect changes in wisdom. However, norms, which are “free” to produce, economize on production costs relative to private rules. Thus norms are more efficient than private rules only when private rules’ production costs are large enough to exceed the difference in “alterability benefits” between private rules and norms. When the gap between the alterability of social rules produced privately versus via norms is larger, or when private rules’ production cost is smaller, private rules are more likely to be efficient than norms.

Together the foregoing remarks imply that private rules are likely to be more efficient than both legislation and norms as a social-rule source when citizens’ rule demands change frequently and citizens value “dynamic wisdom” highly. In this case, even if private rules generate significant external costs relative to legislation and generate significant production costs relative to norms, citizens will prefer to incur these costs to “purchase” a greater match between their rule demands and the rules that are produced as those demands change over time.

Presumably, social rules’ reflection of citizens’ demands as those demands change over time is a highly valued—perhaps the most highly valued—attributes of social rules. After all, if social rules don’t come at least reasonably close to the rules citizens desire, it’s unclear what good they are regardless of how inexpensively they may be produced or how much they economize on

external costs. Under this presumption about citizens' preferences, at least, private rules will almost always be more efficient than either legislation or norms.

Today nearly all societies regulate social interaction on the basis of some mix of legislation and norms. Private rules, as we've described them, are rare. This means one of two things. On the one hand, the situation we observe may reflect inordinately high private-rule production or external costs over most of the globe. In this case the predominance of legislation and norms we observe reflects an efficient outcome. Alternatively, the situation we observe may not reflect the efficiency of legislation and norms but instead reflect an inefficient outcome over most of the globe. More societies should be regulating social interaction through private rules. But they're relying on inefficient social-rule sources instead.

Our intuition suggests that the latter case is more likely. For reasons we discussed above, governments, which govern nearly every country in the world, have weak incentives to rely on efficient social-rule sources—in particular when the efficient source is private rules, which would undermine government's power and ability to extract rents from society's members. Private rules, more than norms, are close substitutes for legislation. They therefore pose a stronger threat to governments, which therefore often find it in their interest to suppress private rules.

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