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Wisdom, Alterability, and Social Rules

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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. On the cost side, we consider the production and external costs associated with producing social rules under each source. We find that legislation is relatively alterable but unwise. Norms are wiser but unalterable. Private rules avoid the wisdom–alterability tradeoff and are both wise and alterable. However, private rules have higher external costs than legislation and may have higher production costs than norms. Many societies may be able to produce more efficient social rules privately. Copyright © 2012 John Wiley & Sons, Ltd.

1. INTRODUCTION

Social rules are proscriptions and mandates that regulate interpersonal interactions. These rules include formal laws and 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. Perfectly wise social rules satisfy the Kaldor–Hicks criterion: there is no movement from a prevailing set of social rules that would produce more social benefits than social costs as measured by citizens' willingness to pay for alternative sets of social rules. Wiser social rules are closer to satisfying this criterion. Less wise rules are further from doing so. 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 shape resulting social rules' wisdom and alterability and thus their effectiveness.

To analyze the comparative effectiveness and thus benefit of the social rules produced by each of our social-rule sources, we ask three questions: (1) What

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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 costs social rules create when they are not uniform over a given geographic area—the costs citizens must incur to interact with citizens governed by a different set of social rules.

To analyze the comparative costs of social rules produced by each of the social-rule sources, we ask two 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) How high are the external costs a particular social-source creates?

The answers to these five 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 that legislation creates are easy to alter but are relatively unwise. The social rules that norms create are wiser but are difficult to alter.

In contrast, the social rules that 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 may involve higher production costs than norms. Thus, there is 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 reality, these rule sources may overlap and blend and 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 as associated with each ideal type.

Still, 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 are not. Legislation is produced by a monopoly, governmental, social-rule producer. Norms and private rules are not. Finally, norms are unintended social rules. Private rules and legislation are not. Thus, although in practice a private-rule producer might introduce a rule-making body that in important respects resembles and functions like a legislature, this does not change the fact that the resulting social rules' source is private, because those rules are produced for profit and the social-rule producer lacks a monopoly on social-rule production.

To facilitate the comparability of our analyses across social-rule sources, we consider each alternative social-rule system in the same society—that is, for a population with given demographics (such as size and heterogeneity) that inhabits a given geographic territory. The hypothetical society we have arbitrarily selected for this purpose is that which has the same demographic and geographic features as present-day California.[1] To simplify our analysis and bring the forces shaping alternative social-rule sources' comparative efficiency into sharper relief, we assume that this society exists in isolation.

We assume that this hypothetical society has three, mutually exclusive options for how it may produce social rules: (1) legislatively under a government consisting of a single, democratically elected legislator who competes at regular intervals with one other candidate for legislator to produce all legislation (aka via 'legislation'); (2) through endogenously emergent norms (aka via 'norms'); or (3) privately through a system of competitive clubs in the marketplace wherein each club owner produces his or her club's social rules (aka via 'private rules').

Obviously, in reality, these are not the only three social-rule sources available to societies seeking governance. For example, legislation under a non-democratically

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elected governor is one of many other potential options. Further, as noted previously, in reality the options we consider are not mutually exclusive. It is possible, and indeed common, for societies to rely on both legislation and norms, for instance, to supply social rules. However, because we cannot consider all variations of alternative social-rule sources, we have to choose which ones we will consider. Our selection reflects the three, analytically distinct social-rule sources identified previously, albeit, unavoidably, particular varieties of each. Likewise, to pin down important differences between the characteristics of these alternative social-rule sources, it is important to consider each in isolation—that is, as a mutually exclusive option—despite the fact that in practice various social-rule sources are often complements instead of substitutes and different kinds of social rules can be used simultaneously. What we lose in realism through this procedure we hope we gain in analytical insight by imposing a *ceteris paribus* condition across our cases that permits direct comparisons.

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; Kahan, 1998; Kuran, 1998; Posner, 1998b; Posner, 1998a, 2002; Pildes, 1998; Cooter, 2000; 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 in regulating social conduct, they have 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 a democratically elected legislator who enjoys a monopoly on social-rule production. The rules he or she produces are enforced by legislator-appointed officials, such as state police and judges, who exercise a legislator-delegated monopoly on the legitimized use of force.

The legislator has a monopoly on social-rule creation. Thus he or she may introduce, modify, or undo social rules through the legislative process. Because of this, legislation is relatively easy to alter and driven by the legislator's desire to change it.

Legislation is highly alterable. However, it is also unwise. The information about citizens' social-rule demands available to legislators is that which citizens provide in supporting competing candidates for legislator at the voting booth. This information is extremely crude. Because each voter possesses a single vote equal to all other votes, this information does not include the intensity of citizens' demands for various social-rule alternatives. Thus, legislators lack crucial information required to produce wise social rules.

Legislators also lack information about citizens' preferences over most possible social-rule bundles. Under legislation, citizens' social-rule choices—the options over which they express preferences—are artificially restricted. There are only two candidates for legislator and so only two social-rule bundles over which citizens may express preferences. Thus, legislators lack additional crucial information required to produce wise social rules.

Legislators also have weak incentives to produce the social rules that citizens demand. 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 principals) 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. The legislator is the agent.

The principal–agent problem can be overcome, or at least significantly mitigated, if the principals are able and have incentives to hold him or her accountable for his or her choices. The voting booth would seem to provide this (Ferejohn, 1986), but it does not. The reason is provided by public choice economics: principal–agent interactions under democracy are characterized by vote-seeking politicians, rationally ignorant/abstinent voters, and special interest groups. These features of democratic politics thwart the potentially incentive-aligning features of democracy.

Because the chances of any one vote influencing the outcome of an election in a population the size of California's are miniscule, citizens are rationally

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ignorant of the legislator's behavior. They have weak incentives to invest in monitoring what the legislator is doing. Similarly, because the cost of voting exceeds the benefit for any individual voter, even if well informed, the average citizen is likely to rationally abstain from voting.

In contrast, special interest groups have strong incentives to invest in collecting information about the legislator's behavior. They also have strong incentives to vote. Although 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.

Responding to the incentives this situation creates, the legislator produces social rules that cater to well-organized, well-informed special interests at the expense of the unorganized, rationally ignorant, and rationally abstinent mass of citizens. The resulting social rules are unwise.

This situation does not arise because under legislation social rules have no residual claimant. They do: the legislator. This situation arises because under legislation the residual claimant's residual claim attaches to the 'wrong' thing. The residual claim is attached to social rules that benefit special interests at the expense of other citizens—that is, less wise social rules—instead of being attached to social rules that benefit society generally—that is, wiser social rules.

Even when the logic of rational ignorance and special interest groups does not interfere with the legislation process and legislators faithfully produce social rules that comport with the preferences expressed by the median voter, legislation tends to be unwise. Legislation produces one set of social rules for the entire society. In a society as demographically diverse as California's, this means that a sizeable minority will be required to live under a set of social rules they do not prefer. Legislation is 'one-size-fits-all'. However, for many citizens, that one size does not fit. Indeed, owing to the absence of information about citizens' preferences for alternative sets of social rules that are never reflected in the platforms of competing legislators under legislation, even the median voter may be required to live under a set of social rules that deviate significantly from the set he or she prefers.

In the foregoing discussion, we have focused exclusively on legislation's effectiveness in the context of static citizen demands. 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 that legislation confronts as discussed previously. It matters little that social rules are highly alterable in the face of changing conditions if legislation's producer has 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 that the legislator confronts 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

The most significant production costs of social rules via legislation are the social costs of rent seeking. The social-rule producer under legislation is subjected to the rent-seeking pressures of special interests because his or her position as social-rule producer depends on satisfying these groups by producing social rules that cater to them at others' expense. Thus, legislation's production costs are relatively high.

In contrast, legislation's external costs are very low. Legislation produces uniform social rules for the society it governs. The same social rules cover everyone in society. This contrasts with the cases of norms and private rules, which we will consider subsequently, where 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 do not 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 is more costly for citizens from different areas to interact. When rules are uniform, this cost is minimized. In this sense, legislation provides 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 are high. (4) Legislation's external costs are minimized.

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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 or she attempts to improve his or her individual circumstance. Norms are endogenous responses to the specific obstacles that individuals confront. They institutionalize the pattern of voluntary behaviors that individuals develop to help them overcome these obstacles.

Norms are enforced privately in a decentralized fashion. Norm violators may be punished 'peacefully', such as when they are ostracized, or violently, such as when they are 'outlawed'—that is, viewed as fair game for assault and theft. 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; Ullmann-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. 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 and enforce 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 (see Leeson *et al.*, 2006). 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 tend to be wise compared with legislation.[2] The social-rule production process that norms involve is fully decentralized. This permits norm-created rules to reflect the local conditions and contexts in which they emerge. There is only one society, but norms permit a variety of social-rule bundles to coexist within that society. Unlike under legislation, under norms, exiting life under a less preferred set of social rules to live under a more preferred one is possible. The result is a degree of citizen sorting among alternative sets of social rules, contributing to social-rule wisdom. These social rules' bottom-up emergence means that they tend to reflect citizens' diverse and specialized problem situations when they emerge. They are 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 do not change.

However, for the same reason that norm-produced social rules are at least initially wiser than legislation-produced social rules, norms are costly to alter compared with legislation. Just as norms often emerge through a long, evolutionary process, they often only change through a long, evolutionary process. Norms are legal fossils. They are part of culture. Thus they display tremendous inertia. This makes norms difficult to change—even when conditions change that might render them 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).[3]

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

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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, although 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

In principle, norms' production costs can be very low. Because these social rules are not deliberately produced but rather emerge endogenously as the byproducts of other behaviors, norms are in one sense 'free' to produce. Nor do norms involve production costs associated with rent seeking. There is 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.

However, norms' production costs remain positive. Those costs stem exclusively from the long duration that can be involved in norms' production. It takes time, often years, for norms to develop. In the interim, social rules remain unclear and thus ineffective. When norms develop quickly, their production costs are minimized. When norms develop slowly, their production costs can be high.

Because norms emerge endogenously in response to individuals' particularized problem situations, and citizens' problem situations tend to vary significantly from place to place in a society with the size and demographic heterogeneity of California, norm-produced social rules vary significantly across society. 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, say the southern part of the equivalent of California, who interact with others in a neighboring area, say the northern part of the equivalent of California, will confront different social rules that 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.

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 can be low or high, depending on the speed with which they develop. (4) Norm's external costs are high.

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 must pass the 'market test' for private producers to select them over alternatives. Citizens' demands for different social rules drive the rules that private producers offer. Private rules are enforced privately by social-rule producers through, for example, private police and judges.

Private-rule production and enforcement 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 did not emerge because an array of clubs produced social rules privately, filling the governance gap.[4]

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 the social rules and attendant services the clubs provided.

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Unlike legislation and norms, private rules do not 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.[5] Club owners are residual claimants on revenues they generate through providing social rules that 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 that citizens desire. If club owners fail to supply social rules that citizens desire or fail to enforce those rules once they are in place, they lose customers and hence profit. The residual claimancy inherent in the system of clubs aligns the interests of the owners with those of the club members.

The incentive alignment private-rule producers' residual claimancy creates is imperfect. Exiting a club is not costless. Thus, club owners need not 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.

How costly exit is depends on how many social-rule alternatives exist in the society in question—one the size of California. The more competitive and decentralized the system of social-rule provision, the more 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.

In a system of private rules, there are no artificial barriers to creating rule-providing clubs. This fosters the availability of alternative, close-by, and thus cheaply accessible clubs that provide alternative sets of social rules. One need not go far to find an alternative set of social rules he or she can live under. Indeed, if need be, an individual can create his own club. Because of this, exit costs under private rules are relatively low.

Compare exit costs under private rules with exit costs under legislation. Legislation centralizes and monopolizes social-rule production. It minimizes the number of social-rule providers and thus sets of social rules. This, in turn, maximizes exit costs under legislation.

Compare exit costs under private rules with exit costs under norms. For reasons discussed previously, similar to under private rules, under norms a large variety of social-rule alternatives may exist. Thus, exit costs under norms are lower than under legislation. However, exit costs under private rules may be lower still.

As a club grows, diseconomies of scale in private-rule production that result from congestion eventually set in. This limits how few clubs, and thus how few social-rule alternatives, may exist under a system of private rules.

In contrast, there are no clear diseconomies of extending norms over ever-increasing population sizes or geographic areas. In principle, there is nothing that prevents norm-produced, social-rule alternatives from dwindling to very low numbers. Thus, although social-rule alternatives will exist under norms, the number of such alternatives may be fewer than under private rules. Low exit costs under private rules strengthen club owners' incentives to produce and enforce social rules that citizens demand.

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-selection. 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 (boycott) imposes a higher cost on social-rule producers compared with bilateral punishment (singular exit). This strengthens private-rule producers' incentives to produce and enforce the social rules that 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 reference to Surowiecki's conditions. The possibility of different clubs offering different social rules, including the possibility of forming a new club, contributes to the existence of a

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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 are able to reselect 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 is 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. They have an incentive to do so because their income depends on this.

4.2. Examining the Cost Side of Private Rules

Private rules avoid the rent-seeking costs associated with social-rule production. In this way, they are similar to norms but contrast 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. Thus, the production cost of private rules is low.

The external costs associated with private rules are this social-rule source's chief potential costs. As discussed previously, there are no artificial limits (although there may be economic ones, such as scale economies) to the number of private-rule alternatives that might emerge in the society in question. Even within a small area within that society, which, recall, is the size of California, multiple clubs may exist. 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, which is unlikely in a society as large and diverse as that of California, 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, which is much more likely to be the case in the context of the society we are considering, 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 are low. (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 norms or legislation 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'

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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, when they emerge rapidly, are essentially 'free' to produce, permitting them to at least in principle 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 norms' production cost is higher (for example, because norms evolve only very slowly), 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—attribute of social rules. After all, if social rules do not come at least reasonably close to the rules citizens desire, it is 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 have 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 are relying on inefficient social-rule sources instead.

Our intuition suggests that the latter case is more likely. For reasons we discussed previously, 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 may therefore find it in their interest to suppress private rules. Thus government may, and in fact does, legally prohibit individuals from creating clubs that have and enforce their own social rules, such as those relating to narcotic sales/use, those relating to labor law, and so on. The range of legally permissible clubs is constrained by state-made law, in effect restricting private social rules to those that are consistent with, or at least not inconsistent with, those created legislatively.

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NOTES

1. Note that our analysis can be applied to any single society, as well as across societies, although the relevant costs and benefits identified in the subsequent analysis would change accordingly.
2. On the 'wisdom' embodied in norms, see Boettke *et al*. (2008).
3. Specific examples of norm inertia can be found in Schelling's (1971) segregation model and Mackie's (1996) analysis of the persistence of foot binding in China.
4. For other examples of private rules filling the governance gap created by anarchy, see Leeson (2007a, b, c, d, 2009).
5. Of course, if credit constraints are severe, these prices would not fully reflect the intensity of citizens' desires for alternative rules. Thus, like all markets, the market for social rules will exhibit only a *tendency* for efficiency. Still, for reasons described previously, this tendency is absent when there is no market for social rules, as under legislation and, to a lesser extent, norms. Friedman's (1973) excellent book was one of the first to describe a system of private rules. See also, Leeson (2011).

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