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# nning nance

## **Governing Governance**

A Liberal-Democratic  
View on Governance  
by Relationships,  
Bureaucracies and Markets  
in the 21st Century

European Liberal Forum

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**A Liberal-Democratic View on Governance by Relationships,  
Bureaucracies and Markets in the 21st Century**

Arjen van Witteloostuijn, Mark Sanders,  
Dennis Hesselning and Corina Hendriks  
*in cooperation with Jelmen Haaze and Harald Edquist*

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The European Liberal Forum, asbl (ELF) is the non-profit European political foundation of the liberal family. ELF brings together liberal think tanks, political foundations and institutes from around Europe to observe, analyse and contribute to the debate on European public policy issues and the process of European integration, through education, training, research and the promotion of active citizenship within the eu.

## Preface

Dear reader,

I am honoured to write a few opening words for this ELF publication, especially considering the centrality of the topic to liberal thought and the impression of liberalism in the eyes of the public. Regarding questions of governance, liberals have too often been placed in the corner where ‘the market’ was considered to reign supreme. This ignores the most fundamental tenet of liberalism however; namely that of realising freedom for all individuals. In a true liberal perspective the market is just a means to an end, and not an end in itself. As this publication makes clear, liberal thinking on governance questions is much more nuanced, and asks first of all for a political judgement on the goals to be achieved in each particular instance. Only based upon this, the question arises of which governance principle should be applied to achieve the desired goals.

The authors present considerable evidence that, next to the well-known governance principles of market and bureaucracy, a third principle should not be overlooked, especially by liberals: namely relationships. These include everything people can deal with amongst themselves without needing either market mechanisms or bureaucratic principles. The result is a liberal framework in which these three governance principles are placed next to each other, rather than in any particular hierarchy. The task of liberal politicians is to find a balance between the three in each particular case. This does not necessarily make liberals’ work or political positioning easier, but it does streamline the thought process, while stimulating the decision-maker to act reflectively.

ELF is an organisation made up of 35 member liberal think tanks, foundations and institutes in all of Europe, without which our ambitious agenda would not be implementable. I want to therefore extend a particular debt of gratitude to ELF member organisations, the Mr. Hans van Mierlo Stichting (the Netherlands), Liberales (Belgium) and FORES (Sweden) for their work and dedication in seeing this publication through. This publication marks the outcome of two workshops, in The Hague and Brussels respectively, which saw liberals from all over Europe engaging in discussion on questions of governance. I am certain that the resulting publication, which now lies in front of you, will be of value to liberals and democrats in Europe and beyond.

The publication might not prove to have the final say on the discourse of liberal thinking in governance questions. As the authors themselves argue, a Popperian trial-and-error approach is to be preferred. In that sense, I trust that this publication proves stimulating to its readers when it comes to applying the governance principles in practice. Further, I hope we will receive feedback from our readers on what works under which circumstances and what does not. Thus, this publication may very well be seen as the starting point of a broader discussion on the theory and practice of governance questions. ELF will be happy to continue supporting such developments.

I wish you an inspiring read.

With liberal greetings,

**Felicita Medved**

*President of ELF*



## Contents

<b>1</b>	<b>Introduction</b>	7
<b>2</b>	<b>From confusion to clarity</b> Definitions of key concepts	11
<b>3</b>	<b>Main principles of a liberal-democratic political philosophy</b>	19
<b>4</b>	<b>Another perspective on governance issues</b>	25
<b>5</b>	<b>Governance on a small scale</b> Relationships	29
<b>6</b>	<b>Governance on a large scale</b> Bureaucracies and Markets	39
<b>7</b>	<b>Liberal governance in practice</b> Tools	53
<b>8</b>	<b>Liberal governance in practice</b> Application	63
<b>9</b>	<b>Conclusion</b>	75
	<b>Literature</b>	81
	<b>About the authors</b>	87
<b>*</b>	<b>Notes</b>	89

## Introduction

In the 1990s, Fukuyama (1992) heralded the end of history and the final victory of the system of liberal-democratic market capitalism. After the collapse of the Berlin Wall, a wave of privatization and market deregulation followed the demise of communism in a large part of the world. The rise of China and the financial crisis which began in 2007, however, have shown that perhaps unfettered free market capitalism is not the only or even the best road to the highest welfare for the largest number. The political battle between more market-oriented liberals and conservatives, on the one hand, and more government-oriented socialists and greens, on the other hand, has re-entered the heart of the political debate. Because of its strong ideological foundations, this debate on the governance of society quickly degenerates into an ideological gridlock in which neither side is willing to seriously consider the other's perspective. The left side of the political spectrum insistently calls for a bureaucratic comeback of the state: the government needs to retake responsibility for such important societal matters as public health and sustainable energy. The right side of the spectrum, conversely, argues that markets should face fewer restrictions: the current malaise derives from defective free market capitalism. Betwixt and between, the corporatist middle ground advocates a return to self-regulation by shifting more responsibilities to civil society and its organized lobby groups.

Perhaps the truth – if there is such thing as ‘the truth’ in such matters – lies somewhere in the middle. And perhaps this truth can only be found by conducting ‘Popperian’ experiments, that is, by continuous reassessment, and by arriving at better results in incremental steps using a trial-and-error

approach.<sup>1</sup> As modern liberal-democrats,<sup>2</sup> we might agree that such trial and error is indeed the best way forward. But in the political debate, liberal parties also have to position themselves more convincingly *vis-à-vis* competing perspectives, in front of a larger audience. This essay aims to contribute to this, and give fresh impetus to the ongoing debate as to how to govern society: through bureaucracies, markets, or something different?<sup>3</sup> We aim to do so not from a purely ideological perspective, but by providing a structured political-theoretical frame of reference for determining the liberal-democratic position regarding specific aspects of governance in society in these debates. In so doing, we hope to produce an analytical framework applicable to the discussion about how to ‘govern governance’.

#### **Relationships, Bureaucracies and Markets from a liberal-democratic perspective**

The starting point of our analysis is a critical analysis of core assumptions central to the contemporary view of different governance principles’ weak and strong points. The first common pitfall of these sorts of analyses is to narrow the scope to a simple dichotomy of market versus state (or, more precisely, bureaucracies; see below), rather than including the set of all relevant governance principles available. In various relevant literatures, from anthropology to economics and from political science to sociology, scholars (e.g., Ouchi, 1980; Braddach and Eccles, 1989; Rhodes, 1996; and Adler, 2001) have typically distinguished three ideal types of governance. In this essay, we will refer to these three main ways of governing society as **Relationships**, governments (or more precisely: governmental bureaucracies or, as a shortcut, **Bureaucracies**) and **Markets**.<sup>4+5</sup>

**Relationships** among individuals and groups of individuals were the dominant governance principle in more primitive, small-scale societies. This governance principle is still found in many domains of social interaction: people work jointly toward solutions to a wide variety of issues of predominantly but not exclusively local scope. Over the course of history,

as societies grew in size and complexity, **Bureaucracies** and **Markets** came to play larger roles as governance principles.<sup>6</sup> In the beginning of the twentieth century, regulation by bureaucratic principles became dominant throughout most sectors of society. After a number of evident shortcomings, culminating in the collapse of the Soviet Union and Eastern Europe’s planned economies, people in the last two decades of the twentieth century expected little from ‘governments’. The dominant view became instead that ‘the market’ and private actors would produce certain products and services that had formerly been seen as public in a much more efficient and effective way. To justify this profession of faith, economists and politicians emphasized two apparently innocent assumptions about human behaviour and market competition: people act rationally and markets are efficient. These two assumptions still constitute the basic framework for most governance-related policymaking around the world. But there have been many new insights into human behaviour in economics and other social sciences in recent years. These new insights create responsibilities for liberal-democratic thinkers and other parties who take scientific knowledge more seriously than ideological dogmas.

Modern governance – and especially the choice of an appropriate mix of the above governance principles – should derive from an analysis grounded in realistic assumptions about human behaviour. We offer such an analysis in this essay. Consequently, we reject the logic of orthodox market thinking, as this is based on unrealistic assumptions, and extend the discussion to transcend the overly simplistic dichotomy between ‘the market’ and ‘the state’. Moreover, our framework does not result in a purely ideological plea for more civil society, more government or more market, but in an analytic-theoretical argument to establish clear distinctions between three principally equal ideal-typical governance principles: **Relationships**, **Bureaucracies** and **Markets**. A well-considered choice for one principle or another, or a combination of principles, will be influenced by the specifics of the issue at hand, as well as by the primary objectives of political parties

and society at large. What we aim to achieve in this document is to develop a political-theoretical framework that is rooted in a liberal-democratic perspective and that will facilitate decision-making regarding desirable governance arrangements that are tailored to the case at hand. Basically, this framework connects a ‘socialist’<sup>7</sup> emphasis on basic economic securities and a ‘corporatist’ plea for more personal and moral engagement to ‘liberal’ principles of individual freedom and contestability, aiming to strike a balance between cohesion (as found in interpersonal **Relationships**), fairness (often through **Bureaucracies**) and efficiency (as produced by governance via **Markets**).

### Structure of the document

Our analysis starts with a set of definitions in Chapter 2 and, in Chapter 3, an explanation of the key political goal central to our understanding of liberal-democratic governance. This goal is a sustainable form of governance that is sufficiently equipped to deal with both today’s and tomorrow’s challenges and that fosters individual liberties. After all, the choice of a governance principle or mix of principles should serve as the means to reaching that end, and must never become an end in itself. Chapter 3 also deals with the link between this central goal and liberalism’s core values, leading to a different perspective on governance issues, which is discussed in Chapter 4. Next, in Chapters 5 and 6, we discuss what **Relationships**, **Bureaucracies** and **Markets** are capable of, where their respective weaknesses lie, and what criteria are therefore relevant for developing an appropriate set of governance principles. In so doing, we develop a frame of reference that is useful for politically tackling the governance issues at hand in the context of a multitude of policy areas. This application of the framework in political practice is the issue we focus on in Chapter 7 and 8. Chapter 9 contains the conclusion.

## From confusion to clarity

### Definitions

Governance issues are at the heart of politics. What authority or mechanism organizes what and in which manner? Every society, however large or small, is regulated, governed by a set of, ideally, legitimate institutions, rules, norms and values, which operate at different levels of society, from households and organizations to industries and society at large. Among other things, this is reflected in the way in which human interactions and transactions do (or do not) take place, and the way in which conflicts are (or are not) resolved. Rhodes (1996) discusses the many possible definitions of ‘governance’ that have been proposed in the literature. Following Bell (2002: 4), we define governance as follows.

*definition 1* – **Governance is ‘the use of institutions, structures of authority and even collaboration to allocate resources and coordinate or control activity in society or the economy’.**

Following this definition, governance involves the way in which we organize human interactions (which includes transactions).<sup>8</sup> ‘Good’ governance serves to prevent and mediate conflicts of interest. Institutions, both formal and informal, make up the governance structure in a given context. Governmental authorities and legal rules are examples of formal institutions, and implicit codes of conduct and cultural values are illustrative instances of informal institutions. For governance to work, it must have legitimacy among those who are governed.

### Governing actors and governance principles

In practice, the political discussion of legitimate and effective ‘governance’ is characterized by considerable confusion.

A key reason for this is that a tendency exists to haphazardly mix and match *governance principles* (the way of governing interactions) and *governing actors* (what or who does the governing). It is therefore hugely important to provide clear-cut definitions of key concepts at the outset. This essay follows several strands of literature in distinguishing three (ideal-typical) ways to regulate human interaction: through **Markets**, through **Bureaucracies** and through **Relationships**.<sup>9</sup> We use this set of three concepts of **Markets**, **Bureaucracies** and **Relationships** to refer to three fundamentally different *governance principles*. We explicitly do not mean to refer to *governing actors*. For instance, a choice for the governance principle of **Markets** does not imply that we want to ‘leave everything to the market’. The latter part of that false equation often concerns privately owned and profit-driven enterprises that operate as actors on the marketplace. The former concerns governance through market mechanisms. Equivalently, this also implies that we do not simply equate **Bureaucracies** with governmental authorities as actors. Rather, **Bureaucracies** concern governance through bureaucratic principles. Following this logic, the principle of **Relationships** does not refer to specific people, but rather involves a governance mechanism driven by interactions between people based on trust and reciprocity. In our view, the key question regarding governance issues is not *who* decides or operates under the roof of what governance arrangement, but *how* governance is organized.

The relevance of this distinction becomes particularly clear when considering the current endless debate on ‘markets’ versus ‘states’, which might mean many different things, for example, should an issue be left to a state agency or a private party? Or should private parties produce something, but with strong bureaucratic regulation? Or should market principles apply to government agencies? *Etcetera*. This juxtaposition confuses both market enterprises as private actors with **Markets** as a governance principle and the government or bureaucracy as an organization with **Bureaucracies** as an organizing principle. This is problematic for at least two reasons. First of all, ideal-typical governance and ‘real’ governing actors

do often, but not always, coincide in practice. For example, the government or state as a governing organization actively employs all three governance principles. Every citizen who wants a passport can acquire one from her or his local government if s/he is willing to pay the price, the typical coordination device of **Markets**. The government also competes in the labour market by offering certain salaries and other conditions to civil servants. However, the government also collects taxes based on enforceable responsibilities, an activity typically associated with **Bureaucracies**. Moreover, the government internally organizes much of professional processes in small teams, which function through **Relationships**. And *vice versa*, commercial enterprises as market actors employ bureaucratic procedures and team production, again relying internally on **Bureaucracies** and **Relationships**, respectively, to govern part of their in-house interactions. In other words, framing the governance debate in terms of actors – of ‘markets’ versus ‘states’ – does not tell us anything about the more important question of *how* governance is or should be organized.

### ‘Framing the governance debate in terms of actors – of “markets” versus “states” – does not tell us anything about the more important question of how governance is or should be organized’

Secondly, the juxtaposition between ‘markets’ versus ‘states’, when understood as governance principles, is false because the two are complements rather than substitutes. Even in its pure form, a market (both as in actors and as a governance principle) cannot function without bureaucratic principles and bureaucracy to enforce contracts and to ensure fair and open competition. A government or state in the broadest sense of the word, the complete *trias politica* – the democratically legitimated legislative power (the political government), the

bureaucratically organized executive power (the bureaucratic government) and the independent judiciary power (the legal government) – is therefore not the opposite of the market or **Markets**. In the governance debate, we need to be accurate by distinguishing between **Markets** and **Bureaucracies** as governance principles.<sup>10</sup>

### **Markets and Bureaucracies**

From our Definition 1 above, we see that governance establishes a coordinated allocation mechanism that organizes the way people and organizations interact (and transact). The governance principle of **Markets** coordinates by organizing voluntary transactions as a mechanism to distribute scarce goods and services. In well-functioning **Markets**, individuals and organizations can trade rights at a market price that equates supply and demand. At that price, people can voluntarily part with their rights or acquire them.

*definition 2* – **Markets regulate (voluntary and free) transactions between parties that demand and supply products or services based on price incentives.**

Ideally, in perfect **Markets**, the only information needed is the price at which a transaction can take place. This makes perfect **Markets** a very efficient governance mechanism. Neither buying nor selling parties in the perfect marketplace care about the other party's identity, as long as the agreed-upon contract is honoured at the agreed-upon price. Following the basic theorem of welfare economics, the fact that market transactions are voluntary ensures a perceived improvement for both sides after the trade. After all, if it was not an improvement, either side of the potential transaction could and would withdraw from the deal.

Governing through **Bureaucracies** is fundamentally different than governance through **Markets** because bureaucratic principles coordinate and allocate goods and services through enforceable rights and obligations.

*definition 3* – **Bureaucracies as a governance principle refer to the coordination of transactions based on enforceable rights and enforced responsibilities.**

In modern society, the government has a monopoly on violence. The government can therefore regulate transactions between people on the basis of enforceable rights and enforced responsibilities. But **Bureaucracies** as a governance principle is not solely reserved for the government as an actor, as it can be applied in non-governmental organizations as well, such as cooperatives and firms where labour contracts establish a hierarchy. The type of information needed make decisions within this principle of governance is typically of an administrative nature. Someone has an enforceable right to social welfare payments if s/he meets certain legally pre-specified criteria, and people are obliged to pay taxes based on administrative data.

At this point, it should be noted that in the case of both bureaucratic and market *transactions*, there is not necessarily *interaction*. That is, the transactions take place between actors and agencies that do not need to engage in a relationship. In the case of a market transaction, there are no obligations beyond the transaction, and both parties to the transaction can walk away with no further strings attached. The same holds for bureaucratic transactions. In this case, the agent or agency receives or gives up what was due, and no further relationship with the counterparty is developed. In the case of both market and bureaucratic transactions, the rule of law, and ultimately the monopoly on violence of the state, enforces the transactions, implying that, in principle, there is no need for high trust. Both governance principles are inherently low-trust mechanisms, and both are designed to operate when high-trust alternatives are not available (Ouchi, 1980).

### **A third governance principle: Relationships**

As said above, the state-versus-market dichotomy is standard in the governance debate while a third governance mechanism is often overlooked: **Relationships**.<sup>11</sup> In the case of governance

through **Relationships**, neither completely free **Markets** nor the enforceable rights and enforced responsibilities of **Bureaucracies** are needed. The rights and responsibilities that coordinate interaction and allocation in **Relationships** are ‘voluntarily’ felt by the actors, and not enforced upon them

## ‘Governance by **Relationships** requires repeated interaction, and is founded on reciprocity, high trust and reputation’

by any outside authority. With **Relationships**, interactions are voluntary, but not free. Governance by **Relationships** requires repeated interaction, and is founded on reciprocity, high trust and reputation. Since the very beginning of civilization, human beings co-existing in the same space have ‘spontaneously’ regulated their interactions using this governance principle. Even today, people organize their societies by adhering to a great many unwritten but stable sets of social norms and values, without the need for either a state monopoly on violence or market prices to regulate highly sophisticated interactions. This governance mechanism has its role in modern post-industrial societies, often in smaller circles or under the umbrella of an organization operating within **Markets** or **Bureaucracies**. Well-known examples are interactions within families, between neighbours and friends, within sports clubs, but also within hospitals or multinational enterprises’ departments and teams.

*definition 4* – **Relationships regulates human interactions based on trust, reputation, reciprocity and non-enforceable but deeply felt rights and responsibilities.**

Interaction takes place voluntarily, but is not free of responsibility: people can but will not easily withdraw from the group. The governance principle **Relationships** prescribes rights and

responsibilities without resorting to a monopoly on violence for enforcement and while allowing for voluntary interactions without market prices. A final note on **Relationships** is that they coordinate interactions, and not transactions. The two parties to an exchange under **Relationships** cannot be anonymous.

To sum up, an analytical discussion on governance should distinguish between **Bureaucracies**, **Relationships** and **Markets** as complementary governance principles, and governance actors, or governments, firms and people.<sup>12</sup> But what governance principle or mix of principles is the best way forward? To answer this question, we need to look at the goals that we, as liberal-democrats, want to achieve by governing (parts of) society.

## Main ideas of a liberal-democratic political philosophy

From a liberal-democratic perspective, the key aim of setting up a system of governance for a particular part of society is to ensure the long-term quality of life for as many people as possible, and to do so in a sustainable way.<sup>13</sup> Since ‘quality of life’ is a subjective notion, a key principle is the freedom of the individual to pursue her or his own path to happiness as s/he deems fit. As Mill (1859: 72) proclaimed:

**Mankind are greater gainers by suffering each other to live as seems good to themselves than by compelling each to live as seems good to the rest.**

Therefore, we start from the conviction that people are the best judge of their own needs, desires and ambitions in life. From this follows a belief in the capability of people to choose their own direction in life, *ceteris paribus*. This *ceteris paribus* clause is important, as our confidence in people’s individual judgements and actions is not naïve and without limits. There are limitations to human cognition and behaviour: for instance, people find it difficult to look beyond their own, sometimes limited, horizon, both in time and place. Also, solidarity may be more limited when it comes to people outside their own circle.

This view fits into the current of liberal thinking that can be described as social liberalism,<sup>14</sup> which is focused on what Berlin calls ‘positive freedom’ (Berlin, 1969: 178), as opposed to more classical liberal thought that focuses on ‘negative freedom’.<sup>15</sup> Following the overview of the main differences between these two currents as presented by Stouthuysen (2001), one could say that these currents differ in their view on man-

kind, in their interpretation of freedom, and in the role they see for the state. Basically, on the one hand, classical liberalism regards human beings as having their own preferences that they want to fulfil. The main role of the state, in this view, is to eliminate all obstacles to the fulfilment of these preferences. Social liberalism, on the other hand, goes one step further by maintaining that such negative freedom is necessary but not sufficient to achieve freedom for all. Since not all people will have the same opportunities to develop their own talents and fulfil their own ambitions, they see an important role for the state in creating conditions for such self-realization. Skidelsky and Skidelsky (2012), for example, argue that to realize a ‘good life’ people must secure basic levels of health, security, respect, personality, autonomy, harmony with nature, friendship and leisure. Important authors who are seen to represent the classical liberal point of view include Adam Smith and Friedrich Hayek while Amartya Sen and Martha Nussbaum are often referred to as important representatives of the social liberal point of view.

### Three criteria and three instruments

The key question now becomes how a specific governance arrangement can best facilitate this overarching liberal-democratic aim of organizing a sustainable society that intends to ensure long-term quality of life for as many people as possible. In order to achieve this aim we have three ‘dials’ which we can rotate: efficiency, fairness and social cohesion<sup>16</sup>. Which combination of these criteria, and hence, of governance principles, achieves our main goal in the most optimal way?

The preferred blend of governance principles needs to be *efficient*: we cannot permit inefficient use of scarce resources in a world that needs to accommodate population growth while aspiring to provide high quality of life for all.<sup>17</sup> From an EU perspective, efficiency implies that European economies can increase their performance in the context of global competition for resources and means of existence. *Prima vista*, contestable **Markets** are best equipped to generate dynamic efficiency. Furthermore, the selected form of governance should be *fair*,<sup>18</sup> and be experienced as such by the majority of society.

Scarce resources should be distributed in a ‘fair’ or ‘reasonable’ way. **Bureaucracies** are usually most suited for securing fairness. Finally, the social sciences – as well as liberal-democrats – recognize that the individual cannot reach her or his full potential in a social vacuum. People are social beings who need their fellow humans to feel appreciated, to feel welcome, to develop a positive self-image, and to benefit from all those

‘A sustainable society should be cohesive. Very few people derive happiness from enforceable rights and abundant material goods alone’

components as a platform from which to make a contribution to society. This is key to the individual’s wellbeing, which in turn enhances a wide variety of outcomes, from organizational productivity to the development of a moral compass. A sustainable society should therefore be *cohesive*. Very few people derive happiness from enforceable rights and abundant material goods alone. **Relationships**, for obvious reasons, best foster cohesion.

In short, from a liberal-democratic perspective, any governance structure should offer people a home (cohesion), manage internal tension (fairness) and deal with external competition (efficiency) to be sustainable. A form of governance that underperforms on any one of these three criteria will not be sustainable, even if respecting ecological boundaries, and will not therefore fulfil the central liberal-democratic goal of governance.

To improve the score on this set of three criteria, we suggest that three mechanisms be considered: individual engagement, basic security, and economic (or political) contestability. The first, individual engagement, is essential for improving cohesion and is, in this sense, tied to the ‘social’ in the social variant

of liberalism. A certain degree of engagement in and responsibility for her or his direct environment is attached to the individual's right to self-determination. In primitive – or small – societies, individual engagement with the rest of the group often suffices to achieve efficient and fair governance. When interaction within such a limited group is repeated without power asymmetries and in varying degrees of dependency, a form of governance based on reciprocity and trust will spontaneously develop.<sup>19</sup>

In larger and more complex societies, however, a system is needed to ensure basic social security.<sup>20</sup> Such security is a precondition for achieving fairness. This entails both securing basic material (e.g., income and housing) and immaterial needs (e.g., fundamental rights and tolerance). Governance only facilitates maximum self-development and creativity when basic needs are covered and capabilities are secure. Discussing and establishing what are to be considered basic needs and capabilities, and subsequently securing them through enforceable rights and obligations, will increase fairness and thereby improve governance outcomes. In addition, however, for both fairness and efficiency, success needs to be rewarded and established positions challenged. Securing basic needs should therefore not be confused with protecting people's positions and vested interests. The liberal principle of contestability is a key notion for achieving fairness as well as improving efficiency: every enterprise, every product, every position, and every opinion should be open to challenges. Only when insiders are challenged to keep defending their position do outsiders retain a realistic perspective of improving theirs. In short, contestability, in a liberal view, is a necessary precondition to secure the essential freedom to pursue the good life.<sup>21</sup>

The link between the three criteria – cohesion, efficiency and fairness – and the three mechanisms – engagement, contestability and security – is visualised in Figure 1. Even though security plays an indispensable role in fostering fairness, contestability in stimulating efficiency, and engagement in facilitating cohesion, the other mechanisms also matter to ef-

iciency, cohesion and fairness. A contestable market can lead to results that are fair or perceived to be so – such as the entrepreneur who makes a fortune with her or his own invention. Security is a prerequisite for sustainable dynamic efficiency, because the individual can only engage in risky ventures when her or his basic needs have been secured. Having a secure platform to operate from is therefore to the benefit of the individual, as well as to that of society at large (e.g., someone eligible for social security who can afford to pursue a suitable job). And engagement is of evident importance for achieving both efficiency and fairness, while insecurity and incontestability undermine societal cohesion.

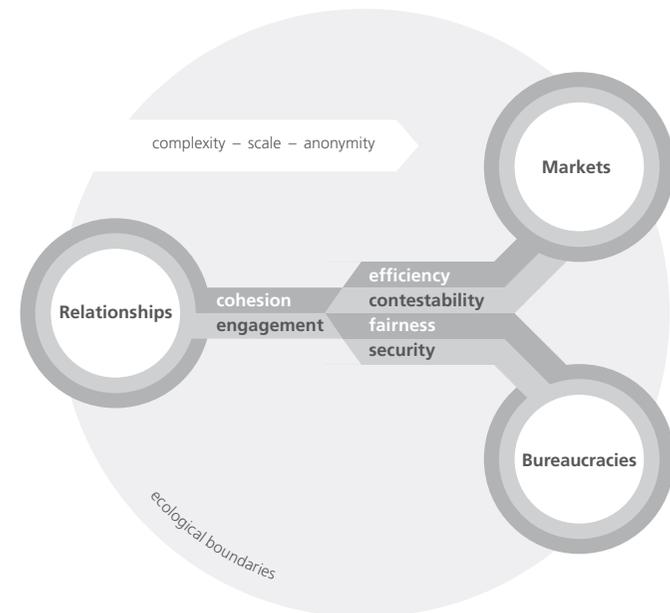


figure 1 – Elements of an analytical framework for the liberal-democratic governance of society

A liberal-democratic form of governance connects socially secure, engaged individuals to liberal contestability in a level playing field (van Witteloostuijn, 2008a). This is no easy task: too much of one aspect often comes at the expense of the other

two. The inevitable downside of too much contestability is insecurity. What works today can be contested tomorrow; someone who enjoys success today can be challenged and defeated tomorrow. This generates the desired dynamics from the viewpoint of efficiency, but may also diminish the willingness to take risks because of excessive insecurity. Those who do enjoy security but who lack engagement (e.g., bankers enjoying implicit guarantees) might take undesirable risks. *Vice versa*, the downside of too much security is a move toward stagnation (e.g., why risk bankruptcy as an entrepreneur when you can stay in a safe job?). And if attained rights and positions become unassailable, we revert back to the unfairness of a class society in which talent and effort are insufficiently rewarded and in which security can degenerate into stagnation and instability. Finally, too much engagement might lead to the danger of clientelism, nepotism and ‘old boys network’ favouritism, all of which are both unfair and inefficient.

Furthermore, we claim that cohesion (engagement), fairness (security) and efficiency (contestability) are inseparable in yet another way. On the one hand, real or perceived unfairness (e.g., a wide income gap or labour discrimination) leads to the disintegration of engagement and to sabotage and resistance, which hurt efficiency. On the other hand, inefficiency (e.g., unemployment, inability to apply new ideas, or waste of natural resources) may trigger a certain disinterest or even human isolation – phenomena often perceived as unfair.<sup>22</sup>

To conclude, the liberal-democratic view on governance implies that we should aim to safeguard and maximize cohesion, efficiency and fairness by looking for the appropriate balance between contestability, security and engagement. A choice of one or more governance principle(s) should therefore be based on the extent to which this arrangement contributes to the chosen goals. This leads to a different, more nuanced approach to governance issues than is currently dominant in many public debates.

## Another perspective on governance issues

As said earlier, the political debate on governance principles is often framed in terms of ‘market versus state’. In line with the so-called Washington consensus, many (neo)liberals would argue that of these two, **Markets** should prevail as a matter of principle, leaving only a role for the state (or, more precisely: for **Bureaucracies**, as the dominant governance principle of the state) in case of market failure. The question is whether such a hierarchical dichotomy, and the associated universal prioritization, fits with a liberal political philosophy. Here, we will argue that this is not the case.

### From dichotomy to trinity, and from hierarchy to equality

First of all, **Relationships** as a governance principle should be added to the analysis. Since, as a matter of principle, liberals of all kinds value people’s capabilities to determine their own life, we believe that governance through **Relationships** cannot be ignored, and should be treated on par with governance via **Bureaucracies** or **Markets**. Therefore, we should not restrict ourselves to choosing between **Bureaucracies** and **Markets**, and should add **Relationships** to the choice set. After all, both **Bureaucracies** and **Markets** tend to limit social cohesion.

Second, a dogmatic hierarchy that universally ranks **Markets** above **Bureaucracies** – even when the choice is just between these two governance principles – is misplaced. Just like **Bureaucracies**, **Markets** have strengths and weaknesses (these are addressed later in this essay). Sure, well-organized **Markets** yield plenty of efficiency. But the results are only coincidentally perceived as secure and fair. Security in markets often acts as contestability’s enemy; and in markets, might (purchasing power) makes right. In contrast, well-organized and managed **Bureaucracies** can offer security and foster fair-

ness, but they are unlikely to find the most efficient solution or to adopt more efficient ones as they arise. Generally, one will therefore have to strike a balance between the two by connecting security and contestability in one way or another.

#### Pragmatic approach

The liberal interpretation, as fleshed out in this essay, implies that **Relationships**, **Markets** and **Bureaucracies** are not hierarchically prioritized governance principles, but rather different principles that each have unique limitations and strengths<sup>23</sup>.

‘This fundamental equality implies an inherent flaw in any sort of ideological or pragmatic hierarchy that primarily ranks one governance principle over the other’

**Markets**, **Relationships** and **Bureaucracies** can each succeed, as well as fail. This fundamental equality implies an inherent flaw in any sort of ideological or pragmatic hierarchy that primarily ranks one governance principle over the other. In a general theoretical sense, **Relationships**, **Markets** and **Bureaucracies** do not constitute a vertical hierarchy or superordination, but a horizontal juxtaposition. Only if two or more governance arrangements score equally well on the three criteria is there a preference for the one that implies maximum positive freedom, since such freedom is at the very heart of liberalism.

However, politics, in contrast with academia, is primarily interested in what works well in practice, rather than with what should work in theory. In a specific field or specific context, one could draw conclusions as to which governance principle deserves to be put centre stage, often with the other two playing a background role. In many political fields, **Markets** and **Bureaucracies** usually are complements instead of substi-

tutes. They often are, however, substitutes for a form of governance grounded in **Relationships** among engaged individuals. The logic of **Markets** or **Bureaucracies** does not sit well with the foundations of human interaction. Both rules and prices reduce interactions that come with two-way **Relationships** to one-sided market or bureaucratic transactions. In general, the balance between the three governance principles should be weighed on a case-by-case basis, with attention paid to ways in which they complement and/or strengthen each other.

In conclusion, this essay puts forward a more nuanced liberal-democratic view on governance, in which we refrain from an ideological preference for one governance principle over another. The key determining factor is to what extent a governance arrangements helps us to achieve our liberal-democratic goal of developing and nurturing a sustainable society that produces a high quality of life for as many as possible in a setting that emphasizes positive freedom. Sometimes, **Relationships** might facilitate this goal, sometimes **Markets**, sometimes **Bureaucracies**. Hence, the choice for one or the other, or any combination thereof, should depend on the governance principles’ weak and strong aspects in different contexts. The next two Chapters will deal with this analysis.

## Governance on a small scale

### Relationships

In much of human history, communities had no choice but to make use of spontaneous forms of governance for a considerable period of time. These spontaneous forms were based on the principles of personal **Relationships**, which we defined in Chapter 2 as *regulation of human interaction based on trust, reputation, reciprocity and non-enforceable but deeply felt rights and responsibilities*. Nomadic tribes of up to a few hundred individuals had to organize themselves on the basis of trust, reputation and social pressures without recourse to **Bureaucracies** and **Markets** (see, e.g., Daimond, 1997; Fukuyama, 2011). Such communities continue to exist until the present day. Sports, hobbies and leisure activities are often reasons to form networks that are governed by **Relationships**. Millions of people assume responsibilities as referees, coaches or bartenders. Volunteering abounds in political parties, in health, day and elderly care, in voluntary fire brigades, in the arts and culture, *et cetera*. All of this activity is not counted in the usual measures of economic activity and commercial success, such as GDP or profit, but adds tremendously to the wellbeing and quality of life of many – if not most – people. This chapter discusses the main features, strengths and weaknesses of this particular governance principle. When, how and under what conditions does governing by **Relationships** lead to a cohesive, fair and efficient outcome?<sup>24</sup>

#### **Relationships, clans, networks**

Eleonor Ostrom received the 2009 Nobel Prize for Economics for her research into this type of ‘spontaneous’ governance: governance both without **Bureaucracies**, but with clear rights and responsibilities, and without **Markets** of anonymous and voluntary transactions, but with all kinds of human exchange.

Her work was chiefly concerned with small communities, focusing on the governance of natural resources: how are small communities able to manage those resources efficiently and sustainably without enforceable laws or pricing mechanisms?<sup>25</sup> Inspired by her work, the EU Institutions for Collective Action project<sup>26</sup> collected many current and historical examples of governance by **Relationships** – examples of how people organized collective action involving commons, guilds, water boards, beguinages and co-operatives. In many of these examples, governance is spontaneous without any bureaucratic hierarchy or market exchange being involved in managing the collectives' resources. Instead, there are elaborate and complicated sets of implicit norms and rules that are enforced in the social context of small communities. In fact, a large literature has emerged on the reward and punishment mechanisms that are required to make such cooperation sustainable in the absence of bureaucratic rule and market exchange (e.g., Oliver, 1980).

In the management literature (e.g., Ouchi, 1980), the **Relationships**-based governance principle is known as 'the clan', referring back to the prehistoric roots of this social governance mechanism. In modern parlance, this form of governance is referred to as 'the network organization' (e.g., Rhodes, 1996), to emphasize that in modern society the relevant ties are no longer necessarily those between relatives. Instead, in modern network organizations, ties or **Relationships** can be maintained for several reasons. Sociologists have distinguished numerous types and taxonomies to characterize ties among people, even within a small unit such as families (Weiss 1998). In modern network arrangements, ties among people can vary from the thick unbreakable bonds of blood between children and their parents, to 'light communities of citizenship' (Hurenkamp and Duyvendak, 2004) or even to the thin watery lines of one-time bureaucratic and market exchanges among strangers.

These examples of governance by **Relationships** can be found throughout human history, and therefore seem to be deeply embedded in human nature. People form ties and develop

relationships all the time. Neuroscientists (e.g., Leary, 1990; Eisenberger et al., 2003; MacDonald and Leary, 2005) have shown that social exclusion lights up parts of the brain that are also active when we mourn. Frans de Waal's (2009) research reveals that many of the skills and processes that we

**'Examples of governance by Relationships can be found throughout human history, and therefore seem to be deeply embedded in human nature'**

use when governing by **Relationships**, such as empathy and friendship, are present in primates and hardwired into human biology. Hence, it is hardly surprising that governance by **Relationships** continues to play an important role in modern society. Families, classrooms, offices and clubs, to name just a few prominent arrangements, all demonstrate this form of governance. Pedagogues, psychologists and psychiatrists (e.g., MacDonald and Leary, 2005) all stress the human need for emotional attachment and social connectedness to develop an individual's full potential.

#### **Governing by Relationships: weaknesses**

Strictly speaking, in an ideal world without any constraints, governance by **Relationships** might theoretically be the preferred governance principle from a liberal-democratic perspective. This is because of the fundamental liberal-democratic belief in the capabilities of individuals to choose their own directions in life, usually together with other individuals.<sup>27</sup> Societies governed by **Relationships** are by no means peaceful and without problems, but they are egalitarian in the sense that all citizens can, in principle, resort to violence and/or withdraw from the prevailing institutional arrangements if they choose to do so. Given high interdependencies – even for survival, in the long gone times of hunting and gathering

– these governance arrangements are not, however, automatically free by any modern standards. There is no real freedom if withdrawing means exclusion, destitution, and even death. Under such conditions, interaction is neither contestable and efficient, as Adam Smith’s invisible hand only works when all sides to an exchange benefit, nor fair and secure, as power is largely unchecked. Dependency often implies submission to the group, and does not automatically create the highest quality of life for all. In the absence of positive freedom, a hierarchy tends to evolve. But without the constraints on power imposed by bureaucratic rule of law, protecting the basic rights of all, such hierarchies easily become oppressive and unfair. History is full of examples of this, and the liberal struggle in the past has often been to remove the chains of tribalism, corporatism and social conventions as much as those imposed by hierarchies and state bureaucracies.

*‘The light communities of citizenship offer the social cohesion and engagement that are essential for our socio-psychological wellbeing’*

**Governing by Relationships: strengths**

However, provided that ties and **Relationships** do not evolve into social chains and that positive freedom can break the ties if that is preferred by any one of the ‘nodes’ involved, this governance principle is associated with a few very attractive strengths<sup>28</sup>. Most fundamentally, these ‘light communities of citizenship’ offer the social cohesion and engagement that are essential for our socio-psychological wellbeing. In addition, these kinds of **Relationships** provide contestable and dynamic efficiency<sup>29</sup> as well as basic security, and are generally perceived to produce fairness in processes and outcomes.<sup>30</sup> These conclusions are supported at both the philosophical (Fung, 2006) and the practical level (Sampson et al., 2005).

It is well-established, for instance in the management literature, that good human resource management – which is here viewed as an investment in **Relationships** – provides both high performance for organizations and high satisfaction for employees (Pfeffer, 1996; Sorge and Van Witteloostuijn, 2004). That is, ‘high-commitment human resource management practices’ have a positive effect on company performance (Huselid, 1995; Delaney and Huselid, 1996). An employee who feels that her or his employer takes her or him seriously is more motivated to perform well for that employer than her or his counterpart who is treated like a robot. Increased motivation can be expressed in increased creativity, effort and/or cooperation. Modern human resource management as taught in modern textbooks (e.g., Armstrong, 2006; Mathis and Jackson, 2011; Folger and Cropanzano, 1998) stresses the importance of stating clear goals and careful monitoring of these goals, but also warns against too much governance by **Bureaucracies** and **Markets**. That is, good human resource management should refrain from bureaucratically micromanaging employees, reducing individuals and teams to production units, and ignoring their natural human interaction. The days of the Taylorist or scientific approach to management, in which workers were reduced to interchangeable parts in the machinery such as in Chaplin’s ‘Modern Times’, are long gone.

**Relationships** in horizontal networks govern our social lives even more than in the commercial and public domains. Governance by **Relationships** comes naturally for families, but also for less clear ties between people interacting in sport clubs, voluntary organizations, et cetera. Findings from modern multidisciplinary (semi-)experimental research in economics, psychology and sociology support the view that **Relationships** improve performance of individuals and teams. Humans are naturally inclined to give their greatest exertion, creativity and dedication when facing joint challenges, that is to say, when participating in communal projects with individual responsibility (Lindenberg and Foss, 2010; Tomasello et al., 2005). In many circumstances, the strengths of people become most apparent when they seek to reach shared goals with oth-

ers. Orthodox economic hypotheses about the individual who acts out of self-interest leave no room for the added value (and enjoyment) of joint production. In fact, the opposite is true: in that view joint production has elements of free-riding, with traditional game theory suggesting the design of incentive schemes and contracts that prevent free-riding in cases where this behaviour often will not arise in the first place. In real life – in families, companies, and communities – joint production increases the individual's potential and the participation. For efficient and cooperative production, engagement and a sense of fairness are both eminently and evidently important.

### **Asymmetric Networks and Governance of Professional Communities**

These positive results of governance by **Relationships** is most evident in horizontal networks – that is, in networks where the participants are indeed more or less equal, relevant information is readily available, and dependencies are weak or work both ways such that voluntary engagement and loyalty are ensured. **Relationships**, however, can also work when network ties are asymmetric, for example in the relationships between parent and child, teacher and pupil, banker and client, and doctor and patient. One party, which we refer to as the 'expert', has much more information and expertise than the other, who we refer to as the 'dependent'. The asymmetry in the relationship remains, no matter how often they interact. This is particularly important in the production of goods and services where it is hard or impossible for the dependent to objectively establish and measure the quality and quantity of inputs or outputs. There are many examples of this in health care services, education and security.

Under these conditions, how can the goals of efficiency, fairness and cohesion still be met? When ambiguity characterizes the product or service provided, organizing goal congruence is key to making sure that the experts are intrinsically motivated to do the right thing (Ouchi, 1980). Luckily, the experts are often naturally inclined to do the right thing to the best of their ability, as this is part of their professional norm system. Indeed, in many instances professional communities

have emerged spontaneously. Bureaucratic rules and market incentives tend not to work well in such circumstances (Adler, 2001) and governance by **Relationships** might produce better results. Intervention among experts (professionals) can foster the development of professional ethics, coupled with an effective mechanism for enforcing disciplinary rules, and **Relationships**-based control mechanisms such as professional reputation and social status can be powerful complementary instruments. A profession differs from a job in that the 'professional' shares her or his terrain with a community of peers. Reputation within that community, peer appreciation (or lack thereof) and peer review are elements of institutionalized governance by professional **Relationships**. Professions such as law, medicine, education and health care are examples of such communities. **Relationships** with patients/clients/students are perhaps not always equal, but professionals in these fields value their colleagues' approval highly.<sup>31</sup> Professionals are thereby disciplined and held accountable by each other. This is necessary in order to safeguard the quality that is delivered and to provide the motivation to deliver the best service appropriate for the individual clients/patients/pupils.<sup>32</sup>

From the other side, engagement of dependents may reduce transaction costs, and may increase innovation and value creation. Hirschman (1970) argued that in the absence of real exit options, loyalty and voice are strong alternative mechanisms by which dependents can exert discipline and promote both fairness and efficiency. Again, these loyalty and voice mechanisms presuppose that a relationship can be established. Consequently, **Relationships** will co-determine the governance structure in place. Students give feedback on courses and programs, patients unite in patient organizations, and tenants form a committee to raise issues with the landlord. Such organizations of dependents can counter the possible tendencies for professional organizations to turn into closed shops. Of course, to function properly, such organizations need to also represent the less vocal interests adequately. Voice can be delegated. A good example of delegated voice can be found in children's daycares. Here, the voice of parents on behalf of

their children should be used as a complementary system of quality control, in addition to the ongoing debate among professionals in that field within and across organizations.

#### **Engagement and cohesion: policy implications**

The great synergy of governance by **Relationships** is the engagement that is both demanded and rewarded, as well as the cohesion that is created in the process. That means that the governance of small groups of individuals who interact repeatedly in differing roles can usually best be left to the group itself. This insight is politically highly relevant. Wherever engagement and commitment are required or desirable, governance according to the principle of **Relationships** makes the most sense. This implies that for policymaking in these cases, we must actively keep governance by both **Bureaucracies** and **Markets** at bay. Policy often enters into the arena of professional or spontaneous organizations by introducing competition and pricing, or by intervening through bureaucratic measures that allocate rights and obligations by rule. The existing framework of **Relationships** is then replaced, typically being destroyed in the process. Sometimes, this is necessary or justified because networks can be exclusive and abusive, and, as such, they are dysfunctional and infringe upon liberal values. The emancipation of women and gays, the democratization of universities and churches, and the breaking of the power of closed-shop unions and strong corporate lobbies are all examples where liberals have actively tried to break up **Relationships** in favour of more open **Markets** or fairer **Bureaucracies**. But with many of these obvious struggles now behind us, ignoring the importance of social relationships means that more is destroyed than is created. When spontaneous governance by **Relationships** becomes the collateral damage of intervention, individual engagement and cohesion come under pressure, with all the negative consequences that this can generate. Much has been written about the destructive effects of market incentives or bureaucratic rules on motivation, commitment and job satisfaction (e.g., in education by Atkinson et al. 2009; and in health care by Claassen, 2006). In the context of globalized financial markets, societies are now

suffering from these destructive effects, since professional ethics were apparently eroded as cutthroat free market competition took over. A call for stricter bureaucratic control is often heard these days, but several authors (e.g., Boot, 2000) have also argued for a return to ‘Relationship-banking’ to make bankers feel more responsible to their clients (see also Chapter 8). The plea for a so-called ‘bankers’ oath’ and efforts toward a revival of professional ethics and culture should be understood in that light as well. It is important to realize, however, that efforts to create an efficient market or effective bureaucracy will typically undermine the key mechanisms of spontaneous **Relationships**-based organization – reciprocity, empathy, reputation, and gift exchange.

### **‘Governance by Relationships reaches its limits when those involved do not know each other personally’**

#### **When Relationships are not possible...**

Governance by **Relationships** is not always feasible or desirable. In a complex, specialized and global society like ours, spontaneous governance principles often simply will not suffice. When groups become large, when interaction is usually one-off and anonymous, and when possible negative secondary effects occur outside the direct environment or beyond the comprehension of the individuals involved, then governance by **Relationships** is fragile and may turn out to be inefficient, unfair or both. Fukuyama’s (2011) main argument in *The Origins of Political Order* is that mankind continuously struggles against exactly its natural tendencies to return to this more natural governance model, which is easily perverted at a large scale. The corrupting effects of nepotism, clientelism and the abuse of power are all too obvious in many parts of the world today. Acemoglu (2009) refers to such ‘bad institutions’ as probably the most prominent fundamental cause for poverty and lack of economic development in too many societies.

On the one hand, if there is insufficient positive freedom for the individuals involved, uncontested positions of power can be established and abused. In this case, **Bureaucracies** are required to establish and safeguard basic rights for all. If, on the other hand, too much positive freedom exists – that is, if people can easily and without consequences take advantage of others and walk away – then **Markets** need to be introduced to price all relevant costs and benefits to ensure that only informed voluntary and efficient transactions will be made. After all, under such circumstances, the ‘soft’ coercion of continuous social interaction disappears and needs to be replaced by ‘hard’ institutions that will govern non-binding, single transactions. Governance by **Relationships** reaches its limits when those involved do not know each other personally. Cohesion and engagement are no longer ensured, and additional governance via **Markets** or **Bureaucracies** is to be considered. Politicians are typically the ones who will then have to decide how matters are to be managed when governance moves to a scale larger than a small community.

## Governance on a large scale

### Bureaucracies and Markets

When **Relationships** fail, policymakers have to act and establish a governance mechanism by introducing **Bureaucracies**, **Markets**, or a mixture of the two. As stated above, as a governance principle **Markets** *regulate (voluntary and free) transactions between parties that demand and supply products or services based on price incentives*. By contrast, **Bureaucracies** *refer to the coordination of transactions based on enforceable rights and enforced responsibilities*. Both governance mechanisms require elaborate sets of rules and regulations to function properly. We want to stress again at this point that it is a mistake to consider **Markets** to be efficient without such rules and regulations in place. Hence, setting up a properly functioning market never involves complete deregulation. In that sense, all governance will require a strong government in combination with a political process that determines which governance principles best fit the case at hand.

This Chapter analyses the strengths and weaknesses of the two governance principles of **Markets** and **Bureaucracies**. Under what conditions do these respective principles help to achieve our liberal-democratic goals?

#### ‘Markets where possible ...

The (neo)liberal fascination with the market is based on the idea that markets allow individual choice, and thereby leave more room for individual self-realization. In a market environment, individuals are free to pursue their individual goals. And in doing so, they serve the common interest of dynamic efficiency by Adam Smith’s (1779) famous ‘invisible hand’. It should be noted that perfect market mechanisms – as formalized in neoclassical economic models – require heroic assumptions. If these assumptions are not met, as is the rule

in reality, even a hardcore neoliberal economist will accept a role for the government.<sup>33</sup> Every basic economics textbook contains a well-known list of causes for market failure: external effects, information asymmetries, market power and public goods are all classic examples of market deficiencies that justify government intervention. Such intervention, however, is still justified with an efficiency argument; according to this logic, the government only intervenes if **Markets** fail to generate efficient results when left to themselves.

We follow modern institutional economics and go a little further. It is unwise to put blind trust in market efficiency, even where sources of classic market failure are absent. After all, the proposition that **Markets** lead to efficient allocation is based on two key assumptions, the *homo economicus* and the *efficient markets* theorem, neither of which can stand the test against recent scientific insights and political reality. Furthermore, it cannot be stressed enough that efficiency alone does not meet the full spectrum of decision criteria proposed above. Liberal-democratic governance should aim to balance efficiency with fairness and cohesion, while remaining within ecological boundaries. We will come back to this after we discuss the concepts of *homo economicus* and the *efficient markets* theorem in little more detail.

#### Homo Economicus

It is difficult to argue that a human being acts as a *homo economicus* – that is to say, that s/he, after processing all available and relevant information, rationally makes choices by maximizing expected benefits based on well-understood self-interest. The evidence shows that this is largely a false assumption. Research reveals that only about ten per cent of people are extreme maximizers – that is, behave approximately as a *homo economicus* would. The rest are to some extent more or less extreme satisficers (Schwartz, 2004; Simon, 1947). Moreover, self-interest is not ‘well-understood’, people do not exclusively – or even mostly – act out of self-interest, they have different but always limited cognitive capacities for processing information accurately, they often avoid making choices, *et cetera*. Left

to our own devices, we save too little for our pension, are easily tempted by slick financial advisors to buy bizarre products or can be convinced to sell such products to others. In short, humans are complicated economic, psychological and socially driven beings who make choices in which factors such as limited rationality, imitational behaviour and greed play important roles (Thaler and Sunstein, 2009). Moreover, even if we were rational and extreme maximizers, what is individually (and in the short term) rational is not necessarily collectively optimal in the long term. The world is full of problems structured like the famous ‘prisoners’ dilemma’, in which individually rational choices imply collectively inferior outcomes.

‘Humans are complicated economic, psychological and socially driven beings who make choices in which factors such as limited rationality, imitational behaviour and greed play important roles’

Many economists, mainstream and unorthodox, will now acknowledge this reality and qualify their results based on these insights. Notwithstanding this disclaimer, they continue to use their tools and techniques, recognizing the caveats that come with this approach. However, few policymakers probably fathom the far-reaching implications of these standard assumptions, ignoring the scientific qualifications too often in their policymaking practice. The price incentives example (e.g., energy taxes) illustrates this very well. Where the *homo economicus* would respond to changing relative prices in the direction intended by policymakers, especially at the margin, the same incentives – perhaps unexpectedly – barely influence real people’s actions. In practice, most people follow the majority opinion or custom, and will respond only if a sufficiently large shock moves the herd in another direction. Thus, **Markets** and market-related policy instruments do not neces-

sarily lead to more efficient allocation. Every now and then, humans need a nudge, or even a big push, in the right direction.

But if *homo sapiens* is such a complex and fallible creature, can we still rely on people to make their own decisions? Liberals must still rely on people being the best judge of their own interests not because they believe in the cognitive superpowers of the *homo economicus*, but for lack of a better alternative. They must recognize, however, that the decision-making strength of people is limited and heavily dependent on individual self-regulating capacities and on the abilities both to make plans and implement them and to harmonize conflicting goals in a fashion that minimizes regret (Lindenberg, 2008, 2010). Therefore, relying on individual judgement in **Markets** should imply taking such self-regulation into consideration. The ability to self-regulate is rooted in cognitive and psychological capacities to plan and design one's own actions in a disciplined manner so as to contribute to individual self-realization and joint production. This ability differs starkly between individuals and over time and place, and is closely related to the other criteria for governance – fairness and cohesion – that we have detailed above. People who feel excluded see their ability to self-regulate diminish (Baumeister et al., 2005). Arguably, the same applies when they feel they are being treated unfairly.

For **Markets** to function as designed in a liberal society, we need to stimulate the ability of individuals and groups to self-regulate. Accessible and excellent education, for instance, is of great importance in this context. Further, deficiencies in self-regulatory ability can be partially compensated for in collectives such as the state, not by prescribing paternalistic choices with formal laws or difficult-to-dismiss 'norms and values', but by aiming to neutralize differences in self-regulating abilities as much as possible. An important instrument is to provide a secure *default* (Thaler and Sunstein, 2009). In other words, to regulate not by a moral behavioural code: 'Ye shall not sell complicated mortgages to unsuspecting consumers', or even a law: 'Ye are prohibited from selling complicated

mortgages', but by ensuring that – at the very least – mortgage brokers offer a guaranteed safe standard mortgage and are obligated to explain deviations from the certified standard to their clients. Furthermore, consumer protection can easily be designed in such a way that only those maximizers who knowingly buy risky products are able to become their victims. Liberals should respect everyone's freedom to take a risk in hope of gains, but a true liberal view requires individual free will and full information in this context. Any business model that is built on customer naivety, habits and cognitive limitations does not add true value, and is therefore both inefficient and unfair.

### The efficient markets theorem

It is not only the notion of man as a full-time *homo economicus* that is problematic. It is also hard to argue that actual real world markets are efficient by default. A wide variety of markets are not so, and many – if not by far the majority – will never be. Adam Smith's (1779) invisible hand can only exert its healing powers under a very specific and restrictive set of circumstances. Actual markets and **Markets** can only be and remain efficient if they are *contestable*. Free entry and exit is crucial (Baumol et al., 1982). Businesses and organizations that are protected by the state or their own strategies lose the incentives to attain higher efficiency and become complacent.<sup>35</sup> Only in contestable positions are *insiders* kept alert; and only then do *outsiders* enjoy what liberal-democrats would consider fair and equal opportunities. **Markets** as a governance mechanism, in principle, allow for maximum space for individual choice and reward achievement, which is precisely the aim of liberal governance. But while contestability is essential to achieving that aim, it is far from a natural state of affairs in actual markets, even in the absence of classic market failures. Contestability implies that better ideas can always challenge the good ones, and stand a fair chance of winning the day. To a liberal, contestability is therefore both fair (equal opportunity and meritocracy) and vital for achieving dynamic efficiency. Efficiency and contestability, however, are far from natural consequences of liberalizing or deregulating markets.

In fact, the opposite may well be true. Modern institutional economics has shown that a large number of markets are created and preserved imperfectly through special interest protection. Efficient markets are in fact therefore rare exceptions rather than the general rule.<sup>36</sup> If the principle of **Markets** is adopted as the dominant governance mechanism in any context, strong and alert monitoring and supervision – and hence **Bureaucracies** – are almost always essential to keep such real world markets contestable and efficient.

We conclude by noting that actual markets always function with a good-sized portion of **Bureaucracies** and **Relationships** infused in them. Pure market mechanisms can be described as theoretical constructs, but they can rarely function in reality. Market parties as actors (firms) take on organizational forms that cannot be managed without bureaucratic principles, especially when these organizations grow in size. The role of **Relationships** can also not be neglected in this context. As we have argued in detail above, the management literature has made it abundantly clear that creativity and productivity require and benefit greatly from engaged employees and customers. This implies that an increasing share of high value added production is organized through **Relationships** – that is to say, via small independent teams with clear goals and lots of autonomy in the production processes. The mixing of governance principles, however, has to be designed carefully, keeping goals, strengths and weaknesses clearly in mind. We will return to this issue in the next chapter. But before doing so, we first consider **Bureaucracies**.

#### ... and regulation where needed'

For most (neo)liberals, regulation by the government is considered unwelcome because of the belief that **Bureaucracies** are inefficient. **Markets** are expected to yield superior results in that respect.<sup>37</sup> But because fairness and cohesion, in addition to efficiency, are essential criteria for a sustainable quality of life, perfect **Markets** alone will generally not achieve our ultimate multidimensional goal set. In addition, we argued above that dynamic efficiency in **Markets** requires strong

**Relationships** and effective **Bureaucracies** in and around the market. But **Bureaucracies** have an additional important strength. A contestable market may excel in efficiency, but a risk averse and effective bureaucracy might have a comparative advantage in terms of securing basic rights and enforcing obligations *vis-à-vis* the collective, thereby guarding the common sense of fairness. In fact, historically, that is always what **Bureaucracies** were designed to do. Initially, the Chief's spoken word was law in the context of tribes. When organizational scale increased, a King was forced to write his words down and sign them into law for his **Bureaucracies** to uphold. Thereby, they gradually gave up discretion and arbitrariness to make room for the rule of law. And after signing subjects' obligations into law, it was a small conceptual step (but a long struggle) to also protect their rights. With written rules and regulations, **Bureaucracies** were born. A quote from von Mises (1962: Section 3 of Chapter 2) nicely establishes this fundamental nature of **Bureaucracies**:

**Bureaucratic management is management bound to comply with detailed rules and regulations fixed by the authority of a superior body. The task of the bureaucrat is to perform what these rules and regulations order him to do. His discretion to act according to his own best conviction is seriously restricted by them.**

Interactions with **Bureaucracies** are thereby fully predictable, *ceteris paribus*. This sets them apart from **Relationships** and **Markets**. They are also both impersonal and involuntary. In that sense, they do not provide cohesion or efficiency. But the fact that they operate based on rules and regulations that are subject to change only following another set of rules and regulations implies that **Bureaucracies** are secure and able to implement legitimately chosen policies very effectively. As Max Weber (1947: 973) argued: 'The decisive reason for the advance of bureaucratic organization has always been its purely technical superiority over any other form of organization.'

But like **Markets** and **Relationships**, **Bureaucracies** can clearly

fail to deliver. As are perfect **Markets**, perfect **Bureaucracies** are ideal-types, too, that are rarely – if at all – observed in practice. Adler and Borys (1996) distinguish between *enabling* and *coercive* **Bureaucracies** in the context of firm organization, where the latter involve rules and regulations to control the workers and the former aim to provide a secure and predictable environment in which the worker can excel.

## ‘There are plenty historical examples of coercive **Bureaucracies** running amok and creating enormous inefficiencies and social disintegration’

This is easily transposed to the macro level as well. There are plenty historical examples of coercive **Bureaucracies** running amok and creating enormous inefficiencies and social disintegration. The big famines that killed many millions in the USSR and Communist China in the last century stand out as striking examples. But it has to be recognized that coercive **Bureaucracies** also occur in private organizations, causing large problems, albeit on a smaller scale (van der Mandele and van Witteloostuijn, 2010). They provoke sabotage, rebellion and revolution, and they clearly do not contribute to the aim of sustainably providing the highest quality of life for as many as possible. Enabling **Bureaucracies**, in contrast, have helped mankind to achieve its greatest achievements. Bureaucratic entitlements to health, basic needs and education have lifted millions out of poverty, and were instrumental in building the institutional environment we often take for granted. As much as **Bureaucracies** can reduce the individual to an anonymous number at the mercy of superiors, the same rules and regulations can protect individual rights and entitle all to education, health, basic security and a decent livelihood. This is where enabling **Bureaucracies** may be a solution to the exclusiveness and dependencies that **Relationships** may entail.

Another important element in **Bureaucracies** is that they one-sidedly give and take (backed by the monopoly of violence), whereas **Markets** facilitate transactions in which both sides engage voluntarily. This power of the collective over the individual does, of course, not sit well with the basic principles of liberalism. But inevitably, society must decide who pays for collective goods and who is entitled to use them. This cannot be settled by **Markets**, since collective goods imply a classic market failure. So **Bureaucracies** inevitably act as redistributors, and are often required to do so for other reasons than efficiency. They do not force this redistribution upon us because government officials autocratically and directorially decide to do so, but because modern citizens hold their governments accountable for guaranteeing basic security and correcting perceived unfairness and injustices. After all, **Relationships** and **Markets** produce a distribution of basic goods at larger scales that can only incidentally be characterized as fair.

**Bureaucracies**, by their rule-based nature, are designed and best equipped to provide one-size-fits-all solutions. This may look like a disqualification, but one-size-fits-all solutions are exactly what need to be provided in many cases, such as the basic security and fair treatment to which every individual is entitled. Clean water, reliable electricity, accessible roads, public transport, safe food, a good (basic) education, a safe bank account, and fire fighting, security and ambulance services could all theoretically be provided through diverse offerings catering to many different individual needs and preferences by **Relationships** at a small scale or by **Markets** at a larger scale. Some might even argue that they should be. By definition, however, basic security and needs are basic because everybody requires and appreciates them. It is, therefore, typically considered fair and just that all should be entitled to these basic needs and that rules, rather than connections or wealth, should determine an individual's entitlements. Thus, **Bureaucracies** arguably ensure the provision of basic minimum levels of security and the fair redistribution of scarcity in these areas most effectively – that is, if the rules are indeed fair and just and if **Bureaucracies** are and remain limited to those goods and

services we consider truly basic needs. Also, note that when we say that **Bureaucracies** are most effective as a governance mechanism, we do not mean to imply that the government should actually step in and provide the goods and services. It is perfectly possible to use **Bureaucracies** as a governance principle to manage private firms or individual people as actors. We will return to the issue of implementation below.

Recall that it is not the bureaucracy or the bureaucrats that set the rules by which **Bureaucracies** operate. These are ideally set in an open and democratically legitimized political process in which questions like ‘What should be considered basic security?’ and ‘What is a fair (re)distribution of access to public and private goods and services?’ will have to be answered. That is, such decisions should emerge in a political arena where political parties, politicians and their ideas are democratically contestable. According to John Rawls’ *Theory of Justice* (1999), a fair society provides the most destitute individual with a minimum guarantee to live in safety and security. But no matter how society comes to its shared norms and values on fairness and justice, in a fair and just society the government has a (re)allocating task that is best implemented through the governance mechanism of stable and predictable **Bureaucracies**.<sup>38</sup>

Of course, **Bureaucracies** have their own limitations.<sup>39</sup> **Bureaucracies** are not intrinsically secure and fair, just like **Markets** are not naturally contestable and efficient. The many historical examples of coercive **Bureaucracies** destroying individual freedom imply that the question of legitimacy cannot be ignored. It would take us too far outside the scope of this essay to discuss these very important issues of constitutional design, and the emerging literature on the importance of institutional constraints on the executive (e.g., Acemoglu, 2009). Suffice to say that a legitimate legislative process has to be in place for the executive **Bureaucracies** to work. The *trias politica* was, of course, an explicit attempt at keeping legislature and executive strictly separated. But that leaves open the question of how rules can be legitimized. Unlike **Markets**, where transactions are legitimized by the mutual consent of those

involved, rules and regulations do not legitimize themselves – for that, something else is needed.

Liberal-democrats would argue that the legitimacy of rules can only come from a transparent and open democratic political process.<sup>40</sup> In a way, liberals see the ongoing democratic debate as a way to organize the process, which Binmore (2011: Chapter 12) describes as continuously and incrementally renegotiating the social contract. This is what provides the natural connection between liberalism and democracy. Without democracy, there is no legitimate basis for **Bureaucracies** to determine what is fair and just, and there is thus a basis lacking for the rights and obligations they confer and impose on individuals. The analogue to a strong market supervisor that ensures contestability in **Markets** is a strong democratic representative body that ensures that **Bureaucracies** follow rules deemed just and fair by at least a qualified majority.

### ‘Liberal-democrats would argue that the legitimacy of rules can only come from a transparent and open democratic political process’

The democratic quality of decision-making at all levels then becomes a key issue. From the EU to municipalities, much work needs to be done in this context. Certainly, democracy is the tool by which the executive **Bureaucracies** can be kept accountable and contestable. Just as in **Markets**, it is essential that free entry and exit are guaranteed in the political process, as well as in **Bureaucracies**. *Outsiders* should always be able to challenge *insiders* – also within the government (legislature), and also *vis-à-vis* **Bureaucracies**. This ensures the vitality of both bureaucracies and governments. In the democratic debate, the balance between contestability (especially efficiency through **Markets**) and security (especially fairness through **Bureaucracies**) has to be determined in an ongoing debate

in which all relevant voices are heard. The liberal agenda of democratization therefore is and will continue to be of great importance. A democratically checked and contested bureaucracy is uniquely equipped to organize citizens' basic security and to equitably (re)distribute the scarcity thereof, without indulging in an Eastern bloc-like state of corruption, waste and stagnation.

Also, this raises the issue of scale. In many of the modern **Bureaucracies'** functions, the scale at which action is required or desired is not or cannot be matched by the level at which adequate democratic legitimization has been organized. This is most challenging in areas where interdependencies among people have clearly outgrown the size of nation-states. Issues surrounding global financial markets and trade or the protection of universal human rights are examples where the democratic debate simply cannot be organized at a level that spans the complete geography where the issue is located, hampering the legitimate bureaucratic organization of basic security and fair redistribution. But also when subsidiarity is violated can this scale mismatch be a cause of unfairness and illegitimate violations of individual freedom. European bureaucrats deciding on the curvature of bananas in the local grocery store or setting rules on the maximum height of ladders for painters are perhaps urban legends, but very useful in making the point. Political representatives at local, regional and national levels all too often hide behind bureaucratic rules that were delegated or usurped by higher-level governments with their full consent. This, however, eliminates the essential link between democratic recourse and accountability, on the one hand, and bureaucratic rules and regulations, on the other hand. Such mismatch makes **Bureaucracies** uncontestable, with similar destructive effects on both efficiency and fairness as we observe in uncontestable **Markets**.

Finally, as liberals, we should stress that democratically legitimized **Bureaucracies** still have no right to limit fundamental individual freedoms, even if a large majority of the electorate or their elected representatives would favour

such infringement. That is, democratic legitimacy is not the same as being ruled by the tyranny of 50%+1 or *Das gesunde Volksempfinden*. Contestability in the democratic process is a first way to secure minority rights, but more needs to be done. Liberal politicians need to speak on behalf of minorities, must argue for tolerance and have to question the authority that others may claim to represent.<sup>41</sup> In general, liberals are correct in keeping a sharp eye on **Bureaucracies**. Rawls (1999), as his second criterion for a just and fair redistribution, claimed that all voluntary transactions should be permitted as long as his first principle, a fair initial distribution, was ensured. This implies that society is fair when it rewards achievement and, by implication, punishes apathy and failure – a consequence all too often overlooked by egalitarian politicians arguing for a fairer distribution. And as Binmore (2011) makes abundantly clear, the commonly understood norms of fairness and basic needs are subject to constant renegotiation processes and power struggles that the democratic debate needs to channel.



## Liberal Governance in practice

### Tools

Up to this point we have discussed the basic outlines of an analytical framework for understanding governance issues. But how can this be applied in political practice? What steps does a policymaker need to make to find the ‘proper’ governance balance in a particular field and implement it?

#### **Ideal types versus real-world mixes**

The first, perhaps rather obvious, question a policymaker needs to ask is: ‘Does this constitute a governance issue?’ There are many important political issues that do not qualify as governance issues and obviously the above framework is of no help in those cases. We have also argued, however, that questions of governance do constitute the core of what politics should be about and many issues on the table clearly require governance mechanisms to be (re)designed. Wherever people interact, governance plays a role and wherever interaction among people no longer functions properly, that is, wherever the outcomes are inefficient, perceived as unfair and/or undermine cohesion, a governance issue is on the political table. In this broad definition the European banking union, the organization of home care in the village of Elzendorp and the management of the Italian water supply system are all governance issues, playing at various levels of political decision-making.

Once we agree a governance question is on the table, the question should be: ‘What is most important for us in this case? Efficiency, fairness or cohesion?’ All too often this question is not asked or is only answered implicitly, as one might be tempted to assume it speaks for itself. There can be widely different positions on the relative importance of fairness, efficiency and cohesion, however. And it is very useful to recognize such differences in priorities early on as they

will make it hard to agree on anything down the line if they are left unaddressed.

If priorities are set and agreed upon the next question is: ‘How do we arrive at and implement the appropriate mix of governance by Relationships, Bureaucracies and Markets?’ First of all, it is important to bear in mind that the governance principles described above are ideal types only; in practice it

**‘No single governance principle scores high on all relevant criteria and if taken to the extreme they are all likely to fail’**

is impossible to organize society – or even a specific policy field – along pure market principles, bureaucratic rules or stable relationships only. In addition, we argued that no single governance principle scores high on all relevant criteria and that if taken to the extreme they are all likely to fail. The main task at hand, then, is to find the appropriate balance between governance principles, for any given policy terrain and period in time, given the priorities established. We would argue that a liberal politician should try to do so free of ideological dogma, political fashion and personal prejudice. Projecting the set priorities onto the governance principles is illustrated in Figure 2. Weighing strengths and weaknesses against the goals of governance (after we have set our priorities) gives us the corresponding choice for the theoretically appropriate mix of governance principles. The specific choice of priorities as well as principles are marked by the spots in both triangles.

The last question to be asked is then: ‘Which actors will do what under the chosen blend of governance principles?’ The discussion above has already alluded to the subtle but crucial difference between actors and principles. Each of the individual actors, firms, people and governments, perform best under

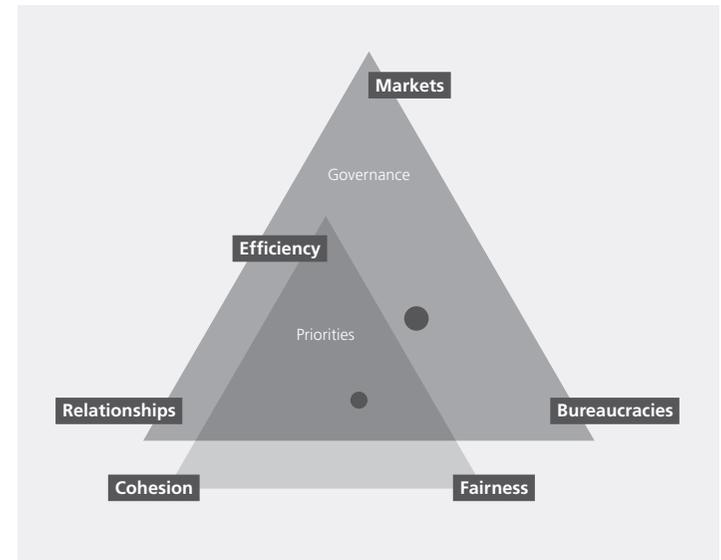


figure 2 – Projecting priorities onto Governance Principles

one of the governance principles, Markets, Relationships and Bureaucracies, respectively. However, for practical purposes it is useful to first consider a taxonomy of real-world organizational constellations that have proven to be workable mixes of principles at the system level. At this point, we can distinguish between at least four governance mixes that are relevant for large-scale governance:

- 1 **A governance mix in which bureaucratic principles are the only way in which a certain field is governed, usually where governments are the only implementing actor.**
- 2 **A mix in which bureaucratic principles still dominate the field, but in which market actors can also play a role.**
- 3 **A situation in which market principles and actors dominate, though the government is actively monitoring and intervening in the functioning of the market by bureaucratic rules.**
- 4 **A situation where market principles and actors dominate, and where the government only passively monitors market outcomes.**

All four blends can be infused by more or less room for governance and management by Relationships to build high trust within the organization and between parties involved. If implemented appropriately this will move them from being low trust to high trust governance systems. Figure 3 presents these different options in a triangle.

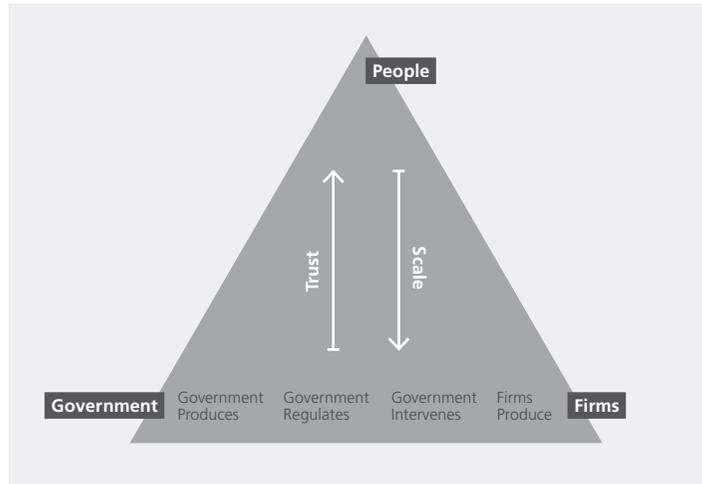


figure 3 – Blends of governance arrangements scale and trust

The figure shows that conceivable mixes of Bureaucracies and Markets can be identified and positioned on a continuum by appropriately dividing responsibilities between the actors, in this case governments and firms. By infusing the mix with elements of Relationships one can move governance in a direction that increases trust, but this is typically only possible if we can reduce the scale at which things are governed, either within or among the organizations and individuals involved. Increasing trust with Relationships in this manner should not be considered going back to tradition. Indeed Adler (2001: p. 228) explicitly warns against this and argues that leaders should favour and build a modern, inclusive, open and democratic kind of trust that should be mixed and balanced with Bureaucracies and Markets:

The efficacy of trust for knowledge management and the likelihood of its growth over time are maximized if: (a) trust is balanced by hierarchical rules to ensure stability and equity, (b) trust is balanced by market competition to ensure flexibility and opportunity, and (c) trust is modern and reflective rather than traditionalistic and blind.

Figure 4 distinguishes more explicitly between actors and governance principles. The black spot we put halfway between Markets and Bureaucracies in Figure 2, above, now has a reflection on the actors triangle, suggesting we should organize this issue by having government agencies and private firms do most of the governance between them. Being slightly more to the government side suggests the government should regulate in this particular example. Being in the interior of the triangle reflects that we want to endow this set of institutions with some room for people to make their own decisions and mistakes.

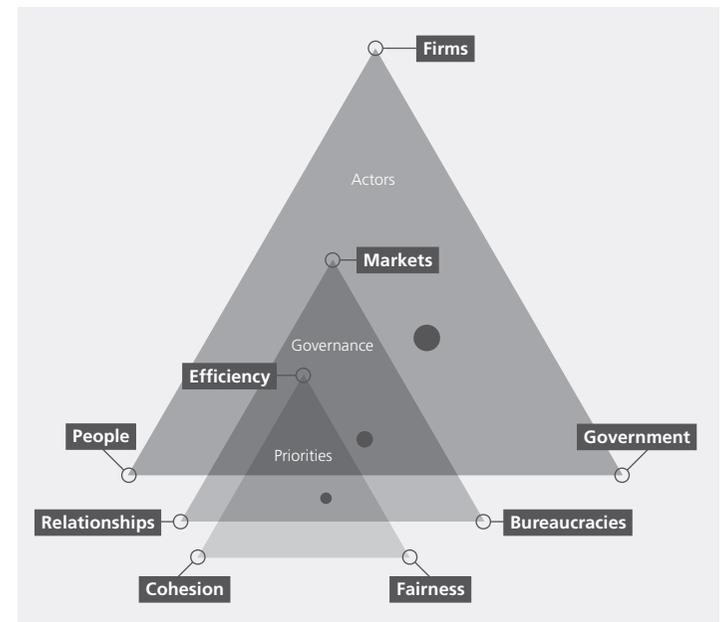


figure 4 – Blends of governance arrangements priorities, principles and actors

The respective priorities in the front and corresponding governance principles in the middle are now projected onto the actors' plane under the assumption that indeed these actors are actually present and strong enough to manage the issue under consideration. Obviously, the specific political, economic and social context in which governance will be implemented is important. Though a specific mix might be the preferred balance in theory, in political practice such a mix might prove impossible to implement. For instance, governance by Bureaucracies might be theoretically preferable when the criterion of fairness is deemed most important, but when in a specific local situation public administration is a mess or spanning international agencies simply do not exist, the outcome may have to be that firms or people are the only realistic alternatives for managing the task in this specific context.

‘Though a specific mix might be the preferred balance in theory, in political practice such a mix might prove impossible to implement’

**Flow chart**

The process of designing a governance structure by assigning tasks and responsibilities and freedoms and restrictions to real people, firms and governments, in the actor-triangle should follow a careful consideration of the goals of governance and a weighing of the relative strengths of the various governance principles in light of those goals. For practical purposes we have put this decision process into a flow chart of questions that summarizes our framework. Figure 5 presents the basic steps in terms of questions that should be answered to arrive at a specific governance mix and repeats the questions we have discussed above.

The first question serves to determine whether or not the policy question at hand is a governance question. Not all

policy issues require governance in the sense of institutions, structures of authority and collaboration to allocate resources and coordinate or control activity in society.



Figure 5 – Flowchart for governance issues

If the answer to Question 1 is ‘yes’, then the next crucial question concerns the way in which our governance goal – ensuring the quality of life for as many people as possible, in a sustainable way, fostering individual liberty – is best achieved. Is stimulating efficiency the optimal way? Or do concerns for fairness prevail? Or is cohesion more important than either efficiency or fairness? In essence, this is the stage where the political debate starts. Sometimes it is clearly one of these

three that dominates. Sometimes the criteria are equally important. But most of the time, opinions on this balance will differ. Socialists and Social Democrats will tend to emphasize fairness, where Conservatives and Christian Democrats will care about cohesion and Liberals tend to stress efficiency. Opinions will differ on what is most important for a sustainable future. It is, however, crucial to discuss and settle these differences before proceeding. If the parties involved are trying to achieve different goals in a governance structure, it is unlikely they can ever agree on the appropriate solution and in the confusion of goals and instruments the political process might very well deliver the worst of all outcomes.

Once this issue is settled – which usually is a compromise of goals, as in ‘fairness is the most important, but cohesion should be considered as well’ – one can determine the theoretically appropriate governance principle or principles. As argued throughout, in theory **Markets** is the most appropriate governance principle for achieving efficiency, **Bureaucracies** for fairness and **Relationships** for cohesion, but a balance needs to be struck. Finding the appropriate mix means putting the dot on the governance triangle.

Finally, the question of what mix of actors can implement the chosen governance structure most accurately needs to be answered. A similar logic applies here: private for-profit firms usually operate best under the governance logic of **Markets**, civil servants under the logic of **Bureaucracies** and people thrive under **Relationships**, but this is also not always the case. One should avoid, however, discussing the issue in the reverse order, as is often the case in the political debate.

#### Clear and Contestable

When designing and implementing a specific governance mix, some final additional issues need to be taken into consideration. First of all, in implementing a governance mix, it is still important to make a clear distinction in responsibilities and tasks between actors. We can expect little from unclear and hybrid constructions, for example, where a governmental actor operates more or less as a market party but with stringent bureaucratic requirements or where private firms are

granted public guarantees without democratic legitimacy or accountability. All too often organizations find themselves in some no-man’s land between governance by **Markets** or **Bureaucracies**, which creates all kinds of problems as neither political nor market discipline keeps decision makers in check.

Second, and related to the first point, actors should not divert too much from their ‘natural’ governance principle, unless it is not possible otherwise. Too much governance by **Markets** within a bureaucratic actor, for instance, might run the risk of regulation necessarily becoming very complex in

‘We can expect little from unclear and hybrid constructions, for example, where a governmental actor operates more or less as a market party’

order to deliver the ‘product’ a specific ‘buyer’ wants. The attempts in the public sector to be customer-oriented typically fail when one forgets that interaction via **Bureaucracies** is simply involuntary.<sup>42</sup> Similarly, private parties cannot operate and deliver efficiency when the market is regulated to a point where no degrees of freedom remain. Finally, it is crucial that **Relationships**, **Markets** and **Bureaucracies** are kept fresh and contestable through open discussion, intense competition and vibrant democracy, respectively. In other words, all governance principles should be actively maintained, and frequently challenged. Outsiders and newcomers should always contest established interests and the balance between **Bureaucracies**, **Markets** and **Relationships** should be continuously subject to political debate.

## Liberal Governance in practice

### Application

Now that we have the tools for designing a governance arrangement, this Chapter now turns to its political relevance. In this Chapter, we first discuss how we evaluate recent attempts to make actual bureaucracies more efficient by infusing elements of **Markets** through privatization. Then we turn to the impact that the introduction of **Bureaucracies** and **Markets** may have on **Relationships** among people in collectives and the current sentiment towards more bureaucratic control on markets run aground. The last part of this chapter will apply the lessons learned to a case study: the European financial markets.

#### Markets within Bureaucracy?

Since the 1980s and especially after the fall of the Communist Bloc in the 1990s, there was a strong push for privatization of public utilities and services.<sup>43</sup> The underlying idea was that bureaucracy, with its tendency to maximize budget and security, was generally inefficient and wasteful and unable to cater efficiently to the needs of demanding consumers. As we have argued above, **Bureaucracies** are indeed not designed to be very flexible or cater to individual needs and desires. In addition, the way actual bureaucracies were organized made them often rigid and uncontestable and democratic legitimacy may have been thin. It was thought that **Markets**, with their automatic legitimacy and theoretical efficiency, would solve many of these problems. But is it advisable to introduce market principles into a bureaucracy (or vice versa) with the aim of compensating for one governance principle's weakness with the other's strength? In other words: can market efficiency provide an answer to the lack of efficiency in bureaucracies?<sup>44</sup>

As usual with ideological paradigm shifts, at the start of the

process of privatization there were probably many cases where such a move made perfect sense. Government bureaucracy under the build-up of the modern welfare state had gradually encroached upon many aspects of life and arguably lost some legitimacy in the West. In the East this lack of legitimacy and inefficiency were so pronounced that revolutions could only be avoided by political overhaul. But an argument can be made that privatization within actual bureaucracy may have over-shot its utility. Generally, one sees that voters and the public, even in the former East, are sceptical of privatization in a realm of responsibilities that used to lie within the government's exclusive domain. Without being exhaustive, we highlight three important causes of the existing discord. First, when democratic accountability of the bureaucracy fails it should be strengthened, not replaced by a mechanism of market discipline, even if that could be implemented successfully by a political system that failed to control bureaucracy. Second, 'privatization' only makes sense if a contestable market can be constructed. In that case, democratic control needs to be replaced by transparent responsibilities and strong market discipline or, failing that, strong regulation. Often, this does not prove to be an easy task and sometimes it is simply impossible. Trading a democratically legitimate bureaucracy for a faulty and weakly disciplined market is a recipe for failure. And third, privatizing government responsibilities is a bad idea if citizens

### 'Trading a democratically legitimate bureaucracy for a faulty and weakly disciplined market is a recipe for failure'

continue to hold their democratically elected representatives accountable for a fair distribution, while these representatives have transferred their instruments of control to private parties that answer to different interests. If voters and the public consider the provision of some basic security, good or service primarily a public responsibility, then elected representatives do

well to keep some measure of control over the provision. As we argued above, the debate on what is and is not an essential government responsibility can only be settled in a democratic process. Privatization is a good idea when most agree that efficiency takes clear precedence over fairness and security and all are willing to accept the conditions that a healthy market requires.

#### Markets, Bureaucracies and Relationships

And what about the principle of **Relationships**? Here it needs to be re-emphasized that governance via **Relationships** also plays a role in real world bureaucracies and markets. Hence it should not be considered incompatible with those two. In fact Adler (2001) argues convincingly that both **Markets** and **Bureaucracies** function better under conditions of high trust, especially in sectors where knowledge sharing and joint production are vital for performance. In addition to the rules, rights and obligations of **Bureaucracies** and prices in **Markets**, trust reduces transaction costs and improves satisfaction with the process. Such trust can be built or maintained by direct interpersonal contact, by building a reputation in a network or by a mutual understanding of how institutions shape values and behaviour.<sup>45</sup> That is, **Relationships** build trust, whereas strong bureaucratic rules (supervision and fines) or market incentives (profit and bonuses) can easily undermine it. This observation implies two things.

First, politicians must always question whether or not intervention – in the form of introducing enforceable formal rights and responsibilities or prices and competition for resources – will undermine adequately functioning expressions of self-regulation. That bureaucratic rules invite one to subsequently hide behind them is a well-known phenomenon.<sup>46</sup> However, it is not only **Bureaucracies** that potentially destroys governance through **Relationships**. Levitt and Dubner (2006), for example, describe how an important social element for parents at a day care centre disappeared after the instalment of a fine system for picking up their kids after hours (see also Heesterbeek et al. 2012). After this market intervention, the

problem got worse as parents now felt that ‘they were paying for it’. But most importantly, parents did not return to their original behaviour after the fine system was abolished. In their worst forms, **Bureaucracies** and **Markets** dehumanize people. Keeping a close eye on the important role of **Relationships** in any governance decision therefore seems prudent.

Second, if one decides to intervene and introduce bureaucracy or a market to manage interactions, governments and businesses should leave room for spontaneous organization through **Relationships** wherever possible. This can be achieved by, for example, entrusting small teams with shared responsibilities, trusting that the process is shaped to the best of the teams’ abilities. These teams will have to be held accountable for their decisions by their peers. This creates room for professional ethics and the maintenance or rebuilding of high trust within the organization and between organizations and their stakeholders. Within actual bureaucracies and markets professionals should therefore be freed or protected from the shackles of a rule-based hierarchy or the tyranny of cost efficiency.

#### **An application in the European context**

As should be clear from the above discussion, the political debate on governance is ongoing and democratically elected representatives should consider it their core business to think and rethink these issues constantly. An issue that clearly is and will be on the table in Europe for some time to come is the financial sector. Since the collapse of Lehman Brothers in 2007, the world has seen a financial meltdown of epic proportions. Billions of euros and dollars have evaporated and taxpayers all over Europe have been forced to foot the bill and rescue a sector they had no real control over. As this is being written, Europe is still suffering from the fall-out of this meltdown and the impact of the crisis has brought the Euro to the brink of collapse. After the Independent Commission on Banking under Sir John Vickers in the United Kingdom produced its report and Paul Volcker proposed the Dodd–Frank Wall Street Reform and Consumer Protection Act in the United States, Europe installed the European Commission’s

High-level Expert Group on Bank Structural Reform under chairman Liikanen. With that commission the European Commission opened the discussion on a key governance issue. The Commission stated in its mandate: ‘The Group is therefore requested to consider in depth whether there is a need for structural reforms of the EU banking sector or not and to make any relevant proposals as appropriate, with the objective of establishing a safe, stable and efficient banking system serving the needs of citizens, the EU economy and the internal market.’ From this quote it is clear that the Commission considers safety and stability at par with efficiency and requests the Group to explicitly consider structural reforms.

**‘The financial sector has operated under a governance regime in which both market discipline and democratic control have clearly failed and relationships played virtually no role’**

The Liikanen-group presented its report to Commissioner Barnier on 1st October 2012. In it they concluded that structural reforms, that is changing the governance structure in the financial sector in addition to imposing the new rules and regulations of the Basel III and EU-directives, are not necessary. The only structural reform Liikanen proposed (not unanimously) was that very large banks with a lot of proprietary trading should effectively ring-fence their trading books. What can we say about this conclusion specifically and the governance issue of this sector in general, using our analytical framework?<sup>47</sup>

The first question in the previously presented flow chart is: Is this a governance issue? The answer to that is a resounding yes. The sector has operated under a governance regime in which both market discipline and democratic control have clearly

failed and relationships played virtually no role. The second question is more complex. What do we want to accomplish? The Commission in its mandate to the Group has explicitly formulated its goal as a ‘stable, safe and efficient banking system’. But although this already limits our focus on banking, this is not specific enough for our purpose, as we know that requiring safety and efficiency will create a tension between the most appropriate governance principles. A market solution may deliver efficient outcomes, but is inherently less safe. Regulation and bureaucratic interventions can create safety, but inherently reduce efficiency. This trade-off, however, is not inevitable. We should realize that these criteria are not equally important in all functions of the banking system. Any banking textbook (e.g. Freixas and Rochet, 1997) distinguishes roughly 5 basic functions of banks. These include: [1] Providing a safe store of value that can [2] Serve as a medium of exchange. Furthermore, banks [3] Inter-mediate between savers and investors, [4] Facilitate liquidity transformation, and [5] Manage and pool risks. Some of these banking functions clearly require safety and stability, whereas in others efficiency is more important.

Offering savings and deposit accounts to private households and firms basically performs the first two functions. These households can use such deposit balances to make payments and settle debt amongst each other and to store their wealth in liquid form. These functions have strong public good characteristics. It is because private households and the government accept payment via these deposits that they can function as medium of exchange and that using bank deposits has strong positive network externalities. The system is more efficient when more people use it. Also, there are obvious economies of scale and the payment system is a natural monopoly (there is only one system) even if more banks provide this service. It is cheaper to administer a single system of accounts and manage transactions in a single, integrated system. Such a system is established when banks allow for transfers from one deposit to another. Banks and the European Union have worked hard to establish and improve such a system of payment across the

European Union. We should realize, however, that by using deposits at private banks this system is inevitably prone to instability. If an individual bank is hit by a shock, the impacts of it going into default may ripple throughout the system, simply because the trust in private banks is key for private bank debt to be acceptable as medium of exchange. Only a fraction of deposits is held in reserves at the central bank and any bank would currently collapse if that trust were to drop for whatever reason. To prevent such classic bank runs a system of deposit insurance has been put in place, where, under a long list of conditions, deposits at private banks, that is, private bank debt, is implicitly or explicitly publicly insured and guaranteed. This clearly signifies that security in these functions is of paramount importance. In fact it is clear that access to a safe deposit account is one of the basic necessities of modern

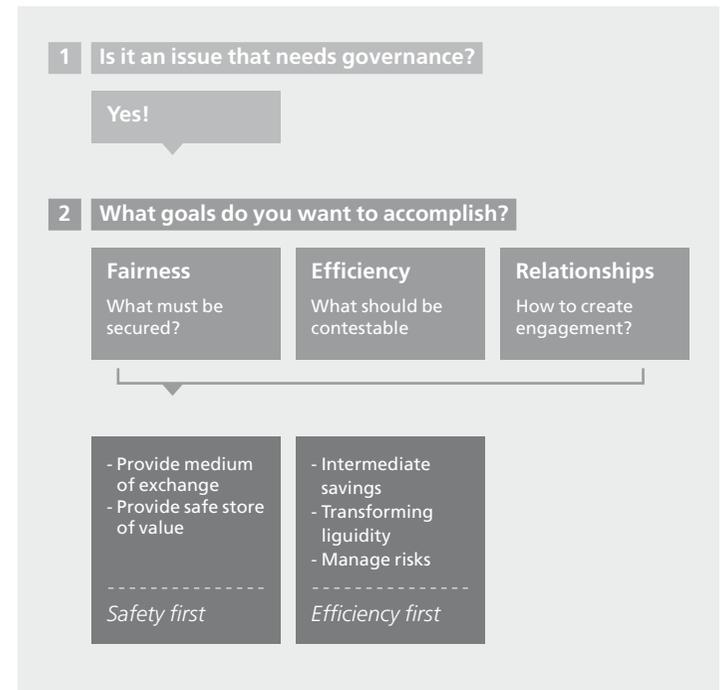


figure 6 – Flowchart for European banking (1)

life. In our flow chart on these two functions we should thus answer: security and access first and foremost, efficiency is a distant second and engagement is immaterial.



figure7 – Flowchart for European banking (2)

This is quite different, however, for functions 3, 4 and 5. Investment is a key driver of economic growth and we cannot afford to misallocate savings in the economy. As savings are in short supply, they should be invested in the most promising, least risky projects with the highest returns. Banks historically and presently play a key role in channelling the available savings in the economy to such projects, especially in continental Europe. By bundling savings, borrowing short to lend out long, diversifying risks and monitoring projects on behalf of the investors the banking system creates value for the European economy. And it is obvious that first and foremost these functions should be performed efficiently. Nobody is entitled to a loan and the bank should only give one if it feels the lender can repay the loan and will invest it in a project that generates a return to compensate for the risk. That is, banks should not be pressured or tempted (by strong personal relationships) or forced (by rules and regulations) to make bad loans and waste scarce and valuable resources on projects that cannot compete in the market place. In the flow chart for these functions we should therefore answer: efficiency first and foremost, engagement is a distant second (as explained below) and fairness is not a big issue.

Given what we have argued about the strengths and weaknesses of **Markets**, **Bureaucracies** and **Relationships** we should therefore consider securing the basic public financial infrastructure by bureaucratic principles but organize a free and contestable market for intermediation, liquidity transformation and risk management. In the last three functions we should also think about (re)establishing relationships between lender and borrower, between banker and client, as **Relationships** through engagement and the resulting high trust will reduce moral hazard and transaction costs on both sides of the loan.

We should turn to actual implementation and actors only after establishing the theoretically ideal optimal mix of governance principles per function. In Arrow 4 of the flow chart we ask: who should do what? In this case many answers are possible,

ranging from fully nationalizing the payments and deposit function (e.g. by allowing everyone to make deposits with the tax authorities or using a government-owned postal service for the safe storage of value and making transactions) to keeping the current system but establishing very strict bureaucratic controls and regulations to safeguard the first two basic functions. The Chicago Plan (Benes and Kumhof, 2012) of full reserve banking was suggested as a way of doing the latter. In that plan private banks still offer deposits to private households and these households use them as store of value and medium of exchange. The reserve fraction, however, is brought to 100%, implying that the deposits are as safe as the government's ability to create money on demand. Alternatively, a wide variety of deposit insurance schemes have been discussed and proposed in the literature.<sup>48</sup> The key concern in these discussions is typically the moral hazard such insurance entails on behalf of the depositors. But although this is a real concern that should be addressed, we would argue that this should never be a reason to abandon the quest for solutions that offer security first.

## 'Relationships can help reduce the problem of moral hazard and related monitoring costs by building trust'

Our framework also suggests that private, profit oriented banks should continue to provide credit to the economy. Intermediation and liquidity transformation, however, should involve banks financing their loan portfolio with loans, not deposits held for making transactions. The bank's business model is then effectively reduced to borrowing cheap (and short), lending out expensive (and long) and monitoring loans on behalf of the financiers. This activity can be subject to market discipline. Banks performing well will be able to borrow cheap and ample funds and select projects with favourable risk-return profiles, creating social value and private profits for

the stockholders. Banks performing badly will suffer losses, pay increasing risk premiums and eventually fail if stock- and bondholders do not intervene. The performance criteria are pretty unambiguous and Adam Smith's invisible hand should automatically allocate the available savings to the best projects in the economy through such a banking system. Banks can exit and enter this market relatively easily, especially if we ensure that banks do not become too interconnected by settling all interbank lending through a clearinghouse at the possibly public central bank.

In addition to creating a truly contestable market for intermediation, transformation and risk management, we should also consider the possible beneficial effects of **Relationships**. **Relationships** can help reduce the problem of moral hazard and related monitoring costs by building trust. Traditionally the banking literature focuses a lot on moral hazard on behalf of the borrower. Arguably, however, securitization, bonuses, job rotation and semi-automated expert systems have created a distance between the banker and the client, creating moral hazard on behalf of the lender (the banker) as well. The resulting loss of trust has increased monitoring costs and created a deadweight efficiency loss that partially offsets any gains in allocative efficiency. The intentional breaking up of bank(er)-client relationships has perhaps made the intermediation, liquidity transformation and risk management more rational, 'professional' and efficient but at the same time caused bankers to slip on the confidence ladder from the most trusted (up with doctors, teachers and judges) to the least trusted professionals (about equal to politicians and marketers). Arguably these trends have eroded professional ethics and pushed these important economic functions from a high trust to a low trust market. Abandoning bonuses and forcing originators to keep a significant portion of their loans on their own balance sheet to maturity can significantly align incentives at the organizational and individual level with those of the customers and investors.

Of course, as always, the devil is in the details and a lot more can be said about this issue and the many other governance

issues politicians face on a daily basis. Our framework does not provide a single and unambiguous answer to such questions and taking all the steps in the flow chart will prove to be hard work in practice. We do hope, however, that our framework will help politicians to ask the right questions in the correct order, not lose sight of their own priorities and help to distinguish between the many technical details and the more fundamental political choices involved.

## Conclusions

Governance issues are key in any society, and therefore at the heart of politics. The current economic and financial crisis is a hard lesson, teaching us that if a society does not get its governance institutions right, things can go horribly wrong. However, governance is a notoriously complex issue, with arrangements that differ across levels of analyses, and that are different from one sphere of life to the other. Moreover, the answer to the question of what an 'optimal' governance arrangement should look like is inextricably bound up with cultural and ideological issues. What is regarded to be the 'optimal' governance system for, say, the banking sector in the US might deviate quite a bit from the dominant opinion in Sweden. Similarly, a socialist view is unlikely to be in agreement with a liberal one.

In this essay, we have presented an analytical framework that is meant to facilitate systematic thinking about governance issues from a liberal-democratic perspective. More than trying to find a definitive answer, our analysis is intended to help politicians and policymakers to ask the right questions, to identify the critical tradeoffs, and to structure the debate. The reasons for not providing a definite answer are fundamental: a universal solution for all governance issues simply does not exist and simply cannot exist. What is 'optimal' today, may no longer be optimal tomorrow; what works well in sector X, may produce disaster in sector Y; what may be acceptable in country A, may be out of order in Country B. And even more fundamental: any governance arrangement will involve tradeoffs, with positive impact on criterion *I* (say, efficiency) generating collateral damage in the area of criterion *J* (e.g., fairness). The main challenge for policymakers is to weigh all these considerations in order to determine the arrangement that best fits our common interest.

Our analytical framework distinguishes three ideal-typical governance principles: **Relationships**, **Bureaucracies** and **Markets**. We systematically evaluate their respective strengths and weaknesses, applying insights from a variety of modern social sciences, including economics, psychology and sociology. We argue that **Relationships** may generate *efficiency* and *fairness* in a natural way, and may foster *cohesion* among those involved to help infuse high trust in and between firms, governments and people. **Relationships** can function well when those involved have voice and the positive freedom to *engage* (and the negative freedom to *disengage*). They are likely to fail, however, when power is asymmetric, when dependencies become one-sided, when the system becomes exclusive or arbitrary, or when governance simply needs to be scaled up. Governance at a large scale implies that personal interaction inevitably takes the form of anonymous *transaction* (rather than *interaction*). Under those circumstances, **Bureaucracies** and **Markets** offer complementary governance principles. On the one hand, **Bureaucracies**, as a principle with enforceable rights and obligations based on administrative information, are best suited to providing equal access and basic *security* and so ensuring *fairness* and justice in a system. Of course, this requires an authority in the hierarchy that is legitimized by open and *contestable* democratic debate. On the other hand, **Markets**, with their voluntary transactions based on prices and quality information, are associated with competitive processes that foster dynamic *efficiency* in which the best possible solutions are selected and realized at the lowest possible costs. Again, this outcome can only be expected when markets are kept open and *contestable*, and a level playing field is ensured and actively maintained.

In our analytical framework, the actual choice for one or the other of these *principles*, or a well-balanced mix of them, should always follow from a careful analysis of the case at hand, benchmarked against the priorities that are given to the criteria of *fairness*, *efficiency* and *cohesion*. **Relationships**, **Markets** and **Bureaucracies** in their pure forms, however, will rarely – if ever – deliver a workable governance structure

because a balance between *fairness*, *efficiency* and *cohesion* has to be realized by blending minimum *security*, optimum *contestability* and maximum *engagement* – quite the balancing act indeed. Key to our argument is that the three governance principles are not dogmatically or ideologically ranked in any way because they are means toward an end, and not ends in and of themselves. This implies that the means should not be ideologically laden. The ideology comes through the ends, the priorities set in the *efficiency*, *fairness* and *cohesion* triangle, not the means. From a liberal-democratic perspective, the ultimate end is to ensure the long-term quality of life for as many people as possible, and to do so in a sustainable way, providing maximum positive freedom to all as the default.

With this end in mind, after a careful analysis of the to-be-governed case at hand, the desirable governance principle or mix of principles should be designed. Sometimes, efficiency takes centre stage, implying the need for a governance regime dominated by contestable **Markets** (e.g., food retailing). In another cases, fairness is key, suggesting that governance must be organized primarily through democratically challenged **Bureaucracies** (e.g., social security). Often, though, different purposes have to be served simultaneously, requiring a subtle balance of efficiency and fairness (e.g., health care), and hence an intricate mixture of **Markets** and **Bureaucracies** without either dominating the other. And always, care should be taken that **Relationships** are not destroyed in the process, which would produce collateral damage by undermining cohesion and trust. The bottom line is that a careful case-by-case analysis is needed, leading to tailor-made governance arrangements.

Implementing a specific mix of governance principles is anything but easy, however. A sharp analysis of which governance *actors* will and can take what responsibilities under what type of governance regime is needed. First of all, a single organization bringing all *principles* together will rarely be optimal. A governance system must therefore blend actors appropriately. Second, the general rule is that actors should stay as close as possible to their ‘natural’ governing principle. Commercial

enterprises perform best under contestable market conditions, civil servants must apply transparent and democratically legitimized rules and regulations, with the default that people have to be allowed to find their own solutions and make their own mistakes. Third, and related to the first two points, the creation of hybrid organizations should be avoided, as these tend to ultimately escape market discipline (vigilant owners), democratic accountability (vigilant politicians) and the voice of those involved (vigilant people), and rather turn into entities that will act on their own behalf and in their own interest without answering to anyone. A public office that is inherited or given to a friend, a profit-driven firm that enjoys public guarantees or a legally protected monopolist that is free to maximize profitability do not deliver socially desirable outcomes from a liberal-democratic perspective. In making the step from governance *principles* to governing *actors*, the default is to decide on a mix of non-hybrid actors to achieve the appropriate blend at the *system* level. And finally, the theoretically preferred actor might be unable to generate the desired outcomes in the real world; for example, a public agency might not be functioning very well in practice, or people themselves are unable to work together to solve an issue. That is, in the real world, both governance principles and actors might succeed as well as fail.

We conclude by stating that not all politics is governance, but all governance should be politics. It is issues like the governance of health and elderly care, of the banking system and of many welfare state arrangements that will continue to constitute the core of the political debates that liberal-democrats should engage in. The 20th century saw major catastrophes emerging from ideologically infused utopian attempts at overhauling governance. Socialist experiments with bureaucracies and neo-liberal experiments with unfettered markets have failed; not because these governance principles cannot function properly, but because their weaknesses were ignored and they were applied dogmatically without regard for sustainably balancing social goals. A piecemeal approach to a more rationally designed, democratically legitimized governance struc-

ture will bring a more sustainable, *efficient, fair* and socially *cohesive* Europe in the 21st century. Liberal-democrats owe it to their political ancestry to champion such an approach, and we hope that the analytical framework developed in this essay will help them do so.

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- 1 Karl Popper, especially in his *The Open Society and Its Enemies* (1945), advocates a pluralistic approach that leaves space for trial and error, rejecting all-encompassing monolithic theories.
- 2 Liberals come in many different shapes and forms. For instance, they may add 'classic', 'conservative', 'neo' or 'social' before the 'liberal' label. In this essay, we use 'liberal-democratic' as it is a commonly used label for liberals in the European political context.
- 3 Even though we attempt to offer a theoretical-analytical account, this essay has no scientific pretensions. To this end, this essay favors accessibility and applicability over profoundness and completeness. Footnoting and referencing is therefore kept to a minimum (albeit perhaps still too extensive).
- 4 We decided to print this set of three ideal-typical governance principles in demi-bold, to avoid confusion with their common-sense meaning, as we will explain below in more detail.
- 5 In the literature, different terms have been suggested, especially for what we refer to as **Relationships** in this essay. A more traditional term is **Clans** (e.g., Ouchi (1980)), and its more modern equivalent is **Networks** (e.g., Rhodes, 1996). Some have also distinguished institutionalized interactions, such as religious practices in churches, from their informal counterparts (e.g., Ouchi, 1980). The latter governance principle, however, seems less relevant for our purposes as this principle is impossible to implement by design.
- 6 Jared Diamond (1997), for example, puts the upper limit for this type of governance (in our terms, **Relationships**) at a few hundred individuals. Human civilization has developed from hunter-gathering groups of about this size to *tribes*, *chiefdoms* and ultimately to *nation-states* and *empires*. Diamond offers much evidence to support his thesis that **Bureaucracies** and **Markets** emerged more or less as societies grew larger and more complex as institutional arrangements

- to settle the inevitable conflicts of interest. Graebner (2011) offers a compelling narrative of how the rise of **Bureaucracies** was essential and instrumental in the coevolution of **Markets**, finance and money.
- 7 Of course, just as liberals do, corporatists and socialists also come in many different forms and shapes. Inevitably, in a short essay such as ours, we cannot do justice to the many subtle nuances that circulate in the literature and in the political arena, but rather revert to straw-men. To signal this, we use quotation marks here.
- 8 Transactions are different from interactions. For instance, a school-teacher interacts with her or his pupils to teach them that  $1 + 1 = 2$  without involving in any transaction with these pupils. We will return to this issue below.
- 9 Terms suggested in the literature include markets, hierarchies and clans (Ouchi, 1980) or networks (Rhodes, 1996). Others focus on the associated key control mechanisms such as prices, authority and trust (Braddach and Eccles, 1989).
- 10 In the literature, **Bureaucracies** are often referred to as hierarchies.
- 11 Ouchi (1980) refers to 'Clans', suggesting that blood ties are as important as they have been historically. Rhodes (1996) discusses the more modern 'Networks', which suggests that ties can be very weak indeed. We prefer the notion of 'Relationships', because we believe that this term best captures the essence of such governance structures. It is personal ties, along with reciprocity, trust and reputation, which govern interactions among people in the absence of enforcement and prices.
- 12 When we refer to 'governments' we mean all public agencies employing civil servants. The term 'firms' refers to profit driven enterprises or consumers and 'people' refers to individuals and organizations in self-organized social networks.

- 13 This is our own interpretation of the definition of sustainability from the Brundtland report (UN 1987), combined with the utilitarian concept of societal welfare.
- 14 Depending on the political culture and history, this current can also be described as left liberal or liberal democrat, *freisinnig* in Germanic countries, or *radical* in Latin countries. It is not our aim to discuss the proper name for this current, if any could be chosen as such.
- 15 Again, different names are possible for this current, including right-wing liberals, utilitarian liberals, conservative liberals or (interestingly enough) neo-liberals.
- 16 Whatever we take as our preferred mix of criteria and principles for governance, we need to respect ecological boundaries. This criterion applies to any governance arrangement. We do not further address the ecological and physical boundaries in this paper, not because we feel they are irrelevant, but because they do not link directly to the issue at hand, which is to select and design 'proper' governance institutions. Whether you govern by **Relationships**, **Bureaucracies** or **Markets**, governance should always respect ecological boundaries or it is doomed to be unsustainable in the long run anyway. Staying within ecological boundaries is therefore not a choice, in our view, but a constraint that cannot be ignored. In contrast, opting for more **Bureaucracies** over **Markets** or **Relationships** is a choice. That is, opting for an ecologically unsustainable governance arrangement can never be the 'proper' choice from a liberal-democratic perspective, but deciding for one that stimulates, say, efficiency at the expense of fairness can, depending upon the specific issue at hand.
- 17 Economic efficiency should be interpreted in a broad sense. It should not only relate to lower costs (so-called static efficiency), but also to innovation (dynamic efficiency). In that sense, efficient means that no valuable possibilities and resources should be wasted or under-utilized.
- 18 The concept of fairness is used here in a rather general and intuitive sense. For a more detailed account, please consult, for instance, Rawls (1999) and Sen (2009), one of Rawls' main critics.

- 19 Such spontaneous governance structures have been described by Nobel laureate Elinor Ostrom, among others. For example, Jared Diamond (1997) explains why such **Relationships**-based governance structures cannot easily be established and sustained in groups beyond 300 to 400 individuals. Beyond that number, the probability of one-time encounters with people who are more than one hand-shake away will increase exponentially, and spontaneous governance quickly weakens. Diamond (1997) argues that, for that reason, hierarchies, states and other **Bureaucracies** emerged first to subsequently allow the emergence of even more anonymous **Markets** to manage human interaction. Fukuyama (2011) also describes how out of gradually expanding clans and tribes, blood ties and reciprocity gave way to **Bureaucracies** and, much later, **Markets**, which emerged as systems that allowed rulers to muster, mobilize and allocate resources effectively (e.g., for conquest and defence) and efficiently. Nonetheless, spontaneous governance is still prevalent in many important aspects of modern civilization. In families, at school or on the work floor, **Relationships** matter a lot, and play a decisive role in governance.
- 20 In this sense, Adam Smith (1776) speaks about 'basic necessities' and Amartya Sen (2009) refers to 'capacities' that everyone should possess to be able to function well in society. Smith states: *'By necessities I understand not only the commodities which are indispensably necessary for the support of life, but what ever the custom of the country renders it indecent for creditable people, even the lowest order, to be without. (...) Custom (...) has rendered leather shoes a necessary of life in England. The poorest creditable person of either sex would be ashamed to appear in public without them.'* Even in Adam Smith's time, therefore, basic social security and fairness ensured more than the primary material needs.
- 21 See, *inter alia*, an article by van Witteloostuijn (2008a) in *Idee*, the political-scientific magazine of the Mr. Hans van Mierlo Stichting.
- 22 The optimal mix between fairness, contestability and engagement is also partially culturally determined. Some things that are considered fair and contestable in the United States, for instance, may lead to significant frictions in large parts of Europe, and the other way around.

- This implies that we can learn from practices abroad, but always have to carefully consider local circumstances.
- 23 This question implies a pragmatic approach, which fits with the open character of the liberal-democratic political philosophy. Generally speaking, dogmas are likely to frustrate rather than enhance progress.
- 24 The Mr. Hans van Mierlo Stichting will publish a more extensive analysis of the role and position of the governance principle of **Relationships** in social-liberal thinking (expected publication date: Spring 2013).
- 25 The work of Eleonor Ostrom aims at analyzing the conditions under which communities are able to successfully cooperate to provide public goods (see, for example, her book *Governing the Commons*, 1990). A detailed analysis of the conditions under which such self-regulation, what we have labeled **Relationships** here, should be preferred over **Bureaucracies** and **Markets** lies beyond the scope of this essay (see Lindenberg, 2008 and 2010).
- 26 See: <http://www.collective-action.info>
- 27 See the essay 'Rely on people's own strength', published by the Mr. Hans van Mierlo Stichting (2009).
- 28 Hirschman (1970) extensively discusses how 'loyalty' – as a result of personal interaction via relationships – shifts the balance from 'exit' to 'voice' as a mechanism to govern exchange in organizations.
- 29 Evolutionary game theory (e.g., Axelrod and Hamilton, 1981) shows that an efficient strategy will result in higher reproduction (and an inefficient strategy in lower reproduction) and ultimately dominance of that strategy.
- 30 Note that what we consider fair today is not necessarily what is considered fair in all societies and times. Binmore (2009, 2011) has shown that there is no absolute standard of fairness, other than that all involved need to more or less consider the allocation process and its outcomes as 'fair'. Binmore would, for example, argue that

women in Afghanistan are treated ‘fairly’ if both women and men in Afghanistan, when behind Rawls’ ‘veil of ignorance’, would consider such treatment fair. An illustration is the often-voiced complaint that it is not men but rather other women that put most pressure on young women to conform to society’s norms on gender roles.

- 31 Indeed, much greater store than the appreciation of managers that comes in the form of bonuses, targets and promotions.
- 32 This form of governance is similar to that organized through the medieval guilds. Of course, one should always be vigilant as guild-like structures can easily turn into groups of insiders that use their power to keep vested interests protected and outsiders out. Towards the end of the middle ages, the guilds were not particularly contestable; but earlier on, they played an important role in developing more dynamic urban economies by setting standards and creating a clear avenue for upward social mobility.
- 33 In economic science, the neoclassical equilibrium with perfect competition serves as an ideal-typical benchmark that is never presented as a realistic description of existing markets or as a policy objective. Even the *homo economicus* is not omnipresent in neoclassical mainstream economics. Nobel laureate Gary Becker, especially, has stretched this concept to its extremes (e.g., Becker, 1976) by applying the rational decision-making apparatus to such topics as investing in education, selecting a spouse and choosing the optimal number of children. But his models were never intended as descriptions of real individuals’ behavior. Rather, they are meant as mental constructs and ideal-typical benchmarks.
- 34 See Thaler and Sunstein (2009).
- 35 For this reason, one must be extremely reluctant to grant public guarantees and protection to private organizations. Such protection almost inevitably leads to inefficiency and unfairness. Security must be provided at the level of individuals and the system, not by protecting positions inside organizations or organizations themselves, either in the private or in the public sector. Contestability is always and everywhere a key concern.

- 36 See, for example, Acemoglu en Robinson (2006) and van Witteloostuijn (1999, 2007).
- 37 To emphasize this point, again, when we put **Bureaucracies** in contrast with **Markets**, we are talking about the governance principles, and not about the actors. Also, the democratically legitimized legislative and judicial government is explicitly outside the realm of **Bureaucracies**.
- 38 Rawls came to this criterion for justice and fairness by proposing the famous thought experiment of the ‘veil of ignorance’, where a societal order is deemed just if somebody ignorant of his later place in that society would design it in that way. Binmore (2011) criticized Rawls for not realizing that even behind the veil of ignorance cultural and societal norms and values do not disappear. But he criticized the metaphysicists and moral philosophers even more for not realizing that such norms and values will emerge spontaneously in society as the result of empathy and repeated interaction.
- 39 It is important to bear in mind that **Bureaucracies** can only function effectively when the issue under scrutiny also spans the real sphere of control or jurisdiction. A national government, e.g., is not effective in supervising worldwide financial markets. **Bureaucracies** should be organized and legitimized at the level at which the issue is relevant. This is however not always possible, as the climate change issue continues to illustrate. The only viable option then seems to be to turn to unregulated **Markets**, here and there complemented by arduous forms of governmental coordination and self-regulation (Ostrom, 1990). As we have argued above, however, **Markets** require quite a number of enforceable rules and regulations to be efficient. In the absence of adequate supervision, only a relatively limited set of products and services can actually be exchanged efficiently through **Markets**.
- 40 Where Montesqueu’s *trias politica* separated the legislative, executive and judicial powers of the state, we distinguish between those that set the rules legitimately (politicians), those that execute the rules (bureaucrats), and those that see to it that this is done as was intended (controllers). This implies that our ‘trias’ can also apply to

**Bureaucracies** other than the state (such as corporations, cooperatives and social organizations).

- 41 Socialists and social-democrats will speak for vulnerable and oppressed groups, Christian-democrats claim moral or divine authority, greens represent the planet, populists will speak on behalf of 'the people', and technocrats will present their arguments as undeniable scientific truths. A liberal should question authority of all kinds, and defend the individual right to freedom in the pursuit of happiness and the good life.
- 42 This is not to say that civil servants should not treat the citizen with respect, but one should not expect the same reaction in return as under **Relationships** or a willingness to pay for service as in **Markets**.
- 43 See Megginson and Netter (2001) for an overview of privatization policies all over the world.
- 44 *New public management* proposed this idea. In the governance literature, a lot can be found on modern management practice and explanations for why the introduction of such market principles often lead to counterproductive outcomes (Van Witteloostuijn, 2011). Often this is related to the eroding effect of **Markets** on mechanisms related to **Relationships** and the effects on perceived fairness that were secured in the **Bureaucracies** they replaced.
- 45 E.g., Coleman (1990).
- 46 Ahrend (1963) described convincingly where such behaviour might lead in its extreme.
- 47 This analysis of the financial sector does not (necessarily) reflect the opinion of ELF or its member organisations. This example mainly serves to illustrate the analytical framework as presented in this essay
- 48 Google Scholar returned over 100.000 hits on 'deposit insurance'. Chan et al. (2012), for instance, analyse whether fairly priced deposit insurance can be provided in a deregulated private market and show that this is not possible.

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# Governing Governing

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