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Hayek, Leoni, and Law as the Fifth Factor of Production

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Abstract This paper discusses the nature of law as the fifth factor of production, or more fundamentally as the institutional framework within which the production process takes place. Unlike land, labor, capital, and entrepreneurship, whose coordination is an outcome of institutional arrangements, the law itself is the institutional embodiment of the voluntary exchange processes evolving from the decisions, but not the design, of judges that form the reliable expectations about who "plans" the coordination of the other four factors of production. The legal theory of Hayek and Leoni lends itself to this dual nature of spontaneous order analysis and also the basis of the burgeoning literature on analytical anarchism. Although Hayek and Leoni were not legal centralists, their conception of law as part of a larger spontaneous order was open-ended to competition and experimentation on the constitutional level of rules just as that experienced on the post-constitutional level of the market itself.

Keywords Legal institutions · Developmental state · Comparative economic systems

JEL K4 · O12 · P51

Introduction

What it is the role of law in a free society? Both F.A. Hayek and Bruno Leoni were among the leading classical liberal theorists who recognized that the rise of socialism and central planning in the twentieth century coincided with an erosion of the rule of law. Following Hayek, Leoni understood that liberty and prosperity depended upon a legal framework that provided both fixity and predictability necessary for individuals to realize the gains from trade and innovation. Economists who have sat in the seat of Adam Smith have long recognized that property, prices, and profit and loss are the key institutional components of a market economy. Within such an institutional context, entrepreneurs are able to exploit pure profit opportunities by coordinating land, labor, and capital into valuable goods and services. Among Leoni and Hayek, other classical

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liberal theorists, such as Nobel Laureate James Buchanan, recognized a dual analysis of the market, one on the constitutional level of the rules of the game, of which law is paramount, and another on the post-constitutional level within which entrepreneurs act on profit opportunities as players of the game within a given set of legal rules. The motivation of entrepreneurs to utilize land, labor and capital to truck, barter, and exchange rather than rape, pillage, and plunder depends on the institutional incentives of the law.

This paper discusses the nature of law as the fifth factor of production, or more fundamentally as the institutional framework within which the production process takes place. Unlike land, labor, capital, and entrepreneurship, whose coordination is an outcome of post constitutional arrangements, the law itself is the institutional embodiment of the voluntary exchange processes evolving from the decisions, but not the design, of judges that form the reliable expectations about who "plans" the coordination of the other four factors of production.

Hayek and Leoni recognized that an alternate conception of law as those commands which emanate from legislatures was positively related with the growth of socialism and central planning. They both recognized, in the words of economist P. T. Bauer (2000: 27), the "need to restate the obvious" in order to forestall a greater centralization of the law by statutory legislation and administrative decree. This is not to say that Hayek and Leoni were not legal centralists. However, their conception of law as part of a larger spontaneous order was open-ended to competition and experimentation on the constitutional level of rules just as that experienced on the post-constitutional level of the market itself. To intervene in the invisible hand of judge-made law with legislation displaces law as the institutional framework into the voluntary production process and places it as a post-constitutional coercive mean to effect ad hoc the ends of legislators and administrators on the level of the game.

The Basic Analytics of Economic Progress

In the opening of *The Wealth of Nations*, Adam Smith recognized that "the greatest improvement in the productive powers of labour, and the greater part of the skill, dexterity, and judgment with which is any where directed, or applied, seemed to have been the effects of the division of labour" (Smith 1981: 13). Since at least the days of Adam Smith, economists have debated why certain societies have grown rich while others have remained stagnant and poor. Increases in total factor productivity are produced by entrepreneurs, who drive the market process toward more efficient outcomes and play a central role in the "creative destruction" of technological progress.

Certain institutional frameworks encourage the spontaneous order of the market economy, as well as its entrepreneurial drive towards economic growth, while others erect barriers to growth and pervert the incentives of entrepreneurs towards rent-seeking and predation. Institutions, such as the rule of law, private property rights and free trade ensure the emergence of a spontaneous order, in which entrepreneurs are driven by consumer preferences and encouraged to invest in enterprises that spur innovation and create wealth.

According to Kirzner (1973: 48), entrepreneurship refers to the process of individuals acting upon previously unnoticed profit opportunities. Through purposeful actions

of entrepreneurs, economic resources and knowledge, which are dispersed in particular to time and place, are coordinated through the incentives of the price system. However, how entrepreneurs coordinate economic knowledge and resources depends heavily on the institutional framework, or the rules of the game, that happen to prevail in the economy. According to Douglass C. North, institutions refer to the humanly devised constraints that shape human interaction. Institutions affect the performance of an economy by structuring the costs of human exchange and production. Thus, how entrepreneurship manifests itself in an economy depends largely on the institutional reward structure (North 1990: 3–10).

In societies that have prospered, the basis for wealth creation has rested on the institutional framework of a free society. A free society consists of a political-legal framework in which productive entrepreneurial activity can take place and is characterized by such institutions as the rule of law, property rights, sanctity of contract, and free trade. These institutions expand peace, mutually beneficial exchange, and individual freedom. In a decentralized market economy, in which the price system reflects consumer demand, resources and "data" are coordinated by the market process, in which entrepreneurs discover profit opportunities conducive to capital investment and technological progress. Through this process, entrepreneurship effectively leads to greater productivity, higher real wages, an expansion of output, and an overall increase in human welfare.

In societies that have stagnated and remained poor, the institutional framework has erected barriers to economic growth, driving entrepreneurship towards profit opportunities in the form of predation and rent-seeking. An institutional environment that is interventionist and arbitrary in nature undermines the spontaneous order and complex impersonal exchange essential to a free market economy. A political-legal environment lacking stability and certainty drives entrepreneurial activity towards profit opportunities that are politicized in nature. Successful entrepreneurs within such a context are encouraged to discover profit opportunities that capture political influence and privileged access to the factors of production. As a result, entrepreneurs drive the market process toward unproductive and inefficient economic outcomes, enriching themselves at the expense of the society in which they operate.

The prosperity or stagnation of societies rests on the allocation of entrepreneurship (Baumol 1990). The institutions that constrain human behavior within a particular society largely influence how entrepreneurial activity will be allocated and the nature of their purpose, which may be productive or unproductive in result. In prosperous societies, in which private property rights, the rule of law, and free trade have prevailed, entrepreneurship has been driven by consumer preferences and led the market process to more efficient outcomes, leading to economic growth. Poor and stagnating societies are characterized by institutions that are interventionist and arbitrary, leading to the politicization of entrepreneurial activity. Such an environment encourages rent-seeking and predation and discourages innovation, capital investment, and economic growth.

What Smith also recognized was that the productive or unproductive nature of the entrepreneur in coordinating land, labor, and capital depends on such entrepreneurial activity being fixed and realized "in some particular subject or vendible commodity, which lasts for some time after that labour is past" (Smith 1981: 330). What Smith meant to say is open to interpretation, but what we may infer from this quote that is consistent with Smith's understanding of the market order is that the manner in which

entrepreneurship manifests itself is institutionally contingent (see also De Soto 2000: 39–67).

Max Weber also observed that economic development was contingent on the legal framework of a society. Although he is best remembered for attributing the rise of capitalism to the Protestant work ethic, his observation for why capitalism developed first in the West rather than China was based on a comparative legal-historical analysis, from which he concluded that "the Western legal tradition relied on a logical mode of juristic reasoning, instead of the discretionary, ritualistic, religious, or magical considerations often found in alternative legal traditions." Protestantism "provided the ethical or moral justification for practices conducive to economic development; it was not the source of development" (Boettke 2001: 240). A clear distinction must be made between analyzing the proximate causes of economic development, such as the accumulation of capital and productive entrepreneurship, and analyzing the fundamental cause of economic development, such as the institutional framework of private property under the rule of law (Acemoglu 2008: 21).

The source of economic development rests on a fifth factor of production, the law, which provides the framework for the coordination of the other factors of production by entrepreneurial human action according to their foresight about future profit opportunities. Unlike the other factors of production, which are proximate causes of economic growth and depend on the given institutional framework, the law itself represents the constitutional framework of the production process, or the institutional embodiment of individual expectations about how the land, labor, capital, and entrepreneurship is fixed and realized within the market process. In rich countries, the law provides entrepreneurs with reliable expectations to truck, barter, and exchange their land, labor, and capital without fear of being expropriated by other individuals or the state. It is this notion of the law that Hayek and Leoni stressed as the cornerstone of liberty; a society in which liberty is paramount establishes a framework of rules that provide a degree of fixity and certainty so that individuals coordinate their actions amid the flux of their own competing ends among "the throng of economic possibilities that one can only dimly perceive" (Mises 2008: 117) over an uncertain economic horizon.

The Hayek-Leoni Analysis of the Law as Evolutionary Process

Friedrich Hayek and Bruno Leoni were the leading legal theorists of the 20th century to revive the idea of the law as discovered through invisible hand processes. Precisely when intellectuals were corrupted by the fatal conceit that such institutions could be consciously reconstructed and controlled, they recognized the Mengerian notion that the study of law, like any other social institutions, begins with "the discovery that there exists orderly structures which are the product of the actions of many men but are not the result of human design" (Hayek 1973: 37). The role of the law that Menger envisioned was part of the same spontaneous order that Adam Smith envisioned for markets. Law evolved as an institutional input to coordinate the actions of individuals more effectively. Those laws that more effectively facilitate cooperation among individuals replace less effective laws, leading to institutional arrangements in which entrepreneurs more efficiently coordinate land, labor, and capital into good and services.

Hayek and Leoni embraced a notion of law that was well-known during the era of European *laissez-faire*, but was regarded as reactionary among 20th century intellectuals, who viewed socialism as being consistent and indeed complementary to the freedom that Hayek and Leoni were defending. Hayek warned in *The Road to Serfdom* that the logical conclusion of greater central planning is totalitarianism and the complete erosion of law upon which individual freedom is based. According to Hayek (1994: 90–91):

> The Rule of Law thus implies limits to the scope of legislation: it restricts it to the kind of general rules known as formal law and excludes legislation directly aimed at particular people or at enabling anybody to use the coercive power of the state for the purpose of such discrimination. It means, not that everything is regulated by law, but, on the contrary, that the coercive power of the state can be used only in cases defined in advance by the law and in such a way that it can be foreseen how it will be used.

Following the Hayekian notion of law as part of a spontaneous order, Leoni (1991) defined law as *individual claims* which "have a good probability of being satisfied by corresponding people in a given society at any given time, the reasons why they may be satisfied in each single case being variable and based alternatively or jointly on moral or technical rules." Laws that stand the test of time are those that exhibit three fundamental, but related attributes to resolve unforeseen conflicts and facilitate cooperation. These attributes include generality, equality, and certainty (Hayek 1960: 207–210). To be general, the law must be purpose-independent, or must be applicable and impartial to further instances of unforeseen conflicts of interest, each of which varies in particular circumstances. The law must not have any prior aim that results in favoring one party over another. Hayek (1973: 113) further states:

> In the ordinary sense of purpose the law is therefore not a means to any purpose, but merely a condition for the successful pursuit of most purposes. Of all multi-purpose instruments it is probably the one after language which assists the greatest variety of human purposes. It certainly has not been made for any one purpose but rather has developed because it made people who operated under it more effective in the pursuit of their purposes.

The fact that law as Hayek defines it makes individuals more effective in the pursuit of their goals bring us to the second attribute of the law, which is certainty. Laws that are certain are those known in advance and "intended for such long periods that it is impossible to know whether they will assist particular people more than others." Laws that are certain are procedural or constitutional inputs that "could be described as a kind of instrument of production, helping to predict the behavior of those with whom they most collaborate" (Hayek 1994: 81). When laws are uncertain, they lose their characteristic as the fifth factor of production. Therefore, long-term entrepreneurial forecasts become harder to make in the production process and increases the power of the government to direct the means of production to particular ends, including the direction of entrepreneurship into unproductive, rent-seeking activities.

Legislation that aims at achieving particular results is not the only means by which certainty in the law erodes. Leoni recognized that certainty of the law could also be undermined by the misleading idea that certainty means laws must be written in advance. Under this interpretation of certainty, "neither the common law nor that part of it that can be called constitutional law would be certain at all" (Leoni 1972: 72). A free-market in the law-making process requires mechanisms of adaptation, discovery and negative feedback loops, which are embodied in the common law tradition. Not recognizing that laws are also tacit and unwritten renders them incompatible as a safeguard of liberty, "but if one seeks historical confirmation of the strict connection between the free market and the free law-making process, it is sufficient to consider that the free market was at its height in the English-speaking countries when the common law was the only law of the land relating to private life and business" (Leoni 1972: 92).

The third attribute of the law defined by Hayek and Leoni is equality, requiring that all individuals be regarded as equal before the law, applying to everyone, including government officials, without making arbitrary distinctions or references among people. For Hayek (1960: 210), "the ideal of the equality of the law of equally improving the chances of yet unknown people but incompatible with benefiting or harming known persons in a predictable manner." The attributes of generality, certainty, and equality defined here reveals the relationship between law and liberty when liberty is understood as a principle that describes the conditions in which individuals are free to adapt to unforeseen circumstances in the pursuit of their own individual ends. Laws that approximate generality, certainty, and equality aid the entrepreneurial discovery process by providing the institutional incentives within which productive entrepreneurship and efficiency emerges. The efficiency of the production process can only be evaluated on the level of the rules or laws that incentivize which entrepreneurial activities are deemed efficient. More will be said about this in the next section.

While recognizing the role of constitutions and codified laws in constraining government size, Hayek and Leoni understood that such formal embodiments of law were only derived from the accumulation of precedents that had evolved and adapted to the particularities of time and place. The role of the judge in the common law tradition or the lawyer in the Ancient Roman legal tradition is the articulation and implementation of those habits and customs which contesting parties already acknowledge as established practices. From an economic standpoint, the role of the judge is to decide on the margin. On this point, Leoni states that judges "are concerned with the marginal fringe of the cases in which the conditions for the exchange of the actions are not clear, or not settled, or not agreed upon ex post facto." By referring to past precedents, "it is from that comparison that they are able to derive ultimately the *ratio decidendi*, regardless of the fact that they seem to discover it only in the precedents" (Masala 2003: 228). It is the invisible-hand process of legal formation upon which such formal codifications of law as the U.S. Constitution or the Justinian Code are based.

The Market and the Law

The previous section described the dichotomy of analysis between the level of the legal rules and market itself. By recognizing that the market and the law are different branches of application in the study of the invisible hand theorem, in this section we

will discuss the open-ended of nature of Hayek's and Leoni's political economy. Although both Hayek and Leoni were legal centralists in the sense that the state had to monopolize the enforcement of law, their view of law as discovered through a competitive process had been neglected by free-market economists who regarded the rules of the game as being given.

More importantly, within the legal theory of Hayek and Leoni study lies a latent glimpse of analytical anarchism (Boettke 2005). Analytical anarchism refers to the positive study of the origin, formation, and process of social institutions as part of a broader spontaneous order analysis. Generally speaking, it is the consistent and unwavering application of invisible hand processes to social institutions that is traced throughout the research of economists in the Austrian School dating as far back as its founder, Carl Menger, and has continued among modern Austrians (see Benson 1999; Boettke 2005; Boettke et al. 2005; Leeson 2006, 2007a, b, c, 2008).

The legal theory of Hayek and Leoni consistently applied with the invisible hand theorem also lends itself to the "public capital paradigm" suggested by James Buchanan in *Limits of Liberty*. A conception of the legal structure as a form of public capital illustrates that sustaining the rule of law requires "investment" by individuals to engage in "law abiding," which means "a generalized respect to the defined rights of all others in the community, as opposed to a particularized or directed result" (Buchanan 2000: 138). Touching on the points made by Leoni and Hayek, Buchanan states that "the very purpose of adopting laws or rules is to restrict behavior in future periods, restrictions that will, in turn, allow planning to incorporate more accurate predictions. The isolated person secures greater efficiency, he accomplishes more good for less bad, if he lays down rules for his own behavior in advance" (Buchanan 2000: 157). Just as "capital is an intricate, delicate, interweaving *structure* of capital goods" (Rothbard 1962: 836) fitted to a particular time and place, law is also an intricate, delicate interweaving structure of legal precedents based on particular historical and cultural context. This idea of law as public capital, or meta-capital if you will, lends itself to the constitutional importance of the accumulation of legal precedents for the emergence of law and the sustainment of a market economy. Arbitrary legislation on the part of the government leads to the atrophy of law, much like a stock of capital being consumed, leading to less predictability and coordination among individuals as well as a deterrence of investment and experimentation.

The question then is the following: if the law itself can emerge endogenously, much like capital formation in a market economy through the mutual adjustment of diverse individual ends, then why cannot the mechanisms for its enforcement emerge endogenously as well? Stringham and Zywicki (2011) have argued that Hayek's and Leoni's rendition of the market and the law as discovery processes is not merely a semantic coincidence in their theory. If the market requires competition in order to utilize relevant information to correct errors in prices, then so does law as well. This observation is best expressed by Leoni in correspondence with Hayek after the latter's praise of Leoni's recent publication of *Freedom and the Law*:

> I think that the underlying idea of such a theory is that there is a market of the law as well as there is a market of goods. The rules correspond to the prices: they are the expression of the conditions requested for the exchange of actions and behaviours, just as the prices are the expression of certain conditions requested

> for the exchange of the goods. And the rules, as well as the prices are not imposed, but found out. I said before that the rules are found out by some special kind of people. But even this is true only partially. Everybody can find out a rule under given circumstances: this happens whenever people exchange their actions, their behaviours etc. at certain conditions without being compelled to consult anybody (Masala 2003: 228).

If the basis of Hayek's and Leoni's theory of law as a discovery process depends on competition, experimentation, and the communication of tacit and dispersed knowledge, just as in the market process, then it also stands as a critique of a centralized provision of law itself. Centralized law enforcement faces knowledge and accountability problems similar to those of central economic planners (Stringham and Zywicki 2011). Not only does the centralization of law lack the negative feedback loops of correcting errors made in legislation or interpreting legal precedents, but it is also susceptible to self-interested judges and legislators capturing the law to pursue their own ends in the name of the public interest. Consistent with Hayek's reconsideration of the merits of central banking in *The Denationalization of Money* based on his own theory of spontaneous order, the decentralization of law into a plurality of competitive legal systems must also be considered on the same basis as well.

Conclusion

The great insight expressed in the legal theory of F.A. Hayek and Bruno Leoni is that the examination of exchange and the laws within which exchange takes place are distinct, yet complementary levels of a broader spontaneous order analysis. From the works of Hayek and Leoni flow three fundamental ideas about political economy: (i) The recognition of rules as a product of human action, but not human design; (ii) The extension of exchange and the logic of choice not only to the analysis of the market order, but of the rules as well; and (iii) The analysis of the law as the institutional framework within which the production process takes place, shaped by entrepreneurship and in turn shaping entrepreneurship as well.

Like any stock of capital, which is dependent on the accumulation of assets, the rule of law requires "investment" from both judges and individuals by acknowledging the accumulation of legal precedents and the informal customs and habits from which they have evolved over time. The "consumption" of such a capital stock results in the erosion of the framework of rules and expectations; more importantly, it results in the replacement of decentralized market planning governed by law with central planning governed by decree. By developing a positive analysis of law as fundamental to individual liberty and economic freedom, Hayek and Leoni hoped to safeguard the capture of the law from political privilege and economic tyranny.

But instead of relying on the rule of law as a constitutional constraint on leviathan effects, scholars of Hayek and Leoni should also reconsider the latent roots of analytical anarchism embedded in their legal theory to completely eliminate the threat. The lessons of governmental collapse in Somalia and economic transformation in Central and Eastern Europe in the post-Soviet era have taught us not only the constitutional importance of legal rules, or lack thereof, for economic development, but also that the

discovery and enforcement of such rules may sometimes be better left to the invisible hand of the market as an alternative to the grabbing hand of the state.

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