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## Rule of Law

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### Abstract

This entry explores the role of the rule of law in a market economy. The emergence of the rule of law is a *precondition* of not only political and economic liberty but also economic growth and overall human progress. The presence, or lack thereof, of the rule of law determines whether human interaction will be positive-sum or negative-sum in nature. We explore first the fundamental attributes to the rule of law in relation to property rights and entrepreneurship. Second, we discuss in detail three attributes to the rule of law that generate this productive entrepreneurial process: (1) generality, (2) predictability, and (3) equality.

### Introduction

Simply put, the rule of law refers to the absence of political or legal privilege among market actors *and* the absence of arbitrary discretion among political actors. It is a political–legal principle,

whereby the governing authority of a particular society is restricted to enforcing laws applied equally to all *and* not intended to benefit one particular party at the expense of another. Any violation of the rule of law implies that political–legal privileges cannot be granted without simultaneously granting discretionary power to those political actors who are in the position to grant such privileges. Therefore, the presence, or lack thereof, of the rule of law determines whether human interaction will be positive-sum or negative-sum in nature.

### The Rule of Law, Property Rights, and Entrepreneurship

According F.A. Hayek, one of the leading economists and legal scholars of the twentieth century, “the gradual transformation of a rigidly organised hierarchic system into one where men could at least attempt to shape their own life, where man gained the opportunity of knowing and choosing between different forms of life, is closely associated with the growth of commerce” (1944 [1994]: 18). Such a gradual transformation can be framed in terms of an inherent link between the rule of law, property rights, and entrepreneurship. The presence, or lack thereof, of economic development cannot be explained by an abundance or shortage of entrepreneurship in a society (see Baumol 1990; Boettke and Piano 2016); individuals are always and everywhere on the lookout for

previously unnoticed profit opportunities (Kirzner 1973). However, whether or not such a pursuit of profit opportunities manifests itself as productive activities, such as trade and innovation, or unproductive activities, such as rent-seeking and theft (Tullock 1967), depends upon the allocation of entrepreneurial talent in a society (Murphy et al. 1991). Such an allocation is dependent upon the establishment of well-defined and well-enforced private property rights that can be exchanged via money prices, allowing entrepreneurs to calculate the relative scarcity of resources through the guiding signals of profit and loss. Such guiding signals communicate to entrepreneurs whether or not resources have been allocated to their most valued consumer uses (Mises 1920 [1975]). Both the productive allocation of entrepreneurship and the productive allocation of resources via exchange and innovation that follows from entrepreneurship require that property rights restrict competition only to profit-seeking that creates social wealth, not rent-seeking that destroys social wealth (see Boettke and Candela 2014b). Such a restriction, however, implies the presence of the rule of law, without which entrepreneurship will be negative-sum rather than positive-sum. Following Hayek (1960: 205–210), there are three attributes to the rule of law that generate this productive entrepreneurial process: (1) generality, (2) predictability, and (3) equality. We discuss each of these attributes below in relation to property rights and entrepreneurship.

## Generality

To understand the way in which laws are general and abstract, rather specific and concrete, it is important first to make a distinction, following James Buchanan, between the rules of the game and interaction within the rules of the game. The distinction we make between the rules of the game and social interaction within rules follows a “law and economics” approach (Marciano 2016; see also Wagner 2016). Law and economics analyzes, in a world of positive transactions costs, the degree to which different legal rules, particularly

the absence or existence of the rule of law, affect economic performance, namely by ameliorating or exacerbating the costs of defining property rights and facilitating exchange. This approach is related, though distinct, to “the economic analysis of law.” Although the terms are sometimes used interchangeably, the economic analysis of law approaches legal analysis by assessing the efficiency of legal rules in a world of zero-transactions costs.

The attribute of generality implies that the rule of law operates as a “meta-legal doctrine” (Hayek 1960: 206), through which the types of laws that are filtered through the legislative process are those that are *end-independent* and *impersonal*. Laws that are consistent with the rule of law must neither command any specific purpose upon individuals nor does it assign any concrete status or outcome that differentiates individuals before the law. This does not mean that laws that recognize individuals on the basis of sex, race, or creed violate the rule of law; rather, it is only when such groups are preassigned a special status or privilege at the expense of other individuals that the rule of law is violated. This violation occurs in a twofold manner. First, resources and income are transferred by force to the politically privileged to the expense of the politically disenfranchised. For example, import tariffs on particular goods lead to the loss of consumer surplus and generate rents for domestic producers of that good. Secondly, and more importantly, the political transfer from one party to another cannot occur without simultaneously granting discretion to the political official, who must exercise arbitrary force in making such a transfer. When the rule of law is violated, the legislator is no longer “blind,” but can in fact foresee how and to whom laws will effect particular groups of individuals in society. As a result, entrepreneurship in such a society will mutate from profit-seeking to rent-seeking, as entrepreneurs will expend resources to capture privileges through political exchange, which wastes resources that could have otherwise been used for productive innovation (Harnay and Marciano 2011).

## Predictability

The rule of law does not assign marching orders to individuals but acts like traffic signals that guide the interaction of individuals in a noncoercive manner. Like traffic signals, they do not rely on legislators directing any other individual in advance, by force, or how to act explicitly. Rather, because individuals can reliably expect that laws will not be changed arbitrarily, “planning” is left to the individual at a particular place and time. Predictability, however, implies neither the complete lack of change in the law nor the absence of a judiciary. Rather, it only implies that laws will be changed on the margin by judges to facilitate coordination between contesting parties according to the circumstances of place and time. Such evolution in the law will be marginal, but adaptive for the adjudication of new disputes, yet consistent with the body of judicial precedent. Therefore, if rule of law is in place, entrepreneurs can reliably feel secure in their property and be able to deploy their resources in long-term investment projects that are productive and wealth-creating. Predictability means laws are intended for such a duration that no one, not even the legislator, can anticipate who will benefit from such laws. It is in this sense that the rule of law operates as a “fifth factor of production” (Boettke and Candela 2014a), providing the framework for the coordination of the land, labor, and capital by entrepreneurs according to their foresight about future profit opportunities. This has important implications for entrepreneurship and economic development. First, entrepreneurs in the marketplace can reliably “predict,” or anticipate, that they will only be harmed by the threat of losses from competing entrepreneurs, without fear of being harmed by the threat of public predation in the form of outright theft or regulation that bars them from entry into the marketplace. The unintended consequence of the rule of law, then, is to discipline entrepreneurs to accrue profits only by innovating, lowering costs, and producing resources according to consumer preferences. When the rule of law is violated, the only “predictability” that entrepreneurs have in their ability to accrue profits is to bar their competition from

entry into the marketplace via capture of monopoly privileges.

## Equality

The link between the predictability of laws and the spontaneity of the market process is the attribute of equality before the law. Under the rule of law, laws are applied equally to all, both to the ruler and the ruled. Social interaction and the outcomes of such interactions are guided horizontally by voluntary contract between individuals within the game, not vertically by capturing legal status or manipulating political officials to “bend the rules” in an individual’s favor. Thus, under the rule of law, one’s relative wealth or status in society is not predetermined by privilege; rather, it is *discovered* by learning how best to serve their fellow man via contractual exchange and innovation. In this capacity, government only acts as a referee, or umpire, to enforce the law, setting the precondition within which not one but multiple purposes and plans can be pursued by individuals via trade and exchange. Equality before the law is crucial to entrepreneurship and economic development because it recognizes that individuals are different and unique in their talents, potentialities, and knowledge of a particular time and place. It is freedom from legal discrimination that allows the spontaneous interaction of diverse individuals to generate entrepreneurial discoveries that are accidental and previously unforeseen. How could Malcolm McLean have applied his unique knowledge of trucking and shipping to pioneer the container ship in the 1950s if he was legally barred by shipping regulations? (see Levinson 2006) The rule of law cannot be violated without the tendency of substituting the rule of men. Under the rule of law, profits and losses in the marketplace are determined by the ability of entrepreneurs to serve consumers. Under the rule of men, profit and losses are determined by the ability of entrepreneurs to win political privileges, which come at the expense of the consumer.

## Cross-References

- ▶ [Austrian Perspectives in Law and Economics](#)
- ▶ [Austrian School of Economics](#)
- ▶ [Common Law System](#)
- ▶ [Customary Law](#)
- ▶ [Efficiency](#)
- ▶ [Hayek, Friedrich August von](#)
- ▶ [Liberty](#)
- ▶ [Mises, Ludwig von](#)
- ▶ [Rule of Law and Economic Performance](#)

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