CAPITALISM AND THE RULE OF LAW: THE CASE FOR COMMON LAW

By

Professor Svetozar (Steve) Pejovich
Professor Emeritus, Texas A&M University

Prepared for discussion at **Workshop in Philosophy, Politics and Economics at George Mason University, October 9, 2007**

INTRODUCTION

Capitalism is the only system in the recorded history that has been successful in pulling the average person above the subsistence level and sustaining a steady, if cyclical, rate of economic development. Yet, from the very beginning capitalism has had numerous critics. The demise of two major socialist movements of the last century, National-Socialism and Marxism did not discourage the critics of capitalism. As we enter the 21st century, environmentalism, multiculturalism, welfarism and EU bureaucracy have become the homes for the critics of capitalism. In addition to the systems that have been tried to replace capitalism, many critics find capitalism, *as it exists*, inferior to blackboard models that *have never existed*. Karl Brunner summarized the contribution of this group of critics as follows: 'The sacrifice of cognition is particularly easy to detect in objections to the market system introduced by discrepancies between one's desires, glorified as social values, and the results of market processes. However, our ability to visualize "better" states more closely reflecting our preferences yields no evidence that this state can be realized.'

The observed success of capitalism raises two discussion issues. The first is about the relationship between capitalism in the West vs. the Rest. It should be easy to argue that the success of capitalism is to be found in the incentive effects of the rule of law on the freedom of individuals to pursue their private ends.

The second and central issue of this paper is about economic differences between capitalist countries. I conjecture that the economic efficiency of alternative institutions is largely responsible for the observed performance of capitalist countries. That is, a set of institutions that offers greater incentives for voluntary interactions among individuals is more efficiency-friendly than another set of institutions that provides weaker incentives for free exchange. I use the term *efficiency-friendly* because with positive transaction costs, economic analysis can do no more than determine whether the incentive effects of formal and informal rules are expected to move scarce resources from lower-to higher-valued uses.

FROM CLASSICAL LIBERALISM TO CAPITALISM AND THE RULE OF LAW

The two cornerstones of capitalism are methodological individualism and classical liberalism.

Methodological individualism means that the unit of economic analysis is the individual. Decisions made by governments, parliaments, corporations, and other organizations are actually decisions made by individuals who conceive ideas, invest time and effort in formulating policies and convince others to accept those policies. Holding the individual to be superior to any group encourages behavior based on the principles of *self-interest*, *self-responsibility,* and *self-determination.* Hence, the culture of individualism rewards competitive performance, promotes risk taking, and views income inequalities as desirable results of entrepreneurship and free trade.

Eventually the Enlightenment, the French Revolution, socialism and many other ideologies have replaced the freedom of individuals to pursue their private ends with that of a common good defined by the elite running the state and/or representing various ideologies. Yet the concept of individualism has survived to our days. The Chicago School and Austrian Economics, to mention two major intellectual movements in the West, have successfully continued to present analytical and empirical evidence that our understanding of the economic forces at work requires that we consider the individual as the unit of analysis.

We can trace the philosophical foundations of classical liberalism--the second cornerstone of capitalism--to the writings of great thinkers from the 15th to 18th centuries, such as John Locke, David Hume, Bernard Mandeville and Adam Smith. Classical liberalism is about individual liberty, openness to new ideas, tolerance of all views, private property rights, the rule of law, and the freedom of contracts. Individual liberty, openness to new ideas, and tolerance of the values held by others create an environment in which individuals are free to pursue their private ends.

Classical liberalism in England and classical liberalism in Western Europe gave birth to two different legal systems, common law and civil law. And the incentive effects of those

two systems are arguably responsible that the development of classical liberalism has taken different paths in England and continental Europe.

Classical liberalism in England harbors a strong dose of skepticism about the rulers' foresight and their goodwill. It considers that the primary function of laws and regulations is to support the objectives of interacting individuals rather than to seek specific outcomes. What we today call Anglo-American capitalism is the institutionalized version of the classical liberalism of England.

Classical Liberalism in Western Europe rests on two assumptions: (1) there exists a just society, and (2) human reason is capable of discovering the formal rules required to bring about such society. These two assumptions of the Continental tradition provided both the philosophical raison d'être for the academic community to support social engineering, and the political justification for governments to pursue it. Contrary to the English and American experiences, the role of a powerful state has never been seriously questioned on the European continent. The French Revolution was carried out in the name of a new concept of legitimate centralism enforced by "enlightened" ruling elite. Even two most prominent classical liberals in Europe accepted the state as the watchdog of all individual actions, including those in the economic domain: 'The economic system cannot be left to organize itself' (Eucken 1951, p.93), for 'undiluted capitalism is intolerable' (Roepke 1958, p.119).

Achieving the transformation of classical liberalism into Anglo-American and Continental capitalism required a set of formal institutions strong enough to secure individual liberties, enforce private property rights, create incentives to reduce the transaction costs of exchange and maintain competitive markets. Those institutions structure the rule of law. The rule of law, then, was a major vehicle for the institutionalization of classical liberalism into capitalism.

Bruno Leoni (1961, pp. 59-76) and Friedrich Hayek (1960, chapters 11-12) argued that the rule of law has to satisfy three key elements: *the absence of arbitrary power* on the part of the ruling elite, which means that no laws are enacted with the intent of helping or harming particular individuals or groups; *equality before the law*, which guarantees that all citizens, including members of the ruling group, are subject to the same laws enforced

by independent courts; and a well-defined procedure for replacing the ruling group, such as regularly scheduled *democratic elections.*

The purpose of the rule of law is to tame the discretionary power of government and thus enable individuals to pursue their private ends in efficiency-friendly way. On the other hand, the rule of men is about the power of the ruling group to make discretionary changes in the pursuit of its own ends. A major difference between the rule of law and the rule of men is that the rule of law requires a well-defined, stable and credible process by which formal rules can be changed. In a rule of men state, changes in formal rules are a vehicle through which the ruling group seeks its ends.

We can think of the rule of law, then, as the container holding a set of well-defined formal institutions that satisfy the conditions stipulated by Hayek and Leoni. Perusing academic literature of capitalism indicates that the most important formal institutions setting capitalism apart from other systems are private property rights, the law of contract, an independent judiciary, and a constitution. While many other institutions are part of the system, the container we call the rule of law must include those four formal rules, which generate benefits in excess of the costs of producing and maintaining them.

The idealized concept of capitalism based on the rule of law and competitive markets probably never existed. However, its four basic institutions, which exemplify the rule of law, exist in all countries in the West. In some countries those institutions are more attenuated than in others. Thus the rule of law and competitive markets are not merely ideal or imaginary concepts for protecting competition, freedom of exchange and individual liberty; they are part of the institutional landscape of the West. By implication the rule of law is a useful yardstick against which we can evaluate both the prevailing formal institutions of capitalism in different communities as well as the economic efficiency of any proposed institutional reform.

If private property rights, the law of contract, an independent judiciary and a constitution are major institutions in the container of the rule of law; their behavioral incentives must be largely responsible for the observed performance of capitalism. And differences in the credibility and stability of those four institutions, on a country by country basis, should

explain differences in economic performance between capitalist countries. This relationship is discussed in some detail in the last section of this paper

Analysis of the incentive effects of its four basic institutions is then a realistic point of departure for better understanding of the success of capitalism. One can argue that the four basic institutions of capitalism, however attenuated they might be, have been the source of energy that explains the economic performance of the West vs. the Rest. Moreover, non-western countries that have accepted some features of the rule of law and/or open markets have been performing better than others.

As mentioned earlier, the process of institutionalizing classical liberalism into capitalism moved along different paths in England and on the Continent. In 17th century England, common law provided the legal framework for classical liberalism and methodological individualism. The legal systems of the United States, Canada, Ireland, Australian and New Zealand evolved from English common law, while civil codes dominated the development of formal rules in Western Europe.

The common law and civil code then provided the legal foundations for the rule of law in Anglo-American and Continental capitalism. Analysis of the incentive effects of common law and civil law should then give us some verifiable insights into these two legal systems expected effects on economic performance.

THE CASE FOR COMMON LAW[1]

Both formal and informal institutions affect individual behavior. However, unlike informal institutions, formal rules are a policy variable. Formal rules are constitutions, statutes, common laws, and other governmental regulations. They define the political system (the hierarchical structure, decision-making powers, the individual's rights); the economic system (property rights, freedom of contract, open entry into all markets); and the protection system (judiciary, police, military). The major function of institutions is to enhance the predictability of human behavior.

[1] Adopted from Steve Pejovich, *Law, Informal Institutions and Economic Performance*, Edward Elgar forthcoming, chapter 12.

Formal rules could be institutionalized customs and traditions, whereby they serve the function of making informal rules more uniform, predictable, enforceable and transparent. Formal rules are also enacted in order to accommodate changes in the economic conditions of life, in which case they reduce the transaction costs of playing the game. Finally, formal institutions can also be the outcome of a top-down decision-making process in response to the majority rule, lobbying, and the pressure from rent-seeking groups. I conjecture that the first two reasons for making new formal rules have low transaction costs of integration with the prevailing institutions. Those two reasons for enacting formal rules are then consistent with efficiency-friendly institutional change.

The issue to discuss is the incentives and constraints under which the carriers of change (i.e. makers of law and regulations) work in common law and civil law countries. The point of departure for analysis is the Public Choice School assumption that the carriers of change pursue self-interest. This means that the incentives and constraints operating on lawmakers and regulators affect the choice of new rules. And the choice of new rules informs us, via transaction costs, of their acceptance by the prevailing institutions. Economic analysis must then identify the carriers of change in common law and civil law countries and discuss the incentives and constraints under which they function.

Major sources of formal rules in most common law and civil law countries are judgments entered by judges and laws enacted by legislatures. All common law countries have legislators who enact rules and all civil law countries have judges who rely on the previous decisions of other judges in deciding their own cases. Thus no country is exclusively common law or civil law country. The terms refer to the *prevailing* legal system in a community.

Economic Efficiency of Judge-Made Formal Rules

The common law is the body of formal rules that has its origin in decisions made by judges. The process of creating formal rules in common law countries subsumes the hand of the past. Henry Manne put it well (1997, p.21): ‘A common law system does seem peculiarly well suited to the need in any legal system to respond appropriately to new circumstances. In its origin…common law was primarily local, tribal, or customary law, and, probably for this reason, common law judges have always had a predilection to

subsume local customs into decision rules'. And William Blackstone wrote back in 1765: 'For the sake of attaining uniformity, consistency, and certainty, we must apply those rules [precedents], where they are not plainly unreasonable and inconvenient, to all cases which arise; and we are not at liberty to reject them, and to abandon all analogy to them….because we think that the rules are not as convenient and reasonable as we ourselves could have devised.'

An implication is that the transaction costs are low for monitoring and enforcing precedents arising either from the institutionalization of informal rules or from the adjustments of the rules to changes in the game. Precedents arising from those two methods of making formal rules represent institutional change within the structure of tradition. And this means that precedents are efficiency-friendly.

As an outgrowth of the hand of the past, common law has never emphasized social justice, the common good, or other vague terms legislators and bureaucrats use as the façade of words hiding their preference for top-down regulations. The focus of common law has always been on the protection of individual freedom, free exchange, and private property rights. Michigan Supreme Court ruling in 1919 is an important example of the respect that common law has for private property rights: in the Dodge v. Ford Motor Company case, the Court held that Henry Ford owed a duty to the shareholders of the Ford Motor Company to operate his business for profitable purposes as opposed to charitable purposes. This efficiency-friendly decision was never reversed or overruled.

And the consistent protection of individual freedom, free exchange, and private property rights means that common law has been in tune with the capitalist culture that emphasizes self-interest, self-determination and self-responsibility. Moreover, common law is not amoral. Only informal rules that meet a shared notion of ethics can survive the test of time. Common law precedents have passed the test of time not because they were reasoned to be socially just or politically correct but because they subsumed customs and traditions. Hence the moral context of the hand of the past is implicit in common law precedents.

To say that common law is institutionalized tradition and customs requires an explanation. Translating informal rules into formal laws is not analogous to putting a

dime in the machine and getting out the written version of informal rules. Different judges have different subjective perceptions of prevailing informal rules. Their understanding of the basic legal principles is not necessarily the same. It is then fair to say that while the process of creating formal rules in common law countries subsumes the hand of the past, it also bears the imprint of actions by common law judges.

Indeed common law judges can rule from the bench. Bruce Benson (2005) said: 'Courts can follow precedent and explicitly state that they are bound to do so ...They can also legislate new law and explicitly acknowledge that they are overturning precedent.' The fact that judges can rule from the bench raises a critical question: does the common law system have a self-correcting bias that would replace less efficient with more efficient precedents from within the system. The answer to this question depends on the efficiency-consequences of the process of selecting precedents, the independence of common law judges, and the incentives and constraints under which they function.

Incentives of Common Law Judges

Many scholars argue that inefficient precedents could result in moving cases from common law courts to private arbitrations and out-of-court agreements. This means that common law judges face competition that could erode their power and prestige. Hence they have incentives to seek and maintain efficient precedents. Moreover, going along with precedents creates more time for leisure, which is an important good for most people including common law judges.

Unlike legislators who deal directly with individuals and groups, judges in higher courts, where most precedents are made, deal primarily with activities. By making it difficult for common law judges to accept monetary and nonmonetary payoffs, the rules under which common law judges operate reduce the influence of rent-seeking groups.

Thus major sources of utility for common law judges are nonmonetary goods, such as power, prestige, and leisure. And those sources of utility make judges sensitive to being reversed by higher courts and eager to contribute to new precedents. Posner writes (2003, p.541) 'An odd feature of [the production of precedents] is that the producers are not paid. Neither the judges nor the lawyers in Hadley vs. Baxendale received any royalties or other compensation for a precedent that has guided the decision of thousands of

cases....The costs to judges of professional criticism are modest, but because the rules of judicial tenure and compensation attenuate the usual incentives that operate on people, judges are likely to be influenced by what in most walks of life is a weak force'.

Constraints on Common Law Judges

Legal decisions entered by common law judges, if challenged, have to pass the scrutiny of higher courts. If challenge persists, the Supreme Court has to rule on the constitutionality of lower courts decisions. An implicit assumption is that cases the Supreme Court does not choose to consider are consistent with the constitution. This does not mean that reviews of lower courts rulings by higher courts (including the Supreme Court) are always in tune with the prevailing informal institutions and the United States Constitution. And it would be equally wrong to gauge the process of creating new rules by reference to either the character of judges or their mistakes (at all levels). Judges are human beings who have their own subjective perceptions of reality.

Yet the system is reasonably self-correcting. Common law judges know that higher courts can reverse their decisions. Appellate court judges in turn know that the Supreme Court can reverse their rulings. And the Supreme Court justices know that there are ways for the US Congress to rein in the courts. In short, common law judges are reasonably constrained to stay with precedents, which in turn increase the predictability of the legal system.

The independence of Common Law Judges

One important function of the US Constitution is to protect common law judges from being influenced by the preferences of the median voter, changes in the balance of political power, and pressures from rent seeking groups.

The importance of an independent judiciary as one of the four basic institutions of the rule of law was fully appreciated by Hayek, Leoni and most law and economics scholars. In recent years, a body of literature has shown that judicial independence correlates with good economic performance. Klerman and Mahoney (2004) found that their research lends 'support to the proposition that judicial independence is one of the key features of the design of a high–quality legal system. It is remarkable that incremental changes in the

security of judgeships are so persistently associated with abnormal returns in the direction that we would expect if market participants viewed judicial independence as a good thing'

Common law judges in the United States enjoy good protection from other branches of government. However, they have been much less protected from the intrusion of legislators and bureaucrats into the market for formal rules.

The Process of Selecting New Rules

I conjecture that the common law system has self-correcting bias that tends to replace less efficient with more efficient precedents from within the system. The argument goes like this: The total set of precedents in a community at a point in time consists of the sum total of efficient and inefficient rules. Since the costs imposed by inefficient rules are greater than the costs imposed by efficient rules, a larger proportion of contested rules will be inefficient. If the litigated rules are decided on some basis unrelated to efficiency of outcomes, the common law efficiency will tend to increase over time. George Priest (1977, p. 72) argued that 'efficient rules survive in an evolutionary sense because they are less likely to be re-litigated and thus less likely to be changed….Inefficient rules perish because they are more likely to be reviewed and review implies the chance of change whatever the method of judicial decision….the tendency of the common law over time to favor efficient rules does not depend on the ability of judges to distinguish efficient from inefficient outcomes'. An implication is that the process through which new rules emerge is more important than the quality of judges.

The efficiency of any legal system also depends on its response to technological changes in the economy. Technological changes create new opportunities for exchange. To capture the gains from those opportunities for exchange, individuals have to enter into mutually beneficial contractual agreements. Yet, technological changes often make prevailing precedents obsolete. And obsolete precedents raise the transaction costs of exploiting new exchange opportunities. Rules developed to deal with collisions between the horse-driven wagons in 19th century Texas could not be readily applied to the consequences of automobile accidents in the 21st century. To reduce the transaction costs of contracting, new precedents are then necessary.

The accumulation of responses to technological changes creates new precedents or formal rules. The process through which new precedents arise is thus both *incremental* and *selective*. The former means that legal disputes are litigated repeatedly in lower courts, and potentially checked and re-checked in higher courts. The latter means that the precedents emerging are also the rules most efficient in reducing the transaction costs of exploiting new exchange opportunities.

Two examples should suffice to illustrate this tendency of making efficiency-friendly formal rules in common law. In the second half of the nineteenth century, the discovery of mineral deposits in the American West created new opportunities for profitable exchange. The absence of clearly defined rights in mineral deposits was a major problem in exploiting those opportunities. The absence of transferable property rights raised the transaction costs of exploiting new opportunities for exchange. In the pursuit of self-interest, the original group of settlers got together and defined property rights in mineral deposits. Their agreement was to be applied to all newcomers as well. The agreement worked because the benefits from the now defined private property rights turned out to be in excess of the transaction costs of monitoring and enforcing those rights. However, as the number of individuals moving into the region increased, common law judges began providing enforcement of those informal agreements and, in doing so, arrested potential increases in the transaction costs of maintaining and protecting private property rights in mineral deposits. Thus the initial informal agreements on property rights became common law rules. Eventually, those rules were accepted by the state of Nevada legislators.

The law of limited liability is another example. Technological developments in the second half of 18^{th} and the first half of 19^{th} century made possible the expansion of trade and mass production of consumer goods at declining costs. However, prevailing formal rules created a problem. The exploitation of new technological advances required large start-up investment in fixed assets, which the-then prevailing law of unlimited liability made difficult to finance. With each partner held personally liable for the entire debts of the firm, it was too difficult for existing partners to accept new ones. Every partner could ruin others through incompetence or opportunistic behavior. The rule of unlimited liability also raised the cost of absentee ownership. Not to monitor one's partners could prove costly. Clearly,

the prevailing institutional framework was out of tune with the changing requirements of the game.

Driven by self-interest, entrepreneurs sought to resolve the problem of pulling together large amounts of capital. Some types of contracts did better than other and were repeated. By the 1850s this process of trial and error led to the law of limited liability. This law limited each owner's liability to the market value of that individual's investment in the firm. Investors could now choose their risk. They did not have to worry about other partners. Equity investments were divided into small shares, which were traded in financial markets. And the law of limited liability, which emerged spontaneously in response to changing economic conditions of life, made the corporate firm by far the most efficient method for voluntarily raising large amounts of capital.

The incentives and constraints of common law judges, the selective process through which new rules emerge, and the independence of judges from other branches of government are three major factors that create incentives for common law rules to be efficiency-friendly and allow them to serve as an engine of economic development.

Inefficiencies of Common Law

Two major potential sources of economic inefficiency in common law are the intrusion of statutes and government regulations into the legal system, and the so-called activist judges. The intrusion of law and regulations enacted from the top-down affects both private property rights and the freedom of exchange. In common law, private property rights serve the subjective preferences of property owners, which mean that owners decide what to do with their assets, capture the benefits, and bear the costs. Private property rights in many civil law countries such as Germany, France and Italy serve the rule-makers hazy vision of social justice and social welfare, which means that a portion of the value of a privately owned asset is transferred to non-owners. Robert Higgs (1997) presented convincing evidence on how Roosevelt’s New Deal contributed significantly to prolonging the Great Depression by denting investors’ confidence in the stability of private property rights. He said (p.587): ‘From 1935 through 1940, with Roosevelt and the ardent New Dealers who surrounded him in full cry, private investors dared not risk their funds in the amount typical of the late 1920s. In 1945 and 1946, with Roosevelt

dead, the New Deal in retreat, and most of the wartime controls being removed, investors came out in force.'

We observe a relatively high degree of top-down regulation of economic activities in civil law countries. We also observe the intrusion of statutes and regulations in most common law countries, including the United States. Yet, common law countries have done a better job than civil law countries in protecting economic freedom. The *2007 Index of Economic Freedom* ranks only seven countries as *free* countries and all seven are common law countries (Hong Kong, Singapore, Australia, United States, New Zealand, United Kingdom and Ireland).

Common law judges can make decisions that diverge from existing precedent as well as from the prevailing informal institutions. Possible reasons that some common law judges choose to ignore existing precedents in deciding the cases before them are a craving to get their names in law books, a desire to pursue ideological sentiments, or a strong wish to objectivize their subjective feelings of right or wrong. The high transaction costs of monitoring and enforcing those rules translate into less economic development. Rulings by activist judges, then, should be highly suspect. It is important that the conversion of those decisions into new precedents depends on the usual review steps. Unless activist judges can produce strong and convincing explanations in support of decisions to 'propose' new precedents, higher courts are likely to reverse them. And reversals happen. Here are two examples.

A former member of the Boy Scouts of America got his membership revoked when the Boy Scouts learned that he is a homosexual. The Boy Scouts argued that his conduct is inconsistent with the values the organization holds dear. The expelled member sued for the violation of his freedom as guaranteed by the Constitution. The Boy Scouts argued that theirs is a private, not-for-profit organization entitled to have its own internal rules of conduct. The lower courts agreed with plaintiff. The Supreme Court sided with the Boy Scouts.[i]

Students in a school district are required to begin every day with the US Pledge of Allegiance, which includes the words 'under God'. A divorced father of a student sued the school for religious indoctrination, which is unconstitutional. The lower court

dismissed the suit, but the appellate court agreed that the school was violating the Constitution. The Supreme Court decided for the school on the ground that child's mother is legal custodian and that she did not object to her daughter reciting the Pledge of Allegiance.

Laws Enacted by Legislators

The common law tradition generalizes legal principles from specific decisions (precedents) entered by common law courts. As old precedents are dropped and new ones are added to the legal system, judge-made rules change the legal system from within the structure of tradition. In the Continental tradition, legal principles are written by experts, debated by various groups of citizens, and eventually enacted by parliaments. Relative to the common law tradition, where changes in the rules are incremental and tied to informal institutions or caused by changes in the game, the civil law tradition gives the political elite more room for discrete changes in the legal system. An implication is that the close relationship we observe between the prevailing culture and formal rules in common law countries is weaker in civil law countries. In short, common law is a major vehicle for making formal rules from within the structure of tradition, while civil law is a major method for making exogenous changes in formal rules.

The incentive structures and constraints of legislators in civil law countries (and common law countries, including the United States) and those of common law judges are not the same. Legislators have more discretionary power and face fewer restrictions in choosing between, on the one hand, formal rules that institutionalize into the legal framework changing requirements of the game and, on the other, formal rules that are enacted with the purpose of changing the game. That is so because in common law countries, higher courts or repeated litigation can self-correct inefficient rules (which stand only in the jurisdiction of the court that made the rule). But to correct an inefficient rule in a civil law country requires a legislative decision to change the rule. Such decisions take more time and resources, while in meantime the inefficient rule applies to the entire country. This is an important distinction because it reemphasizes the link between culture and common law rules, which is less strong in civil law countries.

A new formal rule often signals the intention of law makers to seek a specific outcome. Examples are, Affirmative Action in the United States, the harmonization of laws in the EU, and privatization laws in post-communist Eastern Europe. In terms of our analysis, the efficiency of a new rule depends on the response of the prevailing institutions. If the transaction costs of the integration of a new formal rule into the system are significant, policy makers either have to make clarifying rules and regulations, or invest additional resources in enforcing the rule, or both. Thus, the number of clarifying laws and regulations and additional expenses in law enforcement are a proxy for the effects of the new rule on transaction costs. And those proxies are costly. Secondary laws and regulations are costly to produce. Moreover, by creating the perception of frequent legal changes the enactment of secondary laws and regulations reduces the predictability of the legal system, which in turn retards economic development. The enforcement of an inefficient rule consumes current wealth.

Legislators also want to be reelected. And if so, formal rules enacted by legislators depend on the terms of exchange between their personal morals and their potential gains from 'selling' rules to the median voter and various organized pressure groups. This means that the preference of the median voter (or the majority of voters) in their districts is an important constraint on their law-making choices. And the median voter is influenced by current fads and immediate economic gains.

The role of the median voter should not be exaggerated. The median voter cares about some issues but is unconcerned about many others. Hence legislators have more discretion in choosing new rules concerning the issues not central to voters. For example, people in the state of Utah care a lot about the use of federal lands. And they care little if at all about US foreign policy in the Balkans. Congressional representatives and senators from Utah will vote the preference of the median voter regarding uses of federal land but will vote however they prefer when it comes to relations with the Balkans.

Predictably, the behavior of legislators resembles that of Santa Claus, especially at election time. They go around promising goods in exchange for votes. We have all heard legislators tell us that we need more schools, roads and hospitals. We have never heard them tell us what is to be given up in exchange for those goodies. And when they try to

answer that question they demonstrate their ignorance. A few years ago, the City of Dallas decided to subsidize the building of a new sport arena. The funds were to come from additional taxes paid by people staying in Dallas hotels. The argument was that the sport arena is a free good because the costs are going to be borne by 'foreigners'. The people of Dallas were never told that the real cost of new sport arena is the value of another bundle of goods that the amount of money raised by taxing 'foreigners' could produce.

Legislators also depend on rent seeking groups and various ideological organizations for both reelection and financial support. In most EU countries, labor unions have lots of influence over legislators; hence we observe that senior workers are well protected, while young people aiming to enter the labor market are largely unemployed and on welfare. The behavior of labor unions and other rent seeking groups is both predictable and rational. They do not exist in order to pursue the efficient allocation of resources. They exist to maximize the wealth of their members. For them, the issue of economic efficiency is a nuisance. In comparison with the incentives and constraints of common law judges, the incentives and constraints of legislators do not push them in the direction of making efficiency-friendly laws. A dissipation of resources is then a predictable consequence of exogenous changes in formal rules.

The most serious external constraint on legislators is judicial review. Judicial review means that courts can declare a new law unconstitutional. Yet, the effectiveness of judicial review is not the same in common law and civil law countries. In Germany, the court might declare a new rule unconstitutional but the rule stands until the final decision is made by the constitutional court, which could be many years later. In the United States, the court might declare a new rule unconstitutional and the rule is *suspended* in that court's jurisdiction until the Supreme Court makes a final ruling, which usually takes five to ten years. In the latter case, judicial review frustrates legislators' incentives to impose rules seeking specific outcomes that are either consistent with their private ends or that represents their tradeoff with various pressure groups.

Conclusion

Common law judges make formal rules. Some are made to adjust the rules to changes in the game; those are spontaneous rules, for which the transaction costs of integrating into the system are low. Common law judges also have the power to contribute to the making of new precedents. Those rules could be in conflict with prevailing informal institutions; that is, they could attenuate the rule of law. However, credible constraints, competitive market for litigation and the independence of judges from other branches of government exert pressures on common law judges to refrain from making rules that are not in tune with prevailing precedents and /or informal institutions. In consequence, the power of common law judges to engage in discretionary law-making, while not eliminated, is constrained. This means that formal rules emerging from within the system promote economic development by reducing the transaction costs of exploiting exchange opportunities and developing new ones. The result is a significant predictability for common law.

Laws made by parliaments in civil law (and common law) countries have fewer efficiency-friendly constraints. The median voter is an important constraint who often provides legislators with incentives to make inefficient rules. Moreover, the preferences of the median voter translate into majority rule that give more power to the ruling party to impose its concept of social justice on the society as a whole. And those discretionary powers have consequences. A good example is President Franklin Delano Roosevelt's New Deal in the 1930s. The failure of the Supreme Court to protect the Constitution and individual rights from Roosevelt's regulatory and redistributive program had both short-run and long-run consequences. In the short run, those rules forced the game to adjust to new rules. In the long-run, they gave rise to the culture of dependence in the United States. It was only in the 1980s that the Supreme Court began slowly, albeit unevenly, to reemphasize the original intent of the Founders.

While common law emphasizes individualism and private property rights, which translates into an emphasis on the equality of opportunity, civil law stresses social justice and the public interest, which emphasizes desired outcomes. Being closely tied to the way the median voter perceives social justice, the desired outcome is a shifting concept.

Thus, the advantage of common law over civil law comes from the predictability (i.e., consistency) of formal rules arising from the linkage with the hand of the past. Simply said, common law serves the rule of law well.

APPENDIX: SOME EMPIRICAL EVIDENCE

A growing body of literature supports the premise that formal and informal institutions affect economic performance, and empirical evidence supports it as well. Given that premise, linking capitalism with economic performance are incentives that the institutions of capitalism generate and the effects of those incentives on transaction costs. And Anglo-American capitalism, which is much closer to the roots of classical liberalism, has been doing better than the Continental capitalism. Richard Rahn (January 2, 2006) described the economic situation in Western Europe in the early 2000s as follows: 'Europe has not yet suffered from bird flu, but it suffers from an even more debilitating economic flu: excessive government dependency. That dependency is sapping both its economic vitality and its spirit and has grown most acute in the core of Europe: Germany, France and Italy'.

The Index of Economic Freedom published jointly by the Heritage Foundation and the Wall Street Journal and the Economic Freedom of the World Index published by Fraser Institute use categories that are consistent with the institutions and policies of capitalism to measure economic freedom. They compare, in effect, the strength of the rule of law in a wide range of countries. Both indexes have technical limitations and methodological problems but they are also the best we got. They confirm that the freer a country is the better is its economic performance over a long-period of time. James Gwartney wrote (2003, p.3): 'The maintenance over a lengthy period of time of institutions and policies consistent with economic freedom is a major determinant of cross-country differences in per capita GDP… cross-country differences in the mean rating during 1980-2000 explain 63.2 per cent of the cross-country variations in 2000 per capita GDP'. And Stocker (2005, p589) that 'increases in economic freedom are associated with higher equity returns [statistically significant at the 99 per cent confidence level] while the absolute level of beginning and ending economic freedom do not affect equity returns'.

For consistency, I use the Index of Economic Freedom published by the Heritage Foundation and the Wall Street Journal (hereafter: *Index*). Until 2006, the Index classified all countries into four broad categories of economic freedom: *free* (1-1.99), *mostly free* (2.00-2.99), *mostly unfree* (3.00-3.99), and *repressed* (4.00 or higher). The highest ranking countries in the world were Hong Kong and Singapore, with the scores of 1.28 and 1.56 respectively. Until 2006, when the system of rating changed, score of 1 represented the non-attenuated rule of law. Scores above 1 represented various degrees of attenuation of the rule of law.

Let us now make use of the Index to compare the effects of common law and civil codes on economic freedom in capitalist countries.

The Period from 1996-2006

The analysis in previous section of this paper suggests that relative to civil codes, the incentive effects of common law are more efficiency-friendly. The Index should then be expected to show that common law countries have lower scores (i.e., that they are freer) than civil law states. To test this proposition, Western capitalist countries (in the cultural rather than geographical sense) are separated into two groups. The first group consists of countries in which common law is a dominant legal system. Those are the United States, England, Ireland, Australia, Canada and New Zealand. Singapore and Hong Kong are left out because it is not clear whether they are part of Western civilization. The second group of countries includes all Western countries that use civil law. Those countries are Portugal, Spain, France, Luxemburg, Germany, Belgium, Holland, Italy, Switzerland, Austria, Sweden and Denmark. Left out are Greece, which was dominated by the Ottoman Empire for centuries; Finland, which has somehow remained between the West and the East; and Norway, which uses both common law and civil law.

Table 1 shows the average scores for those two groups of countries in 1996 and 2006. It appears that relative to civil law, common law has been more protective of the institutions of capitalism. In 2006, the average score for civil law countries was still in the *mostly free* category (2.00-2.99), while common law countries were firmly in the *free* category.

TABLE 1
Economic Freedom in Common Law and Civil Law Countries

Legal Tradition	Type of Capitalism	Score, 2006	Score, 1996
Common Law	Anglo-American	1.78	2.00
Civil Law	Continental	1.98	2.30

Source: Miles et al. (2006). The scale is 1 to 5, with 1 representing the greatest economic freedom.

Table 2 reduces the comparison between civil law and common law countries to four major capitalist states representing the Continental and Anglo-American capitalism: France, Germany, England and the United States. The comparison makes even a stronger case for common law. While neither legal system has been able to tame the state (that is, to get close to the score of one), economic freedoms in Anglo-American capitalism have remained much stronger.

TABLE 2
Economic Freedom in Major Capitalist Countries

Legal Tradition	Type of Capitalism	Score, 2006	Score, 1996
Common Law	Anglo-American	1.79	1.94
Civil Law	Continental	2.23	2.33

Source: Miles et al. (2006).

Still another important test involves the protective effects of common law and civil law on the rule of law. Some of the categories that comprise the Index are more closely related to the rule of law than others. For example, scores for property rights reflect the credibility of the right of ownership while black market activities are major consequence of the attenuation of the freedom of exchange. On the other hand, scores on banking and finance, and on monetary policy do not necessarily contain the same message about the strength of the rule of law (the former USSR was fiscally very tight). Moreover a poor score on the fiscal burden of government might reflect expenditures necessary to enhance

national security. For example, United States and United Kingdom expenditures for national defense during the Cold War years had to impact negatively on their scores for economic freedom, yet at the same time those expenditures helped to protect the private-property, free-market economies of Western Europe.

The issue, then, is to identify those categories in the Index that are closely tied to the rule of law. I conjecture that the following three categories definitely bear on the rule of law: private property rights, government regulations and black market. The importance of property rights is self-evident. A poor score for government regulations suggests large interferences with efficiency-friendly voluntary interactions. Black market activities are both normal and predictable responses to constraints on the freedom of contract, an important element of the rule of law.

Tables 3 and 4 include same countries as tables 1 and 2, respectively, but average scores are based only on property rights, black markets and government regulations.

TABLE 3
The Rule of Law and Economic Freedom

Legal Tradition	Type of Capitalism	Score, 2006	Score, 1996
Common Law	Anglo-American	1.39	1.55
Civil law	Continental	1.83	1.80

Source: Miles et al. (2006).

Table 3 shows that common law protects the rule of law better than does civil law. Table 4 suggests that between 1996 and 2006 the rule of law has gotten worse in all four major capitalist countries

TABLE 4
The Rule of Law and Economic Freedom in Major Capitalist Countries

Legal Tradition	Type of Capitalism	Score, 2006	Score, 1996
Common law	Anglo-American	1.41	1.33
Civil law	Continental	2.08	1.66

Source: Miles et al. (2006).

The Effects of Recent Changes in the Index of Economic Freedom

In 2007, the Heritage Foundation and the Wall Street Journal added two important categories to the Index of Economic Freedom. *Business Freedom* is a measure of how free entrepreneurs are to start businesses, how easy it is to obtain licenses, and, very importantly, how cheap the exit is. *Labour Freedom* is a measure of the ease of hiring and firing employees. It covers minimum wage laws, wage controls, laws inhibiting layoffs and other legal restrictions in the market for labour.

In the same year the Heritage Foundation and the Wall Street Journal changed the system of grading from one to five (one being the best) to 0-100 (100 being the best). The 2007 Index also increased number of categories of economic freedom from four to five. Those categories are: *free* (80-100), *mostly free* (70-79.9), moderately free (60-69.9), mostly unfree (50-59.9), and repressed (0-49.9).

Those two new categories of economic freedom are good proxies for entrepreneurial incentives to start new firms. Tables 5 and 6 extend upon tables1 and 2. With respect to business freedom, common law countries and civil law countries are *free.* However, the average score is higher for common law countries. The difference between two legal systems is much greater with respect to labor freedom.. Common law countries rank free while civil law countries are only moderately free.

TABLE 5
Entrepreneurship in Common Law and Civil law Countries, 2007

Legal Tradition	Type of Capitalism	Business Freedom	Labour Freedom
Common Law	Anglo-American	93.48	83.48
Civil law	Continental	85.60	60.70

Source: Kane, et al. (2007). The scale is 0 to 100, with 100 representing the greatest economic freedom.

Table 6 reduces the comparison between civil law and common law countries to four major capitalist states representing the Continental and Anglo-American capitalism: France, Germany, England and the United States. The comparison confirms the finding in table 5. Incentives to enter into business are greater in common law than in civil law countries. Especially depressing are the numbers for labour freedom in Continental capitalism.

TABLE 6
Entrepreneurship in Major Capitalist Countries, 2007

Legal Tradition	Type of Capitalism	Business Freedom	Labour Freedom
Common Law	Anglo-American	93.30	87.40
Civil law	Continental	87.15	60.25

Source: Kane et al. (2007).

REFERENCES

Benson, B. (2005), 'Common Law Versus Judge Made Law', W*orking Paper,* Florida State University.

Blackstone, W. (1765-69), *Commentaries on the Laws of England*, Oxford: Clarendon Press.

Eucken, W. (1951), *The Unsuccessful Age*, Edinburgh: William Hodges.

Hayek, F. (1960), *The Constitution of Liberty*, Chicago: University of Chicago Press.

Higgs, R (1997), .Regime Uncertainty: Why the Great Depression Lasted So Long and Why Prosperity Resumed After the War', *The Independent Review*, 1 (4), 561-90.

Leoni, B. (1961), *Freedom and the Law*, New York: Van Nostrand Company.

Klerman, D. and D. Mahoney (2004), 'The Value of Judicial Independence: Evidence from the 18th Century England', *Law and Economic Working Paper Series*, No 03-12, University of Virginia Law School.

Libecap, G. (1966), 'Economic Variables and the Development of the Law: The Case of Western Mineral Rights', in L Alston, T. Eggertsson, and D. North (eds.), *Empirical Studies in Institutional Change*, Cambridge: Cambridge University Press, pp. 34-58

Manne, H. (1997), 'The Judiciary and Free Markets', *Harvard Journal of Law and Public Policy*, 21 (1), pp.11-37.

Posner, R. (2003), *Economic Analysis of Law*, New York: Aspen, sixth edition

Priest, G. (1977), 'The Common Law Process and the Selection of Efficient Rules', *Journal of Legal Studies*, 6 91), pp. 65-82.

Röpke, W. (1958), *Social Crisis of Our Time*, London: Thames and Hudson.