1. Law and economics: the contributions of the Austrian School of Economics

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I. INTRODUCTION

> It is regrettable, though not difficult to explain, that in the past much less attention has been given to the positive requirements of a successful working of the competitive system than to these negative points. The functioning of competition not only requires adequate organization of certain institutions like money, markets, and channels of information – some of which can never be adequately provided by private enterprise – but it depends, above all, on the existence of an appropriate legal system, a legal system designed both to preserve competition and to make it operate as beneficially as possible. . . . The systematic study of the forms of legal institutions which will make the competitive system work efficiently has been sadly neglected. (Hayek 1944 [2007]: 87)

Commercial life always exists inside of an *institutional framework*. Whether social life exhibits Adam Smith's human propensity to "truck, barter, exchange" or Thomas Hobbes's human capacity to "rape, pillage, plunder" is a function of the *institutional framework* within which social life is played out. It is the *framework* that determines the marginal benefit/marginal cost calculus that individuals face in pursuing sociability. If the marginal benefits for productive specialization and peaceful cooperation exceed the marginal benefits of predation and confiscation, then that society will tend toward the Smithian expansion of commercial and civil society. But if the calculus tends toward the other way, then Hobbes's depiction of life as being "nasty, brutish and short" comes to dominate. Most of human history, in fact, is best characterized as Hobbesian. But starting with the "Great Enrichment"[1] as Deirdre McCloskey has dubbed it, the history of humanity took a different turn. McCloskey puts great emphasis on the ideas that generated this transformation. We do not disagree with the primacy of ideas, but our focus is on the *framework* that these ideas

[1] The Great Enrichment refers here to increase in income per capita by a factor of 40 to 100 that began first in northwestern Europe around 1800. See McCloskey's *The Bourgeois Virtues* (2006), *Bourgeois Dignity* (2010), and *Bourgeois Equality* (2016).

legitimated, and the practices that were engendered by that *framework.* As the great Austrian school economist Ludwig von Mises put it:

> Saving, capital accumulation, is the agency that has transformed step-by-step the awkward search for food on the part of savage cave dwellers into the modern ways of industry. The pacemakers of this evolution were the ideas that created the *institutional framework* within which capital accumulation was rendered safe by the principle of private ownership of the means of production. Every step forward on the way toward prosperity is the effect of saving. The most ingenious technological inventions would be practically useless if the capital goods required for their utilization had not been accumulated by saving. (emphasis added, 1956 [2006]: 24)

This emphasis on the *institutional framework* was lost in the first half of the 20th century due to the rise of formalism in economic reasoning. The classical political economists – say from Smith to Mill – were also philosophers and historians, as well as political and legal theorists. They also sought to produce logically sound arguments, rather than merely logically valid ones. This meant that realism of assumptions mattered greatly in the theoretical systems being constructed. They sought to steer an intellectual course between purely free-floating abstractions and momentary concrete description. Political economy was a theoretical edifice consisting of realistic abstractions that aided and guided empirical investigations. But understanding human society is complex; there are no constants. As a result, there was (and always will be) scope for varied interpretations of events. This was often mistaken in the late 19th century and early 20th century as a sign of the immaturity of the science, and due to the nature of verbal reasoning. Ambiguity resulted because the same words were being used to mean different things, or because different words were being used to mean the same thing. As a result, disputes about fundamental issues seemed to be repeated without resolution. So this could all be cleared up, the thought was, by substituting mathematical models for verbal chains of reason. Now, hidden assumptions would be eliminated, and the ambiguity of words would be replaced by the clarity and precision of mathematical expression. There was some resistance to this transformation of economic science for the first few decades of the 20th century, precisely because it was understood that this transformation moved critical reasoning in the social sciences from a quest for logical soundness to a quest for logical validity. Thus, early 20th century thinkers who resisted formalism continously stressed the lack of realism of assumptions as a problem. The formalistic turn required simplifying assumptions – that is different than the earlier use of abstract reasoning in the construction of theory. But as advances were made in statistical analysis, the belief was that these statistical techniques could effectively sort between the array of logically valid models those which were empirically meaningful from those that were empirically useless. Thus, modern neoclassical economics was born, and classical political economy was discarded.

One of the key casualties of this transformation was the explicit recognition of the *institutional framework*, let alone its analysis. In fact, a formalistic rendering of the structure of economic reasoning in the 1930–1960s strove to be *institutionally antiseptic*.[2] First, the *framework* was assumed to be given and fixed for the purposes of analysis. Second, its very "givenness" eventually resulted in the *institutional framework* being forgotten.[3] The classic example of this was in the debate in the 1920s–1940s over the possibility of economic calculation under socialism – with one side emphasizing the importance of private property rights and freedom of contract, and the other side insisting that the optimality conditions that defined economic efficiency could be established through judicious economic planning and effective public administration. This debate, we will argue, played an essential role in the re-discovery of the *institutional framework* in the post-WWII era. But before we walk through that argument, let us put in context the contributions of Austrian economics to law and economics, which is the study of endogenous rule formation, or the spontaneous evolution of social institutions, going back to the founder of the Austrian School, Carl Menger.

While Menger's emphasis on spontaneous institutional analysis was born out of the *Methodenstreit,* a methodological battle engaged against the German Historical School, we argue in this introduction that the unique Austrian contribution to law and economics emerged directly from

[2] See Francis Bator (1957: 31), where he states that the theorems of welfare economics are "antiseptically independent of institutional context." Furthermore, he argues that the optimality conditions are "technocratic" and that the theorist seeks to avoid any "institutional overtones." Bator is in the intellectual line of economic thinking that developed from Lange-Lerner, to Samuelson-Bergson, and eventually to Arrow-Hahn-Debreu. The flip-side to this evolution was the rebirth of classical political economy and the rise of neoclassical institutionalism between 1950 and 2000 that we are highlighting.

[3] Barry Weingast (2016) recently identified what he dubbed the "neoclassical fallacy." First, the standard economist treats the institutional framework as given and fixed for analysis, and thus eventually forgets the central role in the analysis and assessment of alternative economic systems that institutions must play. Second, upon realizing this intellectual error, the standard economist will acknowledge the importance of institutions, but remain silent on the analysis of the working mechanisms of those institutions for their maintenance, stability and/or fragility. In our narrative, exposing and correcting the "neoclassical fallacy" is one way to think about the Austrian-inspired law-and-economics revolution in the second half of the 20th century.

the socialist calculation debate against market socialism. This debate, we will argue, played an essential role in the re-discovery of the institutional framework in the post-WWII era. In the aftermath of the socialist calculation debate, the earlier Mengerian emphasis on the spontaneous emergence and evolution of the rules that govern economic and social interaction was reemphasized by F.A. Hayek, who in turn influenced the early pioneers of law and economics, particularly Aaron Director, Ronald Coase and Bruno Leoni.

II. FROM SMITH TO MENGER TO MISES: THE REFINEMENT OF INVISIBLE HAND THEORIZING

Classical political economy consists of a set of ideas about how to understand the social order that follows from the Scottish Enlightenment moral philosophers, namely David Hume and Adam Smith, and was further developed by the French liberals, namely J.B. Say, and the British utilitarians, namely Jeremy Bentham, David Ricardo, and John Stuart Mill. From Hume, we learn that the foundation of civil society is to be found in property, contract and consent. In order for the human condition to be characterized by productive specialization and peaceful cooperation, that society must have security and stability of possession, the keeping of promises, and the transference of property by consent (see Hume 1739 [2000], Book III, Part 2, Sec. II–IV: 311–31). Where property is insecure, promises are not kept, and violent taking characterizes the social situation; human sociability will be truncated and the Hobbesian propensities will prevail. On the other hand, when the social situation is characterized by property, contract and consent, the Smithian propensities prevail and peace and prosperity prevail. Smith's argument in *An Inquiry into the Nature and Causes of the Wealth of Nations* must be understood in this two-stage manner. Yes, the greatest improvements in the material conditions of mankind are due to the refinement in the division of labor. But, as Smith pointed out, the division of labor is limited by the extent of the market. The division of labor is, to use more modern language, a proximate cause of development. The fundamental cause is what gives rise to the expansion of the market, and thus the refinement of the division of labor. That fundamental cause – as mentioned already by Mises – are the ideas that gave rise to the institutional *framework* that made savings and capital accumulation safe. As Smith (1795 [1982]: 322) stated in his lecture notes that he used to develop *The Wealth of Nations*: "Little else is requisite to carry a state to the highest degree of opulence from the lowest barbarism but peace, easy taxes, and a tolerable administration of justice; all the rest being brought about by the natural course of things." Unpacking precisely the institutional infrastructure that produces those consequences has been one of the central tasks of political economists and social philosophers ever since Smith.

The early neoclassical economists in the wake of the marginal revolution in value theory did not see their tasks as all that radically different than Smith's. They just had a new set of analytical tools to utilize in explaining value, exchange and productive activity within the market economy. The Austrian economist Carl Menger was one of the founders of the marginal revolution – alongside co-discoverers Leon Walras and William Stanley Jevons. Yet, what distinguished Menger from the other founders of the marginal revolution was in applying invisible hand theorizing, as emphasized by his predecessors in classical political economy, to the analysis of social institutions. In distinguishing Menger from his counterparts in the marginal revolution, Bruce Caldwell writes the following: "The marginal concept was only a small part of a much larger contribution, namely, a theoretical demonstration that individuals, acting in their own self-interest, give rise to social institutions that have effects that no one intended and that are in many cases benign" (2004: 73–4).

All the early neoclassical theorists from the founders to Wicksell, Wicksteed, Clark, and Knight possessed a deep appreciation of the *institutional framework* within which economic activity takes place. However, most theorists simply began their analysis by assuming well-defined and strictly enforced property rights. Taking the next step and analyzing the emergence of the rules that govern social interaction, the enforcement of those rules, and the effect of changes in those rules was unique to Menger and his junior colleagues in Vienna – Eugen Bohm-Bawerk and Friedrich Wieser. The label – the Austrian School of Economics – was given to this group of thinkers by their intellectual opponents, the German Historicists. Originally, Menger thought he was contributing to the German language scientific tradition by providing the theoretical grounding for the historical and institutional analysis that the German Historical School claimed they wanted to conduct. Menger's point, for our purposes, was rather a basic one – you can do historical and institutional analysis guided by an articulated and defended theory, or you can do it with an unarticulated and non-defended theory, but what you cannot do is conduct the analysis without any theory. The German School rejected the classical political economists because they found the theory too abstract, based on an unrealistic theory of human nature, and for ignoring the historical and institutional details of the situation. So while the older German Historical School of Roscher would have perhaps met Menger's overture with gratitude, the "younger" German Historical School of Schmoller violently rejected such an effort to provide theoretical foundations. Menger was dismissed as "the Austrian," and thus was born the first school of neoclassical institutional economics – what later became known as New Institutionalism, of which the entire field of law and economics is a part.

Menger responded to Schmoller and the German Historical School's rebuff by engaging in the *Methodenstreit* and followed up his *Principles of Economics* (1871) with *Investigations into the Method of the Social Sciences* (1883). While Menger's work was grounded in economic theory, this book discusses general sociology, politics, and jurisprudence, as well as history. It is important to note that at the University of Vienna, advanced economics education took place within the school of law. So in addition to technical economics, students studied jurisprudence, sociological theory, political theory, and history. Economics was a branch, though the most developed branch, of a more general theory of social interaction. But the Austrian economists argued that the most scientifically productive way forward in this general social theory was to ground the analysis in *methodological individualism*. As Menger put it in *Principles of Economics* (1871 [1981]: 108), man "is himself the point at which human economic life begins and ends." The analytical focus was on the rational actor's arrangement of scarce means to satisfy unlimited wants in the most efficacious manner possible. These actors were acting in an uncertain world and with very limited knowledge, so errors of judgment and errors of execution could plague their efforts, but the basic structure of striving to achieve the most for the least is not deterred by this recognition of man's imperfections. In fact, it is precisely our imperfections and the possibilities for change that motivate acting man, and lead acting man to learn through time how better to pursue his purposes individually and through exchange with others who are similarly trying to improve their lot in life.

The Austrian school of Menger, Bohm-Bawerk, and Wieser divided economic science into three branches: pure or exact theory; applied theory or institutionally contingent theory; and empirical examination (both historical and contemporary public policy). Critics thought incorrectly that the classical political economists and Austrian school economists worked exclusively in the realm of pure theory, but this was mistaken. As Buchanan (2001: 290) notes, "to Adam Smith, the 'laws and institutions,' the political-legal framework within which persons interact, one with another, are important and necessary elements in the inclusive 'constitution' for the political economy." Or consider how Hayek (1978: 124–5) summed up Smith's position: "Adam Smith's decisive contribution was the account of a self-generating order which formed itself spontaneously if the individuals were restrained by appropriate rules of law."

The interaction of pure theory of the logic of choice with the institutional context that defined the logic of the situation simply was missed by critics, and as we have mentioned, by the formalists. This is perhaps because the critics among the German Historicists and the American Old Institutionalists believed there was an ideological commitment to reform, and one of the serious implications of the classical political economists and the early neoclassical Austrians was that reform faced its own set of constraints.[4] Note we did not say reform was impossible. Rather, we just merely said that it faced constraints, but that was enough to invoke the ire of the would-be reformists who like Adam Smith's "man of systems" were very wise in their "own conceit" and thus believed they could "arrange the different members of a great society with as much ease as the hand arranges the different pieces upon a chessboard." (Smith 1759 [1982], VI.ii.2.17: 234) Stressing the play between context and choice, and understanding intended and unintended consequences – the seen and the unseen; immediate effects and long-run effects – is essential to analyzing the impact of reform measures. Such an analysis was too irksome to the aspirations of the reformers, and too nuanced and subtle in the institutional contingencies for the formalists.

III. THE SOCIALIST CALCULATION DEBATE: THE CRITICAL JUNCTURE BETWEEN THE EARLY AUSTRIAN SCHOOL AND THE MODERN AUSTRIAN SCHOOL

The Austrian school economists were caught between historicism and formalism as 20th-century economics was evolving throughout Europe and the United States. Between WWI and WWII, a new generation of theorists emerged to carry the banner, namely Ludwig von Mises and F.A. Hayek. They would be involved as primary actors in three intellectual dramas during those years: the debate over socialist calculation; the debate over business cycles; and the debate over the methodology of economics. For our purposes, what matters most is how each of these debates were interconnected and resulted ultimately in Hayek's turn in the post-WWII era to an explicit focus on the institutional *framework* as seen in *The Constitution of Liberty* (1960) and *Law, Legislation and Liberty* (1973–79). In both the socialist calculation debate and the business cycle debates, the unique "Austrian" contribution related to the guiding role of

[4] On the reform mentality of the Old Institutionalist thinkers see Thomas Leonard's *Illiberal Reformers* (2016).

relative prices in the processes of exchange and production. The coordination of economic plans – whether the production plans meshing with consumption demands, or the savings of some with the investment plans of others – was guided by relative prices in those respective markets. And, the very existence of those relative prices is based on private property rights. Prices without property is a grand illusion, since property, as we saw from Hume, is the basis of exchange and contract. Without private property in the means of production, Mises argued, there would be no market for the means of production, and without a market there would be no relative prices established in the means of production. And, without those relative prices, there could be no rational economic calculation of the alternative use of scarce resources (Mises 1920 [1975]: 111; Mises 1922 [1951]: 119; see also Boettke 1998: 134). Prices guide production; calculation aids coordination of complex economic arrangements. Advanced material production and wealth creation is only possible within the context of the private property market economy.

But during the interwar years, economic science had taken a turn toward excessive formalism and excessive aggregation, and in the process tended to cloud our understanding of the subtleties of economic coordination. Consider, for example, the problems associated with coordinating the use of capital within a firm, let alone within an entire economy. Capital goods are heterogeneous but possess multi-specific uses; they are not homogeneous and perfectly fungible. Yet, modeling is more tractable if one abstracts from the heterogeneous characteristics and assumes capital is homogeneous and perfectly fungible in production plans. But making this assumption results in two things – first, the coordination of production activities through time appears to be simple, and second, errors in the process of coordination are less costly. This rather trivial step in the assumptions had very significant implications. In the socialist calculation debate, the absence of private ownership in capital goods, and thus a working market-based price system, did not cause concern and instead a planning procedure of trial and error could easily substitute to achieve the optimality conditions of general equilibrium. In the business cycle dispute, the manipulation of money and credit would not be seen as generating a costly malinvestment in the capital structure, and any errors that were induced could easily be corrected within the model; the problem with macroeconomic volatility wasn't seen as a bug, but a feature of a more realistic rendering of the market economy, where agent optimism and pessimism and prices do not play a guiding role in exchange and production activity. In short, the conclusion by the end of the 1930s was that models of market socialism were workable and that the market economy was inherently unstable and could suffer from aggregate demand deficiencies that could only be dealt with through activist government intervention.

The teachings of classical political economy, as well as the early neoclassical school of economics, was overturned not by historicism and institutionalism, but by a formalistic version of neoclassicism that drew attention away from the institutional context, and an excessive aggregation that drew attention away from the active choices of individual actors within the economic system. The logic of choice and the logic of the situation in studying the processes of complex coordination were replaced by the economics of control characterized by macroeconomic demand management and market socialism to address any microeconomic imperfections and inefficiencies. Abba Lerner, in fact entitled his book, *The Economics of Control* (1944). Milton Friedman's review of Lerner is instructive for our narrative because Friedman points out that Lerner's analysis was logically valid, but was impractical because he did not address the administrative costs associated with his proposals (Friedman 1947: 415).

Recall our emphasis from Adam Smith on a "tolerable administration of justice." One simply cannot do political economy without addressing the institutional infrastructure within which economic activity takes place. Yet, during the period of 1940–60 the economics profession turned increasingly away from paying attention to institutions. The pockets of resistance to this trend are seen in particular developments during this period, especially in the 1950–70 period of property-rights economics, public choice economics, and law-and-economics associated with names such as Armen Alchian, James Buchanan, and Ronald Coase, respectively.[5] But Mises and Hayek actually started this intellectual trend during the debate over socialism, the debate over business cycles, and the debate over methodology. They entered into the last debate because of the communicative frustration experienced in the first two. As Mises would often stress, nothing in his proposal for praxeology should be seen as new, but instead as the methodology that was followed by all the leading economists past and present. And besides the emphasis on the pure logic of choice, Mises's praxeological analysis required the economist to take into account the *institutional framework* within which economic activity takes place. This is the basis of his comparative institutional analysis of the unhampered market economy, socialism, and interventionism, as well as his examination of bureaucracy,

[5] For our purposes, Ronald Coase is the critical figure of these three, but as suggested earlier we also would highlight the role that Aaron Director played before in developing the law-and-economics movement, and Bruno Leoni after for his work focusing on the lessons from the socialist calculation debate on how we should approach the study of the evolution of law.

the war economy, and the total state. The pure logic of choice does not change in each of these institutional settings, but the manifestations of that choice, and the consequences of the interactions among choosers, will vary depending on the institutional context.

In one of the most ironic twists of modern intellectual history, and very telling for our purposes, Oskar Lange actually accused Mises of being an old-style institutionalist because of his emphasis on private property in the means of production and a market price system for the rational calculation of alternative uses of scarce resources in investment projects (see Lange and Taylor 1938: 62). The fact that many in the economics profession at the time found Lange persuasive, and even found Hayek and Robbins's respective rebuttals to be wanting, shows that the insidious influence of formalism was already taking hold in the minds of economists by the end of the 1930s. Institutionless economics resulted in purging not only law, politics, history, and sociology, but ultimately also the human decision-maker and the agony of choice the human decision-maker must embrace in trying to sort through the uncertainty of the future.

To Menger, man was caught between alluring hopes and haunting fears, as he attempted to envision a future path in bettering his condition. The institutional environment was thus seen as a useful guide, or a hindrance, in this effort to be better off tomorrow than one is today. In an uncertain future, one characterized by ceaseless change, the *institutional framework* provides the background to give the world some predictability for coordinating our actions.[6] Thus, to the classical political economists and the early neoclassical economists, a constantly shifting *framework* and/or a deteriorating *framework* would simply compound the problem of coordination. Coordination failures, which are not to be ignored, resulted from *framework* issues, and were not inherent in the operation of a private property market economy. This last point is essential to understanding the rise of New Institutional Economics in the 1950–70s. Markets *per se* do not fail, but the *rules* that govern human interaction in the market could be, and often are, imperfect and result in significant deviations from ideal allocations of resources. Unexploited opportunities for mutually beneficial exchange are overlooked, and least cost technologies are not fully employed in production. There was among the classical and early neoclassical economists a general recognition of so-called market failures of

[6] This argument would later become the basis for one of the classic papers in the Austrian approach to law and economics, Mario Rizzo's "Law Amid Flux" (1980), and the even later Richard Epstein's *Simple Rules for a Complex World* (1995).

monopoly power, externalities, the provision of public goods, and macroeconomic volatility. There were, in short, problems of poverty, ignorance, and squalor in the world that must be addressed. Mass unemployment and systemic inequality were just as much of a concern for Adam Smith as they were for Alfred Marshall and as they are today for Joseph Stiglitz and Paul Krugman. The differences in opinion among these thinkers is not in the recognition of the problem or even in the normative desire to ameliorate and hopefully eradicate the problem, but in the diagnosis of the cause and the recommendation for the remedy. For classical political economists, such as Hume, Smith, Say, Bentham, and Mill, as well as Austrian economists, such as Menger, Mises and Hayek, the cause was to be found not in the frailty of human beings (which was after all omnipresent), but in the institutional context within which these fallible but capable human actors were interacting. As a result, the solution was to be found not in any transformation of the human being, nor in the *deus ex machina* of benevolent and omniscient state action, but in the positive program for *laissez faire* as laid out in the reform proposals for changing the rules found in Smith, in Mill, in Hayek, and in more modern times Friedman and Buchanan.

Reform was to be found neither in policy dictates to mimic what an ideal pattern of economic activity would result as in the market socialist model, where state planners were simply told to price equal to marginal cost and produce at the level of output that minimizes the average cost of production. Nor, as was critical to the emerging field of law and economics, was it to be found in pursuing Pigouvian remedies of either taxing or subsidizing until private marginal benefits/costs were aligned with social marginal benefits/costs. As Hayek pointed out in his paper "Economics and Knowledge" (1937), the optimality conditions of the market were a by-product of the competitive process, and *not* an assumption going into the analysis. Competition is an activity, not a description of a state of affairs where all activity has ceased. Hayek, in particular, tended to blend his institutional turn in research in the 1940s with his *epistemological* turn in research. Institutions did not just structure the incentives that actors faced in making their decisions and thus influencing the manner in which they interact with other, but they also impact the quality of information and the flow of new knowledge that decision-makers have at their disposal in making those decisions. Much of the most important knowledge that must be utilized is contextual in nature. Outside of specific institutional contexts, it isn't just difficult to acquire; it simply ceases to exist. Social scientists are still struggling to catch up to Hayek's fundamental insights in his papers on the utilization of knowledge within an economic system and the role that alternative institutions play in that analysis.

IV. HAYEK, THE INSTITUTIONAL TURN, AND THE EMERGENCE OF LAW AND ECONOMICS

In the 1940s, Hayek published *The Road to Serfdom* (1944), and in that book – a further elaboration of a monograph entitled *Freedom and the Economic System* (1939). In those works, Hayek turned his attention to the rule of law and democracy, and how the economic system interacts with legal and political institutions. A close reading of these works, and his subsequent works dealing with the interaction of legal, political, and social institutions and the operation of the economic system such as *The Constitution of Liberty* and *Law, Legislation and Liberty* (1973–79), Hayek both examines how alternative institutional arrangements impact the economic forces at work, and how the tools of basic economic reasoning can be deployed to analyze the institutional logic of proposed rule changes in the legal, political and social spheres. For example, in *The Road to Serfdom*, the reader is first introduced to the argument that comprehensive economic planning will be inconsistent with the rule of law and democracy. This is the rationale for the title of the work, which is meant to capture a tragic tale. Remember, Hayek was not addressing his book to the advocates of communism in Soviet Russia, or the advocates of the total state in Nazi Germany, but to his colleagues in Britain who believed they could combine socialist economic planning with liberal democratic institutions such as the rule of law and individual freedom. The suppression of individual freedom and the erosion of democratic institutions that Hayek envisioned as the logical outcome of efforts to substitute comprehensive economic planning for the market economy was a tragic warning to his colleagues. Their vision of a rational economic order would result in a political nightmare from their own point of view as the rule of law and democracy would prove to be incompatible with the organizational logic of economic planning.

The arrow of argumentative direction in Hayek's line of reasoning was directed at the aspirations to remake the economic system via the political order. One of his main points of emphasis was how political control over economic means was not merely a control over material factors, but necessarily a control over the means by which we pursue our most lofty goals. "Economic control," Hayek wrote, "is not merely control of a sector of human life which can be separated from the rest; it is the control of the means for all our ends. And whoever has sole control of the means must also determine which ends are to be served, which values are to be rated higher and which lower, in short, what men should believe and strive for" (1944 [2007]: 127). Freedom of speech, religion, and the press, e.g., is an empty phrase unless we also have the ability to own the means of the press. Human rights are ultimately property rights. Coming from the grand debate in economic theory over rational economic planning under socialism, Hayek moved the conversation from the technical arguments concerning the price system and the allocation of scarce resources to the institutional environment that would need to compliment that planning task. The rule of law and democratic institutions are the means by which individuals are left free to pursue a great variety of purposes. They provide the institutional impediments to the necessary power and discretion of the planners, making it possible for individuals to pursue their individual plans with a fair degree of certainty as to how government officials will exercise their coercive power. The rule of law allows for the mutual adjustment of conflicting plans through voluntary exchange via market prices as guides to production and consumption. However, the rule of law is inconsistent with political discretion, for government planning can only succeed through the suppression of individual plans by political actors willing to exercise force. At this point, Hayek develops a slightly different argument. In his chapter on "Why the Worst Get On Top," Hayek explains how the selection process among leaders of the planning effort will take place. In this, he follows Frank Knight (1932; 1938), and simply uses an argument about the comparative advantage in exercising discretion and power over fellow citizens and the characteristics of such a person. In short, Hayek argues that even if someone of the character of Mother Teresa was to be put in charge of the planning bureau she would either have to change her character to be more ruthless, or she would lose out in the political struggle for leadership. As Knight put it, only a certain type of character can survive to control the whip on a plantation; it is not a job for everyone. It is the same with those placed in charge of executing comprehensive economic plans.

The fields of public choice and law-and-economics from a Hayekian perspective should be seen as intertwined and as two sides of the same effort to refocus economists' attention on the *institutional framework*. The work of various sociologists during this same era – whether Peter Berger, Rodney Stark, or James Coleman – also sought to integrate social institutions such as norms, mores, beliefs, etc. into this focus on the *framework* in a way consistent with the basic economic way of thinking, but the consensus in this research is less solidified than in public choice and law-and-economics so the integration is not as easily envisioned.

Methodologically, the approach to the study of political and legal institutions works initially in a rather straightforward linear fashion – an animating rational actor initiates that inquiry, that actor finds themselves interacting within an institutional filter, defined by the formal and informal rules of social interaction and their enforcement, that institutional filter structures the incentives and provides the information and knowledge that actors need to act on the incentives, and that in turn results in certain equilibrating tendencies which the system exhibits. As Buchanan often stressed, same players, different rules, produce different games. The explanatory thrust in this approach is to be found not in the behavioral attributes we assign to the individual actors, but in the alternative institutional *frameworks* within which they operate.

As Robert Van Horn (2013) has documented with rich archival research, the relationship between Hayek and Aaron Director in the decade prior to *The Road to Serfdom* and the decade after its publication was indeed a deeply committed one. They saw themselves as "comrades in arms" against the collectivist threat to the competitive order. Director was a student at the LSE in the 1930s, and viewed Hayek as his teacher. Director would use his connections to push for the publication of Hayek's *The Road to Serfdom* by the University of Chicago, and he would review the book extremely favorably in the *American Economic Review*. In addition, when private donors wanted to establish a program at the University of Chicago to study in depth the private enterprise system, and though they approached Hayek to lead this effort (even though he was not at Chicago at the time), Hayek recommended that they work with Director instead, and they did. The project – sometimes referred to as the "Hayek project" in internal memos and correspondence between the principals – was housed at the University of Chicago Law School. The focus of the project turned to a theme captured in our headquote to this chapter, namely the forms of legal institutions which aid, or hinder, the operation of the competitive system.

Ronald Coase was another product of the LSE in the 1930s, and as he has described his own work it was to examine the *institutional framework* that made possible the workings of firms, markets, and economies. Coase is sometimes referred to as an advocate of a pragmatic-empirical brand of economics. But Coase was not an old style institutionalist. He was trapped, as Hayek was, between historicism and formalism. Moreover, like Hayek (and Plant and Robbins), Coase in good LSE fashion was trained in basic economic reasoning and price theory. He was a neoclassical institutionalist, and as such focused on exchange and the institutions within which exchange takes place. This is seen not only in his development of the transaction cost theory of the firm, which he developed directly from his reflections on the socialist calculation debate as taught to him by Arnold Plant, but in the development of the "Coase Theorem" as articulated in his paper, "The Federal Communications Commission" (1959), and then more fully developed in "The Problem of Social Cost" (1960). We do not have to repeat here the arguments in those papers about the allocation of resources and the initial distribution of rights under the assumption of zero transaction costs, or in the face of positive transactions costs, but suffice to say Coase pioneered comparative institutional analysis. He argued that in making the comparison one must take into account that in moving the decision arena away from the market sphere one must recognize that they will have to forgo the monetary calculation of benefits and costs, the division of knowledge throughout the economy, and must account for the additional costs of vested interest groups (see 1959: 18).

In setting up the various contributions to this volume, what matters is that from Hayek one can draw not an indirect line of influence, but a direct line of influence to the founding of the law-and-economics movement after WWII and its development in the 1940s–60s by Aaron Director and Ronald Coase. We do not contend that this development was linear, but instead it went in a variety of new and interesting directions. But the influence was direct nevertheless, and it was seen as a corrective to the disregard for the *institutional framework* by mainstream economists in the 1930s–50s that resulted in fundamental confusions about that operation of the competitive order, and the vital role that legal institutions play in its effective operation.

V. HAYEK, LEONI, AND ENDOGENOUS RULE FORMATION

One final point of emphasis in the Hayekian perspective on the institutional *framework* that has caused confusion among readers is the question of the origin and maintenance of this *framework*. Alexander Hamilton in *Federalist #1* put the puzzle as follows: will we base our constitutions on accident and force, or on reflection and choice? The obvious answer to this question so put is to rely on reflection and choice. One way to think about Hayek's discussion of rational constructivism versus spontaneous order is to see him working through Hamilton's question. Hayek is simply pointing out that we cannot just design institutions out of thin air and place them. We are constrained in our quest for rational institutional design by the historical path we are on. But that does not mean we cannot engage in positive reform of the rules and in efforts at institutional design. The critical rationalist is permitted, and in fact, must, challenge all of society's values, but they cannot challenge all of them at once. This is why Hayek's position cannot be considered "conservative," since he wants to hold nothing as sacred, yet Hayek is not a "constructivist" because he argues we cannot design society from nothing according to our will. It is a subtle and nuanced dance of evolution and design that makes up the spontaneous order of society and the institutional *framework* that shapes that order. Hayek makes this point in *Law, Legislation, and Liberty*:

> At the moment our concern must be to make clear that while the rules on which a spontaneous order rests, may also be of spontaneous origin, this need not always be the case. Although undoubtedly an order originally formed itself spontaneously because the individuals followed rules which had not been deliberately made but had arisen spontaneously, people gradually learned to improve those rules; and it is at least conceivable that the formation of a spontaneous order relies entirely on rules that were deliberately made. (Hayek 1973: 45)

The crucial step in Hayekian analysis was to argue that not only the pattern of social interaction within the *framework* was a result of spontaneous order, but that the very *framework* itself was the product of another spontaneous process of ordering. This focus on endogenous rules, rather than processes within exogenous rules, is what separated Hayek from the earlier Austrians (except Menger) and the later New Institutionalists (except Elinor Ostrom).

The Italian classical liberal political economist Bruno Leoni was one of the earliest writers to see the connection between the socialist calculation debate and this focus on the endogenous evolution of law. In his now classic work *Freedom and Law*, Leoni argues that the theoretical impossibility of economic central planning is considered only a part in a more general problem, regarding the possible action of the legislator in society.

> [T]his demonstration [that a centralized economy does not work] may be deemed the most important and lasting contribution made by the economists to the cause of individual freedom in our time. However, its conclusion may be considered only a as a special case of a more general realization that no legislator would be able to establish by himself, without some kind of continuous collaboration on the part of all the people concerned, the rules governing the actual behavior of everybody in the endless relationships that each has with everybody else. No public opinion polls, no referenda, no consultations would really put the legislators in a position to determine these rules [. . .]. The actual behavior of people is continuously adapting itself to changing conditions. (Leoni 1961 [1972]: 18–19)

In correspondence with Hayek after the publication of *Freedom and the Law*, Leoni summed up his argument as follows:

> 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. (quoted in Masala 2003: 228)

If market coordination through the price system requires competition to sort out errors and provide corrective adaptations and adjustments, then so does a working legal system require competition to discover errors in judgment and rulings, to adapt and adjust to changing circumstances, to minimize conflicts, and promote productive specialization and peaceful social cooperation. The law, like the market, to Leoni, is a discovery procedure. Legislation, like centralized planning, curtails learning and thus becomes an impediment to progress in social intercourse and economic well-being.

The contrast is most starkly seen in the contrast in points of emphasis concerning spontaneous order within a framework of law, and spontaneous order of the framework of law itself in the presentations of Hayek and Buchanan. For our purposes, we want to stress that the contrast is overblown. Hayek's emphasis on the spontaneous order of common law versus the constructivist rationalism of legislation led to confusion in the modern discussions in political economy about the role of constitutional construction in Hayek's system. By drawing on the discussion of conservativism and constructivism, we argue that while there is no doubt a tension, this tension need not be a source of confusion, but instead a source of inquiry. Constitutional construction is a constrained intellectual exercise, but a necessary one for the maintenance of the liberal order. Law evolves, but it can also be improved upon when this evolution is derailed in perverse directions in relationship to liberalism. Hayek stresses, in this sense, constitutional construction from the bottom up, but there is nothing in his system that would prevent constitutional design on the margins.

On the other hand, one of the most challenging research questions law and economics scholars have puzzled over in the past quarter of century in the face of the collapse of communism, the continued failure of state-led development planning in Africa and Latin America, and war-torn failed and weak states around the globe, has been how does one "grow" a rule of law. As Rajan (2004) so eloquently put it, you cannot proceed under the assumption of well-defined and enforced property rights in a world that has completely fallen apart institutionally. The reason why these societies are dysfunctional is precisely because they lack the *institutional framework* that more functional systems possess. We must, as Rajan put it, "Assume Anarchy" if we are going to make any progress. That is our starting point of analysis, and the question is how law develops. As Peter Leeson (2014) has stressed repeatedly, one cannot just assume that in such an environment you can impose a working Western-style government. In such a dysfunctional environment the most likely outcome is an abusive dysfunctional government that will be unleashed to predate on the people, rather than be constrained in its predatory propensities. So one possible avenue of research that has been opened by this is the role of *informal* institutions in providing the impetus for development.

To tie this back to Buchanan, consider the conclusion that Buchanan and Tullock are led to in *The Calculus of Consent* (emphasis added, 1962 [1999]: 80–81) concerning social cleavages:

> The evolution of democratic constitutions from the discussion of rational individuals can take place only under certain relatively narrowly defined conditions. The individual participants must approach the constitution-making process as "equals" in a special sense of this term. The requisite "equality" can be insured only if the existing differences in external characteristics among individuals are accepted without rancor and if there are no clearly predictable bases among these differences for the formation of permanent coalitions. On the basic of purely economic motivation, individual members of a dominant and superior group (who consider themselves to be such and who were in the possession of power) would never rationally choose to adopt constitutional rules giving less fortunately situated individuals a position of equal partnership in governmental processes. On noneconomic grounds the dominate classes might choose to do this, but, as experience has so often demonstrated in recent years, the less fortunately situated classes will rarely interpret such action as being advanced in their favor. *Therefore, our analysis of the constitution-making process had little relevance for a society that is characterized by a sharp cleavage of the population into distinguishable social classes or separate racial, religious, or ethnic groupings sufficient to encourage the formation of predictable political coalitions and in which one of these coalitions has a clearly advantageous position at the constitutional stage.*

So if we take them at their word, either Buchanan and Tullock's analysis is irrelevant to the world of dysfunctional institutions, or we have to embrace the challenge of studying endogenous rule formation in the field of law-and-economics and public choice.

VI. SO WHAT IS "AUSTRIAN" ABOUT "AUSTRIAN" LAW AND ECONOMICS?

The term "Austrian" in the Austrian school of economics can be interpreted in 1 of 2 ways. First, it could be understood as a cultural setting of the founding of a certain approach to economics in *fin-de-siècle* Vienna. This Viennese intellectual and artistic culture was a unique period of human creativity, and the discipline of economics was no different. So the time period is worthy of study for anyone intrigued by intellectual history (see Dekker 2016). On the other hand, the term “Austrian” also designates a certain approach to the study of economics. The interaction of these two is quite fascinating for scholars of law and economics. At the University of Vienna, the economics faculty was located within the School of Law. And, the Austrian economists in their economic analysis always placed great importance on the institutional framework of property and contract.

Boettke (2010: xi–xviii) provides a summary of the ten propositions that are the defining substantive position of the contemporary Austrian school of economics. They are:

1. Only individuals choose.
2. The study of the market order is fundamentally about exchange behavior and the institutions within which exchange takes place.
3. The “facts” of the social sciences are what people believe and think.
4. Utility and costs are subjective.
5. The price system economizes on the information that people need to process in making their decisions.
6. Private property in the means of production is a necessary condition for rational economic calculation.
7. The competitive market is a process of entrepreneurial discovery.
8. Money is non-neutral.
9. The capital structure consists of heterogeneous goods that have multispecific uses that must be aligned.
10. Social institutions are often the result of human action, but not of human design.

These propositions are evident in the various contributions to Austrian law and economics as well. As we have seen, traditional law and economics emerged from taking two fields of study and combining them into one. There was the traditional economic analysis of exchange relationships and competitive behavior within a given set of institutions. And, there is the application of the rational choice tools of analysis developed in economics to study the institutional rules themselves. There are subtle and important differences between an approach that attempts to examine how alternative institutional arrangements impact the operation of an economic system, and the use of economic reasoning to address the efficiency, or possible efficiency, of a set of institutional arrangements. For our purposes, both approaches can be pursued from an “Austrian” perspective, and have been by various scholars as is evident within the pages of this volume.

The Austrian school of economics is identified with methodological individualism, methodological subjectivism, and market process analysis. It is a school of economic thought that focuses on the processes by which individuals coordinate their plans through time. Its first task is to render all human phenomena intelligible in terms of the purposes and plans of individual actors, and then it seeks to trace out the unintended – both desirable and undesirable – consequences of those actions and interactions. It is an approach that takes seriously the subjective evaluations, assessments, and expectations of actors, as well as the decision-making environment within which individuals are pursuing their plans, an environment characterized by uncertainty, ignorance and the passage of time. In short, the Austrian school of economics studies the economy as a complex system.

This approach is to be contrasted with an approach to the study of economic behavior and organization which treats economic phenomena as a simple system. In the extreme, it is a system characterized by mathematical functions that are smooth and continuous and twice differentiable. Such a system is close-ended and exhibits a single exit. These are *equilibrium* theories of market exchange and the social order.

In the process approach, the law provides the institutional framework within which the complex and dynamic processes of exchange and entrepreneurial adaptation and adjustment to constantly changing conditions takes place. Thus, the analysis informs us on how alternative legal regimes impact economic performance. But the Austrian school also developed a process approach to the institutional framework. From Carl Menger to Mises and Hayek, Austrian law and economics studies the evolution of legal rules as a prime example of spontaneous order analysis. "How can it be," Menger (emphasis original, 1883 [1985]: 146) famously asked, "that institutions which serve the common welfare and are extremely significant for its development come into being without a common will directed toward establishing them?" Hayek (1952 [1979]: 69) went further and argued that to the extent that the social institutions are a result of deliberate design, there would be no necessity for theoretical inquiry in the sciences of man and society. It is only because we are dealing with institutions that are the result of human action, but not of human design that we as social scientists have a need for theoretical sophistication and refinement.

In this, as in many other ways, the modern Austrian school was simply updating the political economy and social philosophy of the Scottish Enlightenment philosophers by way of refining economic theory that followed from the marginalist revolution and the development of the subjective theory of value. The equilibrium approach that also emerged in the first half of the 20th century often clouded rather than clarified the fundamental relationship between the institutional framework and economic performance, as well as the study of that institutional framework itself. Hayek famously wrote:

> Nothing is solved when we assume everybody to know everything and that the real problem is rather how it can be brought about that as much of the available knowledge as possible is used. This raises for a competitive society the question, not how we can "find" the people who know best, but rather what institutional arrangements are necessary in order that the unknown persons who have knowledge suited to a particular task are most likely to be attracted to that task. (Hayek 1948: 95)

This argument of Hayek's was deployed to examine the coordinating role played by prices in a competitive economy, and the consequences of distortions to that guiding role that result with interference in the operation of the price system. But the broader point about the evolution of an institutional environment that is conducive to economic growth would be a persistent theme in Hayek's work and was developed in *The Road to Serfdom*, *The Constitution of Liberty* and *Law, Legislation and Liberty*. It is these works that form the classic writings in Austrian law and economics, and as we have stressed they exhibit throughout the emphasis on individual choice not only against constraints, but in an environment of ignorance and uncertainty. The coping function of institutions is to deal with uncertainty by providing predictability and stability in the framework, yet maintain a mix of coherence and flexibility to enable the necessary adaptations and dynamic adjustments to the rules with the passage of time to accommodate the changing circumstances.

VII. CONCLUSION

So we have individuals *and* institutions; we examine how alternative institutional arrangements impact economic performance *and* how the tools of economic reasoning help us better understand the operation of institutions. We study law as the product of evolutionary processes and thus a quintessential example of a spontaneous order *and* the constitutional structures that are most effective at constraining the predatory capacities of the state so as to preserve a framework that allows human beings to flourish. The Austrian school of economics in its historical and contemporary embodiment, as well as the various thinkers that it influenced along the way, such as Alchian, Buchanan, Coase, Director and Leoni, has contributed significantly to the development of law and economics in the post-WWII era, and continues today into the 21st century with a new generation of scholars.

In the volume that follows, we have contributions from a variety of scholars whose work has contributed to the ongoing development of law-and-economics both from within law schools and within economics departments, business schools and in the social sciences and humanities. The range of topics covered run from methodology of analysis, to the evolution of contemporary legal practice, to the teachings of basic law. We believe this provides a strong overview of the contemporary literature in the Austrian school approach to law and economics, and one that reflects both the examination of how alternative legal arrangements impact economic performance, and how to use the tools of basic economic reasoning to study the operation of legal rules. In our conclusion, we will return to the subject we ended with – the prospects and promises for future research in the field of law and economics that follow from the continued refinement of our understanding of the *institutional framework* and how it impacts economic performance through time.

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