Journal of Comparative Economics 000 (2016) 1–13

Contents lists available at ScienceDirect

Journal of Comparative Economics

journal homepage: www.elsevier.com/locate/jce

Legal institutionalism: Capitalism and the constitutive role of law

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ARTICLE INFO

Article history:
Available online xxx

Keywords:
Institutions
Law
Capitalism
Theory of the firm
Property rights

ABSTRACT

Deakin, Simon, Gindis, David, Hodgson, Geoffrey M., Huang, Kainan, and Pistor, Katharina—Legal institutionalism: Capitalism and the constitutive role of law

Social scientists have paid insufficient attention to the role of law in constituting the economic institutions of capitalism. Part of this neglect emanates for inadequate conceptions of the nature of law itself. Spontaneous conceptions of law and property rights that downplay the role of the state are criticized here, because they typically assume relatively small numbers of agents and underplay the complexity and uncertainty in developed capitalist systems. In developed capitalist economies, law is sustained through interaction between private agents, courts and the legislative apparatus. Law is also a key institution for overcoming contracting uncertainties. It is furthermore a part of the power structure of society, and a major means by which power is exercised. This argument is illustrated by considering institutions such as property and the firm. Complex systems of law have played a crucial role in capitalist development and are also vital for developing economies. *Journal of Comparative Economics* **000** (2016) 1–13. Faculty of Law, University of Cambridge, UK; Hertfordshire Business School, University of Hertfordshire, UK; Shandong University, China; Columbia Law School, USA.

At this early stage of its development, legal institutionalism[1] involves claims concerning the nature of social reality, at least in modern, developed socio-economic systems. It does not yet provide a full theoretical approach, but it does provide some tentative and limited indications concerning theory and policy.

There are two primary ontological claims. The first concerns the nature of law. It is argued that law (at least in the fullest and most developed sense) necessarily involves both the state (broadly construed to refer to a realm of public ordering) and private or customary arrangements. Reduction of law to just one of these two aspects is mistaken. As well as drawing from custom, law involves an institutionalized judiciary and a legislative apparatus.

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[1] The term "legal institutionalism" has been used by some legal scholars to refer to institution-orientated theories of law (La Torre 1993, MacCormick 2007). We use it to denote legally-grounded approaches to the institutional and economic analysis of capitalism, as in the cases of Commons (1924) and Samuels (1989).

http://dx.doi.org/10.1016/j.jce.2016.04.005
0147-5967/

The second ontological claim is that law – understood as an outcome of both state intervention and private ordering – accounts for many of the rules and structures of modern capitalist society. Consequently, law is not simply an expression of power relations, but is also a constitutive part of the institutionalized power structure, and a major means through which power is exercised. This claim applies primarily to modern developed capitalist economies. Underdeveloped societies, where the rule of law is compromised by a degree of arbitrary power, may depend even more on propaganda and coercion, and less on the operation of legal rules. But even in these cases, at least in the modern world, law still plays an important role.

Models of the spontaneous development of law typically rest on relatively small numbers of agents and underestimate the complexities and uncertainties in developed capitalism. The law made by organs of the state, including judges and legislatures, while it may itself reflect customary experiences, is a means of overcoming this complexity and uncertainty.

Given these claims concerning the nature and central role of law in capitalist economies, legal institutionalism upholds that an understanding of legal rules is essential for economists and other social scientists. This is not to say that law is everything. Not all social rules are laws. As an evolved but also codified system facing a complex and changing economy, the law is necessarily incomplete and sometimes self-contradictory. There are important areas of social life that rely on frequent interpersonal action rather than the anonymous generalities of law. Nevertheless, the role of law is vital.

The very success of Western capitalism depends on the development of general national systems of legal enforceability. But these took a long time to establish. Even today, in much of the world, state systems of law enforcement are weak, expensive, corrupt or inaccessible. In the absence of adequate systems of law enforcement, people fall back on other means of establishing obligations and ensuring compliance. Commerce then works through clan or family ties, shared religion or ethnicity, bureaucratic co-option and corruption, or threats of violence to person or property. Simply because systems of spontaneous enforcement existed in history and persist today in certain contexts should not mislead us into believing that a fully-developed modern capitalist system rests on purely spontaneous or customary foundations.

Recognizing the centrality of law to the organization of economic and social life implies that law may vary from place to place with implications for the nature of contractual, property relations, or the organization of firms. Different legal systems can set the stage for different modes of social and economic ordering that seem to be remarkably path dependent (La Porta et al.,2008).

This paper has five further sections. It combines general points concerning the role of law, with a selective illustrative focus on some key capitalist institutions, namely property rights, contracts and the firm. Space constraints rule out discussion of money and financial institutions, for example.[2] Section 1 considers the nature of law and argues that it is irreducible to custom or private ordering alone. Law involves a combination of customary input and legislative decree. Section 2 considers whether law is constitutive or epiphenomenal in modern society. Using Marx's base-superstructure metaphor, it is shown that law cannot be consigned to the superstructure. In addition, the state aspects of law should not be treated as secondary and epiphenomenal, as in some other accounts. Section 3 considers the nature of property and contract. It shows that property is often confused with possession, and analyses of contracts and exchange sometimes downplay the importance of legal rights and obligations. Section 4 on the firm shows how the introduction of the important feature of legal personality clears up some enduring confusions about the nature of the firm. Section 5 summarizes some key points, compares legal institutionalism with other institutional approaches in economics, and concludes the essay.

1. The nature of law

Some scholars suggest that custom is the key to understanding law. In turn, custom is seen as evolving without overall guidance and design. Writers in this tradition include David Hume, Edmund Burke, Friedrich C. von Savigny, Henry S. Maine, James C. Carter and Friedrich Hayek. Hayek's writings are among the most sophisticated. In his classic account of the foundations of law, Hayek (1973, p. 72) upheld that law "is older than legislation" and that law in some sense is "coeval with society." For Hayek, laws are simply the "rules which govern men's conduct" (p. 73).

The very concept of "customary law" is sometimes over-extended. Furthermore, contrary to the impression given by Hayek (1973) and others, common law is much more than custom, necessarily involving an institutionalized judiciary (Hasnas, 2005). Generally, customary mechanisms are insufficient to explain adherence to nationwide complex systems of law.

Where "customary law" is prevalent, it is often associated with politico-economic underdevelopment and failings or remoteness of the state legal system. When dealing with modern capitalism, law is a matter of state power; separate customary law dominates only in parts where the state cannot reach, such as in remote regions. The widening and development of capitalism has aided this encompassing process. Contracting parties have found it easier to submit to a single, powerful, legal authority.[3]

[2] Money and financial institutions are discussed in Pistor (2013) and Hodgson (2015).

[3] Private, custom-bound *lex mercatoria* or "law merchants" blossomed in Europe from the eleventh to the fourteenth centuries. But they declined and were eventually replaced by state enforcement (Baker 1979; Berman 1983, pp. 333–356; Milgrom, North and Weingast 1990). A major reason for their demise seems to be that they could not cope with the increasing scale and complexity of contracting.

Please cite this article as: S. Deakin et al., Legal institutionalism: Capitalism and the constitutive role of law, Journal of Comparative Economics (2016), http://dx.doi.org/10.1016/j.jce.2016.04.005