Rivalrous Competition and the Development of Efficient Legal Institutions

1. Introduction

The classical theory of *laissez-faire* champions free enterprise of commerce and stridently opposes government regulation and intervention in the economy. Government is assigned the role of “umpire,” providing protection of property rights through law, judicial and police services. In this formulation, associated with Adam Smith’s “system of natural liberty,” free markets are desired because they tend to lower prices, raise standards of living and create wealth. For the classical economists, government rationally supplies legal institutions because of the “public good” nature of the services. Therefore, it remains somewhat puzzling that Smith, in order to demonstrate the beneficial effects of open competition, cites its impact on the English royal courts of the seventeenth century in *The Wealth of Nations*:

> The fees of court seem originally to have been the principal support of the different courts of justice in England. Each court endeavored to draw to itself as much business as it could… [E]ach court endeavored, by superior dispatch and impartiality, to draw to itself as many causes as it could. The present admirable constitution of the courts of justice in England was, perhaps, originally in great measured, formed by this emulation, which anciently took place between their respective judges; each judge endeavoring to give, in his own court, the speediest and most effectual remedy, which the law would admit, for every sort of injustice (Smith 1776, 241-2).

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Smith implies that the beneficial aspects of competition apply to legal services just as they do to any other service. Examining the history and relevant literature, this paper argues that the strength of property rights and the rule of law in England, which allowed commerce to thrive, have an economic explanation: efficient legal institutions arising from rivalrous competition in legal services. The subsequent subjugation of competition through monopolization, rather than modeling “public good” provision, engendered political rent seeking by the King, resulting in reduced efficiency. This narrative demands the critical reexamination of the possibility of private provision and the positive justification for government monopolistic provision of legal services.

2. Hayek’s “Law of Liberty” and the Law Merchant

In the first volume, “Rules and Order,” of Hayek’s Law, Legislation and Liberty, he distinguishes between two kinds of law, providing a useful framework for analyzing legal development. The first kind Hayek terms nomos, or the law of liberty, which he contrasts with thesis, the law of legislation. The distinction follows from whether rules are generated in a “bottom up” or “top down” fashion. The law of liberty, the “bottom up” variety, which Hayek also refers to as “grown law,” arises out of custom as a spontaneous order. Judge-made law, like the common law, is an example Hayek provides of the law of liberty. Legislation, on the other hand, arises from “constructivist rationalism,” which Hayek characterizes as the conceited “conception of an independently existing mind substance which stand outside the cosmos of nature and which enabled man, endowed with such a mind from the beginning, to design the institutions of society and culture among which he lives” (Hayek 1973, 17). However, Hasnas argues that Hayek has conflated customary law and the common law in his conception of the law of liberty, producing confusion. This confusion and Hayek’s mistake will become evident in the later examination of the historical development of English law. Hasnas contends “Hayek is
identifying the law of liberty with anything that is not legislation” when, in fact, “what Hayek
calls the law of liberty is actually an amalgam” of “customary and common law” (Hasnas 80).
Judge-made law, thereby, is neither wholly customary nor legislative. This finer distinction
established, Hasnas outlines the characteristics of a customary legal order. It “is law that arises
out of human interaction” and “is exclusively a solution to coordination problems” (Hasnas 83,
85). This differs from the common law, at least how it is understood in hindsight by Hayek and
others, because “the issue is always what constitutes a resolution that is fair to the parties to the
instant dispute, not how the outcome of the case will affect the interests of other parties in the
future” (Hasnas 88). This theoretical distinction is helpful to the analysis of the development of
English commercial law.

An excellent historical example of Hayek’s “law arising from custom” is supplied by the
medieval Law Merchant or *lex mercatoria*. With its roots in Roman law and first developed in
the Italian Renaissance city-states, the Law Merchant developed in response to the rising
merchant class’s obstacles to trade of high transaction costs, asymmetrical information and lack
of adjudication services responsive to the their specialized needs. The nature and success of this
legal institution is attested to by the author of the first treatise on the Law Merchant, *Consuetudo
vel Lex Mercatoria*, from 1622: “…it is customary law approved by the authority of all kingdoms
and commonweals, and not a law established by the sovereignty of any prince” (Berman 1983,
342). The Law Merchant dates to around the eleventh century. Since it lacked the procedural
rules of other courts and was comparatively informal, records are sparse. Instead, evidence of its
existence is second hand. Merchants later produced legal handbooks for other merchants, like
*The Little Red Book of Bristol* from 1280, that contain much of the substantive and procedural
content of the Law Merchant. Blackstone, writing in the mid-eighteenth century, also notes of
the Law Merchant as the source of the law governing commercial affairs in England (Berman 983, 343). While disagreement over its legal status persists, the Law Merchant’s existence as a substantive body of law is also attested to by its later wholesale incorporation into the common law by Lord Mansfield. Benson (1989) writes that “virtually every aspect of commercial transactions in all of Europe (and in cases even outside Europe) were ‘governed’ by this body of law after the eleventh century” (Benson 1989, 647).

The primary sites for adjudication of merchant disputes were medieval international fairs, like those of Champagne, where merchants met regularly to trade goods. Zywicki describes the prolificacy of the Law Merchant: “Law merchant courts prospered in towns, fairs, and various markets. Medieval trading fairs and major commercial towns provided courts for merchants to resolve disputes over contracts and torts” (Zywicki 2003, 46). In these close communities of merchants, it is intuitive specialized legal institutions developed. Merchant courts were composed of merchant jurors and judges, enabling specialized understanding of the unique disputes. Collective boycott served as the effective punishment and incentive to cooperate with merchant courts, enabled by centralized record keeping. Thus, although the nature of the Law Merchant was voluntary, since its decisions were nonbinding on the participants, evidence suggests ostracism could effectively end a merchant’s career. If a merchant in a foreign fair defected and refused to abide by the judgment and pay restitution, the boycott would extend to the entire village (Epstein 2004) or all merchants of that merchant’s country (Zywicki 2003, 47).

Over time, as cities and commercial centers grew, the Law Merchant became less a transient artifact of merchant custom and evolved into substantive, recognized law. As a result, commercial law evolved spontaneously based upon custom, what Hayek described as “the
natural selection of rules,” in the absence of satisfactory protections to efficiently meet the adjudication demands of the merchant community (Hayek 1973, 67).

Merchants faced four principal legal problems trading on a transnational scale that the Law Merchant institution ameliorated. In the first place, principalities would not recognize contracts made and agreed upon in foreign countries, increasing incentives to defect from contractual agreements (Benson 1989, 649-50). They often also hampered the movement of foreign merchants. Secondly, especially in regions under the influence of the Church, where canon law prevailed in commercial adjudication, the courts would not recognize contracts incorporating interest, considering them usurious. This hampered the ability to enforce and bind contracts through time, since the contract could always be voided in court. Thirdly, domestic courts were not specialized. Judges and juries did not recognize or understand the technicalities of trade or the merchant customs and were slow to adapt to legal innovations (Benson 1989, 650). As will be elaborated upon later, these domestic courts, the common law in particular, were often inefficient due to cumbersome procedural rules. Similarly, the legal rules of domestic courts were more likely to be systematically biased, either pro-plaintiff or pro-defendant. This would be dissatisfactory to merchants, who were indeterminately likely to be a plaintiff or defendant, and would therefore desire alternative dispute resolutions or substitute away from using the legal system at all, if possible. Finally, in order to sustain cooperation and punish cheating in the merchant community, an institution to collect and distribute information, creating value in reputation, was required. These aspects are treated extensively in the relevant literature. The development of the Law Merchant can be persuasively interpreted as attempting to meet these demands, to facilitate coordination by lowering transaction costs between individuals with limited information, and thereby to realize gains from trade (Berman 1983, 334).
As a voluntary institution based on custom and intended to coordinate interaction, efficient law and legal rules would be expected to evolve. Landes and Posner (1979) confirm this expectation: “Where parties can feasibly stipulate the forum, public or private, for adjudicating disputes arising between them, competition is feasible and we would expect efficient rules to emerge” (Landes 1979, 257). A merchant court, voluntary in nature, would maximize the expected value of potential defendant and plaintiff’s wealth, where the likelihood of being plaintiff or defendant is unpredictable. Milgrom, North and Weingast (1990) utilize a game theoretic model to suggest how the Law Merchant institution might support collusive outcomes between in repeated interactions, simplified below:

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<tr>
<td>Honest</td>
<td>1, 1</td>
<td>B, A</td>
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<tr>
<td>Cheat</td>
<td>A, B</td>
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A is assumed to be greater than 1 and B to be less than 0. In a one shot play of this game, where two merchants can either be Honest or Cheat in their transactions, both will Cheat. This outcome is suboptimal: both merchants could be better off if they agreed to collude. However, if the merchants interacted and traded repeatedly, the collusive outcome could be sustained under certain conditions, which can be modeled with an infinitely repeated game. The repeated interaction introduces a future cost of cheating. It can be concluded then that if the present value of the collusive outcome exceeds the one time benefit of cheating, A, the merchants have a strong incentive to behave honestly and that outcome can be sustained. This probability is increased by longer time-horizons as well as more frequent interactions. Epstein also points out that partnerships and incorporation effectively indefinitely postpone the “final period,” enabling greater cooperation (Epstein 2004). Milgrom, North and Weingast, though, introduce additional
constraints to approximate the institutional incentives under the Law Merchant. Before the game is played, they stipulate that a merchant may pay cost C to inquire if the opponent has any outstanding judgments and, if C was paid and cheating is suspected, may bring the matter to the merchant courts, which decides honestly and awards judgment J to the aggrieved. An unpaid judgment is recorded by the Law Merchant to be disseminated to other merchants in the event of future transactions to punish defection. The authors determine, applying formal analysis and dynamic programming, that “in operation, the Law Merchant system would appear to be a low cost way to disseminate information” because it centralizes and simplifies the process (Milgrom 1990, 615). They conclude,

> What we can say confidently is that the kinds of costs incurred by the [Law Merchant] system are inevitable if Honest trade is to be sustained in the face of self-interested behavior and that the system seems well designed to keep those costs as low as possible. (Milgrom 1990, 616)

The impressive efficiency of the Law Merchant courts is well noted, in particularly their minimization of costs. For example, the author of *The Little Red Book of Bristol*, a treatise on the *Lex Mercatoria* from around 1280, comments that one of the three ways the “law of the market [place] differs from the common law of the realm” is that “it reaches decisions more quickly” (Teetor 1962, 182). A considerable fraction of the costs associated with adjudication, the time required, would undoubtedly be important to the merchant class. As people generally on the move from town to burgh, they had a high opportunity cost of time. Edward III recognized this important fact in a 1353 statute, which stated “that merchants may not often long tarry in one place for levying of their merchandises” and therefore promised “that speedy right be to them done from day to day, and from hour to hour, according to the laws used is such staples before
this time holden elsewhere at all times” (Burdick 1902, 473). Burdick contrasts the speedy nature of the Law Merchant with the common law courts, noting that “the contemplative habit of English common law judges did not fall in well with their necessities” because merchants “insisted upon having not only justice but speedy justice” (Burdick 1902, 472). Merchant courts at fairs, in towns and commercial centers were colloquially referred to as courts of “pie powder” because they “rule[d] on cases before the dust could fall from the feet of the merchants at the fairs” (Zywicki 2003, 46). Merchant courts were comparatively informal and devoid of lawyers and procedural rules like oaths, highlighting the adaptation of procedure to the demands of their constituents.

In addition to speedy justice, the customary nature of the Law Merchant – by merchants, for merchants – intuitively permitted the development of innovations to enhance legal efficiency. This can be shown in contrast to the competing courts, particularly the common law courts. Edward I in his Carta Mercatoria declared that “whenever [the merchants] come, touching any kind of merchandise shall be firm and stable” such that neither party to a transaction “shall be able to retract or resile from the said contract when once the God’s penny shall have been given and received between the parties to the contract” (Kerr 1929, 363) This prescription stipulates that a selling merchant warrants both the title to and quality of the goods sold. This element of the Law Merchant is unique because, as Kerr remarks, “The hard and illogical doctrine of caveat emptor is a pure derivative of the common law” and that “Except in those countries where the common law prevails, exactly the opposite rule, caveat venditor, is universally applied” (Kerr 1929, 363). North notes this fact as well writing, “Under merchant law, the honest purchaser was allowed either to keep the goods or return them if the original owner refunded the purchase price,” a protection lacking in the common law (North 1991, 31). Breaching a warranty was a
recognized claim in merchant courts fully two centuries before the common law (Zywicki 2003, 49). The Law Merchant thereby contained the “good faith” principle wherein the bona fide purchaser was entitled to the goods, but also warranted against fraud. “Good faith” applied in cases of agents making transactions and using credit. Common law courts also wouldn’t accept accounting records as evidence and required all transfers of debts to be specifically sealed (Benson 1989, 650). In contrast, the Law Merchant recognized the use of negotiable securities and credit instruments, originated partnership agreements and offered defenses of fraud, duress and mistake (Zywicki 2003, 44, 49). Due to the customary nature and reciprocity of the Law Merchant system, efficient and innovative commercial law was developed to meet the special demands of the merchant class, creating significant competitive advantages over the common law.

3. The Incorporation and Subjugation of the Law Merchant

A wealth-maximizing European principality faced a tradeoff between seizing the wealth of its citizens now or reaping the long term benefits of wealth accumulation by permitting commerce to develop and thrive in the realm. Very early records can be found of principalities choosing the latter by advertising fairs to attract merchants to come and engage in commerce. For example, in 1166, Emperor Frederick Barbarossa established two fairs at Aachen, declaring “we give this liberty to all merchants so that they may sell and buy their wares in these fairs… Let them be immune from all toll and free…” (Adelson 1962, 181). Disputes would be resolved “according to the justice of the fair” (Adelson 1962, 182). Likewise, in 1157, Henry II of England ordered “that you should guard, watch over, and protect the men and citizens of Cologne, just as if they were my own and friends, and all their chattels, and their merchandise, and possession should also be protected” (Adelson 1962, 180). Notably, he continues: “And,
therefore, let them have absolute peace to carry on their business according to their proper customs, and you should not require of them any new customs or usages which they ought not to follow nor are accustomed to follow” (Adelson 1962, 180). The merchants’ “proper customs” and “the justice of the fair” are references to the Law Merchant. These examples illustrate principalities attempting to make credible commitments, which include the allowance of merchant courts and lack of arbitrary interference, to attract commerce to their regions.

Similarly, the English Magna Carta of 1215 declares:

Let all merchants have a safety and security to go from England and to come to England, and to stay and to move about through England by land as well as by sea, for purchasing and for selling without all unjust tools, according to the ancient and proper customs, except in time of war. (Adelson 1962, 184)

Likewise, Edward I’s Carta Mercatoria of 1303 promised protection to foreign merchants, the provision of speedy justice in disputes and recognized the right of merchants to opt out of the common law courts to enter contracts of commercial custom (Zywicki 2003, 47, 48). Zywicki (2003) and Benson (1989) note the Statute of the Staples, established in 1353, also offered protections to merchants that codified commercial custom. Thus, the “ancient and proper customs” of merchants, the Law Merchant, not only efficiently facilitated continental trade, but also engendered commitment to the institution’s preservation and respect by principalities. Importantly, the credibility of this commitment is contingent upon its incentive-compatibility.

In England, commercial matters had traditionally been, and could be, settled in the common law courts, which were comparatively inefficient and cumbersome. Thomas Scrutton commented that “If you read the [common] law reports of the seventeenth century you will be struck with one very remarkable fact; either Englishman of that day did not engage in commerce,
or they appear not to have been litigious people in commercial matters, each of which alternatives appear improbable” (Zywicki 2003, 45). Rather, commercial disputes were adjudicated in merchant courts. Merchant courts, which realized some economies of scale due to their recognition by wealth-maximizing principalities, competed with these domestic courts. It is intuitive, therefore, that in order to compete effectively with the merchant courts, the English courts, which received revenue from court fees, incorporated the provisions Law Merchant. Landes and Posner (1979) comment, “Gradually, the doctrines developed by the merchant courts to deal with contract and commercial matters were absorbed into the common law and the official courts began winning business from the merchant courts,” a “famous example” of competition leading to the emergence of efficient rules (Posner 1979, 257-8). This effectively drew business away from the merchant courts. This rivalrous competition between court systems produced further efficiency gains, such as improvement in service quality, as well as the cheaper and faster adjudication described by Smith. The three royal courts faced considerable competition from the Chancery, which could hear appeals from the royal courts. The common law courts, however, held a monopoly on real property law and maintained it by restricting supply in form of strict interpretation. As Zywicki tells, faced with the forces of competition, “the great innovation in property forms thus arose,” like “the development of such vehicles as equitable trusts [that] provided individuals with dramatic legal innovations that made it easier for them to execute their legal affairs” (Zywicki 2003, 53). Competition thereby enabled the development of flexibility in the forms of real property and claims thereof, a qualitative improvement and another efficiency improving legal innovation.

The competitive process of incorporation, begun with Edward I’s *Carta Mercatoria*, of the Law Merchant into the common law was appropriated, however, by Lord Coke. The turning
point, Benson (1989) identifies, was a 1606 decision by Lord Coke, then sitting Chief Justice of King’s Bench, reviewing a privately adjudicated case. He wrote “that though one may be bound to stand to the arbitrament yet he may countermand the arbitrator… as a man cannot by his own act make such an authority power or warrant not countermandable which by law and its own proper nature is countermandable” (Benson 1989, 653). Benson interprets the content of the ruling:

This ruling meant that the decisions of the merchant courts could be reversed by the royal courts, because an arbitrator’s purpose was, according to Coke, to find a suitable compromise, while a judge's purpose was to rule on the merits of the case. In essence, Coke’s ruling asserted that the Law Merchant… was “part of the law of the realm.” This was in turn interpreted to mean that merchants were bound to submit to the jurisdiction of the common law courts and subject to those courts’ procedures. (Benson 1989, 653)

Since rulings of the merchant courts could now be overturned, this gave the common law royal courts a significant competitive advantage over the merchant courts. In effect, it created a hegemonic and hierarchal relationship between the courts, granting the royal courts a measure of monopoly power where competition had prevailed prior. The result was the decline of the Law Merchant in England: “The use of private commercial courts virtually disappeared in England after the 1600s” (Benson 1989, 653). While the common law courts had successfully attracted business away from the merchant courts by incorporating the attractive qualities of the Law Merchant, this new arrangement relegated the merchant courts and eventually asserted common law jurisdiction over commercial matters in England. It would be for Lord Mansfield, the so-called “founder of commercial law” in England, to reintroduce the Law Merchant into the
common law (Benson 1989, 654). Lowry notes that “by 1765 Mansfield could declare in Pillans v. van Mierop that ‘the law of merchants and the law of the land is the same’” (Lowry 1973, 609).

4. Theory vs. History Concerning Smith’s Observation of the English Courts

It is to the seventeenth century de facto competition between the royal courts, Exchequer, King’s Bench, and Common Pleas, to which Smith refers in the passage from The Wealth of Nations. Smith’s optimistic evaluation of the effect of competition on the judicial services is not unanimously shared, however. Landes and Posner (1979) contend that it is “incorrect” to expect, in this case of overlapping jurisdictions where the judges are paid by litigant fees, for efficient law to emerge: “The competition would be for plaintiffs, since it is the plaintiff who determines the choice among the courts having concurrent jurisdiction of his claim. The competing courts would offer not a set of rules designed to optimize dispute resolution but a set designed to favor plaintiffs regardless of efficiency” (Landes 1979, 254). Landes and Posner do note that there is no historical evidence “of the kind of blatant plaintiff favoritism that our economic analysis predicts would emerge in such a competitive setting” (Landes 1969, 255). Klerman (2006) describes in detail the nature of this competition and reaffirms Landes and Posner’s economic analysis with a game-theoretic model in which the Nash equilibrium is for the common law courts to be pro-plaintiff. He supports this model with a brief historical survey that contradicts Landes and Posner’s note. Klerman attests that, examining historical books on English law, landmark decisions prior to the eighteenth century were invariable pro-plaintiff while, after Parliamentary intervention like the 1799 statute removing payment out of litigant fees, they tended to be more pro-defendant. Still, Smith’s assessment of competition between the courts is shared by eminent English historians Pollock and Maitland (1952).
One possible explanation of the apparent contradiction between theory and history, neglected in the literature, might also follow Rubin’s (1977) model, whereby strong commitment of *stare decisis* to the legal doctrines absorbed from the Law Merchant prevented systematic bias. Zywicki supplies another potential and compelling resolution: “Indeed, in the common law courts, there was in fact much pro-plaintiff doctrine, such as a notable absence of defenses to contract and the like” (Zywicki 2003, 57). In further research with Stringham, the authors point to Landes and Posner’s (1979) observation that when the parties to a contract can agree in advance on the site of dispute adjudication, efficient legal rules followed. The high degree of reciprocity in competing courts, such as the Law Merchant, canonical courts and the Chancery, maintained efficient legal rules. This condition, however, did not hold with the common law courts in the seventeenth century, in part explaining the development of pro-plaintiff rules. When merchants and others could reach agreement beforehand on the court of dispute resolution, they substituted away from the common law courts: “When people could not opt out of the common law courts, there was much pro-plaintiff bias” (Stringham 2008, 26). Although these agreements were not often explicit, they were customary understood norms (Stringham 2008, 27). The subjugation of the Law Merchant entailed that a disproportionately high amount of the time common law courts were used for adjudication of commercial matters it was because there were no other alternatives. This explanation fits with Lord Campbell’s observation that “mercantile question were so ignorantly treated when they came into Westminster Hall, that they were usually settled by private arbitration” (Lowry 1973, 606). Ex ante agreement, when it was possible, on the site of dispute adjudication would effectively check against biased legal rules. Moreover, the common law courts possessed competitive advantage via vertical integration with an enforcement apparatus. This ability would, *ceteris paribus*,...
reduce the incentive to reach judgments agreeable to both parties. Lastly, increasingly in this period the royal courts began to be subject to political rent seeking by the Crown, a matter examined in the following section. The later pro-defendant doctrines, initiated by Parliament, could thereby be interpreted as competition between rival interest groups by other means. For example, since the royal courts principally dealt in land law, pro-plaintiff rules might be a response to rival competition as a way to serve merchants over the landed aristocracy. The development of efficient legal rules, then, is contingent upon institutional constraints and incentives.

5. Monopolization, Rent Seeking and Decline in Legal Efficiency

With some monopoly power obtained for the common law courts by Coke’s declaration of judicial review, there are potential efficiency gains to be realized from the corresponding competitive advantage of coercive enforcement by royal authority. Of emphasis, this changes the nature of the competitive relationship between courts, not merely the outcome. Despite the institutional support of the Law Merchant in sustaining agreements and coordinating cooperation to realize gains from trade, it remained severely constrained in two respects: realization of economies of scale and its enforcement mechanism. Fairs, often promoted by medieval principalities, were the venues for merchant activity, trade and exchange. As a result, the customary Law Merchant handled disputes at the fairs. However, if a dispute between isolated merchants arose, recourse to a merchant court, with a jury of merchants and merchant judge, would likely be unavailable. Additionally, collective punishment of defecting merchants is constrained by the incentive for merchants to reap immediate gains by defecting and doing business with an ostracized merchant. The inability to bind judgments upon guilty merchants meant the court could not guarantee protection from fraud. Coercive punishment, available to the
royal courts, served as a stronger deterrent. Vertical integration of adjudication with enforcement thereby realizes additional economics of scale because policing more effectively monitors cheating. This insight was not lost on merchants who, presumably, responded agreeably to Parliament’s 1697-98 statute that permitted merchants to seek common law enforcement of arbitration decisions (Lowry 1973, 608). Moreover, in the model before, the aggrieved merchant paid the full cost of adjudication. With coercive enforcement, it becomes feasible to spread the cost over the entire merchant community, in the form of member dues, or possibly over the entire populace, through taxation. Public finance of commercial law judicial services could therefore be potentially efficiency enhancing, in terms of reducing transaction costs, by increasing the quantity supplied, following the standard “public good” model.

The royal courts were under the jurisdiction of the Crown and with increasing arbitrary political interference with the courts during the period, the credibility of the commitment to the rule of law and property rights became threatened, the central topic of North and Weingast (1989). The result appears to be development of abusive monopolistic behavior rather than efficiency enhancing “public good” provision. For a commitment to be credible, it has to be incentive-compatible. This compatibility was reduced as the Crown increasingly looked for new ways to raise revenue. Revenue to the Crown was appropriated by Parliament, which allocated insufficient amounts to cover the Stuarts’ expenses. Thus, Elizabeth, James I and Charles I all sold royal lands to generate revenue (North 1989, 809-10). The Crown also demanded loans, known as “forced loans,” but failed to repay the debt: “In the forced loan of 1604/5 the Crown borrowed 111,891 pounds, nominally for one year; ‘although… ultimately repaid, 20,683 pounds… was still due as late as December 1609’” (North 1989, 810). As North and Weingast conclude, “The Crown’s inability to honor its contractual agreements for borrowed funds is a
visible indicator of its readiness to alter the rights of private parties in its own favor” (North 1989, 810). A similar source of revenue was monopoly grants, the sale of monopolies and the awarding of patents (North 1989, 810). These measures are significant because of their legal ramifications. A grant of monopoly or patent is dependent upon its enforcement in the courts. Initially, the common law refused to recognize monopoly rights, exemplified in the 1601 landmark “Case of Monopolies,” and the Parliament passed legislation to fight the practice (North 1989, 812-13). However, as told by North and Weingast,

Since the Crown was personally responsible for day-to-day government operations, it paid the judges, who served at its pleasure. Increasingly the Stuarts used their power over judges to influence their judgments. Judges—Chief Justice Coke (1616/17) and Crew (1627)—were openly fired for ruling against the Crown. Ultimately this tactic produced judges who by and large supported the Crown. (North 1989, 813)

Clearly, this open arbitrary intervention with the common law courts to secure enforcement of the Crown’s edicts, which included giving them greater monopoly power in the form of sole jurisdiction over property matters, threatened the credibility of the commitment to the rule of law. Therefore, monopoly power in judicial services begot the predictable result of political rent seeking by the controlling interest group, the King. These abuses also served as the impetus for the Glorious Revolution, which established the dominance of Parliament. Similarly, the institutions crafted in wake of the Glorious Revolution reflect a recommitment to the rule of law through limited government, establishment of the judiciary’s independence and weighing competing interest groups against one another via the democratic process (North 1989, 818).
Evidence North and Weingast presents demonstrates that these strengthened institutions, reflected in government credit, spurred the fiscal revolution that catapulted Britain into empire.

6. Concluding Thoughts

A number of preliminary conclusions may be drawn from this history. In the first place, the narrative corrects Hayek’s confusion, as suggested by Hasnas, and refines the distinction between customary and common law. Although Hayek describes the law of liberty to be both customary and “judge-made,” the common law, in as much as it spontaneously evolved and realized efficiency gains, was solely customary. The romantic notion of judge-made law, to which Hayek ascribes, more accurately reflects English common law from the eighteenth century on. In the periods prior, judges rather “discovered” the law by application of customary norms, exemplified well by the Law Merchant (Hasnas 92). Thus, Hasnas’s correction of Hayek is historically affirmed: “judge-made” law consists in some kind of mean between customary law and legislation. In any case, it is most accurate to describe the common law before the eighteenth century, which codified the efficient rules and procedures of Law Merchant and developed its noted protections of private property, as based on custom rather than “judge-made.” An interesting investigation of this historical narrative is its application to criminal law, which arose from edicts of the Crown and “judge-made” law. Stringham and Curott (2007) and Benson (1990) have broached this matter. Commercial and common law, which preceded criminal law, were reciprocal in nature, used juries extensively, emphasized due process and had rules against double jeopardy. Possibly, the incorporation of these provisions in criminal law reflects attempts at making a credible commitment to law enforcement and establishing ruling legitimacy.

Another way of framing the narrative is by way of Berman’s Law and Revolution. Berman chronicles the development of the Western legal tradition, telling a story of decline. In
the medieval ages, following the Papal Revolutions, concurrent competing laws existed within the same geographical areas. There was common law, city law, Law Merchant, canonical law, manorial law, national law and others. An abstract illustration of this arrangement might be overlapping circles. Zywicki terms this arrangement “polycentric” law. In the modern era, however, the abstract illustration has changed to concentric circles, displaying hierarchal or hegemonic relationships, such as between county law, city law, state law and federal law in the present. For Berman, this shift, which parallels a shift towards legislation in Hayek’s terms, threatens the foundational institutions of Western civilization. Commitment to the rule of law becomes comparatively less incentive compatible the more monopoly power obtained by the legal apparatus. The rise of political rent seeking seems to confirm this observation.

It is worthwhile to apply Berman’s thesis and the legal development in England within a Marxian historical framework. Paradoxically, in this modern era of so-described intensive global capitalism in which the division of labor, it is claimed, proceeds virtually unfettered, the underlying legal system – a component of the “superstructure” – is remarkably socialistic, especially so in light of its historical development seen through Berman’s framework. To maintain this apparent anomaly, the materialistic pyramid of causation must be incorrect and, as Hayek and Schumpeter feared, the modern era is in fact progressing towards socialism. On the other hand, it is possible this diagnosis of present affairs is incorrect. More accurately, rather than being capitalistic, the modern legal institutions are instead open to political rent-seeking by capitalists, who happen to be the dominant interest group, made possible by monopolization and nationalization of legal institutions. Hasnas (1995) argues elsewhere that modern legal institutions, comparatively legislative in Hayek’s sense and hierarchal in Berman’s, are both incurably political and arbitrary. It is tempting to ascribe causal relation from the lack of
competition in legal institutions to the decline in efficient legal institutions. Thus, another
possible parallel to draw with respect to provision of judicial services in the present is to the
historical “socialist calculation” debate. Modern legal realist theorists are skeptical and critical of
the possibility of logical, rational decision-making by judges. Perhaps Mises’ thesis concerning
socialism underscores this as a fundamentally an institutional problem: Socialist calculation is
impossible, why therefore expect monopolized provision of judicial services to be rational?

Upon reflection, it is not too surprising that efficiency gains are to be realized from
competition between courts. Supply of legal services developed to meet demand for such
services to an extent satisfactory to significantly reduce transaction costs and realize gains from
trade. Indeed, it would be far more surprising to find that legal institutions are impervious to the
laws of supply and demand. What is surprising, perhaps, is that the rule of law and property
rights protections – preconditional institutions for capitalism in the orthodox liberal
understanding – developed in a free market-like setting where consumers shopped around for
judicial services to maximize their expected utility, at least with respect to commercial law.
Predictable, efficient commercial law evolved spontaneously, as Hayek characterizes “grown
law” based on custom does. This also affirms Posner’s expectation, given voluntary
arrangements and ex ante agreement on the court of dispute resolution. However, this historical
overview challenges classical “laissez-faire” liberalism of Smith’s intellectual heirs*: the legal
institutions which made the industrial revolution possible developed in the absence of any
“umpire,” under the constraints of freedom on contract, voluntary compliance and competitive
conditions. David Friedman writes that “the common law legal rules we observe are, in most
although not all cases, the rules we would get if we were trying to design an economically

* While eminent “classical liberal” economists like Milton Friedman and Stigler claim the intellectual heritage of
Smith, see Samuels and Medema (2005) for the case that Smith has be misinterpreted as a proponent of laissez-faire.
efficient legal system” (Friedman 2000, 16). The prescient, Hayekian point is that the efficient legal rules were not “designed” \textit{a priori} in a rationalistic manner. Indeed, they could not have been.

The microeconomic models of competition and monopoly contain compelling explanatory power of the development of efficient legal institutions and the rule of law. Possibly, the ability of private enterprise to develop institutions to overcome “public good” problems has been underestimated, an historical investigation further undertaken by Benson (1994) and theoretical case made by Hoppe (1993). While monopolistic provision has the potential to reduce transaction costs and realize greater economies of scale, it also drives out competitors like the Law Merchant and alters the nature of the competition. This in turn threatens the rule of law as the commitment becomes less incentive-compatible. The monopolistic judicial service has the potential to engage in rent-seeking, developing either pro-plaintiff or pro-defendant rules or, as the narrative illustrates, narrowly serve the interests of the controlling interest group, like the Crown. A suggested conclusion is that constitutions, by themselves, are insufficient mechanisms for sustaining commitment to the rule of law. It follows that competition, the ability to “vote with your feet,” in judicial services provides an invaluable check on monopolistic behavior, in the same way it does for provision of all other goods in the market. To the degree that this is true and the rule of law is ethically desirable, competition in judicial services realizes normative gains as well. In any case, the lesson to be learned is that the justification for government monopoly provision of legal services cannot be wholly economic, whether theoretical or historical, if at all. Whether the government or private institutions can more efficiently supply adjudication is a question independent of which one \textit{should} do it.