

# THE ECONOMICS OF NON-STATE LEGAL SYSTEMS



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**FOR LIFE, LIBERTY AND PROPERTY**

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BRYAN CAPLAN

“Perhaps the most distinctive characteristic of the Western legal tradition is the coexistence and competition within the same community of diverse jurisdictions and diverse legal systems. The pluralism of Western law, which has both reflected and reinforced the pluralism of Western political and economic life, has been, or once was, a source of development, or growth — legal growth as well as political and economic growth. It also has been, or once was, a source of freedom. A serf might run to the town court for protection against his master. A vassal might run to the king’s court for protection against his lord. A cleric might run to the ecclesiastical court for protection against the king.”

Harold Berman, *Law and Revolution*

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## 1. INTRODUCTION

Law, even more than national defense, appears to be the perfect example of a public good which simply must be supplied by the government if society is to exist at all. It is non-excludable because everyone enjoys the fruits of law merely by living in society. And it is entirely non-rivalrous — once the state creates a body of sound legal principles, an unlimited number of people can benefit from them at no additional cost.

But these seemingly iron-clad truisms can be undermined by even a cursory glance at history. In primitive societies, law develops gradually from custom in the absence of any sort of government. As Richard Posner explains,

The remaining source of law [in the absence of the state], and the one that dominates primitive law, is custom. Custom (including customary law) resembles language in being a complex, slowly changing, highly decentralized system of exact rules.<sup>1</sup>

On occasion, this primitive law gradually spreads outside the narrow confines of a single tribe to encompass a broader community. Thus, early tribal Germanic law evolved into a more universal legal code in the absence of a central government. What makes this progress gradually unfold? As legal historian Harold Berman explains,

Violation of the peace of the household by an outsider would lead to retaliation in the form of blood feud, or else to interhousehold or interclan negotiations designed to forestall or compose blood feud.<sup>2</sup>

By this process primitive law became more civilized, broadening its vision to include anonymous as well as face-to-face societies. In order to exist and evolve, such systems must have given rule-creating incentives to someone; in other words, at least some of the benefits were not public but exclusive.

There is another sense of “non-exclusion” that legal systems must allegedly have: they must govern everyone in order to function at all. If law-breakers could simply drop out of the system, law could hardly protect us from their misdeeds. And yet, history contains many instances of pluralistic legal systems, in which there were multiple sources of law in one and the same geographic region. In the medieval society that Prof. Berman investigates, canon law, royal law, feudal law, manorial law, mercantile law, and urban law co-existed; none was automatically supreme over the others. Naturally, there were jurisdictional conflicts. But this system of concurrent jurisdiction overlapped with a period of economic and political growth (c.1050-1250), not a period of chaos and impoverishment. Apparently these diverse systems did what Thomas Hobbes (along with most modern political thinkers) declared impossible: They created social order and peace in the absence of a distinct, supreme sovereign.

These examples might seem to be historical anomalies, fascinating but irrelevant to current economies and legal systems. Yet in modern times parallels have sprung up, albeit in a less dramatic form. Commercial disputes, for example, are handled virtually in toto by means of private arbitration. Accurate figures are very difficult to get; but one expert in alternative dispute resolution, Jerome Auerbach, estimates that businesspeople arbitrate 75% of their commercial disputes.<sup>3</sup> In earlier times, one of the central functions of government was business dispute resolution; but now it has

largely escaped the state’s sphere of influence. A more extreme example is that of the VISA corporation.<sup>4</sup> Member banks agree to keep their quarrels within the VISA family when they join the central organization. Anticipating many costly legal disputes between the system’s members, the VISA corporation saw the opportunity to invent a cheaper way to resolve disagreements. It created the VISA Arbitration Committee to judge the disputes of the member banks according to VISA’s very own legal code. The methods are quick, lawyerless, and unbureaucratic. Compared to the slow and costly justice that the banks receive when they have to settle a conflict with a firm outside the VISA camp (and within the reach of the public courts), the VISA banks get a bargain.

It is the economic characteristics of these sorts of legal systems that this thesis investigates. How do they work? To what extent might private legal systems of this kind partition and swallow up the near-monopoly of law that most governments possess? How does customary law give incentives to create and develop a legal framework? It should be noted that I am not merely studying the economics of federalism. While there are some parallels between pluralistic legal systems and federalism, there is a crucial difference. Under federalism, a central government delegates the authority to make laws to two or more sub-polities. In this sense, there is legal choice and legal competition. But federalism gets rid of a national legal monopoly by creating a host of smaller geographic monopolists, each of which has sovereignty in its own territory. Truly plural legal systems such as arbitration compete within the same geographic region.

There is more than an analogy between pluralistic legal systems and the economist’s conception of competition. With a large number of potential source of law in a given geographical region, plus some method of excluding non-contributors from benefits, economic theory implies the familiar results that hold of competitive markets generally: productive efficiency (a given level of output gets produced at the minimum cost), allocative efficiency, (resources get assigned to their most socially productive uses), and dynamic efficiency (declining cost curves over time). We might also expect to find the greater flexibility and attentiveness to individual differences that typify private supply.

This thesis investigates the non-state supply of the three essential aspects of law: dispute resolution, rule formation, and enforcement. The first and least controversial is the non-state resolution of individual disputes. The state could still choose the rules and merely privatize their application. Economists usually see the rule-application aspect as the best candidate for privatization, because the parties to the dispute get all of the benefits. This is one factor that explains the emergence of primitive law: the need to avoid inter-family bloodshed over every wrong gave both sides to a dispute an incentive to voluntarily submit to a peaceful settlement procedure and abide by whatever result emerged. Even the loser benefits, since he trades submission on a single quarrel for long-run peace. In terms of game theory, what looks like a zero-sum game (a tort, say) is actually a cooperative game because refusal to adjudicate leads to feuds between individuals, families, or clans that leave both sides worse off.

But there is a second element to law; as Landes and Posner explain,

A court system (public or private) produces two types of service. One is dispute resolution — determining whether a rule has been violated. The other is rule-formation — creating rules of law as a by-product of the dispute-resolution process.<sup>5</sup>

To many people, the latter is a less likely candidate for private supply, because the production of rules of law is a public good. The economic value of precedents (like other intellectual innovations) is hard to internalize. Section three will examine this issue at length. But there are *prima facie* reasons to be skeptical of this criticism of private rule creation. The VISA corporation has its own legal code; so do other professional associations, clubs, and cooperatives. More startlingly, most primitive law and a great deal of commercial law were developed by bodies other than the state. Thus, the law merchant (later adopted, not created, by most governments) evolved during the Middle Ages (c.1000-1200), while national governments ignored the demand for well-defined rules of international trade. Merchant courts gradually developed contract and tort law, defining rules of incorporation, credit instruments, and damages.<sup>6</sup> Legal growth on this level would seem to be possible only if private incentives existed somewhere; section three will seek out the incentives' sources.

Last, there is the most controversial function of law that might be executed privately: enforcement. The right to use force seems to be a necessary monopoly of the state; otherwise wouldn't chaos and random violence be inevitable? Still there are many types of non-violent private enforcement. Commercial boycott and ostracism enforce most forms of arbitration. Within the business community these sanctions are quite effective. Becker and Stigler note that termination of employment (rather than legal action) can and often does deter malfeasance.

The fundamental answer is to raise the salaries of enforcers above what they could get elsewhere. A difference in salaries imposes a cost of dismissal equal to the present value of the difference between the future earnings stream in enforcement and in other occupations.<sup>7</sup>

Section four explores the enforcement tools of private legal systems and how they work. It also raises questions about what might happen if we relaxed the state's monopoly on force and let more drastic forms of enforcement fall into private hands.

In sum, this thesis examines how non-state legal systems work in their three distinct aspects: dispute resolution, rule-creation, and enforcement. It will draw on many conclusions from economic theory; most frequently, the *prima facie* superiority of private competitive supply to public monopoly. There are many conceivable market failures that might exist; but the strategy of this paper is to at least explore overlooked legal alternatives. Before the body of the paper can begin, however, it is necessary to point out a major misconception that might prevent one from seriously considering the private supply of law.

The most deeply rooted obstacle to the appreciation of non-state legal systems is the theory, eloquently stated by Thomas Hobbes, that the law-making function indivisibly and necessarily belongs to the sovereign. As Hobbes famously wrote,

The only way to defend them [mankind] from the invasion of foreigners, and the injuries of one another, is to confer all their power and strength upon one man, or upon one assembly of men, that may reduce all their wills, by plurality of voices, unto one will.<sup>8</sup>

On this view, the presence of more than one law-giver in a region has to degenerate into violent battle until only one remains. Imagine, the argument might go, that two councils issue law in one city. Their laws will inevitably conflict on occasion. And since by assumption there is no higher body to resolve their dispute, they will have to resolve it violently.

Two things can be said here. First, history gives examples of concurrent jurisdictions that operated peacefully. Harold Berman, for example, describes multiple competing sources of law in the Middle Ages, with only a handful of serious conflicts between them. So Hobbes must be wrong at least sometimes. Second, Hobbes' game theoretic deductions are inconsistent. Supposedly, driven by the desire for food, money, and power, rational egoists turn to violence to get what they want when there is no stronger entity to preserve peace. And yet, as Hobbes says, the fear of death is even stronger than the drive for food, money, and power. Given this, isn't the rational strategy the defensive one of live-and-let-live? Given the choice between two evils — a small chance of death vs. slightly less consumption — a Hobbesian man would surely prefer the latter.<sup>9</sup>

This preliminary observation gives a plausible explanation for why peaceful cooperation was frequently the dominant strategy. Throughout this paper I imagine that profit-making firms, rather than non-profit organizations, would be the major alternative suppliers of law. This assumption overlooks the fact that much, perhaps most, arbitration is not run for profit. I do this for two reasons. First, I find it difficult to believe that non-profit firms could compete with for-profit firms if they were on equal legal footing. The second reason is simply that the economic theory of profit-making organizations is better-developed than the theory of non-profit groups. I trust that this assumption will not seriously affect the analysis.

A final caveat. This paper considers only the non-state supply of private, as opposed to public law. That is, it considers systems of alternative resolution of conflict between individuals whose rights are defined by the common law categories of property, contract, tort, and crime. Public law must be left for another time.

## 2. ADJUDICATION OF DISPUTES

### 2.1 Inefficiency in the public courts: overview

One of our most ridiculed institutions is the public court system. Interestingly, economic analysis gives us clues about many of its central weaknesses. Some of these problems could be solved with fairly minor reforms. For example, court services are under-priced (usually, free). These leads to serious excess demand, permanent shortages, and strategic delays. Presumably, if the public courts were so inclined they could charge court fees for civil cases to ration demand. A second problem is nuisance suits. Frequently, there are lawsuits where one party is clearly in the wrong, but drags the battle into court anyway in the hope that the other side will simply give up. The public courts

could solve this problem by changing the indemnification rule — for example, by making the loser in a nuisance suit pay the other side’s court costs. Other inefficiencies in the public courts would be hard to eliminate with minor reforms. The public courts are supported by taxes; they therefore have little incentive to control costs. Trials take too long, appeals are too frequent, and labor discipline is lax. Since juries are conscripted, courts treat their labor as a free good; consequently, they use juries even when the value of their contribution to justice is small. And perhaps most seriously, the courts foster wasteful legal battles. Instead of encouraging litigants to limit their joint legal expenditures, they give them incentives to race to out-spend each other. But since the expenditures usually cancel each other out, this legal competition is rather futile.

It is hard to see how the public court system could solve the second group of problems even if it wanted to. Indeed, it probably won’t remedy the first set of difficulties either. In order to understand the benefits of turning disputes over to private alternatives, we must first understand why and how the public courts fail. This done, we can investigate the ways that private bodies overcome the inefficiencies that the public courts cannot.

## 2.2 Inefficiency in the courts: under-pricing, nuisance suits, input waste, and more

An excellent work detailing the public courts’ failures is Judge Richard Neely’s *Why Courts Don’t Work*. As judge with training in economics, he is particularly qualified to point out the failures of our court system. Neely has a long list of complaints. First, the courts grossly underprice their services, leading to excess demand and non-price rationing (usually, waiting in line). It is illegal to sell one’s place in line. The most urgent cases must wait as long as trivial ones, leading to protracted legal conflict and higher legal costs. If courts charged user fees, people with insignificant disputes would be more likely to drop them. Or they might try a cheaper resolution method. Yet the courts provide subsidized (free) services, often complete with juries. The whole process is expensive, but litigants only need to consider their lawyers’ fees. They ignore the cost to taxpayers of extra trials. They also ignore the cost of justice denied and delayed to everyone waiting behind them for their day in court.

Underpricing also helps the legally well-endowed wear out their opponents. As Neely puts it,

Often the attractive products that the court delivers free are delay itself or a forum that provides the stronger litigant with an opportunity to wear out or outgun the opposition.<sup>10</sup>

(With perfectly functioning capital markets this could not happen: banks would happily loan money to litigants with good cases. But strategic delay does seem to be a real problem.) Since a longer delay gives both sides a greater opportunity to out-spend each other, delay usually favors the richer litigant. Delay also deadens the deterrent effect of damages: future damages, like other future income streams, will be discounted by the interest rate. There is a simple economic explanation for all of these problems: since court services are free, there is no way to ration them other than waiting in line. And this probably is uniquely severe for dispute resolution, because the litigants can ferociously struggle with one another while they wait to go before the

judge. Neely points to a second problem that plagues the justice system: the courts give incentives to litigate non-disputes. For instance, in landlord-tenant cases or creditor-debtor cases, there is rarely any “legal issue”. Instead, as Neely explains, one side normally just refuses to fulfill its half of the bargain.

In the universe of all the routine cases that go to court, most of the time one party will be flat wrong, and he or she will know that from the beginning.<sup>11</sup>

If legal costs exceed the expected value of the judgment, then aggrieved parties may well drop legitimate cases. When nuisance cases do get a full trial, they crowd out more substantive disputes. One solution for insincere cases (though Neely rejects it on distributive grounds) would be to make the loser pay both sides’ costs — but this is a reform that courts are loath to try. At the very least, in areas of the law filled with nuisance suits, this idea has potential.

Professors Landes and Posner argue that the public courts waste and misallocate their resources; after all, it is taxpayers, not judges or litigants, who pick up the tab. Landes and Posner then reasoned that the arbitrators are likely to make more efficient use of inputs than the public courts. Since arbitrators do survive on user fees, disputants and arbitration firms alike will want to contain costs. From these assumptions, these two legal economists proposed the following test of the efficiency of the public courts’ civil trials: the public courts are efficient if they match the practices of arbitration. Since arbitration does not use juries or lawyers, and the public courts do, Landes and Posner conclude that these may be inefficient, at least in civil cases.<sup>12</sup> (Since criminal cases are not arbitrated, we can’t know what criminal arbitration would be like.) This is input waste on a huge scale — a majority of the inputs in civil cases may well be unwarranted. The misallocation of jury time is especially egregious, since they are conscript labor — virtually a free good. While juries cost a great deal to society (including the jury members themselves, who lose work time), courts and litigants have the incentive to use them even when the benefit is negligible.

Landes and Posner use the same efficiency test for other public court practices. For example, controversy exists over the merits of the loser-pays rule for legal expenses. Arguments cut both ways: If trials occur because of over-optimism, then the loser-pays rule leads to more suits; if many suits are “nuisance” suits in which the party in the wrong strategically delays, then the loser-pays rule would lead to fewer suits.<sup>13</sup> It is hard to do an empirical test to everyone’s satisfaction. However, we could reasonably predict that profit-maximizing private courts would use the more efficient rule, especially if the parties pre-contract to arbitrate with a specific firm with a set indemnification rule. How does the test turn out? The American Arbitration Association requires the defendant to pay all legal costs if the plaintiff wins, but splits the difference if the defendant wins.<sup>14</sup> Posner suggests that this vindicates the American rule over the English; but actually this rule implies that defendants are often clearly guilty, whereas malicious suits by plaintiffs are infrequent. Or in other words, nuisance suits by defendants are more common than nuisance suits by plaintiffs (in disputes currently open to arbitration). The parties can also voluntarily change the indemnification rule: some contracts change the standard AAA rules, stipulating that the plaintiff pays the legal costs if he loses.

Landes and Posner bring up another interesting issue: appeals. They argue that private arbitration (excluding trade associations) lack appellate courts because the sole function of such courts is to formulate rules of law, not resolve disputes; and the former, unlike the latter, is a public good. Landes and Posner view the production of rules as a pure public good: society at large benefits when someone refines a legal principle, but (as is often the case with intellectual creations), it is hard to claim a property right in a precedent.

This claim may well be true; it will be examined in section three. But perhaps there is another explanation: Private courts do not permit appeals simply because the extra costs (in time, legal fees, court services, and so on) are not worth the social benefits. Both parties gain if they agree *ex ante* to limit each other to a single hearing. But in public courts there is no way to credibly commit to limit appeals. On this theory, the lack of appeals is a benefit to both parties because it keeps dispute resolution costs low. Posner and Landes point out that trade associations do permit appeals; and these appeals sometimes produce precedents. They argue that this happens because a trade association can internalize the benefit of a precedent. True, but they also concede that appellate tribunals are not universal. In all likelihood, trade associations rarely permit appeals, strictly limit their expense, or both. Furthermore, the VISA corporation does not permit appeals, even though the corporation's unique structure and secrecy enable it to fully internalize the benefit of precedents. Quite possibly the permission of appellate review in criminal cases makes economic sense; for as Posner suggests, the high error costs of convicting the innocent may justify the reasonable doubt rule for evidence in criminal proceedings.<sup>15</sup> On the other hand, the behavior of many arbitration firms and trade tribunals suggests that the appeals process in civil cases has excessive costs.

### 2.3 Inefficiency in the courts: fostering wasteful legal conflicts

Even the most harmonious society has disputes. In the interest of peace, these disputes must somehow get resolved. The upshot is that every dispute comes with resolution costs tied to it. There is some additional burden on top of the costs of the dispute that the disputants must eventually split. This is often a substantial sum. From this it follows that to a limited extent the plaintiff and defendant have a common interest: minimizing their respective dispute resolution costs. We may infer that the parties share an incentive to cheaply resolve their conflict.

In the government's court system we see this principle at work when defendants settle, or alleged criminals plea bargain. Yet public courts have clear inefficiencies that both increase the costs of dispute resolution and make settlement more difficult. Judge Neely's strongest criticism of the public court system is that it promotes futile but expensive strategic behavior. The outcome of a case depends not merely on the facts of the dispute; it is also a function of the respective legal expenses of the two sides. Since the disputants cannot reach a cooperative solution to the dispute itself, it is likewise difficult to agree to limit joint legal expenditures. The result is that both plaintiff and defendant rush to outspend each other, but ultimately the probability of success remains unaltered because the competitive expenditures cancel one another out.

Neely's proposed solution would likely arouse skepticism from economists:

What is needed is a court version of the Strategic Arms Limitation Treaty — a method for determining in advance what a reasonable investment in a particular lawsuit is, and a court order forbidding both sides from spending money for a competitive advantage that in the nature of things will be illusory.<sup>16</sup>

Like statutory caps set on excessive punitive damages, this is probably a band-aid measure destined to create bureaucratic inefficiencies of its own. Hard questions present themselves. First, judicial determination of maximum legal expenditures would itself use up valuable court time. Maximum permissible expenditures might itself be an issue of legal contention. Second, there would surely be active interest groups who would struggle to adjust the ceiling in their preferred direction. Frequent defendants might very well want the cap pushed down as far as possible to remove the incentives for plaintiff's lawyers to bring suits against them. Habitual plaintiffs and their attorneys would in turn lobby in the opposite direction. (Or perhaps they would favor a cap that applied solely to defendants!) Third, it seems difficult to see how lawyers working on contingency could be dealt with under Neely's rule. Would their awards be capped? Would the courts set a ceiling for the permissible total lawyer-hours per case? These problems seem serious — for public courts. Politics would probably prevail over economics. Private courts, on the other hand, already limit legal expenses with marked success. The AAA does not permit lawyers — a quite drastic limitation. VISA does not even allow the parties to attend their own hearing. But these are efficient results. On the average, these practices are unlikely to harm the legal prospects of either side. Yet these practices limit the joint legal costs per case — a big plus. Since both sides typically agree to arbitrate disputes in advance, before cooperation has broken down, it is easy to pre-commit to mutually limit legal costs in future disputes.

Why has private dispute resolution worked so well in this area? The public courts would find it hard to administer such a rule. Is there a critical difference between the limitations that private and public courts place on legal expenditures? I think there is. To understand it, we should turn to Ronald Coase's classic article, "The Nature of the Firm".<sup>17</sup> Managers of a firm, Coase explained, usually run it by the "command-and-control" methods that economists deplore on the economy-wide level. Once a worker gets hired, he is expected to do what he is told; similarly, office supplies are likely to be centrally allocated to each department rather than sold to them. What this shows, said Coase, is that command-and-control methods (since they survive and thrive within competitive firms) must be useful to some extent; most notably, command-and-control reduces transactions costs. The problem with centrally-planned economies is that they extend command-and-control techniques far beyond their efficient point — and then eliminate the competitive pressure that checks this inefficiency. In competitive markets, a firm that grows so large that it cannot effectively manage itself starts to lose market share and profits. This gives an incentive to scale back to a less cumbersome size. Central planning by a government does not face this disincentive.

For private courts, limiting the use of lawyers, expert witnesses, and so on would be akin to any other business decision. All firms use command-and-control to some extent; what prevents inefficient command-and-control is the pressure of competition. When private courts experiment with restrictions on legal expenditures, they need merely judge the needs of their own clientele, not those of the whole society. And when they judge incorrectly, competition can straighten them out. If a firm decides to limit legal expenditures, market share and profits can indicate whether or not the practice is efficient in that particular case. No one ever needs to make the much more difficult judgment about what is efficient for all firms.

In contrast, the public court system is a centrally-planned industry — when it uses command-and-control there is little or no feedback to show whether its actions are sensible. And if it chooses wrongly, consumers often have no close substitute. More critically, the public courts choose not merely for a single firm; they choose for the whole society. Judgments of this kind are likely to be wrong because, first, there is no market feedback, and second, because individual preferences and circumstances differ too much for one set of rules and procedures to suit them all.

Judge Neely is surely right that litigants would often be better off if they could mutually “disarm” by jointly slashing expenditures. Unfortunately, given the public courts’ structure and political constraints, this task may be impossible. Yet private arbitration firms could cheaply explore these possibilities; they do so already (for example, by prohibiting the use of lawyers and appeals). One way to cut back on legal costs without massive administration problems would be to open up a wider range of disputes to private resolution and increase the autonomy of private alternatives from public control.

This list of inefficiencies in the public courts is hardly exhaustive. We might also note that judges make many economically unwise rulings. Juries in civil cases, guided more by emotion than by consideration of long-run consequences, do the same. In any case, the public courts are sufficiently unattractive that we should seriously consider alternatives. And I think that Landes and Posner point in the right direction: if we can measure the efficiency of public courts by comparing them to arbitration, then private dispute resolution, if possible, is a welcome option. Fortunately, this option is not only possible but real and growing. The next two sections will explore its benefits, its solutions to the problems of the public courts, and the its feasible scope.

#### **2.4 Private dispute resolution: an efficient alternative**

Many of the faults of the public courts would not exist (or would be less severe) under private arbitration. Private courts could raise fees to efficiently ration judicial services. They could experiment with indemnification rules to reduce their clients’ expected legal costs. Firms might offer various methods to restrain joint legal costs (by, for example, prohibiting or limiting the use of lawyers). They could limit or eliminate appeals. Each of these problems seems difficult for the public courts to manage: partly for political reasons, but also because public monopolies have little ability to recognize entrepreneurial opportunities.

Consider some further advantages. One characteristic of private supply is that it recognizes that consumer have different needs; and since many suppliers can survive in an

industry simultaneously, it is possible for them to sell a wide variety of services side by side. Some parties prefer swift decisions at the cost of lower accuracy — the member banks of the VISA corporation, for example, realize that errors will even out in the end, but that adjudication costs increase with each dispute. VISA consequently has a system of rough but swift justice. Other conflicts — for example, over isolated contracts between strangers — require a more thorough investigation. Public courts have a systematic bias toward excessively slow resolution; but even if the courts were right on average, they would still ignore the fact that litigants’ preferences vary.

The most impressive arguments for privatizing dispute resolution have little to do with the unique attributes of the adjudication industry; rather, they are the standard arguments for the *prima facie* superiority of private to public supply. Namely: (1) Public bodies have no incentive to be efficient, and private ones do; and (2) Public bodies usually don’t know what is efficient, while private bodies, though not omniscient, know better.

Why don’t courts have any incentive to be efficient? First, there is no residual claimant with an interest in cutting costs and increasing consumer satisfaction. In profit-making firms, the owners have an incentive to keep costs low and make them fall over time. And the incentives of the employees are different. Judges are typically either elected, or appointed for life. Elections are a a bad way to monitor work effort — informing oneself about each judge’s attributes is a pure public good: society at large benefits from intelligent selection of judges, but individual diligent voters bear the costs. Life appointments take away even the meager incentive effects of voting. If we want the public courts to work, we must rely on the self-monitoring of the judges themselves. This might work sometimes. But is it a good incentive structure? The incentive structure of private labor markets is more sensible: while they have imperfections, private labor markets leave employment decisions up to a concerned manager or entrepreneur, not the public at large. These managers reward their employees if they work well and fire them if they don’t. Surely this spurs work effort better than voting or life appointments.

Second, as Hayek and others suggest, private markets use knowledge more effectively than public monopolies.<sup>18</sup> They are more able to calculate costs and benefits. In markets there are explicit prices that measure costs and benefits. But public bodies must estimate social costs and benefits by using (at best) surveys or (at worst) guessing.

The judicial industry needs the low-cost experimentation that private firms can provide. It is cheap and safe if one firm decides to restrict the use of lawyers, or get rid of appeals, or change the indemnification rule; even if these experiments flop, the losses to society are small. Often an experiment proves useful, at least for one section of the consuming public. Private adjudication services would be free to experiment and see what their clientele thinks. Public courts, in contrast, rarely try new ideas. But there is perhaps a justification for this — namely, their error costs are terribly high because public experiments involve everyone. Perhaps public courts hold to the status quo because they fear that their experiments will fail miserably. What we need is to permit experimentation, but keep it decentralized so that mistakes can be abandoned before they become disasters. And private firms are the ideal arena for low-cost

experimentation. For years, academics in law and economics have speculated about the relative efficiency of different rules and procedures for trials. Rather than have the public courts try each out in succession, we could expand the scope of private courts and see what innovations evolve.<sup>19</sup>

## 2.5 The potential and limits of private dispute resolution

As Posner and Landes point out, there are two cases where private dispute resolution works best:

- (1) those where a preexisting contract between the parties requires submission to arbitration according to specified rules for selecting an arbitrator, and (2) those where the disputants belong to an association which provides both arbitration machinery for its members and a set of effective private sanctions for refusal to submit to arbitration in good faith or to abide by its results.<sup>20</sup>

They go on to suggest that (1) works only because the government courts enforce the contract. This seems partly correct. But reflection suggests that preexisting contracts to arbitrate could work if the public courts simply refused to overrule them. Consider video rentals — before we can get a rental card, we must authorize the rentor to use our credit card if we do not return the video or pay our fees. Our credit card company in effect guarantees our trustworthiness; and if we break our agreement, it pays the video rental firm. If we refuse to pay our credit card bill, our company could of course take us to court; but this is usually so ineffective that it simply ruins our credit rating if we renege. If we extend this model further, we can imagine an effective way to enforce all sorts of contracts — including arbitration contracts — non-violently and without the help of the public courts. Put simply, it is not actually necessary that we have repeated interaction with all of our fellow contractors in order to make non-violent enforcement necessary; we must merely repeatedly interact with one firm whose job it is to guarantee our payments.

Repeated interaction, game theory teaches us, can substitute for enforceability. So long as parties develop some kind of bonding relationship, they do not need the public courts to enforce their agreements. However, it is necessary that the public courts and legislature refuse to overrule them. Arbitration is a way to escape from the public courts; but if the public courts regulate arbitration, the “escape” is less effective. What I am suggesting is that contra Posner and Landes, arbitration can work even if the public courts don’t enforce it, but that it can’t work if the public courts positively disallow it. Nathan Isaacs, a professor of business law at Harvard during the 1920’s, noticed that when the government began to enforce arbitration (in 1920 in New York) it also began to hamper it:

There is irony in the fate of one who takes precautions to avoid litigation by submitting to arbitration, and who, as a reward for his pains, finds himself eventually in court fighting not on the merits of his case but on the merits of the arbitration.<sup>21</sup>

What then, should public courts and legislatures do (or rather, not do) to make arbitration work as well as possible? First, courts must refuse to review any arbitration clause in a contract; i.e., make a clear rule about what an arbitration clause must say to be court-proof, and then rigidly stick by

that rule. Second, courts must refuse to review the content of arbitration, leaving the efficiency and justice of arbitration to the parties’ judgment. Third, legislatures must refrain from legally hampering the ostracism and boycott efforts of arbitration firms, professional associations, and credit card companies (for example, by banning credit ratings as an invasion of privacy). Private firms do not have violence at their disposal, so they must use subtler methods of enforcing agreements, like credit ratings and reputation. To put restrictions on these comparatively mild enforcement techniques makes it difficult for arbitration to work at all. Fourth (and least importantly), the government should refrain from making any antitrust charges against professional associations that publicize the untrustworthiness of members who refuse to arbitrate or submit to sanctions.

How come only preexisting agreements to arbitrate work? First, it is difficult to enforce a claim non-violently unless both parties can credibly pre-commit to comply. Especially if one party is sure to lose in any fair trial, he has no incentive to cooperate unless he previously made himself vulnerable to sanctions (for example, by authorizing his credit card company to pay for any damages). Second, it might be difficult to get a fair trial even if two common law strangers agreed to arbitrate. Each side might try to get arbitrators, rules, procedures, etc., beneficial to its case; and if the other declined, he might be accused of “foot-dragging”, of willfully delaying and stifling the resolution process. These problems might make us skeptical of purely private resolution of quarrels between strangers.

Nevertheless, many disputes do not involve strangers; and in principle all of these might be turned over to the private sector. All commercial disputes, employment quarrels, creditor-debtor complaints, landlord-tenant problems, and perhaps divorce and products liability fit the mold well. The parties need merely record their mutual decision to arbitrate future quarrels (including perhaps their preferred arbitrator), plus some sort of assurance or guarantee of compliance. Commercial disputes might rely on reputation effects; employment quarrels on the threat to fire on the one hand (to exact compliance from employees) and the harm to worker morale on the other (to get employers to accept decisions); landlord-tenant relations on a security deposit. In other situations the parties might use credit cards or the like to pre-commit themselves to pay up. (More on this in the section on enforcement.) Consider, for example, sexual harassment. Instead of having court-enforced anti-harassment laws, we might leave firms to develop their own policies, or “law” on the matter. When a male manager and a female employee have such a dispute, either the firm itself or a sub-contractor might conduct an internal investigation with its own procedures, rules of evidence, etc. The firm has the power to enforce the arbitrator’s ruling: it might fire an offending employee, attach his wages in order to compensate the injured party (coupled with a threat to enter the harasser’s name with a sort of “employee rating firm” if he should opt to quit), or any number of other remedies. In order to attract a satisfied workforce, each firm might compete to develop more efficient rules and enforcement techniques. There are at least two important factors that they might weigh: first, the harm done to harassed employees; second, the harm done to those falsely or mistakenly accused. Competing employers would probably better balance these two costs than the courts.

If the government were involved at all, it might restrict itself to summarily enforcing the result of outside arbitration. If, for example, a landlord-tenant arbitration case rules that the tenant must leave at once, the government might restrict itself to enforcing the order. Or if a products liability arbitrator rules in favor of an injured customer and the firm refuses to pay up, the courts might merely summarily order the firm to pay. What about the hard cases, such as torts (between strangers, anyway) and crimes? Courts might summarily enforce arbitration to which both parties agree. In a way, they do this now with plea bargains and settlements. The only difference would be that instead of enforcing a determinate outcome, the courts would agree to enforce the outcome of a process, however it turns out. It might be difficult to get two strangers to agree to a common arbitrator. But, as Posner and Landes point out, arbitration entrepreneurs have thought about this problem for a long time and developed some workable solutions. The AAA sends both parties a list of arbitrators; each side then crosses off unacceptable arbitrators and ranks the remainders according to his or her preferences. Whichever arbitrator gets the highest joint ranking gets the job. And this system aligns both sides' incentives skillfully. As Posner and Landes explain,

A party who crosses everybody off the list hurts only himself, by guaranteeing that the arbitrator will be selected from among the names not deleted by his opponent.<sup>22</sup>

It might be unfair for the courts to impose arbitration on unwilling parties; but perhaps arbitrators would strive to develop reputations for fairness to lure parties to try it voluntarily. After all, the parties to a court case rarely have any choice about their judge unless he is plainly biased. (The side that likes its assigned public judge might refuse to arbitrate. To prevent this problem, one might delay announcing the judge until after the parties learn of their option to arbitrate.) If this section has an overall conclusion, it is that competitive arbitration could successfully take over a large array of disputes currently handled in the public courts. There are no obvious market failures for individual dispute resolution. Arbitration firms' decisions and procedures would be kept fair and efficient by means of free competition, rather than by self-monitoring or voting. Since there are no glaring market failures, the results of competitive arbitration would approximate the high expectations that we have of freely competitive industries in general. But for arbitration to work, we must meet two conditions: (1) The public courts must adopt a simple rule about what arbitration clauses must say to bind the signatories, and then stick to that rule; (2) The legislature must refrain from passing laws that hinder non-violent private enforcement like ostracism and boycott.

Resolution of individual disputes could easily be privatized. There are no apparent market failures, such as externalities, imperfect information, or monopoly. At least these problems do not seem unusually serious. (We might also note that these "market" failures have parallels in the public courts.) The next function of private legal systems that this thesis will investigate has, in contrast, been accused of a quite serious market failure. Landes and Posner allege that private organizations and arbitrators have no incentive to make rules because of serious positive externalities. The next section examines private "law-making" and investi-

gates whether the market failure is as serious as Landes and Posner think.

### 3. FORMATION OF RULES

#### 3.1 Preview

What does economic theory have to say about the private supply of rules of law? First, a rule-production market with no externalities would be economically efficient. If it were possible for rule-inventors to charge judges and arbitrators who use their rules (with some costless copyright system, for example), then private supply would be quite feasible. In fact, such an idealized system would be a marked improvement over rule-creation by the public courts: there would be stronger incentives for efficient law-production, and product differentiation would make it possible to satisfy many sub-markets simultaneously.

Alas, the rule-production market has serious externality problems because it is difficult to establish property rights in a precedent. Posner and Landes take this as proof that private rule formation is an industry with little or no realistic potential. But things are not so simple. For one thing, patents are not the sole or even primary incentive for innovation. Surveyed businessmen in R&D-intensive industries rate several other factors more highly, as we shall see below. Unsubsidized firms continue to produce non-patentable innovations, so other incentives must exist somewhere. On top of this, it is sometimes possible for firms and parties to pre-contract to internalize any possible externalities of rule production. In other words, there are several mitigating forces that could reduce the externality problem for private rule-creators.

Posner himself (in *The Economics of Justice*) points to another source of private rule provision: the evolution of custom. Cultural evolution gradually produced customary law in the absence of government supply; and despite some disadvantages, customary law and other "grown" orders have many attractive features. They draw on centuries of legal wisdom and experience; they are extremely stable; and they easily adapt to marginal social changes. The common law originated in the customary law of early tribes. Cultural evolution leads most societies down parallel tracks: divergent societies' customary laws of property, contracts, and torts are remarkably similar. And these evolved customs of property, contract, and tort are precisely the kind of legal rules that law and economics scholars consider efficient.

All this points to a tentative conclusion: Leaving the production of legal rules to the market may be feasible after all. Markets supply many other non-patentable innovations. Posner and Landes are probably too swift to dismiss the possibility of non-governmental supply; after all, many industries overcome the problem of non-patentability. The potential for private supply turns out to be greater than commonly assumed. The following sections challenge this common assumption in depth.

#### 3.2 The economic theory of private rule-making with no externalities

As is often the case in economics, it is convenient to begin the analysis of private rule-making with a counter-factual assumption. Let us assume for the moment that all legal innovations' benefits can be internalized by their producer

(whether an individual judge or the firm that employs him). Imagine a costless system of rigidly enforced copyrights. Any time someone uses a precedent, procedure, ruling, or law pioneered by another person, the user must pay royalties to the creator. What would happen under these circumstances?

First, every judge or private adjudication firm would strive to develop the most efficient laws that it could find in order to maximize royalty revenue. They would funnel money into research and development, search out weaknesses in the law, and advertise the advantages of their respective systems. Just as with an ordinary copyright, the marginal cost curve shifts upwards in order to eliminate supernormal profits, because firms increase their spending in research and development and educate customers about the latest advances. This is perhaps the dreamland of law and economics scholars — the efficiency of every conceivable legal rule could be tested, not in the arid world of econometrics, but in the practical realm of business.

This market might have a host of possible structures. If Posner and Landes are correct, there are economies of scope in dispute resolution and rule-formation, so we would see “vertically integrated” adjudication firms performing both functions simultaneously. If they mistake an accidental feature of public courts in the U.S. for an economic advantage, then there might be two interrelated industries — one resolving disputes for the public, the other selling rules to the dispute resolution firms. Just as in normal patent law, the discoveries of the distant past would belong in the public domain; only recent innovations would be rewarded by monopoly grants. All firms would probably embrace the basic categories of property, contract, tort, and crime — innovations on par with Newton’s work in physics or Darwin’s in biology. Legal rules at this level of generality, being part of our accumulated cultural heritage, would naturally be free. But specific developments within these categories might be patented just like any other intellectual innovation. To be sure, there would be the usual problems in patent law concerning the breadth of the patent and its duration; but the core intuition is that if there were perfect exclusion it would be possible to have a flourishing law production market.

Posner and Landes assert that private judges might have an incentive to promulgate vague rules that maximize the public’s need for court services. It is difficult to imagine that any system could be more vague than our current public court system, so the argument seems misplaced. More to the point, this could not happen under free competition. Customers would patronize the arbitrators that offered the cheapest and highest quality service. Arbitrators would have to select the proper inputs — most importantly, clear and simple legal rules. The incentives to promulgate vague rules and thereby increase demand might exist if the government sub-contracted its rule-making function to a single monopolist. But the genuine market in rule-formation that this section explores would be fully competitive. In such a situation, a firm that tried to “increase demand” by adopting vague rules would be much more likely to lose all of its clients than reap a bounty from an explosion of litigation.

A competitive market in the formation of rules would be different from our current system of rule-formation by judges and legislatures in one crucial respect: there would be legal diversity within one and the same geographic re-

gion — or if you prefer, product differentiation. Courts and legislatures (leaving the mitigating effects of federalism aside) usually make the same rules for everyone. Posner and Landes offer a plausible economic rationale:

there would appear to be tremendous economies of standardization in the precedent market, akin to those that have given us standard dimensions for electric sockets and railroad gauges.<sup>23</sup>

True enough; but the existence of some economies of standardization hardly shows that total standardization is economically desirable. Only when the production of legal rules became freely competitive could we correctly balance the preferences for both diversity and uniformity. Properly functioning markets do this without us even trying. Restaurants, for example, have many things in common: they are clean, have waiters and waitresses, serve non-poisoned food, and have bathrooms; but they have many differences: quality of service, type of food, decor. Presumably, restaurant entrepreneurs balance the costs and benefits of standardization and diversity when they make a final decision on their business practices, realizing that customers want both uniformity and choice. A competitive rule-formation market that strictly protected intellectual property rights would do the same. In fact, private adjudication (still assuming no externalities) might be better able to standardize law than governments; for it is a characteristic of state law that it applies merely within national borders. Yet as the world’s economies become more interdependent, the need of international businesses for a common legal code increases. Private rule-formation could gradually amalgamate diverse business norms into a common legal code; for just as inventions from one nation can be exported to another, so too might legal practices. So long as law-formation remains a monopoly of governments, standardization requires international treaties, years of negotiations, and so on. And while such agreements claim to bring productive efficiencies like a shared commercial code, there is also the danger (as some critics of the European Community argue) that international standardization might eliminate legal competition on tax and regulatory policy. The economically preferable outcome would be legal standardization without a legal cartel.

Professor Bruce Benson sums up the “legal standardization” controversy aptly:

Where the tremendous economies of standardization that Landes and Posner alluded to exist, the private sector will take advantage of them. Government typically cannot respond because of the artificial constraints of political boundaries. There is no reason to believe that any national government is of the ideal size to take full advantage of the economies of standardization in law. In some areas of law (e.g., commercial law), these economies appear to be greater than any existing nation can encompass. In other areas, such economies may be considerably more limited so that existing political entities are too large. A private system of law would generate efficiently sized ‘market areas’.<sup>24</sup>

These “efficiently sized market areas”, I might add, need not be geographic in character — they could just as easily be broken down by industry-type, by cultural norms, by risk-preferences, or any other factor. Since by assumption law would be produced in competitive markets without externalities, we could be confident that whatever market sizes and levels of standardization emerged would be optimal.

### 3.3 Rule-formation in the real world: the problem of externalities

We have seen that a law-production market with no externalities generates rather attractive results. What happens if we relax the assumption of perfect patent and copyright protection for law-producing individuals and firms?

As Posner and Landes first suggested, all legal innovation could disappear. Everyone might try to free ride on the precedent and procedure R&D of their competitors; but this individually rational strategy is not, as the saying goes, “socially rational”. If there were no public courts, the probable result would be a steadfast adherence to tradition, because tradition would be the only source of law left. Put simply, we would have nothing but a static stock of legal knowledge inherited from the past.

It is not clear how serious a defect this would be; as Posner hints, both the rule of *stare decisis* and the low rate of depreciation of precedents (4-5% according to his research) indicate that rapid innovation is not even desirable.<sup>25</sup> Richard Epstein’s mistrust of legal change is still more pronounced: “the merits of freedom of contract in no way depend upon the accidents of time and place”.<sup>26</sup> Other basic legal principles, he says, are similarly timeless. Unfortunately, legal innovation can alter good laws as well as bad ones. (One of Epstein’s favorite examples is the doctrine of assumption of risk, which modern public courts seriously weakened.) Perhaps legal innovation is not as important as some people think. It is at least possible that the harmful changes made by the public courts in this past century outweigh all of the beneficial ones. Nevertheless, Posner and Landes’ case against purely private production of rules seems strong. It does appear that patent and copyright protection would be difficult to bestow upon legal innovators. And normally economists assume that intellectual property rights of this kind are the only effective way to get the market to invest in research and development. Without effective ways to internalize the benefits of innovation, government funding seems like the only way to assure us of the supply of this valuable good.

### 3.4 Non-patentable innovations and externalities problems

The central problem with the Posner-Landes analysis is that it proves far too much. It is a historical fact that private systems of law began, evolved, and thrived. The medieval law merchant, for example, was so effective that national governments adopted the market’s rules rather than the other way around. Bruce Benson points out that during the 19th century private commercial arbitration competed fiercely with the common law courts.<sup>27</sup> The former relied extensively on business custom and the law merchant, while the latter did not. One of the main ways that the private sector competed with the public was by adopting a different legal code — one that the business community found more efficient and fair. Gradually, competition drove the common law courts to adopt rules similar to those of private adjudication. Competition persisted even though the common law courts were partly subsidized by the crown. Even Posner and Landes admit that,

the doctrines developed by the [private] 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. In a

similar vein English procedural reform in the nineteenth century has been attributed in part to the competition from private arbitration.<sup>28</sup>

Notice how the private and the public courts competed by offering different rules of law, which would not be possible if public courts were the only possible source of law in the absence of patent protection for legal inventors.

Professor Benson raises a still more challenging point: Who free rides off of whom? Posner and Landes observe that public and private courts typically have similar legal codes; they then conclude that the private courts free ride off of the public courts by “borrowing” their precedents. But Benson argues for the opposite view:

[C]ommercial arbitration should enforce virtually the same laws recognized by the public sector, but the causation actually flows in the opposite direction. Public courts enforce virtually the same laws as commercial arbitrators do. If they did not, the public court bureaucracy would lose its commercial business because businessmen would use their own courts (as they are).<sup>29</sup>

I doubt that this is wholly true today, because the private courts cannot compete with the public courts on equal terms. The public courts can trump the decisions of the private courts. Before we can test these alternative hypotheses, we would first have to give private courts the autonomy that they need to compete effectively.

There is a second and more serious reason to doubt the seriousness of the externalities problem. Posner and Landes suggest that private rule-production would not work because of the difficulty of claiming a property right in a precedent. But they overlook the large sectors of our economy in which (a) Patent and copyright protection is unavailable, (b) There is no government R-and-D, and (c) Innovation still occurs. For example, the person who “invented” the modern super-market could not get royalties from other people who wanted to open up super- markets of their own, even though it was a remarkable innovation. General style and model changes, whether in autos, architecture, fashion, etc., cannot be patented. In order to be patentable, something must be relatively specific, but many useful innovations are not. Similarly, many business practices are not patentable: If, for example, I successfully experiment with a new form of vertical integration, my competitors are likely to copy me; but I cannot charge them for the privilege. And still such innovation survives. How is this possible? Part of the explanation is that economists overrate the importance of copyrights and patents. Businessmen surveyed typically rank the legal protection of their innovations as one of the least important determinants of the rate of return on research and development. The most recent survey of R&D executives yielded startling results: on a scale of 1 (“not effective at all”) to 7 (“very effective”), 650 R&D executives rated the effectiveness of different ways to reap the rewards of innovation thusly:

Method	Average Score Product Innovation	Average Score Process Innovation
Patents to protect duplication	4.33	3.52
Patents to secure royalty income	3.75	3.31
Secrecy	3.57	4.31
Being first with innovation	5.41	5.11
Move quickly down learning curve	5.09	5.02
Superior sales/service efforts <sup>30</sup>	5.59	4.55

In a similar vein, F. M. Sherer, an economist who has written extensively about patent protection, notes several non-patent sources of protection for inventions:

natural imitation lags, the advantages of competitive product leadership, and the existence of non-patent barriers to the emergence of a competitive market structure.<sup>31</sup>

In the first category, natural imitation lags, Sherer includes several factors. First, there is secrecy on the part of the innovator. It may secretly prepare to introduce a new product, then spring it on the market; even with perfect imitation, it would still have a lead on its competitors equal to the time from the firm's decision to market the product to the firm's announcement of the product's availability. Second, notes Sherer,

It takes time for entrepreneurs to learn about a new and promising invention, even after its existence has been publicized, and it takes even longer for them to decide it is worth imitating.<sup>32</sup>

Many innovative processes, he notes, take years to catch on completely in an industry. A high price gives short-run profits and swift imitation; a low price gives long-run profits and slow imitation. Finally, imitation is often very difficult unless one duplicates the first-mover's R&D, or hires away former employees of the innovating firm. As Scherer and Ross explain,

free riding on an innovator's technical contribution is often far from free. At one extreme in this respect are airliners. One can inspect a rival's design, but to build a similar aircraft, one must generate detailed engineering drawings for each part, program machine tools to produce the parts, build prototypes, and subject them to static and dynamic testing to ensure that unnoticed design flaws do not lead to catastrophe.<sup>33</sup>

Next, says Sherer, the first firm on the market frequently wins an excellent reputation. Image and consumer trust matter in business; innovation enhances both. In a parallel fashion, uninnovative firms' image and consumer confidence suffer. Sherer's final point is that the lack of atomistic market structures enhances the gains from innovation in the absence of patents. Supposedly, oligopolies with their strict price discipline manage to prevent imitation and profit erosion. I find this third point difficult to take seriously in the light of later work in industrial organization by Demsetz, Bork, and other critics of the structure-conduct-performance paradigm in industrial organization.<sup>34</sup> Anyway, there are strong reasons to think that the market structure of private

rule-suppliers would be fairly unconcentrated; even now, while the market is fairly thin and undeveloped, many suppliers co-exist. But Sherer's first two points are quite pertinent. Patent protection is not the only spur to innovation; if it were, we would see no innovation in areas with no patent protection. Apparently, one of the reasons why unprotected innovations continue to appear is that legal protection is not the primary incentive source. Given this, why couldn't we spur the production of rules with the same incentives that inspire other non-patentable innovations?

### 3.5 The evolution of custom as a substitute for intellectual property rights

F. A. Hayek observes that there are many sorts of "grown orders" in our society.

Although there was a time when men believed that even language and morals had been 'invented' by some genius of the past, everybody recognizes now that they are the outcome of a process of evolution whose results nobody foresaw or designed.<sup>35</sup>

The most obvious example is the market economy, but other valuable cultural features like language, custom, and law fit the same description. In fact, some law is a subset of custom. Basic private law categories like property, contracts, torts, and crimes exist even in primitive societies without any permanent government.

One interesting challenge for economic analysis is to explain what incentives cause the development of language and custom, both of which look like public goods. If we could figure out what incentives there are to produce language and custom, we would understand how customary law, one important branch of custom, arises and evolves. If we could do that, then we might see if these incentives still exist today.

Richard Posner, the very scholar who has criticized private production of legal rules, has coincidentally also studied the legal systems of primitive societies. He does not deny the plain fact that they have legal rules without government supply. But at the same time he gives no clear account of the primitives' incentives to create rules.

Two of the common sources of legal norms, legislation and executive decree, are ruled out by the assumption introduced in the last chapter that there is no state. Since the arbitrators, though private, are a sort of judge, it may seem that the third common source of law — judicial decisions viewed as precedents guiding future conduct — could operate in a primitive society. But one has still to ask what incentive the arbitrator has to issue opinions that will stand as precedents.<sup>36</sup>

Posner concludes that custom is the only alternative source of law; but this merely pushes the question one step back. What incentive there is to create customs? This question is especially pressing for Posner, who argues that even the bizarre laws of primitive societies have an economic justification. Who has the incentive to produce these detailed legal customs, especially customs of such remarkable efficiency?

If we looked at customary law as a final product, the puzzle is difficult. Who would have the incentive (much less the ability) to design a body of efficient customs for his entire clan to use? And how would these customs gain general acceptance in the absence of a government? So long as we

look as customary law as a final product, it is difficult to see any solution.

I do not have a fully satisfactory explanation, but I think that the most promising route begins with the observation that customs arise piece-meal by a process of cultural evolution.<sup>37</sup> When an individual conceives of a radical change in social norms and tries to promote it, his effort is indeed a public good. But suppose that he thinks up a tiny innovation, useful mainly to himself. He then has an incentive to initiate the change. Since the change is so minute, people are less likely to object to it. The better the innovation is, the more people imitate and spread it. The broader order is a sum of these piece-meal innovations. Each tiny improvement benefits the innovator at least somewhat — though there may be externalities, the innovator gets part of the payoff. But the final product of these tiny improvements benefits everyone, even though it would not reward any individual to develop an entire system from scratch. This process is evident in the birth and growth of language. No individual would have an incentive to create a language from scratch. But it would pay to (a) Learn whatever language exists already, and (b) Make marginal improvements and innovations in one's language, which others may in turn adopt. Apparently, this simple process led speechless primitives to slowly evolve common languages, which in turn became modern languages. Only by understanding that language develops piece-meal and gradually could we see how it could arise without government supply or subsidization.

What can we say about the efficiency characteristics of these evolved practices? No rigorous theorem, analogous to the results of welfare economics, proves conclusively that they are maximally efficient. But they nevertheless have many attractive features. First, spontaneous orders create the central features of society, such as language and custom; and it is difficult to imagine that these features could have arisen by design. Second, spontaneous orders have a cheap feedback mechanism. If something is inefficient (always or sometimes) then cultural evolution helps weed it out; if efficient, then cultural evolution helps it spread. Designed orders, in contrast, often lead to disaster before their inefficiency becomes clear. Third, spontaneous orders are a cheap route to social coordination: complete strangers can interact so long as they share a similar cultural background. Fourth, they are extremely stable. I suspect that this is one of their chief drawbacks in the eyes of critics; but perhaps they overlook the dangers of hasty and radical social changes and see only the costs imposed by stagnant traditions. Studying the deadly history of social experiments in the twentieth-century yields a more balanced perspective.<sup>38</sup>

The most reasonable explanation for the birth and evolution of customary law is that it too is a spontaneous order. As with language and custom generally, there were no patents or copyrights to give incentives to develop customary law. But because customary law accretes piece-meal, patent protection was not necessary. The detailed legal codes established purely by custom that Richard Posner discusses indicate that gradual accretion works at least tolerably well. Similarly, the somewhat more civilized Germanic tribes had a sophisticated body of evolved customary law.<sup>39</sup> While there was not vigorous R&D in precedents that perfect patents would foster, neither was there the pathological free-riding that Posner and Landes fear.

The development of rules via cultural evolution is hardly limited to ancient history. Robert Ellickson, in his recent book *Order without Law*, discusses the informal norms that govern the ranchers and farmers of Shasta County, California.<sup>40</sup> Due perhaps to the costliness of legal disputes, the people of Shasta County are fiercely opposed to litigation. They prefer to resolve disputes informally, in accordance with a simple and unbureaucratic code of rules. These rules frequently differ from the official law — but no one seems to know or care. Here is a list of the basic rules of law that people in Shasta County live by, all of which were the product of gradual accretion via cultural evolution rather than a single law-giver or body of law-givers.

1. Owners are held strictly liable for all damage done by their livestock.<sup>41</sup>
2. Ranchers who build or improve cost-justified fences are entitled to bill a share of the cost to noncontributing neighbors.<sup>42</sup>
3. Aggrieved parties must try each of the following remedies in succession: (a) Give notice to the accused; (b) Circulate truthful negative gossip regarding the deviant person; (c) Physically seize or destroy an appropriate amount of the offender's assets.<sup>43</sup>
4. Parties are expected to forgive trivial injuries, unless persistent.<sup>44</sup>
5. Parties should not take their disputes to the government courts except under extreme circumstances. As Norman Wagoner of the Shasta County Board of Supervisors colorfully puts it, "Being good neighbors means no lawsuits".<sup>45</sup>

Ellickson thinks that the relative efficiency of this informal legal code explains its persistence and vitality. It is cheaper to obey simple customs than to learn the law. And the norms themselves are cheap to enforce on account of their simplicity and the informality of the remedies.<sup>46</sup> Ellickson, it should be noted, also sees problems in systems of informal norms — most notably, they may fail to protect the interests and rights of those outside a given community. That is certainly a danger. Still, many norms that arose within close-knit communities later spread to advanced societies.

Why are critics of private rule creation via custom so sure that it doesn't suit the modern world? Posner argues that customary law works for static, primitive societies but is inadequate in dynamic, modern societies:

There is little danger that legal change will lag behind social change in such a society and produce the sort of anachronisms which in the case of English common law and Roman law created the demand for legal fictions, equity, and legislation to keep the law up to date. Evidently Roman and English society were changing faster than a system of purely customary law (no fictions, no equity) could keep up with — which means faster than the typical primitive society.<sup>47</sup>

But it is not so obvious that modern societies have more need of legal change than primitive ones. Richard Epstein, for one, argues in a forthcoming book that it is precisely complex, modern societies that need a small number of simple and constant rules.<sup>48</sup> In primitive societies, life is static enough to create new rules each time a change springs up. But modern societies are so complex that the best that

we can do is provide a few clear and stable rules to build a framework for rapid non-legal change. As society grows more intricate and vast, it becomes less, not more, feasible to modify the law each time society changes.

Robert Ellickson brings up another startling point: public courts often enforce customs which were the product of cultural evolution rather than the state.

In both its original broad outlines and its current substantive details, the Uniform Commercial Code frequently gives legal status to the usages of merchants.<sup>49</sup>

The public courts free-ride on the market's rule-creation! Evolved norms aren't perfect, but they have marked advantages over other feasible methods of rule-creation. Hence, judges and law-makers, despite their traditional hostility to private rule-creation, give custom a big place in the law.

Posner's own work on the legal systems of primitive societies partially answers his critique of private rule-creation. Primitive legal systems grow out of custom in the absence of government, as Posner points out. So if intellectual property rights won't work, custom might. Is custom only suitable for primitive societies? Hayek's theory of spontaneous order and Ellickson's research on informal norms suggest the opposite: A single planner could adequately give rules to a simple society, but not a complex one. Cultural evolution of law is another possible route for the market to build its own rules of law.

### 3.6 Ways to internalize the benefits of rule-production

It is surprising that Posner, who writes at length on entrepreneurs' clever solutions to difficult incentive problems,<sup>50</sup> dismisses private rule-creation so swiftly. Prof. Benson points out a plausible way that judges might internalize the benefits of rule creation:

[M]aximizing profit does not involve maximizing the number of cases decided. A judge who provided clear rules and opinions would command a relatively high price for contracts with various organizations. Once under contract, the judge would actually have the incentive to minimize the number of disputes that go to trial by making his rules clear — that is, by setting precedents. Under this scenario, private judges have precisely the opposite incentives to those predicted by Landes and Posner.<sup>51</sup>

As mentioned previously, parties with a prior contract to arbitrate can easily opt out of the public court system. Hence, a large majority of arbitration consumers could indirectly pay for efficient private legal codes by hiring the firm most noted for keeping peace among its clients.

This solution, notes Benson, closely parallels the structure of HMOs.

In the area of medical care, some have argued that physicians have incentives to 'create demand' for their services by advising uninformed consumers that they need more medical care than they actually do. This is quite similar to the argument Landes and Posner made regarding private judges. But new institutional arrangements have been created during recent years in the face of rapidly rising costs of medical care. Consumers can now play a flat fee for services at HMOs and PPOs, reversing the physicians incentives. Physicians have incentives to keep their patients healthy with preventive

medicine that avoids more costly treatments after illness arises.<sup>52</sup>

It is the incentive to supply "preventive law" — law which keep disputes from happening in the first place — that public courts and legislatures rarely supply. Competing arbitrators would have a strong incentive to select rules that do precisely that.

But what if firms waited for their competitors to invest in research and development, see which firm is most successful, and then copied its rules? Perhaps problems of this sort lead the VISA corporation to keep its legal code secret. A firm might keep its code secret and merely advertise its clients' low dispute rate; after all, customers care about the bottom line, not the production process. This is an imperfect solution, but despite difficulties, private arbitrators have some incentive to adopt and devise prophylactic rules to prevent disputes. The same cannot be said for public courts or legislatures.

As mentioned before, innovation can survive without patents. And if firms were to compile their legal rules in books and copyright them, their innovations would enjoy moderate protection. Small competitors could still free ride, but large firms would fear copyright infringement lawsuits. Just as publishers ignore isolated acts of unauthorized reproduction but pursue large-scale violations vigorously, arbitration firms might ignore small-scale abuse but prosecute plagiarism of their major competitors. Since arbitration firms are in the business of preventing and resolving disputes, they might even have the good sense to strike bargains to compensate each other if they borrow from each other's rule-books. The effectiveness of this depends on the concentration of the arbitration industry; but as Ellickson's work hints, cooperation often blossoms even in large communities so long as members repeatedly interact.

### 3.7 The variety and flexibility of private rule production

As mentioned in the introduction, we usually think of law as a non-exclusive good in two senses. The first is the trivial one that we all benefit from law whether we pay for it or not. That is hardly true of private adjudication, as we saw. But there is a second sense of non-excludability: Opting out of the legal system could not be permitted even if it were possible, because the whole point of law is to encompass everyone, not just people who want to live lawfully. If we could unilaterally renounce legal responsibility, who could resist the option? Since law appears non-exclusive in this sense, it is simply not possible to have the variety and flexibility of normal markets.

When parties have the option, however, to jointly opt out of the state's legal system, variety and flexibility are possible. Suppose that you employ me; in my employment contract, we can specify any arbitrator we like. If the market is sufficiently thick, we should be able to open up the phone book or a professional journal and find hundreds of different sorts of legal rules advertised: no-fault or strict liability, damage or injunction remedies, complex appeals systems and one-hour binding arbitration. There might be firms that offer all sorts of options: arbitrators who make house-calls, over-the-phone arbitration, whatever you can imagine. All of these options could co-exist in one and the same geographic region — just like normal competition.

Law and economics scholars write as if one rule, in principle, were the best for a given society. And if law equals public law, it is difficult to get outside this assumption. But once we let people opt out of the legal system, we see the error. There are as many efficient rules as there are possible sub-markets. Rather than doing econometric analysis of the efficiency of rules, we might simply free up the market and see what happens. It would be miraculous if it turned out that one set of rules were right for everyone. Instead we should expect to see the variety and flexibility characteristic of other markets. Indeed, what are various econometric tests but highly imperfect attempts to find out what the market would have chosen? Isn't there a false presupposition here — that the market would have chosen one and only one legal code? One of the chief efficiencies of private rule-production would be the opportunity for consumers to pick and choose from a host of possibilities. At the same time, law and economics scholars would have a new field to study; instead of theorizing about what is efficient, they could go out and observe what is efficient in each sub-market — then explain why it is so.

### 3.8 Public vs. private rule-creation: an exercise in comparative institutions

Unlike some economists, Posner and Landes realize that one must do more than point out that an industry has a few market failures in order to justify government supply. It is equally necessary to investigate government failures and see whether they are comparable or worse. In "Information and Efficiency: Another Viewpoint", Harold Demsetz makes this point explicit by contrasting the "comparative institution" to the "Nirvana" approach to policy.<sup>53</sup> The former, said Demsetz, considers the real-world advantages and drawbacks of both markets and government; the latter focuses exclusively on the failures of the market and assumes that the government can correct them at no cost. With this in mind, let us draw some tentative conclusions about the economic desirability of the private supply of rules of law.

The Posner-Landes criticism of private supply of rules was that the production of rules is a positive externality; hence they doubted that markets could do the job. This was their justification for the rule-making function of the public courts. In light of the previous sections, what may we conclude about this complaint? Primarily, Landes and Posner overstate the point. There are often ways to internalize the benefits of private rule-creation. (See 3.6) History gives ample evidence that extensive legal systems can arise despite externality problems, largely by gradual accretion. (See 3.5) And while intellectual property rights are one spur to innovation, they is not the most important one; indeed, they they were, all unpatentable innovation would grind to a halt. (See 3.4) Nevertheless, public courts could in principle solve the externalities problem better than private firms could. Since they get their funding from taxes, they could produce rules of law whenever their social benefits exceeded their social costs, even if it were impossible to charge the beneficiaries. Under private rule creation, rules are unlikely to get produced unless it is feasible to collect payments from users.

Yet the argument doesn't stop here. In part two of this paper, I pointed out the public courts' inefficient methods of dispute resolution. Their ability to produce good rules of law is no greater. Public judges have bad incentives; since they are either elected or appointed, they are likely to have

a different attitude toward work than employees in a profit-making firm. Posner suggests that public judges derive utility from issuing precedents purely from the pleasure of influencing the course of the law.<sup>54</sup> (Why mightn't this austere intellectual pleasure not be found in private sector judges — perhaps on their off-time?) He says that judges clearly don't maximize leisure. Judge Neely's assessment of the judicial work-ethic is less sanguine than Judge Posner's ("It is in the nature of the judiciary, with its life tenure or long elected terms, that it can encourage arrogance and indolence, just as the occupation of salesperson tends to mask them."<sup>55</sup>) but that is beside the point. The question is not whether public judges' incentives get them to produce precedents; clearly they do. The question is whether their incentives lead them to efficient rules; and that is far less likely. Posner himself suggests that judges advance their own political agendas, heedless of the possible negative consequences. If this is the case, then each successive precedent might be a source of external harm rather than external benefit.

Since private judges have better incentives than public judges, we should expect their decisions to be more efficient. Public employees can afford to pursue their own agenda; they are hardly likely to lose customers, their salary is fixed, and their jobs are among the most secure in the world. What motivation do public judges have to create rules that benefit everyone, when they could promote their own political views instead? Private judges might have equally strong convictions, but they face the constraints of competition. Their clientele is not stuck with them, and is unlikely to suffer from inefficient rulings when they can switch their arbitrator freely.

And suppose that public judges did want to select efficient rules. How would they know when they had? Law and economics scholars can hardly agree among themselves except in the most egregious cases of legal ineptitude. Knowing whether a legal rule is efficient must be difficult. The problem of public judges is that they have no effective feedback mechanism to tell them if they are doing a good job. Even if they wanted to pick efficient rules, they have no good method to pick them out.

Compare this to market-produced rules. The knowledge is much easier to get, because consumers can express their preferences by switching suppliers. This gives a simple and pragmatic test for efficiency. Imagine randomly creating a hundred different legal codes for a hundred different arbitrators. You could easily find out which codes were efficient — just see what thrives in the market. That would give far better evidence for a rule's efficiency than volumes of scholarly speculation. On top of this, as section 3.7 pointed out, the quest for the efficient legal code is vain because there is no uniquely efficient code for everyone. Instead there are a host of efficient codes, each of which works best for a given sub-market. Public judges' quest for efficient law fails because they can't take this into account.

Perhaps the way to put the criticism is this: While public courts could potentially correct the allocative inefficiencies of private rule creation, they are almost sure to be less productively efficient. Moreover, the allocative inefficiencies of private rule creation are partially correctable. History supports this, since many legal rules originated in the private sector. Yet it is unclear how the public sector could ever attain the productive efficiency of the private sector.

While some quasi-market reforms could be imagined (e.g., Set scarcity prices for court services), the fundamental incentive and knowledge problems of the public sector remain.

Richard Posner is famous for his view that common law decisions by judges are much more likely to be in the general interest than those of legislatures. Legislators' chief activity is redistributing wealth; they do what interest group pressure and expediency dictate. Common law, in contrast, provides efficient rules that encourage production and trade, both of which enhance social wealth rather than merely redistributing it. Posner was not the first to endorse this view; one may find a similar theory in Bruno Leoni's *Freedom and the Law*:

[T]here is more than an analogy between the market economy and a judiciary or lawyers' law, just as there is much more than an analogy between a planned economy and legislation.<sup>56</sup>

[A] legal system centered on legislation resembles in its turn, a centralized economy in which all the relevant decisions are made by a handful of directors, whose knowledge of the whole situation is fatally limited and whose respect, if any, for the people's wishes are subject to that limitation.<sup>57</sup>

Though his analysis was less detailed than Posner's, in one respect Leoni is more sophisticated. Namely, he notes that legislators and public judges both have the same incentive to act against the commonweal. Both have a public monopoly whose power isn't checked by market competition. As Leoni explains,

it cannot be denied that the lawyers' law or the judiciary law may tend to acquire the characteristics of legislation, including its undesirable ones, whenever jurists or judges are entitled to decide ultimately on a case.<sup>58</sup>

If Leoni's point is valid, then Posner's enthusiasm for the common law is premature. It may yield better decisions than legislatures, but retains its basic flaws. A chief point in favor of market creation of rules is that it is genuinely competitive. The arguments that favor judge-made law over legislation also commend private rule creation over the common law. For example, the argument might be made that legislation is too erratic and unstable, while judge-made law has long-run certainty. Yet political motives in the public courts sometimes produce erratic and unstable case law. Products liability, anti-trust, and civil rights law come to mind. Private rule-producers would never make sudden change unless they were convinced that most of their clients wanted it. Another argument for common law is that it enforces what the parties themselves would have accepted if bargaining were feasible; critics of legislation, in contrast, allege that it is usually the tool for the politically powerful and well-organized to grow rich at the expense of the disenfranchised. Yet public courts also bend the rules to help their favorite groups — again, products liability, anti-trust, and civil rights law come to mind. Private rule producers would be more impartial, because their clients must jointly choose them.

Posner and other scholars also argue that the common law tends to be efficient, but have been unable to persuasively explain why. In *The Economic Analysis of Law*, Posner suggested that judges simply have a utilitarian instinct.<sup>59</sup>

Casual observation of judges' philosophies strongly disconfirms this. Other thinkers have pointed out different market-like forces that push common law rules toward efficiency, but Posner and Landes persuasively criticize these.<sup>60</sup> The preceding analysis of the private production of rules has two interesting implications for this debate. First, it seems that only genuine market competition systematically yields efficient rules, because private firms escape the incentive and knowledge problems of the public courts. The discipline of competition plus the feedback mechanisms of profit and loss drive arbitrators to pick the rules that consumers want. Second, perhaps one explanation for the efficiency of public court rules is precisely that potential market competition checks them; if public court rules become too inefficient, firms may shift en masse to the private sector. Posner and Landes themselves note this process in the history of English law, and suggest that this might explain the public courts' hostility to private alternatives.

Consider a final argument for a greater role for private sector rule-creation: It insures us against dangerous social experiments by diffusing power among competitive bodies. It is risky to let one well-organized group — like public judges — choose for a whole society. When most public judges decide to adopt a new rule, all of us bear the costs of their errors. Experimentation by the public sector is costly because its power is centralized and its feedback mechanisms weak. The private sector would give us valuable insurance against the public courts' mistakes. Private firms are innovative, but they sensibly introduce changes gradually. And there are typically many suppliers in a given industry — so even if one firm unwisely leaps into a new practice, consumers have alternatives. While this benefit is political rather than economic, we should keep it in mind.

What policy implications does this analysis have? As mentioned in the section on dispute resolution, private arbitration works mainly if the parties have the opportunity to pre-contract with each other to opt out of the public system. And for opting-out to work well, private alternatives must be independent of the public courts. The same principle applies to private creation of rules. So long as both parties pre-contracted, the courts should categorically refuse to overrule an arbitrator.

The public courts might also quit writing precedents for cases that private arbitrators dominate. Tax-subsidized competition dulls private initiative. Consider commercial disputes — an excellent candidate for privatization at the dispute-resolution level. Since private arbitrators handle such cases already, the courts could spur private production of rules by ceasing to produce them themselves. Courts could encourage private settlement of disputes between strangers by renouncing jurisdiction over any case that both parties agree to arbitrate. If almost everyone waives their right to a court trial in a given area of the law, the court might cut back on its own rule-production in that field. By a process of trial and error, the courts might come to see what types of legal rules the market will supply.

Why does private arbitration break down when pre-contracting is not feasible? The answer is that the right of violent enforcement rests with the state, so private bodies must rely on subtle enforcement techniques such as ostracism and boycott. The next chapter discusses the strengths and weaknesses of private enforcement of law. Since the right to use force is what limits the universal extension of non-state

legal systems, it also considers what would happen if this final limit disappeared.

## 4. PRIVATE ENFORCEMENT OF LAW

### 4.1 Ostracism and boycott

Unlike governments, private bodies do not normally have jails, police, and soldiers to enforce their rulings. This is why many people assume that only governments can enforce private agreements, and, indeed, private arbitration. However, the whole thrust of the economic analysis of crime is that a criminal sanction is much like a price; what precludes private bodies from exacting the same price that the government does? While the usual criminal sanction is imprisonment, it is likely that time in prison has some implicit price. It should therefore be possible to secure compliance by threatening to reduce a person's income. And private bodies do have this power.

The classic non-violent sanctions are ostracism and boycott. A boycott is essentially a refusal to trade with an offender. Ostracism is a more extreme form of boycott; the community completely cuts off an ostracized individual. We frequently hear about sanctions like this in primitive and ancient societies. Cut off from their tribe or nation, ostracized individuals had to either survive autarchically or find another community. The latter was naturally difficult because an individual ostracized by one group might be a bad member of any group.

A common assumption is that boycott and ostracism can only work in face-to-face societies. There are two reasons why people make this assumption. First, the usefulness of boycott and ostracism depends crucially on information. In a small tribe, everyone knows who has been ostracized; it is not feasible for an offender to assume some new identity or move to a new part of town. The complaint is that modern societies are too anonymous for this to work; it is easy to cast off a stigma by finding a new group of friends, trading partners, and community when there are five billion humans on earth.

The second complaint is that boycott and ostracism suffer from a serious free rider problem; hence, if they work at all, they would have to be enforced by the government. The sanction isn't really private at all. Imagine, for example, individuals who find the working conditions of grape workers offensive. They could try a consumer boycott of grapes to punish the employers. Yet there is a serious free rider problem here: all people offended by the grape-workers' conditions benefit if the employers get punished via reduced sales (assuming that this is a good strategy in the first place). But the costs of enforcement are borne solely by the individuals who have to forego their favorite fruit. We might expect cheating and chiselling unless the boycotters are ferociously principled. Like most free rider problems, a boycott could only work if the state enforced it. That seems self-defeating if we want a private means of punishment.

While these two doubts about the feasibility of boycott and ostracism are plausible, they simply aren't true in many cases. First of all, while imodern societies lack the face-to-face character of simpler times, information storage and transmission have advanced in step with modern technology. Credit ratings, for example, or rental histories, have become

ever more feasible and inescapable with the development of the computer. We could easily imagine comparable data banks for information about employment history. More to the point, in the modern world it would be easy to register people who violated arbitration agreements or defied legitimate rulings. There is actually a strong case that the requisite information for boycott and ostracism is more available in modern societies than in earlier ones. Before the advent of modern information storage and retrieval technology, one could simply move to another city and leave one's past behind. As the world's economy globalizes, it grows ever more difficult to get rid of a bad commercial reputation.

The second doubt about boycott and ostracism misses the whole point. Of course, if the benefit produced by the boycott/ostracism really is collective (as in the grape worker example), then it is a public good. But boycotting and ostracizing dishonest trading partners, far from being selfless service to the public good, is in one's immediate interest. Just as landlords would voluntarily refrain from renting to people with bad rental or credit histories because they are bad risks, so too is it in the interest of merchants and employers to refuse to trade with people who break arbitration agreements. This is why the damage to one's reputation is so harmful to merchants — they won't get customers if they can't win their trust. (Or at the least they would have to pay a price premium to compensate trading partners for the extra risk.) Ostracism and boycott work well in the merchant community precisely because the common good — sanctioning dishonest businesspeople — is perfectly consistent with the private interest in avoiding bad risks. If people want to boycott grapes to pressure employers to give grape workers better pay, then the cost is private while the benefit is public. But if merchants want to boycott a cheater in order to avoid bad risks, the benefit of sanctioning is just as private as the cost. There is no public goods problem here. Each individual need merely attend to his private interest, and the public good of punishment springs up automatically.

Here, then, lies a simple tool with which private arbitration might be enforced. It is non-violent and wholly private; but it works in many cases. Private enforcement of law is not only possible but real.

One mustn't forget, however, that boycott and ostracism depend on the free flow of information. Information is hardly costless even in competitive markets; and it is likely that individuals would only check out the history of their trading partners if the value of their deal were fairly high. Landlords, for example, usually run a credit check on potential tenants, but motel owners do not. But, as mentioned earlier, it isn't necessary for every link in a contractual deal to investigate the history of every other link. The traders can get guarantees from some third organization that specializes in information. Consider the motel case. Quite possibly, the owner might bill the cost of damages (e.g., stolen towels) straight to the customers' credit card company. Even though the motel owner finds it too costly to research the history of the tenant, the owner does have information about the trustworthiness of the credit card company. The credit card company researches its customer's credit history because they have a long-term relationship. So it is possible to economize on information costs by contracting with guarantors. The guarantor need be the only body that knows the client's history, and the client's trading partners need only know the guarantor's reputation in order for the client and

the trading partner to trust each other. The problem of information costs in such situations actually becomes trivial.

Observe how stores don't care about the credit history of customers who use credit cards. They don't care because they know that the credit card company pays no matter what; the credit card company bears the risk that the store's patron will default. Since the credit card company has a big stake in the trustworthiness of its clients, it will likely spend the money to check their credit history. But the parties must incur this expense only once before they can enjoy the benefits of mutual trust.

#### 4.2 Aside: the moral argument against credit ratings

This system of enforcement is workable without government help. But it does have trouble if there is government hindrance. Alas, the latter is far more common. Many people find it offensive if a bureau records individuals' wrongful acts and warns people who might be harmed by them. They therefore try to get the government to restrict or even legalize information storage. A common prohibition placed upon credit bureaus is that they must erase information after X years. Others want to declare that credit ratings are an invasion of privacy.

Such regulation would indeed make private enforcement impractical in the modern world. Since private enforcement is non-violent, it has to rely on subtle methods to punish those who break faith. Without the free flow of information, word of mouth would be the only alternative. In narrow business associations this works; but broader privatization rests on free access to information. Critics might object that the right to privacy trumps lesser values like wealth. Some things are more important than social utility, and individual liberty is one of them. I happen to agree with this view, but its application to this question is senseless. For what opponents of credit ratings want to do is suppress the liberty of individuals to announce to the world that they have been wronged, and to suppress the liberty of individuals who would like to protect themselves from dishonest trading partners. Why doesn't the liberty of these individuals count? Moreover, since individuals get bad credit ratings because they did not live up to their own agreements, how is their liberty violated anyway? They consented to the deal in the first place, so they consented to be reported if they broke faith. Since they consented to everything that happened to them, their liberty isn't violated.

Even more shocking is that governments' invasions of privacy and punishments are much more objectionable from a moral point of view. Tax forms, for example, must be filled out by everyone, willy-nilly; why isn't this an invasion of privacy? Boycott and ostracism are unpleasant sanctions. But if private bodies don't punish fraud, the government will have to. It will probably use its traditional sanction: prison. Surely this is a worse violation of the right to privacy than boycott and ostracism. Advocates of the right to privacy should, on their own grounds, support a wider role for non-violent sanctions. Despite the moral high ground that opponents of ratings assume, their case is weak and hypocritical.

#### 4.3 The Becker-Stigler model

In an important article, Gary Becker and George Stigler suggest another method of private enforcement. Suppose that a firm wants to deter employee theft. Rather than rely

on the law, it offers a higher than normal wage. If an employee gets caught, he gets fired — and presumably must accept a lower wage at the next job. (The argument would be stronger if the employer were to “blacklist” dishonest employees, just as landlords report bad tenants to a credit rator.) Becker and Stigler point out that one could spend very little on enforcement if the salary differential were high enough. As they explain,

Trust calls for a salary premium not necessarily because better quality persons are thereby attracted, but because higher salaries impose a cost on violations of trust.<sup>61</sup>

Becker and Stigler also point out that there is actually no need for overall pay to be higher. An employer might pay employees, say, \$100 a month extra. Since workers' expected earnings exceed their opportunity cost, employers could easily charge employees an “entrance fee” equal to \$100 times the expected number of months worked discounted by the interest rate. Alternately, the would-be employee might post a bond for good behavior. If they are honest, their bond earns interest until they quit, at which point they get the bond back. But if they break faith, the employer could fire them and keep the bond. Perhaps a neutral holding company (or arbitrator!) might hold the bond to control any moral hazard problem. A third alternative might be to put the salary premium into a pension fund which an employee must forfeit if the employer gets caught cheating.

While Becker and Stigler main goal is to prevent corruption among public police, judges, and the like, they recognize that its applicability is wider.

Our analysis of malfeasance is applicable not only to enforcers but to all public and private employees who must be ‘trusted’.<sup>62</sup>

If ostracism and boycott is too costly, individuals in long-term contracts might use Becker-Stigler incentives to win mutual trust. Labor contracts are the clearest possibility. While it is quite rare for employers to exact explicit deposits, they frequently require employees to pay for their own uniforms and equipment.

A system of this kind permeates the apartment and housing markets. Typically, a landlord charges a “security deposit”. The point of this deposit is to protect the landlord if the tenant damages the premises or refuses to pay rent. Other rental systems combine deposits with boycott sanctions. For example, when you rent a videotape, you consent for your credit card company to pay any rental fees that you renege on. In other words, you put down a sort of deposit, and your credit card company collects from you by threatening a credit boycott if you decline to pay your monthly statement.

We can also imagine a system of mutual deposits. Suppose you and I draft a long-run contract with each other. We might require each of us to put \$10,000 in the hands of an arbitrator. If cooperation breaks down and we arbitrate the conflict, it would be easy to enforce a judgment. Since the arbitrator already holds our two deposits, he could simply return the winner's half of the deposit plus damages out of the other's person's half. (The remainder would go to the losing party.) By providing our arbitrator with the tools of enforcement before cooperation breaks down, we can assure each other that all arbitration award will get enforced.

There are some problems with the Becker-Stigler system.<sup>63</sup> Sometimes employees face liquidity constraints, making it difficult to charge an admission fee. The result might be underemployment in industries which use the Becker-Stigler method of enforcement. It is also possible that employee resentment against such a system might undermine its effectiveness. Employers must often rely on willing worker participation to get good performance; if workers resent deposit systems, employers may be worse off than if they used a less intrusive sort of enforcement. There is also the danger that employers would issue false charges to steal a worker's bond. While these complaints are not all equally convincing, they limit the effectiveness of Becker-Stigler incentives.

Nevertheless, the use of deposits is one effective way to enforce agreements. It could both substitute for and complement other sorts of private enforcement such as ostracism and boycott. In rental markets, deposits are more efficient; in credit markets, boycotts are. Other markets, like videotape rentals, use both in concert.

Like most of the policy suggestions that I have made throughout this paper, Becker-Stigler enforcement requires no positive government help. Parties use it because it is simple and cost-effective. But for this sanction to be maximally effective, the state must not hinder it. And a number of legal restrictions on deposits exist. In some cities, the government caps the maximum possible rental deposit. The result is that tenant breaches of trust increase and government courts handle more landlord-tenant disputes. The public courts also restrict parties' use of liquidated damages clauses. They routinely refuse to enforce allegedly "punitive" damages in contracts.<sup>64</sup> One can imagine that the public courts might, in a parallel fashion, overrule an arbitrator who awarded damages out of the parties' deposits. The stricter the legal restrictions on the use of deposits, the less effective Becker-Stigler enforcement will be.

A more appropriate policy, and one which would encourage more extensive private resolution of disputes, would be to leave deposit enforcement systems unregulated. The technique is imperfect, but Becker-Stigler enforcement can be a cheap and effective way to enforce private arbitration rulings — and private enforcement in general. It is non-violent and doesn't undermine the government's monopoly on coercion. It just cleverly designs incentives that make coercive enforcement superfluous.

#### 4.4 Posting rewards and the Posner criticism

Becker and Stigler, again in "Law Enforcement, Malfeasance, and Compensation of Enforcers", suggest a novel alternative to government supply of police. Why not simply offer rewards to firms that successfully catch and prosecute criminals? The accused would still get a trial in the government's courts. If found innocent, the enforcers would have to offer compensation to the wrongfully accused. But if found guilty, the enforcers would exact a fine from the criminal. If that is impossible because the criminal is too poor, the government might pay the enforcers a bounty and then imprison the criminal. Though Becker and Stigler do not suggest this, we could auction off criminals as indentured servants to profit-making jails. The government would then merely order that criminals get released once they pay off their debt.

As Becker and Stigler admit,

Free competition among enforcement firms may seem strange, even terrifying, and much more radical than the method of compensation proposed earlier to eliminate malfeasance by salaried enforcers.<sup>65</sup>

But they find that if we look at their system less emotionally, it has many virtues. First, it would entirely eliminate malfeasance. It is only possible for criminals to bribe enforcers now because the private costs to the criminal of getting punished exceed the private benefits to the enforcer of carrying out the punishment. Police officers, for example, get a fixed salary; it makes little monetary difference to them how many criminals wind up in jail. But it matters greatly to the criminal. Profitable trades can and do spring up between criminals and enforcers, since the criminal's welfare falls if he goes to jail, but the officer's income is invariant with his number of arrests. But if enforcers were paid out of the pockets of convicted criminals, the situation would change. If the fine for a crime is \$1,000, there is no way that a guilty individual could bribe an enforcer not to prosecute, because the only sufficient "bribe" would exactly equal the fine. As Becker and Stigler design their system with a perfect link between costs to criminals and benefits to enforcers.

Second, they argue, their system would leave the selection of means to the market. Just as market-like schemes for pollution abatement mandate nothing but outcomes, and leave the choice of methods to the market, the bounty system would set a reward for apprehending criminals but let the market determine the most effective way to apprehend them. As Becker and Stigler put it,

rules usually provide neither the slightest hint of where to look for violations nor the incentive to convict violators.<sup>66</sup>

Both of these functions, in their view, might be left to the market: the bounties would provide both the incentive to figure out the least-cost enforcement methods and the incentive to use them.

Third, Stigler and Becker criticize existing compensation systems for giving victims bad incentives. If there is no compensation for victims, they grow excessively cautious. A system that offers a bounty if criminals get caught would, they say, lead to optimal victim care. If it is easier for victims to take care than extract compensation from criminals, they take care; if the opposite is true, the victim take the risk and relies on compensation. As Becker and Stigler explain,

the right amount of self-protection by potential victims is encouraged, not the excessive (wasteful) self-protection that results when victims are not compensated, or the inadequate self-protection that results when they are automatically compensated.<sup>67</sup>

While the Becker-Stigler proposal is open to criticism, they are sophisticated enough to anticipate and adjust for the obvious objections. To prevent overzealous (or indeed criminal) enforcement, the enforcer would have to compensate any innocent person they apprehend. (Incidentally, this might make it possible for defense attorneys to serve on a contingency basis just as plaintiffs' attorneys often do today.) If criminals has no money, the government would pay the bounty and then imprison the criminal. Since firms might not have enough money to compensate the wrong-

fully accused, they suggest mandatory bonding or malpractice insurance.

In fact, Stigler and Becker anticipate a much more sophisticated complaint later popularized by Judge Posner. Posner begins with some simple claims in the economics of crime. There are two central variables: the probability and the severity of punishment. Since there are two variables, it is necessary to choose some “mix” of the two. Does economic analysis have anything to say on this matter? Posner suggests that the costs of increasing the probability of punishment are high and the costs of increasing the severity are low (indeed, virtually zero). But if this is true, then we could always get the same level of criminal activity at a lower cost if we reduced our spending on enforcement and increased the punishment. The logical conclusion is that we should couple horrific punishments with negligible enforcement. As Posner puts it,

every increase in the size of the fine is costless, while each corresponding decrease in the probability of apprehension and conviction, designed to offset the increase in the fine and so maintain a constant expected punishment cost, reduces the costs of enforcement.<sup>68</sup>

The Becker-Stigler bounty system is imperfect, says Posner, because it cannot reach this optimal mix of probability and severity of punishment. Why? Because the level of the fine automatically determines the probability, too. A \$1,000 fine, for example, would lead, in equilibrium, to marginal enforcement expenditures (neglecting the interest rate) of \$1,000. This in turn should yield some probability of punishment — suppose .2. Now how would the government reach the optimal probability-severity mix. If it lowers the fine, it lowers the probability of conviction (say to .1); if it raises the fine, it raises the probability of conviction (e.g., to .25). There isn’t any way to increase the severity and lower the probability at one and the same time. To do so, the government would have to use a second policy tool, such as an excise tax on enforcers.

Becker and Stigler anticipate Posner’s point (and, indeed, his tax-solution) in their original article. While conceding the logic of the point, they suggested that Posner’s super-high punishments would just lead to more malfeasance. Raising punishments, then, might not be effective since it increases the gains of corruption. If the state taxes bounties to induce optimal enforcement expenditures, the incentive for malfeasance re-emerges. All three systems, whether bounties without taxes, bounties with taxes, or public enforcement, have some problems. But the surprising conclusion that arises out of their debate is that the public sector has no clear advantage over the private sector for the enforcement of crime. On top of this, the debate between these three economists sheds light on the problems of restitution-based systems of criminal justice, which I investigate in the next section.

#### 4.5 Torts and crimes: incentives for enforcement

[M]ost cases, both civil and criminal, in the public courts are settled out of court rather than litigated to judgment, and most of the inputs into the litigation of such systems are private ...<sup>69</sup>

explain Landes and Posner. Private inputs are especially prominent in civil cases — a wealth transfer from loser to winner functions as both an incentive (to try cases) and a

deterrent (against wrongful activity). And both sides in a civil suit pay their own legal costs. Evidently a sizable chunk of civil law enforcement relies on private resources. All that the government does is decree some “bounties” that convicted losers have to pay to winners, and then enforce the judgment. After the courts create these incentives, the system largely runs itself: there are incentives to prosecute and dis-incentives to commit civil wrongs. Here is a startlingly close approximation of the Becker-Stigler enforcement system suggested in section 4.4.

The role of non-governmental parties in civil suits is indeed impressive, and testifies for the importance of the private sector in law enforcement. This section will take tort principles a step further and consider applying the same model to crimes. Crime victims would have a legal right to collect restitution from criminals convicted of harming them; crimes would, like torts, be offenses against individuals rather than society. (We might solve the problem of inchoate crimes by requiring restitution for them, too.) Since criminals frequently have liquidity constraints, the likely corollary of a restitution-based system for crimes would be a system of indentured servitude for criminals. If a court rules, for example, that a penniless criminal owes a victim \$10,000 for an assault, the victim could accept bids from free-market jails. The victim would presumably get his money upfront, and then the business/prison would be allowed to “exploit” \$10,000 worth of value out of the convicted criminal.

Such a system would get rid of government prosecutors and government jails; instead of taxing the general public for such functions, the system would instead set up incentives for private individuals to prosecute and deter criminals. Why don’t we do this already? The usual answer is that deterring crimes is a public good, while deterring torts is a private good. This is the economic rationale for private enforcement of civil wrongs and government enforcement of crimes. Yet this rationale is hardly adequate. Imagine that damages in tort cases went to the government rather than the plaintiff. Deterring risky behavior would become a public good! Deterrence is never inherently a public good; if damages went to the plaintiff instead of the state, it would become a private good. Deterring crime is only a public good if there are no incentives to prosecute and jail criminals. One might reply that a crime victim’s choice not to prosecute injures us all. True, but so does a tort victim’s choice not to sue. In both cases, society benefits if crime and negligent behavior get deterred; and if there were no incentives for either, there would indeed be underdeterrence. But just as award of damages gives private parties incentives to supply the public good of safety from torts, so would restitution give private parties incentives to supply the public good of safety from crimes.

One important conclusion of the economics of crime is that fines could potentially deter just as well as prison. And a major conclusion of the externalities literature is that from an efficiency viewpoint, it doesn’t matter who gets the fine, so long as the creator of the externality pays it. From these two facts alone, we can conclude that a system which required criminals to pay fines to victims could in principle internalize the social costs of crime. Notice that crime victims suffer a private bad. If you doubt this, observe how people try to avoid becoming another crime statistic: they choose safe routes, don’t travel alone, try to live in nice neighborhoods, and so on. If security were really a public

good, there would be no incentives at all for private parties to protect themselves. Thus, there are no effective steps I individually could take to provide national defense for myself. But there are many ways that I individually can take to protect myself against crime. Where is the public good? As far as I can tell, the only public good is prosecution of crimes. We all benefit if someone prosecutes, but the prosecutor bears all of the costs. (Since he is unlikely to be repeatedly victimized by the same criminal.) Yet imagine that the property rules were different — in particular, imagine that crime victims got restitution. Why couldn't this internalize the social benefits of prosecution?

It might be objected that people prefer to live in a society with a low crime rate, even if they are not themselves crime victims. That is quite, but so what? The level of the restitution could incorporate this, too. Tortfeasors don't need to compensate every person who they put at (some minuscule) risk, only the people who suffered harm. But by requiring compensation for the victims of torts, we reduce the average risk of suffering a civil wrong — and with much lower transaction costs. Similarly, criminals don't need to compensate everyone who ever heard of their dirty deeds, only their actual victims. But by requiring compensation for the victims of crimes, we reduce the average risk of suffering a criminal wrong — again with much lower transaction costs. One sensible complaint about criminal restitution is that the compensation is imperfect. The probability of apprehension and conviction is less than one; even if they were, there are some crimes that money can't undo. True, but we have the same problem in torts. There is no price that can compensate for wrongful death, or probably even the loss of a limb. But isn't it preferable to do our best to make victims whole rather than do nothing? No system is perfect; but compensation to victims for torts helps somewhat. Is imperfect compensation for crimes really more common than for torts? Many crimes, such as theft and fraud, could probably be compensated easily; many torts, like wrongful death, cannot be. So perhaps the imperfect compensation problem is no worse for crimes than for torts. In any case, we can adjust for imperfect enforcement by multiplying the damages.

On top of this, one might argue that compensation systems are better for victims on average, because the high burden of proof and procedural safeguards of criminal trials let many guilty criminals get off. Perhaps the severity of criminal sanctions leads to such low probabilities of conviction that victims in general are worse off than if the sanction were milder. In short, correcting for imperfect compensation with criminal sanctions may backfire by reducing the total level of deterrence. (More on this later.)

The lack of restitution for crime victims creates a tragedy of the commons. While the upkeep of common areas is in a sense a public good, it is only a public good so long as the area stays common. If we divide up the commons and create property rights, the area's preservation turns into a private good. There is an especially simple way to divide up the commons in the case of crimes: let each victim have a property right to some amount of restitution from the criminal who wronged him. Of course, privatization is only one possible way to handle commons problems. But since this paper investigates the prospects of non-state law enforcement, let us at least explore the possibility and see whether it would be workable.

The most obvious question about restitution is whether it would be feasible for criminals to pay for their jail accommodations and pay off their victims. Isn't it unrealistic to think that impoverished criminals could have sufficiently high marginal products to do so? It is difficult to know for sure, but throughout history slaves and indentured servants have commanded high prices. (The median price of a slave in 1860 was \$1,500, at a time when median annual income for free workers was \$200.)<sup>70</sup> Even in primitive times, the discounted income stream of a slave's net earnings (marginal product minus the costs of food, shelter, and monitoring) was positive. And Ransom and Sutch, in their study of American slavery, found that the "rate of exploitation" (the percentage of a slave's income that the owner was able to expropriate) for 1859 was about 53.7%.<sup>71</sup> Consider further that slaves were relatively unskilled workers in a semi-industrial society. As a society grows wealthier, the fraction of the average worker's income that goes toward basic necessities declines. Consequently, the feasible rate of exploitation should increase in step with per capita income, making restitution systems more feasible in modern societies.

A second fear is that private prisons would mistreat prisoners. It is difficult to imagine that any private prison could be worse than public prisons, with their reputation for abuse and violence. Still, prisoner abuse in private prisons could be a serious problem. Courts might help by grading prisons according to their strictness (e.g., parole with weekly checkups; evening and weekend detention only; minimum security; moderate security; maximum security); then they could set a maximum "security level", along with the restitution fee. The convicted criminal might then bargain with the victim for better living conditions in exchange for more restitution. Alternately, the court could fix the total restitution without reference to prison costs, so that the victim would have to weigh the greater security of stricter prisons against the lower return. Another possible way to protect criminal rights is to give inmates the right to switch to any comparably restrictive prison that would take them. Even if there were no court-imposed checks on the treatment of prisoners, they would probably be much better off than today. While scholars of American slavery differ on some points, they agree that slave-owners had a strong incentive to make sure that their working slaves were adequately fed, housed, and otherwise cared for. (Non-working slaves, such as children, received markedly worse treatment.<sup>72</sup>) In particular, profit-making firms would have strong incentives to prevent prisoners from using violence against one another. Some obvious tactics would be to strictly separate violent and non-violent criminals, to segregate prisoners according to might and size, etc. There would also be incentives to monitor abuse by guards.

Prisons might invest in prisoners' human capital, since the firms could collect a large fraction of the benefit. One common complaint about prisons is that they release prisoners without any job skills; hence, the notoriously high recidivism rate of our public prison system. While a private prison could not reap the full benefit of training unless a criminal's debts added up to a life sentence, it would at least have some incentive to invest in job training. Most students of slavery argue that prejudice and social sanctions prevented slave-owners from training slaves for skilled professions. Prison entrepreneurs, in contrast, might try to turn inmates into skilled workers.

Another way that private prisons might reduce recidivism would be to hire criminals after their sentence runs out. Since by assumption the criminal was profitable to employ while serving time, he should still be profitable to employ after he pays off his debt. Indeed, since he would no longer owe restitution, and since his monitoring costs would fall, he would likely get a raise. While the failure of public prisons to rehabilitate criminals surely owes a great deal to the criminal personality itself, profit-making prisons might better prepare criminals to become self-supporting members of society. (Whereas prisons, as the quip goes, prepare criminals to become better criminals.)

Prisoners would have an incentive to work as hard as possible because they would only get released once they paid off their debt. For this reason, restitution has been called a “self-determinative sentence”. The prison time is fixed not in terms of years, but in dollars of work; criminals who work hard and cooperate with management get out sooner. (To correct for the problem of super-wealthy criminals, courts might grade restitution according to the criminal’s wealth.) This is the central positive incentive to work hard in restitution-based systems. Prisons might hold out other positive incentives, such as television, nicer cells, free time, and so on. It is difficult to know a priori what incentives would best elicit work effort from criminals, but this is surely a possibility. Public prisons are so conservative that they ignore attractive innovations; but anecdotal evidence from a few experimental prison programs is quite heartening. During the 1970’s the Maine State Prison (conveniently located along a major tourist route) allowed prisoners to go into business for themselves. The prison issued canteen coupons for currency, allowed workers to hire each other and form “firms”, and eventually set up a patent system for novelties. Over two-thirds of the prisoners participated, and out of this labor pool arose some exceptional entrepreneurs. One criminal-entrepreneur bought out the prison canteen and ran it at a profit; another employed 30-50 other workers and branched out into television sales and rentals. Nevertheless, this highly successful program got shut down in 1980 due to bureaucratic resistance.<sup>73</sup> While we should be cautious about generalizing from one case, the Maine State Prison experiment does hint at the innovative potential of private prisons. After all, it takes entrepreneurial talent to be a drug-dealer. Maybe the problem with past rehabilitation programs is that they tried to completely remold inmates’ characters rather than appeal to their entrepreneurial spirit.

A final complaint is that restitution systems could only work for crimes with a small number of identifiable victims. This is largely correct, although class action suits against pollution and other public bads exist. But there remain other crimes, like drug possession or prostitution, that seem difficult to fit within the restitutive model. Rather than digress, I will briefly point out some possibilities. First, one might get rid of victimless crime laws, precisely because they don’t have an identifiable victim. Second, (this is apparently what Stigler and Becker suggest) whoever “narcs” on the law violator would collect the fine, even though the user did the informant no harm. Third, one might use restitution for crimes-with-victims and government enforcement for victimless crimes. Although I find the first option ethically superior, disagreement should not lead us to dismiss restitution altogether.

Now that I have discussed the popular objections to restitution-based criminal enforcement, we shall turn to Judge Posner’s technical economic criticisms. Posner argues that private enforcement for torts and contracts and public enforcement of criminal law is economically rational because  $p$  (= the probability of apprehension and conviction) is likely to be near unity in the former and low in the latter case. As Posner suggests,

The victim of a breach of contract knows who breached it; the victim of an automobile accident usually knows the identity of the other driver; but the victim of a burglary does not know the burglar’s identity.<sup>74</sup>

If you recall section 4.4, Posner’s complaint about the Becker-Stigler bounty system was that it did not give incentives for an optimal severity-probability mix. But Posner embraces private enforcement for tort and contract because, he says, the probability is near unity in civil cases. Hence higher severity won’t induce greater expenditures because  $p$  is already at a maximum. In contrast, crimes have low  $p$ ’s; therefore, higher severity induces greater spending on enforcement. And as Posner pointed out earlier, such expenditures are suboptimal because we could get the same level of deterrence by merely raising the severity and slashing the enforcement budget (and thereby the probability of conviction). Posner is not in his best form here; he forgets that  $p$  = the probability of apprehension and conviction, not just the former. All that his examples prove is that victims of torts and breach of contract are more likely to know who did it than victims of crimes. But that hardly shows that the probability of conviction is 1 without any expenditures! All of our statistics on the amount of money spent on civil suits indicates that the sum spent on the enforcement is large indeed: Cooter and Ulen estimate that the social cost of trials is at least \$400/hour, and the litigants pay at least half of that out of their own pockets.<sup>75</sup> And this doesn’t even consider pre-trial expenses and the cost of legal battles settled out of court. Evidently, the parties to these disputes think that they can adjust  $p$  by spending more money. Posner is too quick to assume that civil suits don’t encourage enforcement expenditures; plainly they do. Anyway, even if Posner were correct that  $p = 1$  for civil suits, we could still get cheaper enforcement by arbitrarily increasing the level of damages and decreasing the number of suits tried. We may not be able to further increase the probability of conviction, but we could certainly decrease it by, for example, letting the government take over the prosecution of civil suits and permitting selective enforcement. (Alternately, the government could let would-be plaintiffs draw straws for the right to bring suit.) And if Posner is correct that optimal enforcement requires high severity and low probability, that is the the correct strategy. Overall, Posner’s effort to rationalize private enforcement of civil law and government enforcement of criminal law is poorly thought out. The preceding passages appear to justify government enforcement of both civil and criminal wrongs. Both of them have the same inefficiency that Posner brought up earlier — they spend excessive resources on enforcement, when it would always be possible to get the same level of deterrence by arbitrarily increasing the severity and slashing enforcement. Most people, while admitting the economic logic of Posner’s suggestion (i.e., near-infinite severity and near-zero enforcement expenditures), find it morally appalling. I share this reaction, but I also think that there are two solid economic objections to Posner’s proposal.

First, criminals tend to be strong risk-preferrers. As the probability of conviction drops, they are sufficiently myopic to ignore the severity. Overall, they are exceptionally shortsighted and present-minded, and would probably not respond well to a Posnerian criminal justice system.<sup>76</sup> Indeed, brief reflection shows that high severity, low-probability harm frequently fails to deter law-abiding citizens. When you drive, you expose yourself to a small risk of death. The probability is low and the severity is high (indeed, infinite). If incentives like this don't even induce regular people to give up driving, why should we think that they would induce criminals to give up murder, rape, or theft? Posner builds his whole model on the assumption of risk-neutrality; but especially in the case of criminal law, the assumption is ill-founded. (In all fairness, Posner alludes to this problem on p. 170 of his *Economic Analysis of Law*, but does not otherwise discuss it.)

Second, the higher the severity of punishment, the greater the procedural safeguards normally become. Neither judges nor the public would tolerate gruesomely severe punishments unless they were extremely certain of the guilt of the accused. This is a common explanation for the increasing difficulty of conviction: judges are reluctant to sentence people to prison because the punishment is so horrible.<sup>77</sup> Posner briefly notes that since the error costs are higher in criminal suits than civil suits, there is an economic rationale for their respective required levels of proof.<sup>78</sup> What I am arguing is that at least in democratic countries the level of procedural safeguards is often a function of the severity of the punishment. We can easily imagine that as a Posnerian fine-setter kept increasing the severity of punishment asymptotically to infinity, the judicial system would respond by asymptotically decreasing the probability of punishment to zero. This phenomenon is especially evident in death penalty cases: because judges are afraid of executing the wrong person, the trials drag on for years and cost the taxpayers millions of dollars.

There are, then, at least two reasons to doubt that the optimal severity-probability mix is actually infinite severity with near-zero probability. First, since criminals tend to be risk-preferrers, effective deterrence would probably require a considerably higher probability. Second, as punishments become even more severe, the judicial system responds by making the probability of conviction ever more minute. In the real world the severity-probability mix requires a markedly higher probability and lower severity than Posner suggests. What is the optimal mix, then? That question is hard to answer. But since Posner's mix is inefficient in the real world, it doesn't matter if restitution-based enforcement systems (or private enforcement of contract and tort law, for that matter) deviate from his prescription.

Posner, if you recall, argued that apprehension is easy in civil cases and difficult in criminal cases.

The victim of a breach of contract knows who breached it; the victim of an automobile accident usually knows the identity of the other driver; but the victim of a burglary does not know the burglar's identity.<sup>79</sup>

While there is some truth in this point, he perhaps neglects the possibility that the likelihood of apprehension would be greater if the victims had some incentive to assist the apprehension and conviction process. There are, after all, high costs of participation in the criminal justice system. Prof. Benson describes the victim's incentives aptly:

The victims' cost of cooperating with prosecutors can be staggering. In addition to the initial loss to the criminal, victims face the costs of transportation, babysitting, and parking. More importantly, they can lose wages and they endure seemingly endless delays and continuances. There are also considerable emotional and psychological costs of having to confront an assailant, for example, or enduring a defense attorney's questions.<sup>80</sup>

Just as the possibility of damages induces the victims of civil wrongs to help apprehend and "convict" tortfeasors and contract-breakers, restitution gives an incentive for crime victims to help apprehend and convict criminals.

Victims of most crimes have no incentive to report them. Unless revenge is a sufficient impetus, they are better off if they just forget what happened. Nonreporting of rape is well-known in our society; but this is only part of a general trend. Summarizing the well-known *Figgie Report on Fear of Crime*, Benson states that,

an estimated 60 percent of all personal larceny cases where there is no contact between the thief and his victim go unreported; and less than 50 percent of all assaults, less than 60 percent of all household burglaries, less than 30 percent of household larcenies, and only a little more than half of all robberies and rapes are reported.<sup>81</sup>

If victims knew that they could get restitution if their assailant were caught, they would be more likely to report crimes. Similarly, they would probably be more willing to use their time to assist police if they knew that restitution awaited them once the crime was solved.

Restitution incentives would also give victims an asset with which they could hire lawyers on contingency. Under the current system, the district attorney chooses which cases to prosecute and which to dismiss. Prof. Benson suggests that district attorneys' value in the private sector depends mainly on the number of successful prosecutions and their conviction rate. In consequence, they pick cases where it is easy to get a conviction, even if the crime is relatively unimportant compared to alternative cases with a lower probability of conviction. Moreover, since DAs seek to maximize their conviction rate, they do so at the expense of sentence severity.<sup>82</sup> (And police often get rated by total number of arrests, so they arrest people for crimes that they know the district attorney won't prosecute because the probability of conviction is too low.)

The moral here is that bureaucracies cannot directly measure their success according to consumer satisfaction. Instead, they must use imperfect proxies, such as conviction rate and number of arrests. Once you evaluate job performance on this basis, you create incentives to elevate the proxy variable above the end, to sacrifice actual crime deterrence to conviction rates and arrest statistics. These features of our criminal justice system echo the inefficiencies of the Soviet economy. Since performance was not measured by profitability, the central planners had to come up with proxies for good performance: typically, numerical quotas. For example, shoe firms were evaluated according to the number of shoes they produced. Since any sort of shoes would count, they predictably overproduced the cheapest quota-fulfilling footwear: baby shoes.<sup>83</sup> Just as measuring performance according to the total number of shoes

leads to too many baby shoes, measuring the job performance of police according to arrests alone leads to too many unprosecutable arrests. In a parallel fashion, measuring the job performance of district attorneys according to conviction rates leads to too many prosecutions of unimportant crimes and excessively low severity of punishment.

In contrast, a restitution-based system would lead lawyers to pursue victim satisfaction directly. So long as the court properly sets the restitution sums (i.e., correctly ranks them according to severity), the market will automatically spend more resources on the more important crimes. Since the lawyers would probably be paid on contingency (and, in any case, would be answerable to the victim who hired them), they would not have incentives to improperly trade off severity of punishment for certainty of conviction. Most economists who look at the plea bargaining system see nothing but good in it; but they should think about the principal-agent problem and realize that DAs might pursue their own interest at the expense of crime deterrence.

Another problem with public prosecution is that it does not consider the possibility that a victim may value justice at an unusually high level. Just as home-owners often value their homes at above the opportunity cost, crime victims may value justice at above the social deterrence level alone. In a restitution-based system, such a victim could offer his attorney a higher share of the award (e.g., 50% instead of 33%); in exchange the attorney would prosecute a more difficult case. One of the chief problems with the public prosecution system is that it gives much discretionary authority to DAs, then gives them no incentive to respond to unusual cases. The market is more flexible: since there is free bargaining, it is possible to take special circumstances into account. If you recall, I made two criticisms of Posner's severity-probability mix. First, since criminals are risk-preferrers, probability of conviction would need to be higher to deter criminals. Second, since procedural safeguards often increase in proportion to severity of sentence, increasing the severity may be self-defeating. How does a restitution-based system cope with these problems?

First, it handles the problem of risk-aversion by giving incentives to victims to increase the probability of conviction. Since victims get restitution if the criminal who wronged them gets convicted, they have incentives to report crimes, assist the police, and prosecute the case. This might dramatically raise the probability of punishment at a reasonable cost. The second problem is that procedural safeguards often increase in direct proportion to the severity of punishment. Restitution handles this problem in several related ways. First, while the monetary sanctions might be quite high, the prison conditions would be more humane. Non-violent criminals might not even be in prison at all; or perhaps they would merely be confined during their "free time". And imprisoned criminals would enjoy protection from violence from other prisoners or guards, and receive adequate food, shelter, and medical attention. And if an error were ever uncovered, all of the restitution could be returned; while the costs and injustice of error would remain, they would be easier to rectify. A related innovation would be to modify the rules of evidence. Courts could require proof beyond a reasonable doubt to imprison someone, but only a preponderance of evidence to extract restitution. Under such a system, the harm of error would be no greater than the harm of a mistaken ruling in a civil suit. For all these reasons, a restitution-based system could humanely reduce

the level of procedural safeguards, because the injustice and costs of judicial error would be far less. The likely effect would be to markedly raise the probability of conviction.

The system that I outlined in this section would be more sophisticated in the real world. Insurance companies might spring up; their job would be to compensate victims, who would in turn transfer their right to restitution to the insurance company. The insurer would then require, as condition of payment, that the victim help the police and participate in the trial. The alienability of the right to restitution existed in restitution-based systems throughout history. As David Friedman explains,

One obvious objection to a system of private enforcement is that the poor (or weak) would be defenseless. The Icelandic system dealt with this problem by giving the victim a property right — the right to be reimbursed by the criminal — and making that right transferable. The victim could turn over his case to someone else, either gratis or in return for a consideration.<sup>84</sup>

Other possible innovations include punitive damages for wealthy criminals, or an option for pure punishment without restitution in especially horrific cases.

The point of this section has not been to describe in detail every feature of a system of restitution, but merely to explore its chief advantages over the current system. Overall, it looks like the same advantages that lead our society to accept private prosecution of civil offenses might very well lead us to accept private prosecution for crimes. While loopholes exist in restitution-based systems, they don't look more severe than those of public prosecution. None of the most popular objections to restitution make much sense. Where does this analysis lead us? Well, at the very least victims should have an option for restitution and self-enforcement. If it is feasible for restitution to give adequate incentives to prosecute and punish criminals, why not at least permit it as an alternative to our current system? Perhaps private enforcement just wouldn't work. In that case, the present system would continue. But there is a good reason to think that restitution could work in some cases. So why not at least give it a chance?

#### 4.6 Security guards and private police

Up to this point, I have only discussed non-violent forms of private enforcement. These seem relatively unthreatening and noncontroversial in our society, though they face legal hindrances. The right to use violence seems to be a necessary monopoly of government, so much so that anyone who suggests relaxing it appears to be less than sane. Despite all this intellectual baggage, within our current society private security firms employ almost twice as many guards and private policemen than state and local governments combined! In 1982, there were approximately 1.1 million security employees, compared with 653,579 public police in 1979. Payroll expenditures for private security forces in 1982 were about \$21.7 billion, compared with \$13.8 billion for public police in 1979.<sup>85</sup> Evidently our culture's aversion to private use of force is far more theoretical than practical.

Of course, security guards and private police cannot legally imprison anyone; they mainly deter criminals and stop them in the act. Yet the latter activity is an implicit delegation to private parties of the government's exclusive right to use coercion. Despite the competitive disadvantage of private

enforcers (since their authorized powers are narrower than the government's), the security industry's growth rate is startling: from 1964 to 1981, the number of employees in the security industry grew 432.9%.<sup>86</sup> Clearly, security guards and police are not merely a theoretical candidate for private supply, but one of the most significant forms of private law enforcement (indeed, all law enforcement) in our society.

But aren't police a pure public good? That is what the textbooks tell us, but it isn't always true. Private parties find that private benefits are substantial; moreover, these benefits can usually be internalized more readily than economists are wont to suppose. Economics textbooks repeatedly ask us to imagine private supply of patrol cars: since each member of a neighborhood has an incentive to free ride, the textbooks argue, police have to be supplied by the government. This argument ignores the fact that many of the benefits of police are exclusive. For instance, if you want police to respond if your alarm activates, or if you want security guards in your store or business, the benefits are private. Indeed, the free-rider argument outlined above is especially weak since many neighborhoods don't get patrolled regularly by public police either. There are perhaps moderate positive externalities in the security market, but that hardly makes it a public good. (In fact, section 4.5 implies that externalities disappear if crime victims may exact restitution from convicted criminals.)

Imperfect information cause the most significant security externalities. When it is possible to "advertise" one's security resources, the benefit is private; but when security measures are difficult to publicize, the benefit is largely public. This point may be illustrated with an example. Imagine two possible rules for gun-owners. The first rule permits them to wear their guns openly. The second permits them to have guns, but not to expose them by wearing them in a belt holster. Under the first rule, would-be criminals spot the dangerous targets; and since people want to appear dangerous, gun-owners would wear them openly. Thus, people who do not display a gun would probably not have one; they would be easy targets for criminals. If potential victims realize this, they would have an extra incentive to buy one, since armed individuals would get left alone and weaponless individuals would be likely victims. In consequence, the percentage of the public that carried guns would rise. Under the second rule, in contrast, criminals need only consider the average probability that someone carries a weapon. There is no extra incentive to carry a weapon, since gun-bearers and non-gun-bearers would get attacked with equal frequency. Hence, the percentage of the public bearing weapons would fall. What we have here is a typical tragedy of the commons, in which individuals pay the marginal cost but receive the average benefit.

What is the point of this example? The point is this: Private enforcement is most effective when one can credibly show that one protects oneself. Stores can hire security guards and put them in public view. Security guard companies may give their customers "armed response" warning signs. Or consider this common business practice: Stores post signs announcing "All shoplifters will be prosecuted". Since they can credibly commit to prosecution, they reap the deterrent benefit. If I get mugged, prosecution would be a public good, since my decision to press charges would not improve my future safety. But a firm is so permanent and stable that an investment in a reputation for vigorous pros-

ecution can pay off. Consider a final point on externalities and the security industry: different property rights could internalize the externalities of police and security. Imagine, for example, if housing developers, rather than deeding streets and sidewalks over to the local government, kept them in private hands. They might set up a homeowners' association, and require home-buyers, as part of the contract, to pay for local public goods. This could easily internalize the seemingly public benefits like police patrols. Many benefits of police protection are private; furthermore, most of the externalities are local and might be solved with different property rights. This is approximately what malls do in order to provide their "local public goods". The mall-developer rents store space to different firms, and then maintains common areas, supplies security guards, organizes patrols, etc. If the firm supplies local public goods for its tenants, it can charge higher rent. That is the mall-owner's incentive. And the tenants know that they will have higher sales (since customers will be happier in a safe and clean environment) and lower costs (due to lower crime). So long as there is competition for the market, arrangements of this kind should supply an efficient level of local public goods — most notably, police.<sup>87</sup>

Many people who ponder the role of profit-making firms in our criminal justice system find it frightening. Isn't this a dangerous power to leave in private hands? I doubt it. First, while the aggregate figures for private protection are large, this power is extremely decentralized. In 1981, there were 7,126 firms in the security industry, with a growth rate of 285.5% for the period 1964-1981. The average number of employees per firm was 46.5.<sup>88</sup> There is no plausible danger from such small firms, however impressive their aggregate might. One need not be a true believer in the structure-conduct-performance model to worry about the political risks of a highly concentrated security industry; but economies of scale so limited that we needn't worry.

On top of this, private firms are usually more accountable for their misdeeds than public police. One need not mention Rodney King to realize that police can get away with a lot more than private citizens such as farmers, teachers, engineers, and — security guards. Our legal system gives special preference to accused public police. Their testimony gets greater weight, and the doctrine of sovereign immunity makes it difficult to sue the police. Since the police is a public body, it has little incentive to avoid lawsuits by monitoring its employees. In contrast, private security firms have no special legal status, and it is not especially difficult to sue them. Managers have an incentive to monitor their employees for abuse of power, because the firm may pick up the tab. While most people assume that the profit motive encourages abuse of power and democratic control prevents it, the respective incentives of public and private organizations suggest the opposite.

This section has two surprising conclusions. First, private supply of security guards and police is quite feasible; indeed, it may be our society's most significant deterrent to crime. The common assumption that such services are a public good considers only a fraction of the types of police services. Conventional wisdom also underestimates the market's ability to supply local public goods with creative use of property and contract. Second, there is no particular reason to be fearful of private supply of police services. Their power is unconcentrated, and they face more incentives to restrain themselves than government police do.

People concerned about police brutality should look into the potential of the private sector to supply us with protectors we can trust.

#### **4.7 Monopoly on coercion: the source of the limits of arbitration**

Legal privatization eventually runs into a seemingly insurmountable obstacle: It cannot resolve conflicts between complete strangers. When parties have a prior contractual arrangement, ostracism and boycott work. But it is difficult to imagine that ostracism and boycott could compel compliance between strangers. The defendant would have no incentive to consent to adjudication, because even in the best case he is no better off than before he consented. The inevitable conclusion is that the private sector could have a much larger role in the resolution of disputes between strangers than it does today, but there remains a role for the government in every legal system. The government must, at minimum, compel unwilling defendants to submit to a trial when someone accuses them. When parties have a prior contractual arrangement this is unnecessary. Private bodies could do the job with non-violent sanctions, like ostracism and boycott. But when parties have no prior relationship, boycott and ostracism would fail.

Why is this so? Some examples should make this clear. If a crash into someone else's car at my workplace, my employer might threaten to fire me if I don't pay compensation. I am unlikely to mug one of my fellow employees (even a small and weak one) because I would surely be reported and fired if I did. The employer has an interest in protecting his employees, and I have an interest in keeping my job. These joint incentives induce me to respect others' rights and pay compensation even if the government doesn't make me. If I try to find another employer, my reputation may precede me. Non-violent sanctions in this case could work quite well.

But suppose I crash into a stranger's car, or mug someone I never saw before. Imagine that they know my identity. How would they make me pay compensation or even attend a trial if they could not threaten violence? They might refuse to trade with me; but that leaves millions of other trading partners. A boycott by one person makes little difference, especially someone I've never met before. The aggrieved party might tell my employer, trade association, or credit card company, in the hope of provoking others to punish me. But this would probably fail for two reasons. First, there would be no reason to believe a stranger who complained about me. A businessperson who spreads false rumors could ruin his career; but a stranger has no reputation to lose. Second, my trading partners know that I am unlikely to injure them; remember, they can effectively punish me if I do. But what difference does it make to them if I take advantage of strangers? There may be a correlation between taking advantage of strangers and taking advantage of one's trading partners. (Several years ago, columnist Ann Landers proposed the following test of a potential husband's character: Observe how the man treats others who have no possible future use to him whatsoever.) But my trading partners incentive to take up the stranger's cause is tenuous. If this were the only way to deter tortfeasors and criminals, it would be difficult to see how society would get along.

Most people reasonably conclude that while the private sector has potential in law enforcement, it also has limitations.

The government looks necessary to complement private enforcers. The background assumption is that private is always non-violent. Governments, in contrast, have more fearsome arsenals: police, SWAT teams, and soldiers. And government has a near-monopoly on violence. This is why it has such a critical role in modern legal systems.

Nevertheless, this situation is puzzling. Is there some reason why government must have a monopoly of violence? The usual answer is the Hobbesian one: Without a monopoly of violence there is horrible civil war. Yet this reply is unsatisfying, because there have been historical cases where the right to violent retaliation was more equally distributed. While such societies occasionally descended into chaotic warfare, so too have societies where the right to use violence was firmly centralized in the hands of the state. David Friedman brings up a rather startling comparison between medieval Iceland's almost purely private enforcement system and modern America:

During more than fifty years of what the Icelanders themselves perceived as intolerably violent civil war, leading to the collapse of the traditional system, the average number of people killed or executed each year appears, on a per capita basis, to be roughly equal to the current rate of murder and nonnegligent manslaughter in the United States.<sup>89</sup>

The facts cry out for explanation: How could systems without a state monopoly on right to use violence work? Once many groups control private arsenals, what incentive do they have to obey any laws?

The following section considers the economics of legal systems in which the right to use violence is not a monopoly of the state. Its chief point is to understand the incentives that made such systems feasible in the past. At the same time, this section will generalize the theory of non-state legal systems. A legal system without a monopoly on the use of violence could be a legal system in which the market handled all disputes, all rules, and all enforcement. The market would not only supply law between parties with prior relationships; it could also handle disputes between strangers, just like the government does today. This would be the polar case of pure private supply of law. This notion is apt to be frightening. But let us consider the theoretical possibility to see what light the polar case sheds on non-state legal systems generally.

#### **4.8 Purely private enforcement: a model**

Richard Posner writes,

I hope to challenge the assumption, largely unquestioned since Hobbes, that a state (if only a minimal, 'nightwatchman' state) is necessary to maintain the internal and external security of society. I am not advocating anarchy. My argument is that a state is not a precondition of social order in the circumstances depicted in the Homeric epics — and even there, it is just barely not. In our circumstances, we could not do without a state.<sup>90</sup>

This section will consider precisely the workings of a legal system "in our circumstances" without a state, in which no organization has a monopoly on the right to use violence. Imagine this enforcement system: Throughout the society, there exist 10,000 private security and police companies (approximately the number we have today). Everyone in

the society pays premiums to one such security company; in exchange, the client receives protection from criminals and arbitrary prosecution by other police firms. Most people assume that violence and inter-firm warfare would break out at once. But this assumption is inconsistent with history and elementary game theory. An inter-firm war would be fantastically expensive; employee wages would skyrocket to pay the positive wage differential for danger; huge investments could be swiftly lost. The gains from one dispute are so small, and the losses from non-cooperation are so large, that it is difficult to imagine warfare breaking out over one dispute. And this point applies even to a one-turn game. But since firms exist for a long time and must resolve many disputes with each other, the game is actually repeated rather than one-shot. So long as expected profits from non-cooperation are negative, firms would strive for peace. (In contrast, ideologically motivated movements wage wars even when the expected monetary gain is negative.) So long as firms are profit-maximizers, the high cost of violence in a single turn for both combatants, plus the firms' indefinite time horizon, suggests the cooperative solution.

To make this more concrete, imagine that Gary, a customer of Becker Police Services, says that George, a customer of Stigler Security, mugged him. Most people imagine that Stigler Security would defend George to the death regardless of his guilt, and that Becker Police Services would have to start a war with Stigler Security to induce George to pay up. But is that really a profit-maximizing strategy? Stigler Security could either (a) Fight a horrible war, or (b) Agree to arbitrate the dispute. Even in a one-turn game, the choice could hardly be clearer. But of course Becker Police and Stigler Security know that they will interact many times in the future; their relationship is a repeated game. This multiplies the gains from cooperation many times. It also reduces transactions costs, because they could pre-contract to arbitrate all of their disputes with a mutually agreeable judge. As a practical matter, then, the looming danger of confrontation would never rear its head; the firms would likely work out a dispute resolution system in advance.

Most people assume that firms would defend even a guilty client to the death; but the reality is closer to the opposite. Any firm that did that would face a massive adverse selection problem. Just as a health insurance company avoids insuring the terminally ill, so too would a police company avoid protecting professional criminals. Firms that did would attract a lot of high-risk clients. By protecting the guilty, they would virtually announce that all professional criminals should buy their protection. But criminals would, on average, be very expensive customers, since they would frequently injure the clients of other companies and thereby provoke disputes. Law-abiding citizens, in contrast, would pay their premiums but rarely call on upon its services.

Posner recognizes this adverse selection problem (without explicitly mentioning it) when he discusses law enforcement in primitive societies:

To be sure, the alleged thief who is clearly guilty and expects to be so adjudged by an impartial arbitrator may prefer not to submit to arbitration or not comply with the arbitrator's adverse judgment, but his kin group is a restraining influence. They may urge him to submit to arbitration to avoid getting involved in a feud over his deed, as they are likely to do because of their collective responsibility. And he will probably submit to

their urging; otherwise they may desert him when the neighbor or the neighbor's kin retaliate for his refusal to submit to arbitration or to comply with the arbitrator's reward.<sup>91</sup>

Even family would not protect obviously guilty kinsmen for fear of the long-run consequences. A firm that sold security would have to be much more careful about harboring the guilty, because it is easier to switch security companies than join a new family. If a family gives bad incentives, family members may take more risks; but if a firm gives bad incentives, they could attract all of their competitors' high-risk customers plus encourage current customers to take more risks.

Presumably, then, if Gary of Becker's Police Services accused George of Stigler's Security, the two firms would set up a trial. They might sub-contract with an arbitration firm, jointly appoint a panel of judges, or what have you. But on the plausible assumption that accused customers would want trials, it would be rational for firms to protect accused clients until they get convicted. After a conviction, the guilty side would have no alternative but to comply with the ruling, because, as explained, it would be bad business to defend guilty clients to the death.

One vexing question about historical cases of private enforcement involves the rights of convicted criminals. What incentive exists to defend their rights? It is hard to locate them. And yet, criminal sentences were, nevertheless, graded according to severity.<sup>92</sup> Perhaps social opprobrium against overpunishment sufficed. It is possible that competing protection firms might take up the cause of overpunished criminals. The historical facts seem more optimistic than economic theory; this question merits further investigation.

Even the most avid opponent of the structure-conduct-performance model should be concerned about high market concentration in such a system. But most of the information that we have about the modern security industry suggests that there are no substantial economies of scale: about 7,126 firms existed in 1981, and a great deal of the market growth in the previous 17 years came in the form of new firms rather than growth of existing firms.<sup>93</sup> While the need of firms to make many bilateral arbitration contracts might increase the minimum efficient scale, the total industry size (hence maximum number of efficiently-sized firms) would probably be much greater if there were full privatization.

So long as the concentration remains fairly low, fears about outlaw firms staging a coup are far-fetched. Unlike governments, firms would not have a whole society's resources to tap to fight a war; all "war" expenses would have to come from stock-and-bondholders. And oppressed individuals would have many alternative security suppliers. Even if security were a local natural monopoly, abuse could trigger the intervention of a firm from another region. Murray Rothbard discusses this question with great enthusiasm and lucidity:

There is a myth that the 'American system' provides a superb set of 'checks and balances,' with the executive, the legislature, and the courts all balancing and checking one against the other, so that power cannot unduly accumulate in one set of hands. But the American 'checks and balances' system is largely a fraud. For each one of these institutions is a coercive monopoly in

its area, and all of them are part of one government, headed by one political party at any given time. Furthermore, at best there are only two parties, each one close to the other in ideology and personnel, often col- luding, and the actual day-to-day business of govern- ment headed by a civil service bureaucracy that cannot be displaced by the voters. Contrast to these mythical checks and balances the real checks and balances pro- vided by the free-market economy! What keeps A&P honest is the competition, actual and potential, of Safe- way, Pioneer, and countless other grocery stores. What keeps them honest is the ability of the consumers to cut off their patronage. What would keep the free-market judges and courts honest is the lively possibility of heading down the block or down the road to another judge or court if suspicion should descend upon any particular one ... These are the real, active checks and balances of the free-market economy and the free so- ciety.<sup>94</sup>

Rothbard goes on to add that,

The same analysis applies to the possibility of a private police force becoming outlaw ... Of course, such a thing could happen. But, in contrast to present-day society, there would be immediate checks and balances avail- able; there would be other police forces who could use their weapons to band together to put down the aggres- sors against their clientele.<sup>95</sup>

One need not agree wholeheartedly to see his point: Compe- tition checks the abuse of power. Indeed, our system of federalism and division of powers purports to be precisely that. But it is hard to deny that U.S. history reveals (1) cooperation (or “collusion”) between the executive, legisla- tive, and judicial branches to enlarge the power of the federal government, and (2) growing federal dominance over state and local governments. Imagine what would hap- pen if three large security firms had 60% of the industry and 50 small firms shared the remaining 40%. It would not be surprising if the three largest colluded with each other to expand their power and bully the 50 small firms into sub- mission. So long as the security market were unconcent- rated, the market’s competitive checks on abuse of power might be superior to those of our own Constitution.

Remarkably, it looks like there is an incentive structure be- hind pluralistic enforcement systems that leads to tolerable performance. Full legal privatization is at least conceivable. Naturally, many criticisms might be levied against such a system. But the most obvious complaint, that plural en- forcement logically implies a Hobbesian war of all against all, is mistaken. This generalization doesn’t hold up histori- cally, and economic theory can give a fairly complete de- scription of the incentives that let pluralistic enforcement systems function.

#### 4.9 Criticism of purely private enforcement

At last, we have a picture of what a fully private system would be like. The horrible costs of inter-firm violence would probably induce voluntary arbitration of conflicts; re- peated interaction would magnify this incentive and reduce dispute resolution transaction costs; the adverse selection problem would discourage harboring the guilty; and compe- titive checks (assuming a deconcentrated industry) would keep would-be outlaw firms in line. This system may be

imperfect, but there is no historical or theoretical reason to think that it would instantly degenerate into gang warfare.

While the simplistic Hobbesian critique is invalid, there are other more sophisticated of purely private enforcement. Let us consider six major complaints, then see how convincing they are.

1. Private enforcers would only handle offenses with identifi- able victims. While the desirability of some such laws — like drug, gambling, and prostitution prohibitions — is questionable, legalizing other offenses would be in- tolerable. Pollution is one example. While we could imagine class-action suits to discourage pollution, the concentrated interest of polluter firms would typically overpower the diffuse interest of the public in clean air. We should not neglect the possibility of private solutions to externality problems (as Coase told us), but private solutions usually work only if the transaction costs are low. Society-wide pollution reduction transaction costs are astronomical.
2. While the market could take over individual protection, it is difficult to envision national or even regional pro- tection. In my model, I assumed that the whole world had private enforcement. But if some areas still had governments, well-organized and well-funded foreign ar- mies might overwhelm private enforcers. Even if the se- curity companies could repel any attack if they united, the transaction costs of organizing joint defense would be prohibitive. Individual security firms have incentives to protect their clients against sporadic crime or the at- tacks of others firms, but the firms do not have incen- tives to protect a whole region or nation. If the concentration of the security market were higher, joint action against foreign aggressors might become more feasible, but then domestic collusion within the security industry would be a danger. The better the market’s checks against foreign governments, the weaker its checks against inter-firm collusion, and vice versa.
3. Who would supply public goods? Granted that firms would have incentives to create law and order, but what about the provision of assistance to the needy, or roads, or other public goods that government provides? One may doubt that the range of public goods is as extensive as commonly supposed (local public goods, for example, might be supplied by housing developers, etc.), the com- plaint about their non-provision is sensible. Indeed, once enforcement were privatized, it would make no more sense to ask security companies to provide public goods than, say, to ask milk producers to supply public goods. Both would be private entities with no special public responsibilities.
4. Many people think that voting and democracy have in- trinsic worth. It is better if vote-seekers run our society rather than profit-seekers. Public choice theory strongly undermines this claim. One might also point out that intelligent voting is a pure public good, and is therefore undersupplied in democracies, just as markets undersup- ply pollution abatement. Nevertheless, many people would suggest that voting counterbalances the power of wealth, and would be preferable for that reason.
5. However beautiful the economic theory of market en- forcement is, it just wouldn’t work. Every social system requires a general sense of legitimacy to survive. People

wouldn't go along with privatization of enforcement, perhaps irrationally or for ideological reasons. Hence it is better to stick with the status quo, which at least enjoys general acceptance and the sanction of tradition.

6. Whatever the economic theory of market enforcement says, most people wouldn't believe that it would work. They would expect that chaos and violence would break out immediately. This would lead them to support almost any leader who pledged to "reestablish order". The result of attempted privatization might be to replace our imperfect political system with something even worse. Other criticisms exist, but these are the most plausible. Indeed, they look devastating. Still, I don't think that the issue is so simple. One of the most important conclusions of public choice theory is that for any imaginable "market failure", we can imagine a parallel "government failure". Thus, market create externalities like pollution, but the democratic process creates externalities like special interest legislation. Markets do not supply public goods, but the democratic process fails to reward public goods like intelligent voting. If markets have imperfect information (as in the Akerloff lemons model), so do governments (for example, voters are usually ignorant about politicians' voting records and sources of funding, as well as the likely consequences of a given piece of legislation). And if markets create monopolies, so too do governments (e.g., agricultural cartels, or the post office). Any valid comparison of market and government performance, then, is essentially comparative; merely pointing out problems in one of the two is never conclusive. Moreover, we mustn't compare an imaginary perfect government with real-world markets; the fair comparisons are between ideal government and ideal markets, and real-world government and real-world markets.

With this in mind, we can see why the previous six criticisms of purely private law are not as convincing as they appear. While market enforcement works poorly for pollution and other dispersed harms, many government activities create comparable externalities. For example, special interest groups lobby for legislation that injures all tax-payers slightly, even though the aggregate damage is high. Might the harm from this exceed the harm of pollution? The question is not an easy one.

Or take the second argument. Market enforcement would indeed be unlikely to provide effective national or regional defense. Yet national defense is necessary in the first place only because some governments use their national "defense" for aggressive conquest. The fact that some governments use their military offensively creates the need for national defense. National defense is, strangely, only a public good on the assumption that some military forces are a public bad. Moreover, once one creates a national defense, there is the danger that one's very own armies will be used for aggressive rather than defensive actions. (Presumably, this is true of at least half of the sides in any international conflict.) Usually this is a public bad. The citizens of Nazi Germany, or Saddam Hussein's Iraq, for example, would likely have been much better off if their military did not exist in the first place. The wars that their militaries provoked were worse than any wars that their militaries deterred. The point is that even though national defense nominally exists to benefit everyone, military actions frequently bring net harm to their own nation's citizens; though

national defense is theoretically a public good, empirically it is often a public bad. If we do an international survey, it is not clear that the advantages of national defense typically outweigh the costs of its frequent abuse.

The problem of public goods is, again, inconclusive. Public choice theory suggests that governments supply what interest groups lobby for. It is unclear whether what interest groups lobby for are in fact public goods; many of them (farm cartels or tariffs, for example) are public bads. As mentioned earlier, local public goods could be supplied by housing developers. Are the remaining public goods that could not be privately supplied so valuable that they outweigh the abuse of legislative power? The answer is far from clear.

The fourth complaint was competitive enforcement would make voting atrophy or disappear. Wealth would be the only measure of social value. Public choice theory undermines this complaint by showing that campaign contributions and wealth strongly influence democratic politics. One might also note that intelligent voting is a pure public good (society benefits if I inform myself before I vote, but I pay all of the cost of informing myself), and is therefore undersupplied under democracy. With these facts in mind, one might doubt that democracy is as wonderful as usually believed, especially if non-political alternatives could work.

Complaints five and six, which doubt that market enforcement could ever win the loyalty and trust of most people, are more difficult to answer. Even in areas where markets are perfectly workable, voters routinely prefer government ownership and control. They have more confidence in the legitimacy of the government than they do in the legitimacy of the market. Perhaps imperfect information is the problem. If people understood the relative pluses and minuses of the two systems, but still selected government supply, economists would have nothing to say. But if people base their preferences on mistaken economic theories, economists have a professional responsibility to at least explain their errors to them so that they may make informed choices.

This section is not intended to be a conclusive proof of the superiority of competitive enforcement outlined in section 4.8. It merely discusses the common arguments against competitive enforcement, and argues that they are not as persuasive as they initially appear. Most criticisms compare perfectly functioning governments to real-world markets; this biases the whole analysis. The appropriate economic comparisons are between perfect governments and perfect markets, and between real-world governments and real-world markets. When we keep this in mind, the choice between the two systems is hard to make. Policy analysis for this section is less determinate than earlier sections'. The lesson to draw is that we have everything to gain from gradual experimentation. Market enforcement has overlooked potential. How much potential? It is difficult to know a priori. What we can know is that if we permit experimentation, we can gradually get a realistic picture of its potential. If problems arise, experimentation can halt; but there is no harm in incrementally opening up alternatives to the status quo.

## 5. CONCLUSION

Almost all scholars regard the supply of law as a pure public good that simply must be supplied by the government. Yet there are many present-day and historical counter-

examples: arbitration, the law merchant, trade associations, ostracism and boycott, security guard companies, and so on. Puzzled by these counter-examples, scholars such as Posner, Landes, Becker, and Stigler investigated the theory behind the private supply of law, distinguishing three aspects of law: dispute resolution, rule formation, and enforcement. This thesis considered non-state provision of each of these conceptual legal branches. Corresponding to each branch is a theory that describes how the system would work in the absence of market failures; a description of the most obvious market failures from which each branch suffers; and a discussion of the severity of the failures.

The overall conclusion of this paper is that, while each branch — dispute resolution, rule formation, and enforcement — has flaws, the problems are rarely overwhelming. Scholars are usually too quick to dismiss them on the grounds of market failure, without first considering the magnitude of the market failure, or whether the government could realistically do any better.

Most scholars find much to praise and little to criticize in private dispute resolution. It reduces transaction costs, gives parties greater flexibility, and helps ease the case burden of the public courts. It would not be difficult to open up a wide range of disputes to private resolution. As the public courts grow more clogged, we can expect alternative dispute resolution to expand. If the public courts give arbitrators sufficient autonomy and enforce their decisions as a matter of policy, the expansion might startle us.

In contrast, there is considerable skepticism about private rule formation. Posner and Landes point out that the production of precedents is a public good. Since a patent system for precedents is not feasible (parties could use precedents without citing them, as Posner suggests), it is difficult to see where the incentive to supply rules and procedures comes from. While there is something to this complaint, Posner and Landes overstate its importance. The externality problem did not stop whole private legal systems from blossoming, from the international law merchant to the customary law of primitive tribes. As my treatment explained, modern patent law fails to protect a whole range of innovations; but innovation in unprotected sectors continues. This is mainly because firms can capture much of the gain just by being the first firm in an industry to adopt an innovation, even if there isn't any legal protection. A second source of customary law, I suggested, is cultural evolution — the piecemeal accumulation of minute innovations. This is the process that gives us language, custom, and frequently the foundations of our legal system. The basic common law categories of property, contract, tort, and crime sprang up long before there were formal governments or even professional judges, as Posner himself shows in *The Economics of Justice*. What conclusion can we draw from this? Mainly, Posner and Landes see a genuine problem for private rule formation, but the problem has been sufficiently mild to permit substantial private rule creation throughout history. There is a sound reason to at least remove legal barriers to private rule formation and see what happens. Private rule creation, like non-patentable innovation in general, could prove quite workable.

The most controversial area is private enforcement of law. Most people see something subversive and scary about this, though such eminent economists as Becker and Stigler see that it has great potential. Whatever one's views on this

matter, private law enforcement is already a respected part of our society and economy. Professional boycott and ostracism is a common sanction for breach of contract, fraud, and other unscrupulous business practices. Security guards and private police give us at least as much protection as public police (probably more, since public police spend so much of their time and money on victimless crimes). There is no reason at all to be frightened of these forms of private law enforcement. Boycott and ostracism are mild but effective ways to enforce decent behavior at very low cost. Since the security guard and private police industries are highly unconcentrated, they pose no realistic political danger to anyone. There is a strong argument for greater reliance on and legal recognition of these sorts of private enforcement.

Yet there is a less conservative side to private law enforcement. Some historical legal systems permitted competing private bodies to take over the most basic function of government: the use of violence against criminals. In section 4.8, I discussed the workings and incentives of such a system, and argued that, at least so far as economic theory is concerned, such a system could, contra Hobbes, operate peacefully, fairly, and efficiently. This is a rather radical conclusion; but I intend it mainly to be a model of a polar case, the polar case in which all enforcement is private. Section 4.9 brought up six economic and political criticisms of purely private enforcement. After probing each of these arguments, I found them less than fully convincing. Public choice theory's most important discovery, I think, is that every market failure has an analogue in the public sector. The critics of purely private enforcement probably make an unfair comparison because they only point out private sector failures without asking if public sector failures are worse. For this reason, as radical as the idea of purely private enforcement is, economic analysis cannot dismiss it out of hand. A great deal of work in this area is necessary before scholars can make an intelligent judgment.

In *Foundations of the Metaphysics of Morals*, Immanuel Kant writes that,

Reason, therefore, relates every maxim of the will as giving universal laws to every other will and also to every action toward itself; it does so not for the sake of any other practical motive or future advantages but rather from the idea of the dignity of a rational being, which obeys no law except that which he himself also gives.<sup>97</sup>

In one sense, expanding the role of the private sector in our legal system fulfills Kant's ideal by permitting parties to opt out of the public court system and set up their own rules and procedures. Private legal systems let parties create the very law that governs them, since they may contract with each other to select an arbitrator, procedures, rules, and sanctions. But the other feature of Kant's ideal, that parties act not "for the sake of any other practical motive or future advantages" is entirely absent. The chief reason why parties opt out of the system is precisely to win "practical motives and future advantages" — to reduce dispute resolution costs, select efficient rules, and swiftly and painlessly enforce rulings. The conclusion to draw is that, contra Kant, non-state legal systems both let parties create law that governs them and enhance their well-being. Autonomy and efficiency are not in tension; each requires and implies the other.

## NOTES

1. Richard Posner, *The Economics of Justice*, Harvard University Press, Cambridge, Massachusetts, 1981, p. 178.
2. Harold Berman, *Law and Revolution*, Harvard University Press, Cambridge, Massachusetts, 1983, p. 52.
3. Jerold Auerbach, *Justice Without Law?*, Oxford University Press, Oxford, 1983, p. 113.
4. For a brief overview, see Robert Cooter and Thomas Ulen, *Law and Economics*, HarperCollins, New York, 1988, p. 480.
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