Henry G. Manne

The Judiciary and the Free Market

Introduction

In much of the civilized world today, there is growing interest in the question of how to establish a free society and its essential concomitant, a free market economy. This interest was greatly stirred by the collapse of the Soviet empire and especially by the dismal showing of the communist economic system. Indeed it has become commonplace — even among members of the political left, who would not have tolerated such calumny merely ten years ago — that only capitalism and free markets can deliver on the promise of material goods that have come to be expected throughout the world.

While a great deal has been written on how to establish a free market economy, far less has been studied or is known about the kind of legal process that is crucial to the functioning of a market economy. That is the central inquiry of this paper. To some extent, of course, everyone agrees on the basic legal ingredients of a free market system: private property and freedom of contract. But these are gross generalizations, and today much of the policy debate is about how strictly these basic notions are to be construed, not whether we should have them at all. In any event, the purpose of this paper is not to examine in any detail the particular substantive rules that are most consistent with the philosophy of free markets. Rather it is to examine the kind of legal system most consistent with that philosophy.

For some reason, the already vast and still growing literature on how to establish a free market economy has not emphasized the legal dimension of the problem. This failure probably results from the fact that most of this literature has focused on the moves necessary to establish a market economy in the first instance. Thus little attention has been paid to the equally important question of how to sustain and preserve such a system after it is initially established. Thus our interest here is not in the familiar tools commonly utilized by political regimes starting their move toward a free market, namely deregulation and privatization. For, by themselves, these actions can never be enough to guarantee the successful perpetuation of a free market system, only its initial implementation. Once these outward appearances of a free market system are in place, the more subtle conceptual and practical problems of sustaining the system begin, and that is exactly where the role of the legal process is most important.

Henry G. Manne es actualmente Decano de la Escuela de Leyes, George Mason University, Arlington, Virginia (USA). Este artículo está basado en una conferencia pronunciada en la Universidad Francisco Marroquín, el 10 de Noviembre, 1996.

Generally speaking, the political and legal underpinnings of a free market economy are not well understood, especially the role of the judiciary in this process. While a system with minimum economic regulation will certainly have fewer legal disputes than one which is heavily regulated, some system for resolving disputes will always be required. Even the most perfectly free market economy will still exist in a political regime where the rules might be changed, where taxation will exist, where some degree of regulation will be tolerated, and where various defenses to the enforcement of contracts as they are written will be available. Furthermore, a free market system is not a static arrangement; it is complex, dynamic, and full of uncertainties, faulty communications, changing circumstances, and risks of all kinds.

All of this creates enormous occasion for claims to come into conflict, and that in turn requires a system for dispute resolution. Ideally it will be a system that is conducive to the free market goals exogenously established, and it will operate in a fashion consistent with the economic goals. It should be emphasized that we are not asking here what substantive rules of law such a society should have.[1] The relevant inquiries here, however, are how the judiciary should interact with other parts of the government (including questions of the selection of the judges), what process of dispute resolution (litigation or regulation, for example) is best suited to a free market's needs, and finally what rules or techniques of decision making should we want the judiciary to utilize.

All of these questions might be subsumed under one phrase that is common in discussions of the prerequisites to establishing a market economy, the notion of "the rule of law." Unfortunately, this phrase, elegant as it may sound, really has little substantive content. As we shall see, the detailed working out of a rule-of-law regime is anything but obvious or simple. The simple sounding idea of the rule of law is actually an extremely complicated set of jurisprudential, political, and economic considerations, most of which are not obvious.

The Rule of Law: What and How

But some aspects of the notion of the rule of law are in fact obvious, and they are essential to a well-functioning market economy. First among these is the basic idea that laws will apply equally to all people under the same set of circumstances. That is, government officials will not have authority to discriminate in the application of substantive rules of law on the basis of favoritism, prejudice, belief, or politics.

But merely saying this is a long way from making it happen. Where are we to find judges who are so honest, so unprejudiced, and so unpolitical? What kind of incentives can we use to best assure this behavior on the part of judges? And even if they are honest, what can we do to insure that they will not make too many errors simply as a result of ignorance? The naive theory is that all judges will perform in this fashion out of some general sense of professional duty and social responsibility. We all know, however, how difficult it is to inspire men to behave other than in their own selfish interest. Yet without some sort of disinterested judiciary, there can be no rule of law and consequently no free market system.

We might start our inquiry by noting that any judiciary that is to act in disinterested fashion on matters before it must of necessity enjoy a degree of independence from political or governmental influence. Indeed, since the government itself will frequently be a litigant in dispute resolution procedures, it is absolutely essential that the judges have no extraneous reason to favor the government in its decisions. This is the straightforward explanation of why the United States Constitution provided for lifetime tenure for Federal judges, as do many state constitutions.

If, however, judges are given total independence from any kind of oversight or constraint, how is it possible to insure that they will not abuse this independence and decide cases on the basis of their own personal interests, political attitudes, beliefs, and moral views? Or that they will not simply become venal? We want them to be independent but not so independent that they are not concerned about the quality of their work. This in turn explains why a number of the states in the United States have regular elections of judges.

The debate between term or lifetime appointment of judges versus popular elections has raged for a long time in the United States, and it shows no signs of abating. Obviously, there is no easy answer to this problem, and we cannot hope to resolve it here. Fine, honest, and professional judges have appeared under each system, and each also has its losers. Very likely the existence of a popular debate on this subject over the years has served to prevent either system from getting out of control, as it theoretically might. There does not appear to be any significant difference in the operation of the legal systems in those jurisdictions using one system of judicial selection rather than the other nor in the substantive law developed in the two systems. And the fact that the two systems for selecting judges have existed side by side in the United States almost from its beginnings strongly suggests that the particular method used to select judges may be less important than the nature of the system in which they are asked to function. On the contrary, one is never surprised to learn that an administrative agency, where appointments are commonly made from among political supporters, has behaved "politically" rather than "judicially."

As stated earlier, the specification of particular substantive laws is not the mission of this paper. It happens, however, that the matter of substantive law appropiate to a market economy and the disinterestedness of judges are quite interrelated. For a market system to function effectively, every participant or competing firm must be subjected to the same "rules of the game" as far as the government is concerned. That is, for the market to function effectively and generate correct signals for allocational decisions, the legal system must not reward or penalize firms except in accord with known and existing law. For example, tax rates must not be arbitrarily higher or lower on one firm than another; regulations must not disparately affect competing firms; and protection of life and property against criminal depredations must be evenhanded.

For all of this ever to be true, it is important that the same substantive rules be applied by every tribunal enforcing a claim, resolving a dispute, or enforcing the criminal or regulatory law. A market economy, as Adam Smith pointed out more than 200 years ago, will exhibit more specialization, and therefore more

productivity, the larger the market. And there can be only one set of laws for all the firms in a single market. This, of course, is the reason for the great interest in "harmonization" of national laws in this era of increased international competition.[2]

Making all courts follow the same rules of law is not as easy as it may sound. One device that has a long history of use in both England and the United States is a system of hierarchical appellate courts, usually two layers, with one court at the top of the hierarchy. This simplifies the task of holding all lower courts to the same substantive rules, since any time a trial or lower court judge veers from what the higher court views as the proper legal rule, the lower court can be "reversed" and the judge forced to reconsider his or her decision in light of the higher court's instructions. Obviously, if the top of the hierarchy is a single court, as in the case of the United States Supreme Court or the state supreme courts, its rulings are totally definitive as far as judicial statements of law are concerned.

This enforcement system does not work perfectly, however, and there is a good deal of slippage, analogous to the famous "agency costs" in any employment relationship. Thus, local differences may easily creep into the substantive rules applied by trial courts or other adjudicative agencies, almost in the way that accents develop in the same language in different locales. In fact, the hierarchical structure of courts, while it is probably necessary to preserve a same-rule regime, is not sufficient for that purpose, especially since, by definition, it offers no judicial monitoring control over the highest court and will in fact only work weakly for intermediate appellate courts.

Something much more pervasive that can be internalized by every judge, whether at the trial or appellate level, can aid considerably in performing that task. This is the doctrine of precedent, that is, the decision rule that once a legal holding is established by an appropriate court, that legal conclusion will be followed by the same court and by all inferior courts in similar or identical cases in the future. To help gain the consistency required by the rule of law the results of litigation must, of course, be made public, for only then can they be followed in subsequent cases. As we have already seen, there must also be a right of appeal to a higher court whose decisions must also be made public. And, although they are related concepts, the doctrine of precedent and the right of appeal are two distinct aspects of assuring a legal system that is consistent with the requirements of a free market. While the right of appeal can be provided in a system of administrative regulation, the underlying requirement of observing precedent is usually, for good reason, absent.

We have seen that the doctrine of precedent is a very valuable adjunct to a free market system, since it reduces uncertainty and therefore costs. If administrative regulation were actually designed, as is often claimed, to make the market function more efficiently, then we would see strong demands for the doctrine of precedent there. But the chief goal of this kind of government action is usually something other than the smooth functioning of private markets, and consequently there is much less reason to insist on a strict doctrine of precedent. This is not to say that administrative tribunals never decide cases on the basis of precedent. They will, to some extent, if for no other reason than to make their own work easier. But not following their own

previous decisions will never be a necessary basis for a reversal, as it would with courts.

There is no traditional or legal requirement that prior administrative holdings have to be followed in subsequent cases, a clear indication of the political nature of administrative regulation as opposed to a system of law courts. And even though there may be many superficial similarities in the procedures of the two institutions, the inherent logic of the two is different, and that difference goes a long way towards explaining why one is consistent with a free market economy and the other is not.[3]

A strict doctrine of precedent in litigation, with publication of results in all cases, has still another extremely valuable benefit for an economy. If business firms can rely upon future courts to apply the law in the same way as they have in the past, that is, in accordance with the doctrine of precedent, they will be able to make business decisions with much greater confidence, lower transactions cost, and reduced risk of uncertainty. This can be an enormous "public good" in any economy, and it suggests another difference between judicial decision making and administrative regulation, since, as we have seen, the latter displays much less emphasis on the doctrine of precedent.

The point is that each litigated case with a published opinion, and therefore each settled rule of law, adds to the social capital of an economy, since each additional known rule of law has a significant value to the community using that part of law. Since even in a totally honest system run by saints there would still be considerable uncertainty about how a given issue will be resolved until a court has addressed that issue and published its decision, each new settled rule of law decreases the costs of transactions by reducing uncertainty. As a body of case law develops and builds, businessmen, usually through the services of lawyers, will experience less and less economic uncertainty.[4] If, on the other hand, disputes are privately settled with no publication of the results and no way of enforcing a doctrine of precedent, this enormous positive externality will be lost to the economy. Perhaps this is merely another way of stating that traditional administrative regulation is much more costly in a market system than is a rule-of-law oriented judicial system. When this opportunity cost is added to the positive costs of a regulatory apparatus and the losses inherent in efforts to perform economic regulation, we can see that the economic arguments in favor of a judicial as opposed to an administrative system of dispute resolution are very strong. But that still leaves us with the difficult question of how such an apparatus is to be developed — especially since the use of administrative authority comes so naturally to governments. Here the history of American legal instituitions, with some British antecedents, can give some insight into the answer to this question.

The Common Law

A. *The Theory*. The common law is viewed by many as the ultimate accomplishment of Anglo-American jurisprudence. In many respects, it is easy to see why this is so. The system evolved with a very strong sense that judges should always follow precedent and only establish new substantive rules when a case could be appropriately distinguished on its facts

from all prior cases. A system of appellate courts, with published opinions, was always in place to discipline lower courts. Finally, at least since the origins of parliamentary rule in Britain, the legislature was always recognized as having the authority and the power to change a rule of common law found by a court,[5] even though courts themselves could not because of the doctrine of precedent. The techniques for deciding common law cases, and when necessary distinguishing away prior holdings, has been the subject of learned discourses by both British and American legal scholars for nearly 200 years, most notably by the 19th century British writer John Austin, from whom we have taken the term "Austinian jurisprudence."

This approach commanded judges never to look further than the facts in the instant dispute and the law as laid down in previous cases. To some extent, the Austinian common law judge was a "black box" already containing all the prior law and into which the new facts were put. Almost magically, or at least we might say mindlessly, out came the proper legal answer to the instant dispute. Clearly this jurisprudential approach was consistent with the goals of both objectivity in law and disinterestedness of judges.

The Austinian system of common law, whether it ever did or could exist in fact, has been seen as peculiarly appropriate for a free society and market economy. This argument has received its most important recent elaboration by the great Nobel-prize economist Friedrich A. Hayek. In his *Law, Legislation and Liberty* (1973-79), he argued that a common law system was especially desirable because it was "evolutionary in nature," that is, there were no sudden lurches in legal doctrine creating uncertainties for people relying on the existing law. He also noted the strong predilection in the common law for enforcement of private agreements and the protection of private property. The latter in particular was not surprising, given the emergence of English common law from local systems of land ownership and control.

Yet slowly the common law would always conform itself appropriately to new, exogenous circumstances. Because in its origins Anglo-American common law was primarily local tribal or customary law, common law judges have always had a strong predilection to subsume local custom into decision rules. This, of course, provided the circumstances necessary for the occasional changes that did take place from time to time in the substance of common law.

The Austinian ideal achieved strong academic and therefore professional support with the formation of the Harvard Law School in 1870 under the leadership of Dean Christopher Columbus Langdell. Langdell assumed not merely that the corpus of existing common law cases could generate correct answers to any new legal problem but that by the application of "scientific" methods this body of law could be organized into a coherent and comprehensive *corpus juris*.

The Harvard method of legal education naturally put almost total emphasis on the reading of common law appellate cases, since that was the source of definitive precedent. The well-trained lawyer understood both the controlling precedents in every field of law and the process by which new situations were resolved. He was also strongly imbued with the philosophy of private property and freedom of contract. But attractive as this Austinian scheme might appear both

philosophically and aesthetically,[6] and even assuming (perhaps heroically) that it did in fact exist, it was not to survive long into the 20th century, and it certainly bears very little relation to what American courts do today.

B. *The Breakdown*. The first source of dilution of the Austinian structure was the growth, particularly during and after the "New Deal" in the 1930s, of vast amounts of regulatory legislation and the enormous growth of administrative law. While the doctrine of precedence still had a small role to play in the interpretation of statutes, most of the "culture" of a common law system, particularly a strong belief in the doctrine of precedent, ceased to be very relevant to what the courts had to do. Interpretation of federal statutes became the dominant part of federal civil and administrative litigation, and the techniques for statutory interpretation bore little resemblance to the techniques of common law reasoning. It goes without saying, of course, that this legislation was anti-free market in almost every respect.

As America in the 1930s began moving rapidly away from the laissez-faire orientation of the 19th century and toward a modern regulatory economy, the Congress of the United States delegated more and more substantive regulatory authority to administrative agencies. During the 1930s there was a considerable debate about the extent to which courts could override administratve agencies' interpretation of their own authority, but ultimately this battle was almost completely won by the advocates of administrative discretion. The courts do still impose some restraints, primarily of a constitutional nature, on administrative agencies. By and large, however, American administrative law is now substantially the same as that of the western European countries, where there is a great deal of discretion on the part of regulators and little opportunity for judicial oversight. This victory of regulation over free markets did not come about because of any logical proof of the former's economic superiority. On the contrary, the record is clear that it was the political superiority of the regulatory system that caused it to win the day; it was and remains peculiarly attractive to politicians because of its ability to generate political power and economic rents. It was only natural that a regime of economic regulation would have serious repercussions on a legal process that had evolved alongside a free market economy.

Federal legislation, unlike a geographically diffused common law court system, offers few opportunities for subtle localized and regional differences out of which new ideas and therefore evolutionary development can flow. The doctrine of precedent was also considerably weakened by the fact that one court, the United States Supreme Court, at the pinnacle of the judicial hierarchy, lost interest in having its own powers restrained and controlled by a strong doctrine of precedent. Once this previously self-imposed, or at least self-enforced, restraint was gone from the Supreme Court, there was no power that could reassert the primacy of the old idea of the rule of law, especially those parts that emphasized the sanctity of private property and the primacy of private contractual arrangements. So while appellate courts might still force lower courts to abide by precedents as established by the higher courts, the technique of case differentiation leading to an evolutionary development of substantive law was substantially lost, and along with it the almost mystical regard for precedent that earlier courts displayed.

C. *Legal Education*. There were intellectual as well as political pressures leading the United States further away from the legal culture that evolved along with a free market system. In the university law schools, early in this century, there developed a set of ideas commonly known as "American Legal Realism." Part of the message of the Realists — who were generally politically left of center — was that the assumptions underlying Austinian jurisprudence were incorrect in fact. Judges were not so disinterested as that theory held, and they clearly understood techniques for writing new law in fact while appearing to follow precedent. This very cynical view of judicial efforts undoubtedly reflected considerable exaggeration by the legal realists, but it had a very profound impact on the thinking of American judges, since the Realists were in effect praising this violation of Austinian norms. They suggested that judges should in the main explicity ignore the strictures of precedent and case law reasoning when this was necessary to reach a more "desirable" end result.

The academics were even more impressed by legal realism's sanctioning of non-Austinian approaches than were the early judges. In their teaching, American law professors began rapidly moving away from the exclusive consideration of appellate cases advocated by Langdell. The titles of books used in law classes changed from "Cases on ..." to "Cases *and Materials* on ...." (emphasis added). The "materials" came to be an incredible mishmash of pseudo-social science, pop-psychology, vacuous moralizing, rank ideological claims, and no little political bias. Law students in the "best" law schools came to think of themselves as trained to be the arbiters of what was socially proper and morally just rather than as technicians functioning within a narrowly constrained process that protected property and private contracts.

This view of academics reinforced and in time very heavily influenced the attitudes of American judges. And so they too came to believe that they were not strictly bound by precedent and that higher appellate courts shared certain powers and responsibilities with administrators and legislators. Legislators for their part became more efficient producers of regulatory schemes. Thus the flood of new law added to the uncertainty created by relaxed judicial standards, all with no attention paid to the economic costs of this new and largely unrationalized system of jurisprudence.

D. *The Lawyers*. This growth in the corpus of law, both judicially and legislatively produced, had a heavy impact on the behavior of lawyers as well as of judges. From the late 1960s until the present, a period of little more than 25 years, the life of a successful lawyer in America (perhaps outside of the criminal law area) has changed more dramatically than it did in the previous two hundred years, and to hear them complain, the change has not been for the better.

Part of the success of the old system of law was related to the small scale of the entire enterprise. Consistent with the free market orientation of the law, there was not a great deal of substantive law, legal issues were not enormously complex, and by and large satisfactory or at least workable answers could be deduced from precedent cases. This in turn allowed for a relatively small, collegial, and professionally indoctrinated group of lawyers, most of whom dealt with the same body of legal materials in the same fashion.

Perhaps another way of identifying that characteristic, as was recently done by Judge Richard Posner in his book, *Overcoming Law* (1995), is to say that lawyers did not seriously compete with one another, either in price or in the quality of service. Thus the profession bore a great deal of resemblance to a medieval guild. This system, however, was unable to cope with the enormously increased demand for legal services resulting from the late-20th century's growth of law. Since individuals could not increase their own production of legal service very much, the only way the market could respond to this increased demand was by increasing the number of lawyers, and that typically occurred through growth of existing law firms.

The five largest law firms in the United States 30 years ago each had fewer than two hundred lawyers, and there were not many more which had reached the exalted ranks of firms with more than one hundred lawyers. Today there are several with well more than a thousand lawyers, and there are probably twenty firms with more than five hundred lawyers. Branch offices of these firms appear not only in cities throughout the United States, but, in keeping with the enormous growth of American involvement in international trade and business, throughout the world.

With this growth in the number of providers of legal services, there was no way to prevent intense competition for business from developing. Numerous characteristics of the modern American legal profession, engendered as they are by this competition, are very different from what had previously existed. The relaxed, personal relationships that once existed between lawyers and between lawyers and important clients are almost a thing of the past today. The new "business" (still a pejorative term among most lawyers) attitude is reflected in such competitive phenomena as negotiated fees, the frequent movement of clients from one firm to another, advertising, bankruptcies, and the frequent restructuring of law firms. All of this has generated a loss of collegiality, confidence, and professional pride among lawyers. The uncertainty and the insecurity that have always characterized competitive business firms have come at last to American lawyers. Many of them are not happy about this, and few understand that their discomfort ultimately results from political forces that radically altered the entire legal system.

The American legal system today has perhaps traveled more than half way from its strict 19th century Austinian roots toward a thoroughgoing regulatory system. Indeed, it is frequently difficult to distinguish between what an administrative regulator does and what a judge does in a trial involving business firms. Technical details of the procedures may be different, but ultimately they seem to be doing substantively almost the same things.

Modern judges certainly feel a great deal more independent and unconstrained by precedent than their antecedent common law judges did. And it is not surprising that with this new found "independence" have come allegations that they are abusing their position by usurping powers constitutionally delegated to elected legislators. This is, of course, the meaning of the heated recent debate in the United States about "judicial activism" in the United States Supreme Court, a debate that figured heavily in the refusal of the United States Senate to confirm President Reagan's appointment of Judge Robert Bork to the Supreme Court.

As indicated earlier, changes in the institutions involved in the training of new lawyers have moved in parallel with the changes in the functioning of courts. No longer do American law schools inculcate a strong sense of the importance of the rule of law among new lawyers, and their leftward ideological leanings are well documented. Their efforts are much more devoted to training lawyers who have the right set of political and ideological ideas than clear skills at manipulating common law precedents. And so the ideal of the rule of law, and along with it the ideal of private property and freedom of contract, has been heavily eroded in spite of the existence of perhaps the most honest judiciary in the world. All of this makes it clear that to gain full economic benefits of a rule of law, more is required than integrity among the participants.

Where do We — and You — Go From Here?

The previous discussions have been designed to establish two lessons. The first is that an effective rule of law is an extremely valuable, almost essential complement to a functioning market economy. The second is that current American legal institutions should not be taken as obvious guideposts for countries trying to establish a more efficient free market system. In many ways, American law is at a crossroads not unlike that confronting a variety of more-or-less capitalist regimes. What I will propose for improving the situation in America will hold as well for the Republic of South Korea and for the countries that were formerly part of the Soviet empire.

The traditional and naive idea of the rule of law, as exemplified by 19th century American jurisprudence, is no longer a practical alternative for capitalist countries. There is little indication that governments are willing to simplify their societies (particularly their systems of economic regulation) to the extent necessary for an old-fashioned common law system to function satisfactorily over a broad range of legal areas. And while greater judicial control over administrative discretion is probably desirable everywhere, the self-serving habits of regulatory legislation are not likely to be completely discarded anytime soon anywhere in the world. And finally there is no strong intellectual pressure for a return to anything like the old common law jurisprudential system.

But the costs of the legal system that has evolved in the United States will remain with us until there is some change. Business decision makers will confront enormous uncertainties that translate into higher costs of doing business. Property owners will continue to lose value as the range of their ownership rights continues to be narrowed. Clearly, the greatest benefit that any government of the world today could offer its citizens is a relaxation of regulatory intrusions into business decision making, property rights, and the sanctity of contracts. But that is purely in the realm of politics and not directly relevant to our discussion of the role of the judiciary in improving the material welfare of a society by improving the functioning of its economy.

This does not mean, however, that there is nothing that courts and judges can do on their own to improve upon the present situation. My prescription is remedial and in some ways represents a "second best" solution to the problem posed for a modern judiciary. Perhaps the first best solution would be to return to a strict 19th century system of jurisprudence

(perhaps as we idealize it and not as it was in actual practice), but that is out of the question, and we must seek a more feasible solution. We do have in place some of the necessary attributes of a better system. We can agree, for instance, on the desirability of political independence for all judges, just as we can agree on the desirability of simple honesty on the part of all judges. Furthermore, a hierarchical system of trial and appellate courts builds in a guarantee of some significant utilization of the doctrine of precedent, since the appellate courts will in their own self-interest tend to enforce that doctrine on lower courts. Furthermore, it is probably understood everywhere that, within constitutional constraints, elected legislatures will always have the authority to overrule nonconstitutional holdings by the judiciary and to change rules of common law. That much is easy!

The culture and the implicit rules of the common law system took at least three centuries to evolve, had less than 100 years of relatively pure practice, and collapsed in the United States over a period of about 35 years. The mechanism was obviously very complex yet very delicate, and apparently the conditions for its survival are very rare.

Fortunately, however, the part of the common law tradition that is more important for a free market economy, the protection of property rights and freedom of contract, can be achieved in other ways. That would be by the direct, conscious generation by judges of rules of law that are consistent with the efficient functioning of a market economy. In the Hayekian system, these desirable rules are a spontaneous, evolutionary by-product of the common law process, that is, the ideas of precedent and common law reasoning. Part of what Hayek saw as emerging from the common law was a judicial respect for private property and for the sanctity of private agreements. Only the most cynical of Legal Realists would accuse 19th century common law judges of intentionally reaching certain substantive results not required by the antecedent case law. Our legal history literature is replete with theories and data suggesting why the results reached by 19th century courts were consistent with the implicit philosophy of a laissez-faire economy, but none of these theories suggests that the judges knew enough economics (or even that the science of economics had developed to the necessary point) to allow them to make conscious decisions along modern market economics lines.

But as we have seen, the common law system and process have given way to a much more regulatory and interventionist attitude on the part of modern courts, sometimes making it difficult to distinguish between courts and administrative agencies. The development of modern regulatory systems has caused a fundamental change in the kind of legal system we have; in other words the relationship between the economic and the legal systems has a degree of reciprocity about it, and now it should be possible to turn around this relationship.

Instead of slowly developing an appropriate set of economic laws because of the nature of the legal system, as Hayek would probably have preferred, it is possible to start with an understanding of the economic system in order to achieve a legal process that serves that economy's purpose. In effect, what is required is that courts, even those willing to make new law, understand and enforce only those rules that are consistent with the philosophy of a free market economy. Very generally speaking we know what the

characteristics of that economy are: private property, free contracting, and very little economic regulation. How then should courts behave in order to develop laws consistent with these goals?

In the first place, it would obviously solve the problem if the courts are aided in this process by a clear constitutional mandate for a free economy. This might include an explicit provision to forbid the government from taking private property without compensation, a provision relating to the sanctity of private agreements, and some kind of restraint on monopoly-creating economic regulation. Such provisions would, of course, guarantee the free market economy if their enforcement could be assured. But that is a big "if," and the constitution would also have to provide specifically for judicial review of legislative and administrative actions to make that likely.

But even without the easy mechanism of constitutional provisions, judges could still be influenced to decide a wide variety of cases in a manner consistent with the philosophy of a free market economy. Two things would be required: first, some legislative direction that a free market economy was a matter of national policy and, second, specific education of lawyers and judges in the kinds of economics required to generate appropriate conclusions in a wide range of legal disputes.

The body of economic science necessary for this purpose exists in substantial part. This is the corpus of modern neoclassical market economic theory. Certain fundamental ideas from this economics would be essential for any judge to function in such a new legal milieu, and these would have to be as much a part of the legal system as the doctrine of precedent was in the 19th century. These core notions would include such standard apparatus as demand elasticity, economic cost concepts (including opportunity cost), production functions, property (the economic, not the traditional, legal concept), transactions costs, the nature and formation of market prices, competition and monopoly, theory of the firm (old and new varieties), public choice theory, and the rudiments of quantitative methods, including statistics, finance, and accounting.

This is not as large an order as it might first seem. This material can be incorporated into the formal educational program of lawyers and judges, as it is today in a small number of leading American law schools. Furthermore, for those who have already missed the opportunity of receiving formal training in economics in a university setting, this material can be substantially accomplished in probably four to six weeks of intensive course work.

What would these new economist-judges be able to do? First, and perhaps most important, they would begin to understand the true function of rules of law in a free society and to recognize that they are not there to regulate individuals' behavior in accordance with their preferences but rather to enforce the free choices and the reasonable expectations of the parties. This "philosophic" change in the attitude of judges who have studied some market economics is one of the most remarkable, and frequently unexpected, results of this kind of education. Perhaps this education alone, without any pressure from the legislature, can be enough to make the judges understand their proper role.

The truth is that in universities the world over the tremendous insights and analytical power of market economics are

avoided like the plague. For whatever political or ideological reasons, we have deprived generations of university students of a clear understanding of basic economic forces and their proper role in a free society. Fortunately, geopolitical events of the past ten years have demonstrated to almost all rational people of good will the abject failure of severely regulated economies and the enormous vitality of free ones. A few simple illustrations from recent American legal history may serve to demonstrate the power of economics to generate more useful rules of law.

In the field of contract enforcement, a doctrine known as "contracts of adhesion" has become dominant in the last 20 or 30 years. Under this approach contracts will not be enforced as written if they are long, complex documents offered by sophisticated sellers to trusting consumers who neither read nor can fully understand the terms of such agreements. The courts held that these contracts resulted from "unequal bargaining power," with the uninformed buyers completely at the mercy of greedy and devious sellers who were trying to trick the buyers. As a result the courts felt free to vary the terms of the agreement as they thought fairness required. This is one of the clearest examples of courts behaving in a fashion not substantively distinguishable from that of administrative agencies charged broadly with "doing good."

If the courts had understood more about the nature of competition and market forces, they would have been much less willing to substitute their own views of fairness for the agreements before them. Clearly such agreements are a result of ongoing efforts of sellers to induce buyers to deal with them. Such contracts in a competitive market represent the appropriate allocation of goods and risks resulting from numerous participants in a market. To suggest that the contract should not be enforced because the buyer does not understand every provision in it is comparable to saying that the contract for the purchase of an automobile is not enforceable because the buyer does not understand metallurgy or the physics of internal combustion engines or the nature of tire-road traction. We all recognize immediately that that would be absurd and that in the competitive market for automobiles such information is not of the essence of the agreement. Markets do not require total information (or indeed much information at all) on the part of either or both parties to a sale in order to function competitively. Advertising, reputation, and experience are the stuff of which competitive markets are made, not the esoterica of long form contracts.

Another notable economic error occurs at least implicitly in connection with the American law of product liability. Until about 30 years ago, the purchaser of goods received primarily whatever protection against defects appeared in an explicit, written warranty agreement. The operative rules were in fact pretty much consistent with a "let-the-buyer-beware" philosophy. But the courts began to view this as an "unfair" situation and assumed that their help was required to protect consumers against malevolent and careless producers. The result was the creation of an edifice of *implied* warranties, even extending well beyond initial consumers, that made producers in effect the absolute insurers of consumers' welfare. What the courts did not understand was that making consumers in effect purchase an insurance policy with every item they bought was an extremely costly and inefficient way of guaranteeing the physical welfare of consumers. It was always within the power of

consumers to purchase first-party insurance in any amount appropriate for a variety of risks which that person assumed and consistent with the degree of risk aversion of that individual. There is no way that a mandated system of packaging an insurance policy with consumer goods can possibly cost as little as the older, "unbundled" approach to the problem. Since consumer goods in the main are sold in competitive markets, much if not all of the costs of this new insurance — really the cost of the new law — would be paid by the consumers (depending of course on relevant demand elasticities and perhaps some other factors). But it is clear that if these judges had fully understood the economics of what they were doing, they would have realized that they were not helping the consumers but rather making goods more costly for them.

A third illustration is taken from the first area of law in which explicit economic analysis was used, the antitrust field. Indeed the antitrust law area stands today as perhaps the most dramatic example in American law of the power of good economics to influence judges to make welfare-enhancing decisions.

Under an older and now discredited view, an arrangement tying the sale of a nonpatented product to a patented product (where there was a legal monopoly) was assumed to be an effort to extend the monopoly illegally to the nonpatented item. An early case involved IBM's efforts to tie computer cards (the new version would involve computer discs) to the sale or lease of the patented machine. Courts held that this created a new and illegal monopoly in the cards and foreclosed competition for that business.

Today the courts understand and conclude that such tying can have highly desirable competitive implications. To reach the most efficient level of production of a monopolized product (here the machines), we would want the seller to engage in so-called multipart pricing, in effect to charge differing amounts to different purchasers depending on the intensity of their demand. In that fashion the patent monopolist would still receive his (legal) monopoly rent, but the market will do a more efficient job of signaling the appropriate allocation of input resources. Today because of a greatly increased understanding of the economic implications of similar agreements, most tying contracts are legal. Everyone is better off as a result.

These represent just a few, easily described situations in which judicial understanding of a free market system can result in welfare-enhancing decisions in legal or regulatory disputes and where its absence has often led to undesirable consequences. There is almost no limit to the number of such examples that could be adduced, and, indeed, the more the approach was experienced by judges, the more welfare-enhancing their decisions would be.

Apart from the obvious difficulties (but not impossibility) of instituting such a regime, there is a danger that when the courts believe more explicity that it is in their power to generate "better" legal results, they may tend to be abusive of their power. This is probably no greater danger than we experience today, but there is a self-correcting mechanism that does not presently exist. An understanding of the nature of a market economy by the general legal community will act as a constraint on judicial overreaching. Just as happened in the 19th century with the common law process, a sense of what constitutes appropriate craftsmanship for

deciding cases will develop. This in turn will serve to constrain judicial activism (in this case, meaning utilizing criteria other than those provided by market economic standards).

Conclusions

We have outlined the enormously complex story of how the nature of a legal system carries strong implications for the type of economic system that a nation can enjoy and how a misstep in one of these can jeopardize all of the benefits of a free society. We have seen that a "rule of law" is a very complex phenomenon, including cultural, educational, economic, and political characteristics. We have also seen how the legal system traditionally proposed as the appropriate complement to a market economy has nearly collapsed in the 20th century and does not promise to be revived.

From this history we can learn a great deal. We can see that certain mechanical devices like a single network of trial and appellate courts guarantees some protection to the fundamental notion of stability in law, usually thought to be a function purely of the doctrine of precedent. We have seen further how intellectual forces can influence the behavior of judges in specific cases, and we have seen the tragic implications for a market economy of forcing the legal system to perform as a part of the regulatory state.

All of this has led to the conclusion that we cannot return to a simple 19th century, common law arrangement. We need a substitute that will intellectually constrain judges to behave in a welfare-enhancing fashion. The only possible candidate for this intellectual task is the body of neoclassical microeconomic theory based on private property rights and freedom of contract. Indeed, if such a regime were instituted, it might even reinvigorate the traditional view of the judicial function and in time return us to the substantive sanity of the 19th century common law.

NOTES

[1]Technicians can largely answer that after we specify the kind of economy we want, though, as we shall see, there is some relationship between the kind of legal process used and the substantive rules that will be generated.

[2]The domestic version of harmonization in the United States is called the "Uniform State Laws," a set of voluntary moves to make the laws of individual states (particularly commercial laws) uniform among all the states.

[3]There are other, more obvious differences as well. Administrative regulation, almost by definition, is the antithesis of a free market. Typically it seeks to control the behavior of participants in an otherwise free market, and, therefore, it necessarily affects relative prices of goods through non-market means. In this sense every regulatory move is to a small degree a form of the central planning usually associated with socialist regimes.

[4]This is usually thought to be the reason that Delaware is the favorite state for incorporating new businesses in the United States. Since, among all the states in the United States, it has the largest body of

settled incorporation law, a high percentage of all new incorporations in the country occur there in order to reduce businesses' legal uncertainties and thus reduce anticipated costs.

[5]Manifestly including those announced by the highest appellate court. Constitutional holdings, however, could only be changed by an amendment to the Constitution.

[6]One is tempted to add "but not intellectually," since there was nothing about 19th century opinions that one could term "scientific" today. Judges made no effort then to address the logic of a particular rule of law nor to analyze different rules in terms of their economic benefits. The late 19th century, however, was a period of grand moralizing on the part of many American courts, though one could hardly call their rhetoric analytical or scientific. Judge Richard Posner, however, in one of his most controversial conclusions, has stated that 19th century common law judges generally reached economically efficient conclusions, that is, that their holdings were consistent with a social wealth-maximization goal. His critics have claimed that this merely reflected the generally laissez-faire attitude of most 19th century American judges, and others have denied that the "efficiency" conclusion is correct as a matter of fact. It should be noted, however, that Posner's conclusion about common law judges is certainly consistent with the strong predilection of common law judges to protect private property and enforce private agreements. This in effect is a recipe for a free market system, and there is no reason to think that that would not generate the most efficient results, even if the judges did not clearly understand that that is what they were doing or intend that result.