# Commentary by Geoffrey Wood

This fascinating essay by Richard Epstein, originating, as Geoffrey Owen notes in his foreword, in the 2003 Wincott lecture, is in a field unfamiliar in Britain—that of Law and Economics. In Britain, these two disciplines are often regarded as separate. An excellent book treating law and economics as a linked and coherent subject (Veljanovski, 1990) has been out of print for more than ten years.[1] Few British universities offer even a single course on law and economics as a part of a degree, and where interest is shown, it is often solely by lawyers. Economists, by and large, neglect the discipline, despite its importance in the work of, for example, the Office of Fair Trading. It is as well, therefore, to start by offering a definition of the field before proceeding to point out some highlights in Richard Epstein's fascinating and stimulating paper and drawing from them some inferences of particular relevance to Britain, and to Europe generally, in the present day.

Cento Veljanovski defined Law and Economics as follows: "The economics of law can be defined rather crudely as the

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1. I understand that the IEA plans to publish a new book on law and economics by the same author in the near future. This will be a welcome addition to the sparse European literature on the subject.

application of economic theory, mostly price theory, and statistical methods to examine the formation, structure, processes, and impact of the law and legal institutions." He then went on to separate the field into "Old" and "New." "The old law and economics is concerned with laws that affect the operation of the economy and markets," he wrote, while the new "takes as its subject-matter the entire legal and regulatory systems irrespective of whether the law controls economic relationships. In recent years contract, tort (the area of the common law which deals with unintentional harms such as accidents and nuisance), family law, criminal law and legal procedure have all been subject to economic analysis" (Veljanovski, 1990, 14, 15).

These definitions are clear and helpful, but they are one-sided. They suggest that economic analysis can be used to help understand the workings and consequences of law. The subject is more wide ranging than that. Law can help us understand economic outcomes and structures. In other words, we can either start as economists and analyze the workings of the law or start with the law and show how it can affect economic outcomes.

The "new" law and economics is the field of Richard Epstein's paper. What is the subject of the paper? Epstein's central point is that it is important to get certain big and straightforward issues right. The more complex issues, which attract much attention, although not unimportant—they can sometimes involve substantial expenditures—are unimportant by comparison with a few really big issues. The basic reason for this is that the hard cases involve a great deal of effort and still have a high failure rate. We can see with hindsight that the wrong decision was made, or, on other occasions, we remain unclear that the right decision was made. An example is the decision to build a new airport. Enormous costs are

involved, and there are consequences for many aspects of life—for "noise, pollution, traffic, land values, business growth, and the like," to quote Epstein. Such is the complexity of that one-off decision that it is easy to be wrong, even with the best will and ability in the world.

Before leaving these difficult one-off issues to one side, though, it is surely worth considering whether a way can be found of establishing a common framework in which to deal with such problems. By removing some of the "one-off-ness," the costs of each decision would be reduced. Surely a way of doing this that is worth exploring is to consider establishing, by law, a form of market framework; a sketch of such a one follows.

Those proposing to build a new airport (for example) and those opposed to it could be required to register sealed bids: the first of how much they would pay in compensation for building the airport, the second of how much they would pay to stop its being built. Thus could be determined how much the airport was worth to each party if built on that spot; whichever party offered more would make the payment to the other side and then have its way.[2]

What we do not have to live with, and most certainly should not live with, is neglect of easy cases that have important ramifications. What are these easy cases? The most important one, and the topic of Epstein's lecture, is "how a society draws the interface between market choice and government behavior. . . . The truly great social catastrophes . . . arise from

2. This proposal exploits the Coase theorem (1960) on externalities, avoiding the usual cost problem by restricting the scheme to where large sums are involved. It was the expense of such negotiations relative to the resulting benefits that led Coase to stress that his analysis revealed how to look at the problem of externalities rather than providing a universally applicable way of dealing with them.

a wholesale disrespect for individual liberty . . . and from a total contempt for private property." Be right on these big issues and much good will follow; be wrong, and "unnecessary social losses" are guaranteed, and catastrophe is possible.

Epstein opens his argument by considering socialism and its associated collectivism as a means of organizing production. Wholesale and complete collectivization is and always will be a failure. If the required information were available to government, it would become available to the citizens, who would try to undo the socialist attempt to separate what is produced from the distribution of that product. "As the night follows the day, every clever government intervention will invite multiple private responses, which are certain to undo whatever good might have come about if dedicated government officials (itself a generous assumption) had exclusive use of the new technologies involved."[3] It is unfortunate that Chancellors of the Exchequer, and finance ministers more generally, do not yet fully recognize this, for if they did, they would abstain from the continual tinkering with taxes, incentives, and regulations that preoccupies so many of them; but they do at least refrain from wholesale nationalization.

Next he turns to the libertarian alternative. This starts from the presumption that "voluntary transactions are presumptively preferred because they are positive-sum games from which both sides benefit." For such transactions to be common and multiply, there needs to be a framework of law to define and defend property rights, for without such rights

3. The observation about government officials may take British readers a little aback. The public choice analysis of government is both better accepted and more widely used in the United States than in the United Kingdom. Possible reasons for this are discussed in Capie and Wood (with F. Sensenbrenner) (2004). A major part of the explanation may lie in the traditionally nonpartisan nature of the British Civil Service, at least until recently, even at the very highest level.

there can be few such exchanges of titles to ownership. The markets, Epstein urges, cannot generate these laws themselves.[4] He cites DeSoto's example of street addresses, "without which it is impossible to organize a system for delivering the mail or supplying electricy, gas, police, and fire service." That a framework of law is necessary is surely correct. We should, however, be careful not to concede government too great a role. DeSoto's example is excellent to illustrate the point. London was the first city to have street numbers, following an act of Parliament of 1765. But that act followed a private initiative. The first street to be numbered was Prescott Street in Whitechapel in 1708, numbered at the initiative of its residents, concerned with delivery of at least some of the services Epstein lists.[5] Nevertheless, the scope for such private initiatives is limited to small groups—the costs of negotiating soon rise as the numbers of participants do and inhibit non-government-organized action. We must therefore focus on how to judge and restrict laws.

Where, Epstein asks, does the "simple logic of voluntary contracting" lead us in addressing that matter? His basic proposition is that there should be no compensation for losses incurred through the operation of competitive markets.[6] This was traditionally defended by lawyers distinguishing between harm and actionable harm. An actionable harm, such as

4. Jonathan Sacks (2002) has also argued this position, with an only partially overlapping set of analytical tools.

5. DeSoto's acceptance that street numbering requires state action is reminiscent of the acceptance of many writers of economics textbooks that the state had to organize the provision of lighthouses to guide ships, because lighthouses provided a good for the use of which charging was not possible. As was discussed by Coase (1988), provision was in fact organized privately by groups of shipowners.

6. Asymmetries of information may, in some cases, produce qualification to this; but the existence of these is most plausible in financial markets, which Professor Epstein does not discuss.

arson, destroys capital. Loss by, for example, not getting a contract because another supplier is cheaper does not destroy capital, leaves the firm that did not get the contract to transact again, and lets two parties gain from a mutually beneficial exchange. That is a brief summary of the economic argument that Epstein advances for a legal conclusion. He then applies it to two important markets: that for agricultural goods and that for labor. Both these markets have been cartelized by government action, legislating with what, no doubt, appeared the best of motives but, Epstein demonstrates, to the harm of society in general.

Agriculture in the United States is supported by producer subsidies, as it was until recently in the European Union. (The changes to the EU system that are soon to take place will break all links between current production and current subsidy; farmers will be paid for having been farmers in the past.) A producer subsidy system has to be buttressed by restrictions on production and on entry. This has served to keep prices unnecessarily high and to inhibit the kind of entry that would promote consumer choice. Much of Richard Epstein's discussion of agriculture is based on evidence from the United States, but the EU's Common Agricultural Policy was at best similar (many would argue much worse) in its harmful effects domestically, and it also did international harm. It did that politically, of course, by creating grounds for international disputes, but it also contributed to poverty in underdeveloped countries—for agricultural surpluses are shipped to these countries, thus destroying the fragile prosperity of their domestic farmers. Then, in further abuse of European taxpayers, taxes are spent in an attempt to relieve the poverty caused at least in part by the agricultural policy that residents of the EU are taxed to support.

Problems arise, too, in the cartelization of labor markets,

which has been produced by legislation supporting trade unions and giving them immunity from many of the legal actions that cartels of producers would face. The result has been that unionized industries have maintained higher prices and innovated less in both products and production methods and sometimes, in consequence, gone into decline that might well have been avoidable had their labor market been different. Examples, admirable for the forcefulness of the demonstrations they provide are, first, Britain's formerly nationalized industries of gas, electricity, and telephones, which have lowered prices and innovated when the joint labor cartels and producer monopolies were destroyed; and second, the British motor car industry, greatly reduced in size by competition from abroad and that had its life made easy for it by the rigid labor market of Britain's industry.

Of course, the biggest thing of all that follows from the "simple logic of voluntary contracting" is free international trade. This not only maximizes the benefits of exchange with any existing pattern of producers, but it also moves these producers toward an efficient structure; for free trade injects into every economy blessed by it a virus—the virtuous virus of competition—which destroys monopolies and cartels through the entry of new firms. If a country has free trade, then the harmful effects of protecting various groups through domestic policies are at least mitigated, and may well be eliminated altogether. Get free trade, and much else good will follow.

Should we adopt free trade unilaterally, or should we, rather, adopt it only in exchange for similar moves by other countries? It has been traditional for economists to argue that unilateral adoption is desirable. Joan Robinson put the case with brevity and clarity; she observed that if other countries have rocks in their harbors there is nevertheless no reason to

throw rocks into your own. And the same applies to tariff barriers as to such physical ones.

This conclusion is correct provided there is no possibility that, by negotiation, the other countries will reduce their trade barriers. But as Epstein points out, it is necessary to consider not only the initial effect of any measure but also subsequent effects. It thus becomes worthwhile asking what the impact of trade liberalization made conditional on trade liberalization by another country will be. An early example of this being taken into account is the repeal of Britain's Corn Laws in 1846. Sir Robert Peel, the then prime minister, was persuaded of the benefits of free trade by the economists of the time. (Frank Fetter [1980] provided an account of the parliamentary part of their activities.) The Corn Laws were repealed as an act of unilateral trade liberalization. The action was unilateral because the countries of continental Europe would not negotiate to reduce their tariff barriers, and Peel eventually decided that it was in Britain's interest to liberalize alone. This led to Britain's becoming a free-trading nation.

Peel hoped that Britain's actions would lead to what Bhagwati (2002) called "sequential reciprocity," or to other countries' following Britain's lead, seeing how Britain had benefited from free trade and hoping to benefit likewise. There was subsequent trade liberalization, but, as Richard Conybeare (2002) pointed out, although the liberalization was clearly *subsequent*, it is not possible to either confirm or deny that it was *consequent*.[7]

Are there advantages to actions that lead other countries to liberalize their trade? Although a formal demonstration that there are such additional advantages is not straightfor-

7. An extensive discussion of these issues can be found in Bhagwati (2002).

ward, the intuition is clear. If both countries liberalize then each can specialize to a greater extent in producing those goods that it is comparatively better at, and consumers in *both* countries have cheaper access to goods that satisfy their tastes. Hence, although Epstein's principle that there should be no compensation for losses incurred as a result of the workings of a competitive market, and its natural extension that there should be no protection from the working of such a market, seems to suggest that free trade should be adopted regardless of foreign behavior, there is a case for multilateralism, provided that its end result is sure to be free trade.

This, it must be said, is not as easy as it may sound. Consider two countries entering into trade negotiations. One country wants both countries to achieve free trade but will adopt free trade even if the other does not; the other is perfectly content if the first country achieves free trade but does not wish to achieve that itself. If that second country knows the first will eventually abandon protection regardless of the behavior of the second, then the first has little if any bargaining power. Nevertheless, the game is worth playing. Free trade for both may be the outcome—not necessarily immediately or even after the first set of negotiations, but as the protectionist country comes to see the advantages free trade brings to both consumers and producers in the free-trading country. (Producers gain as a result of, among other factors, their becoming more efficient as a result of competition and thus doing well in markets outside their home one.)

The current trade negotiations at the World Trade Organization are an example of where these issues should be thought about seriously by economists. We know that there are gains from unilateral free trade and that there are even greater gains from multilateral free trade. These are among Epstein's "easy cases." What is harder to determine is whether

a multilateral or a unilateral course is the better one to pursue in any particular set of trade negotiations.

It is now convenient to move on to certain very recent actions of policy makers, every one a consequence of neglecting Epstein's basic principles of supporting freedom of contract and considering subsequent, as well as first-round, actions, which although of apparently minor significance at the present time are likely to have numerous harmful consequences in the future. These relate to the limitation of working hours in place in most of the European Union and the Trade Secretary's ruling in the case of the proposed takeover of Safeway, the British grocery chain. These are discussed in turn, before we return in conclusion to Professor Epstein's lecture.

Working hours were limited supposedly as a way of helping workers, and also, it was suggested by some, as a way of creating jobs for at least some of the large number of unemployed in parts of continental Europe.[8] This is, of course, another example of the interference with the labor market that Richard Epstein discusses. Interference with freedom of contract in this manner will impinge particularly on some types of workers and industries. Long hours worked over a period of the year, for example, are for some industries an efficient way of organizing production. The workers in these industries (and in any industry where long hours per week, although not necessarily every week, are an efficient way of working) are made less productive by this law. They will continue to be employed only if their wages fall. Thus, they suffer rather than benefit from a law designed to protect them. The

8. Explaining the fallacy behind the belief that by restricting working hours there will be a proportionate rise in the number of workers employed would be aside from the theme of this paper. It is discussed in Wood (2002).

working time directive and associated labor market regulations are, in Epstein's terminology, "easy cases." They break the fundamental principle of freedom of contract—and in this case have the opposite effect from that intended.

The Safeway ruling moves us to some new issues and also directs us to a section of Epstein's arguments that we have not yet mentioned. It is useful first to outline the issue. A grocery store, Wm. Morrison, made a bid for Safeway. This triggered interest from other grocery stores. It was decided that a takeover could affect competition, so a review was undertaken by the Competition Commission. On the basis of this review, the secretary of state decided that only Wm. Morrison could take over Safeway. This ruled out a competitive bidding process for the company, unless some bidder not in the grocery business decided to mount a takeover, and none did. Accordingly, it is highly likely that shareholders in Safeway will not do as well as they otherwise would from the takeover. Now, what are the objections to that outcome, setting aside the obvious one that shareholders in Safeway could make? What harm, except to them, has interfering in a voluntary contract done?

Suppose there had been no interference and a higher price had been paid for the company. This would have increased the incentive in similar future cases for shareholders in a firm that was doing less well than others in the market to put pressure on the management to either improve or be sold. (Imposing such pressure is not costless, in either time or money.) This increased incentive would mean that the economy's productive resources were wasted for less time, and that is to the good of everyone, not just shareholders in the company.

To this argument that there should have been no intervention, there may be opposed the claim that concentration

in the grocery business would have increased as a result of such an unhampered takeover, and that such concentration would have reduced competition to an extent that could well have outweighed the benefits just described. It is somewhat contentious to claim that concentration reduces competition; it is the existence of barriers to entry that allows monopoly profits, and these barriers do not necessarily rise with the concentration of the industry. But be that as it may, an approach to cartels mentioned by Epstein is relevant whatever one concludes on that issue. Do we need to worry about cartels, provided that agreements between cartel members are not enforceable at law, and especially if new firms can enter the cartelized industry? There are arguments for this approach; and there are arguments that lead to the more aggressive anticartel policies of the United States and Britain. But as Epstein points out, whatever one concludes on this matter, the approach of considering legal intervention to prevent cartels is completely inconsistent with the attitude that has been taken to the agriculture and labor markets. The Safeway case involves a (relatively) minor issue—policy toward cartels—but it leads us to a big one. Allowing freedom of contract in competitive markets is of major importance; governments have recognized that principle. It is too important to be applied only where politically convenient.

Professor Epstein's paper is a stimulating one, rich in powerful insights that can help us not only understand the world better but actually improve the world and make every person in it better off, or at least capable of being so. Law and Economics is a discipline little studied in Britain, but it provides such a powerful set of tools that its neglect cannot be justified. I very much hope that this absorbing lecture encourages not only the use in Britain of the kinds of ideas set out in it but also the study and teaching of the subject, so that there are

many practitioners engaged in public policy formation and analysis in this country. This could not but improve both the laws that constrain private actions and public policy and the conduct of policy within the set of laws that constrain it.

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