

THE JUDICIARY AND FREE MARKETS

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I. 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.¹ The collapse of the Soviet empire and the dismal showing of socialist economic systems have greatly stirred this interest.² Indeed, it has become commonplace to acknowledge—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 has come to be expected throughout the world.³

Although a great deal has been written on how to establish a free-market economy, far less is known about the kind of judicial process that is crucial to the continued functioning of a market economy.⁴ That question is the central inquiry of this paper. To

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1. See, e.g., HENDRIKUS J. BLOMMESTEIN & BERNARD STEUNENBERG, *GOVERNMENT AND MARKETS: ESTABLISHING A DEMOCRATIC CONSTITUTIONAL ORDER AND A MARKET ECONOMY IN FORMER SOCIALIST COUNTRIES* (1994) (providing in-depth analysis of many aspects of democratic and free-market reform); VLADIMIR TISMANEANU & PATRICK CLAWSON, *UPROOTING LENINISM, CULTIVATING LIBERTY* (1992) (same).

2. See Jan S. Prybyla, *Introduction to RUSSIA AND CHINA ON THE EVE OF A NEW MILLENNIUM* 1, 1-18 (Carl Linden & Jan S. Prybyla, eds., 1997) (describing failures in Russia and China).

3. See Jose Maria Eyzaguirre, *Chile Update*, in *Proceedings of the Eighth Annual Conference on Legal Aspects of Doing Business in Latin America: Developing Strategies, Alliances, and Markets*, 10 FLA. J. INT'L L. 1, 81 (1995) ("A free market is the only way we can grow and bring prosperity to those areas where investments must still be made."); John O. McGinnis, *The Decline of the Western Nation State and the Rise of the Regime of International Federalism*, 18 CARDOZO L. REV. 903, 913 (1996) ("Global capital markets and trade are now acknowledged to be an indispensable source of prosperity."). As the Director of Policy Planning at the State Department recently acknowledged, "Our interests are most secure in a world where the rule of law protects both political rights and free market economies." James B. Steinberg, *Policy and Principles: The Clinton Administration's Approach*, 19 FORDHAM INT'L L.J. 1340, 1344 (1996).

4. See, e.g., Prybyla, *supra* note 2, at 9 (recognizing that "one cannot let cross-dressed socialists act as guides on the road from serfdom to a competitive market system and

some extent, everyone agrees on the basic substantive legal ingredients of a free-market system—small government, private property, and freedom of contract. Much of the current policy debate is about how strictly we should construe these basic notions, not whether we should have them at all. The purpose of this paper is not to examine in any detail the particular substantive rules most consistent with the philosophy of free markets. Rather, it is to examine the kind of public-dispute-resolution legal system that is most consistent with that philosophy.⁵

Although a system with minimal economic regulation will certainly have fewer legal disputes than one that is heavily regulated, some system for resolving disputes will always be necessary. Even the most perfect free-market economy will still exist in a political regime where the rules might change, where taxation will exist, where individuals commit crimes, and where both public regulation and private contracts will be subject to interpretive differences. A free-market system is not a static arrangement. It is a complex and dynamic phenomenon, 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 free-market goals established exogenously, and it will operate in a fashion consistent with those goals.

It should be emphasized that we are not asking what substantive rules of law such a society should have.⁶ The present inquiries are what process of dispute resolution (arbitration, litigation, or regulation, for example) is best suited to a free market's needs, and what rules or techniques of decisionmaking the judiciary should utilize. All of these questions can be subsumed, with enormous oversimplification, under one phrase, "the rule of law." Unfortunately, this simple-sounding idea of the rule of law is actually an extremely complicated set of jurisprudential, political, and economic considerations, most of

political freedom under the Rule of Law[,]” but not dwelling on what a proper road map would be).

5. The focus is on the American legal system, and, consequently, the parallel aspects of civil-law jurisdictions are not directly covered.

6. As we shall see, there is some relationship between the kind of legal process used and the substantive rules that will be generated.

which are not obvious. This paper will now elucidate a more nuanced understanding of "the rule of law."

II. THE RULE OF LAW: WHAT AND HOW

There are some aspects of the notion of the rule of law that are obvious and 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 relevant circumstances.⁷ That is, government officials will not have authority to discriminate in the application or interpretation of substantive rules of law on the basis of favoritism, prejudice, belief, or politics; and judges must adhere to and enforce this same mandate. Second is the basic notion that no one should have to respond to a legal rule retroactively; that is, laws should be known or knowable in advance, and not made up after the fact.

Merely stating these ideas is, however, a long way from implementing them. 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? Even if the judges are honest and well-meaning, what can we do to ensure that they will not make too many errors simply as a result of ignorance?

We might begin by noting that any judge who is to act in a disinterested fashion on matters before him or her must of necessity enjoy a degree of independence from political and governmental influence.⁸ Because the government itself will frequently be a litigant in dispute-resolution procedures, and always in regulatory and criminal matters, it is absolutely essential that the judges have no extraneous reason to favor the government in their decisions.⁹ Simply put, their jobs should not

7. See F.A. HAYEK, *THE CONSTITUTION OF LIBERTY* 153-54 (1960).

8. See L. Ralph Mecham, *Introduction to Symposium on Federal Judicial Independence*, 46 *MERCER L. REV.* 637, 638 (1995) (stating an independent judiciary "to be the cornerstone of a free society and the rule of law"); see also Karen Halverson, *Resolving Economic Disputes in Russia's Market Economy*, 18 *MICH. J. INT'L L.* 59, 101-02 (1996) (stating that lack of independence makes Russian judges susceptible to bribery and coercion).

9. See James Zagel & Adam Winkler, *The Independence of Judges*, 46 *MERCER L. REV.* 795, 800 (1995) ("Judges . . . are supposed to give equal attention to the arguments of a carnival bozo as to those of the Attorney General if the two go head-to-head in a case.").

depend on how they decide individual cases.¹⁰ These are the straightforward explanations for why the United States Constitution provides lifetime tenure for federal judges.¹¹

If, however, judges are given total independence from any kind of oversight or constraint, how is it possible to ensure 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 judges to be independent, but not so independent that they are not concerned about the quality of their work.¹² That many states have regular elections of judges for a set term of years evidences an attempt to strike this balance.¹³

The debate on the question of lifetime appointment of judges versus popular elections has raged for a long time in the United States, and it shows no signs of abating. 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 had its bad actors. The fact that the two systems for selecting judges have existed side-by-side in the United States almost from its beginnings, however, 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.

The general question of "*quis custodiet*" for judges has no perfect answer, but there is a clear "second-best" solution—keep government as small and simple as possible.¹⁴ Only in that way will serious observers be able to monitor and evaluate the work of judges and apply appropriate pressures when their work is improper or inadequate. In a world with millions of lawsuits filed annually involving pervasive, arcane, and complex

10. See *id.* at 798 ("A judge is independent in this view because the President cannot fire her and members of Congress cannot cut her salary nor transfer her to East Glocksenspiel, Illinois solely to hear foreclosure cases.").

11. See U.S. CONST. art. III, § 1 ("The Judges, both of the supreme and inferior Courts, shall hold their Offices during good Behaviour . . .").

12. See Zagel & Winkler, *supra* note 9, at 829-31 (discussing the tension between judicial independence and judicial complacency).

13. See generally LEADERSHIP DIRECTORIES, INC., JUDICIAL YELLOW BOOK: WHO'S WHO IN FEDERAL AND STATE COURTS 621-990 (Claudia A. Finney ed., Fall 1997) (explaining how judges attain office in each state).

14. See RICHARD A. EPSTEIN, SIMPLE RULES FOR A COMPLEX WORLD 21-29 (1995).

regulations and legislation, such monitoring is not possible.¹⁵ To the extent the judicial system is overloaded, it necessarily comes to look more like the regulatory system.¹⁶ This creates new conflicts of interest, and one is never surprised to learn that an administrative agency, where appointments of top-level decisionmakers are commonly made from among political supporters, has behaved “politically” rather than “judicially.”

As noted above, the rule of law requires that there be only one set of laws for all the firms in a single market. A market economy, as Adam Smith pointed out, will exhibit more specialization, and therefore more productivity, the larger the market.¹⁷ To a large extent today, markets are defined by laws, rather than distance and transportation costs, as in Smith’s time. Forcing all courts within one jurisdiction to follow the same rules of law is not, however, as easy as it may sound, as courts inevitably fall subject to local pressures and customs. Several structures and doctrines have evolved that encourage uniformity in the application of laws within a market economy.

One device that has a long history of use in both England and the United States to help guarantee uniformity in judicial rulings is a system of hierarchical appellate courts, usually three layers, with a single court at the top of the hierarchy.¹⁸ This arrangement simplifies the task of holding all lower courts to the same substantive rules, because 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

15. See generally WALTER K. OLSON, *THE LITIGATION EXPLOSION: WHAT HAPPENED WHEN AMERICA UNLEASHED THE LAWSUIT 15-31* (1991) (chronicling various abuses).

16. See *infra* text accompanying notes 15-18. Regulatory systems generally do not aim for economic efficiency; rather, in regulating safety or environmental impact or the like, such systems often supplant market solutions or disregard market realities. Moreover, the manner in which disputes are adjudicated by regulatory bodies—unpublished dispositions with little or no precedential value—itself undermines economic efficiency by precluding business entities from relying on a stable, consistent body of law. One of the theoretical values of the judicial system in this respect is that disputes are adjudicated publicly and the results are often published, attaining precedential value and thus contributing to a body of law upon which economic actors can rely. This positive externality is sacrificed when the system becomes overloaded.

17. See ADAM SMITH, *THE WEALTH OF NATIONS 3-12* (Edwin Cannan ed., Modern Library 1937) (1776).

18. See generally Evan H. Caminker, *Why Must Inferior Courts Obey Superior Court Precedents?* 46 *STAN. L. REV.* 817 (1994) (reviewing the merits of a hierarchical court system).

instructions. 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 definitive judicial statements of the law.¹⁹

This enforcement system does not work perfectly. There is a good deal of slippage, analogous to the famous "agency costs" in any employment relationship.²⁰ 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. Accordingly, although hierarchical structure of courts is probably necessary to preserve a same-rule regime, it is not sufficient for that purpose. Moreover, it offers no judicial monitoring of the highest court and will only work weakly for intermediate appellate courts.²¹

Another aspect of a market-oriented judicial system that can be internalized by every judge, trial or appellate, and that can aid considerably in performing the task of guaranteeing consistency—here, through time—is the doctrine of precedent. Precedent 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.²² To the extent that judges are strongly influenced by this idea, it becomes less costly to secure consistency in law.

This enormously important idea is, again, not fully self-enforcing. To help make it work effectively, the results of litigation must be made public.²³ Only then can they be known and followed by judges or by ordinary citizens in subsequent

19. See *id.* at 818, 830.

20. Agency costs arise out of a divergence of interests between the agent and the principal. See Linz Audain, *The Economics of Law-Related Labor V: Judicial Careers, Judicial Selection, and an Agency Cost Model of the Judicial Function*, 42 AM. U. L. REV. 115, 135-36 (1992) (applying the agency-costs model to the judicial function).

21. See Caminker, *supra* note 18, at 854-56.

22. See Antonin Scalia, *The Rule of Law as a Law of Rules*, 56 U. CHI. L. REV. 1175, 1176-77 (1989) (discussing the dichotomy between the general rule of law and a mere personal discretion to do justice).

23. See Martha J. Dragich, *Will the Federal Courts of Appeals Perish if They Publish? Or Does the Declining Use of Opinions to Explain and Justify Judicial Decisions Pose a Greater Threat?*, 44 AM. U. L. REV. 757, 760 (1995) (stating that "[s]elective publication [of decisions], summary disposition, and vacatur upon settlement undermine the notion that the "law[]" should be knowable).

cases.²⁴ With a right of appeal to a higher court, the decisions of which must also be made public, the higher courts will enforce the doctrine of precedent on lower courts, even if not always on themselves.²⁵ Thus, although they are related concepts, the doctrine of precedent and the right of appeal are, in fact, two distinct aspects of assuring that a legal system operates consistently with the requirements of a free market.

If administrative regulations were actually designed, as is often claimed, to make the market function more efficiently, then it is likely that we would also see strong demands for the doctrine of precedent within administrative adjudications.²⁶ The chief goal of this kind of government action is, however, usually something other than the smooth functioning of private markets; consequently, there is much less reason to insist on a strict doctrine of precedent.²⁷ This is not to say that administrative tribunals never decide cases on the basis of precedent.²⁸ They will rely on precedent to some extent, if for no other reason than to make their own work easier, or because a reviewing court might require it. Nevertheless, failing to follow their own previous decisions will not normally, in itself, be a sufficient basis for reversal, as it would with purely judicial tribunals.²⁹ 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

24. Unpublished dispositions challenge the fundamental assumptions of lawyers and judges "that the law is findable, that the precedential value of a decision is readily ascertainable, and that past decisions provide sufficient information to guide citizens, attorneys, and judges in the future." *Id.*

25. See generally Erin O'Hara, *Social Constraint or Implicit Collusion?: Toward a Game Theoretic Analysis of Stare Decisis*, 24 SETON HALL L. REV. 736 (1993).

26. See generally Cass R. Sunstein, *Law and Administration After Chevron*, 90 COLUM. L. REV. 2071, 2088 (1990).

27. See *id.* at 2101-04.

28. See, e.g., *Maislin Industries, U.S. v. Primary Steel, Inc.*, 497 U.S. 116, 131 (1990) ("Once we have determined a statute's clear meaning, we adhere to that determination under the doctrine of *stare decisis*, and we judge an agency's later interpretation of the statute against our prior determination of the statute's meaning.") (internal quotations and citation omitted); *Variable Annuity Life Ins. Co. v. Clarke*, 998 F.2d 1295, 1300 (5th Cir. 1993) ("[D]eference under *Chevron* does not permit administrative agencies to overrule [judicial] precedents."), *rev'd sub nom.*, *NationsBank of N.C. v. Variable Annuity Life Ins. Co.*, 513 U.S. 251 (1995); see generally Rebecca Hanner White, *The Stare Decisis "Exception" to the Chevron Deference Rule*, 44 FLA. L. REV. 723 (1992) (discussing the tension between deference to agency interpretations under *Chevron* and the role of *stare decisis*).

29. See White, *supra* note 28, at 742 n.106 (noting that administrative agencies, unlike courts, have traditionally not considered themselves bound by *stare decisis*).

explaining why one is consistent with a free-market economy and the other is not.³⁰

A strict doctrine of precedent in litigation, with publication of results in all cases, has still another valuable, and generally underappreciated, benefit for an economy. As already noted, if business firms can rely upon future courts to apply the law in the same way they have in the past—that is, in accordance with the doctrine of precedent or *stare decisis*—they will be able to make business decisions with less uncertainty and therefore lower transactions costs. This development can be an enormous “public good” in any economy. Even in a totally honest system, there will always be uncertainty about how a new issue will be resolved. But, as a body of case law develops and builds, that community which uses that area of the law will experience less and less economic uncertainty and thus lower costs.³¹ Accordingly, each litigated case with a published opinion—and, therefore, a settled rule of law—adds to the social capital of the economy.

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.³² Perhaps this is merely another way of stating that traditional administrative regulation (including adjudication) is

30. Administrative regulation (as distinguished from administrative adjudication used to enforce regulations), almost by definition, is the antithesis of a free market. Typically, it seeks to control the behavior of participants in an otherwise free market in some specific fashion, 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.

31. Among the States, Delaware enjoys the largest body of settled corporation law, and incorporation there can reduce businesses' legal uncertainties and thus reduce anticipated costs. It is not surprising, then, that Delaware is also the most popular state in the United States for new business incorporations. See Barry E. Adler, *Financial and Political Theories of American Corporate Bankruptcy*, 45 STAN. L. REV. 311, 338 n.116 (1993) (“Delaware has gained a ‘first-mover’ advantage as a state with a rich, predictable set of laws, and with lawyers and courts skilled at interpreting them.”); Melvin Aron Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461, 1508 (1989) (noting that Delaware’s rich case law increases predictability); Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469, 505 (1987) (“[I]t is primarily the certainty and stability of Delaware law that creates opportunities for profits in the first place.”).

32. As one commentator explains, “If the rules are unpredictable, the risks inherent in a proposed course of conduct cannot be calculated, and potentially beneficial transactions will be deferred or avoided altogether.” Dragich, *supra* note 23, at 779.

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 to the losses already inherent in efforts to perform economic regulation, the economic arguments in favor of a judicial, as opposed to an administrative, system of dispute resolution become very strong.

A third method of dispute resolution is the use of private mechanisms, such as arbitration. To the extent that arbitration is explicitly required by a private agreement, it should of course occur when a dispute develops. It should be noted, however, that private dispute-resolution devices can never be a perfect solution to the issues addressed in this paper. In the first place, there needs to be some enforcement mechanism to force the recalcitrant parties to enter into arbitration when they have agreed to it. The same is true with enforcement of the arbitration award, because the arbitrator will not generally have the power of government to carry out its orders. *A fortiori*, criminal law, by its nature, can only be universally administered through public tribunals.

It should also be noted that there is the loss of an external benefit from private dispute-resolution devices similar to what we saw with administrative regulation. The larger community will not benefit from the additional social capital that may have been created in the form of a settled precedent had the dispute been litigated. However, there is no reason to force the parties to supply a public good when it is not in their interest to do so.

Nevertheless, the difficult question remains of how or whether a common-law judicial apparatus can be developed, reestablished, or maintained—especially given the massive administrative authority of governments. A brief history of American legal institutions, with some British antecedents, offers insight into the answer to this question.

III. THE COMMON LAW

A. *The Theory*

The common law is viewed by many as the ultimate accomplishment of Anglo-American jurisprudence.³³ 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 early in place to discipline lower courts.³⁴ 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 (even one found by the highest appellate court),³⁵ even if courts themselves could not do this 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 over 200 years, most notably by the nineteenth-century British writer John Austin, from whom we have taken the term "Austinian jurisprudence."³⁶

This approach commanded judges never to look further than the facts in the instant dispute and the law as laid down in previous cases.³⁷ 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.³⁸ Almost magically, or, at least we might say, mindlessly, out came the proper legal answer to the instant dispute. Whatever its faults, and to whatever extent it

33. See, e.g., RICHARD A. COSGROVE, *OUR LADY THE COMMON LAW: AN ANGLO-AMERICAN LEGAL COMMUNITY, 1870-1930*, at 290-91 (1987); see generally ARTHUR R. HOGUE, *ORIGINS OF THE COMMON LAW* 241-54 (1966).

34. See generally J. HARVEY & L. BATHER, *THE BRITISH CONSTITUTION* 349-56 (4th ed. 1977) (describing the early history of the British judiciary).

35. See *id.* at 9-11 (explaining Parliament's power to change the common law).

36. See generally JOHN AUSTIN, *THE PROVINCE OF JURISPRUDENCE DETERMINED* (Wilfrid E. Rumble ed., Cambridge Univ. Press 1995) (1832).

37. See, e.g., COSGROVE, *supra* note 33, at 28 (explaining that in this view, "[t]he common law . . . comprised an internally consistent body of precedents whose systemization proceeded from the application of induction and logic").

38. See, e.g., *id.* ("Once identified, . . . legal principles then became subject to a deductive process in which the judiciary used these rules to decide cases.").

ever did or could exist in fact, this system is at least consistent with the goals of objectivity and predictability in law and disinterestedness in judges.

Moreover, a pure Austinian system of common-law adjudication has been seen as peculiarly appropriate for a free society and a market economy.³⁹ This argument has received important elaboration by the great Nobel-prize-winning economist Friedrich A. Hayek, who noted a strong predilection in the common law for the enforcement of private agreements and the protection of private property.⁴⁰ The latter in particular was not surprising, given the emergence of English common law in the context of highly individualistic systems of local land ownership and control. Whether that was an inherent aspect of the common-law system, as its most famous eighteenth-century expositor William Blackstone claimed,⁴¹ is a harder question. It seems more likely that historical circumstances rather than logical necessity may account for the apparent interdependence of the two ideas.

A common-law system does seem peculiarly well suited to the need in any legal system to respond appropriately to new, exogenous circumstances. In its origins, Anglo-American common law was primarily local, tribal, or customary law, and, probably for this reason, common-law judges have always had a predilection to subsume local custom into decision rules.⁴² This practice provided a basis for the occasional rapid changes that took place in the substance of the common law and helped give it flexibility that is still not inconsistent with the general goal of

39. See, e.g., S. H. BAILEY & M. J. GUNN, *THE MODERN ENGLISH LEGAL SYSTEM* 5 (2d ed. 1991) ("The common law has always been particularly associated with the protection of such matters as personal freedom, rights of property and contract, and individual interests in reputation and bodily security."). As one commentator describes it, "For if there is any virtue in the Common Law whereby she stands for more than intellectual excellence in a special kind of learning, it is that Freedom is her sister, and in the spirit of freedom her greatest work has ever been done." FREDERICK POLLOCK, *THE GENIUS OF THE COMMON LAW* 124 (1912).

40. See HAYEK, *supra* note 7, at 156-59.

41. See ST. GEORGE TUCKER, *TUCKER'S BLACKSTONE* 123 (Paul Finkelman & David Cobin eds., 1996) (1803).

42. See Andrea C. Loux, Note, *The Persistence of the Ancient Regime: Custom, Utility, and the Common Law in the Nineteenth Century*, 79 *CORNELL L. REV.* 183 (1993) (observing that ancient customs practiced by a specific community and geographic region were recognized by common-law judges to constitute local common law for those people and that area).

legal stability.⁴³ As Hayek describes it, a common-law system was especially desirable because it was evolutionary in nature, that is—there were no sudden lurches in legal doctrine (as almost always exist in legislation) creating uncertainties for people relying on the existing law.⁴⁴

The Austinian ideal achieved strong academic and professional support in the United States with the formation of the modern Harvard Law School in 1870 under the leadership of Dean Christopher Columbus Langdell.⁴⁵ 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 (but not codified) into a coherent and comprehensive corpus juris.⁴⁶

The Harvard case method of legal education put almost total emphasis on the reading of common-law appellate cases, the source of definitive precedent.⁴⁷ Well-trained lawyers, from whom the judges were selected, understood both the controlling precedents in every field of law and the process by which new fact situations were resolved.⁴⁸ They were thus also imbued with the philosophy of private property and freedom of contract firmly embedded in nineteenth-century Anglo-American common law. Nevertheless, attractive as this Austinian scheme might appear both philosophically and aesthetically,⁴⁹ and even

43. See *id.* at 183-85.

44. See HAYEK, *THE ROAD TO SERFDOM* 72-74 (1944).

45. See COSGROVE, *supra* note 33, at 25-58; see generally Anthony Chase, *The Birth of the Modern Law School*, 23 AM. J. LEGAL HIST. 329 (1979) (documenting the origins of the modern Harvard Law School).

46. See COSGROVE, *supra* note 33, at 27-33; Chase, *supra* note 45, at 332, 346-48.

47. See Chase, *supra* note 45, at 329-30 (describing the case method of legal education); see also Charles W. Eliot, *Langdell and the Law School*, 33 HARV. L. REV. 518, 523 (1920) (“Dean Langdell thought that English and American law should be studied by itself without admixture of other subjects, such as government, economics, international law, or Roman law[.]”).

48. See generally Franklin G. Fessenden, *The Rebirth of the Harvard Law School*, 33 HARV. L. REV. 493 (1920) (describing the Harvard case method).

49. One is tempted to add “but not intellectually,” because there was nothing about nineteenth-century opinions that one could term “scientific” today. Judges made little effort then to address the logic of a particular rule of law or to analyze different rules in terms of their economic costs or benefits. The late-Nineteenth Century, however, was a period of grand moralizing on the part of many American courts, though one would hardly call their rhetoric analytical or scientific. Nevertheless, Judge Richard Posner, in one of his most controversial conclusions, has stated that nineteenth-century common-

assuming (perhaps heroically) that it did in fact exist, it was not to survive long into the Twentieth Century, and it certainly bears very little relation to what American courts do today.

B. *The Breakdown*

The most powerful source of dilution of the older structure in American law 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, especially at the federal level. Although the doctrine of precedent still had a small role to play in the interpretations 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.⁵⁰ Interpretation of federal statutes became the dominant part of federal civil litigation, and the techniques for statutory interpretation bore little resemblance to the techniques of common-law reasoning.⁵¹ It goes without saying, of course, that this regulatory legislation was anti-free-market in almost every respect.

As America in the 1930s moved rapidly away from the laissez-faire orientation of the Nineteenth 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 administrative agencies' interpretation of the authority

law judges generally reached economically efficient conclusions—that is, that their holdings were consistent with a social wealth-maximization goal. See RICHARD A. POSNER, *ECONOMIC ANALYSIS OF THE LAW* 254-55, 523-24 (4th ed. 1992) (common-law doctrines are efficient). His critics have claimed that this merely reflected the generally laissez-faire attitude of most nineteenth-century American judges, and others have denied that the "efficiency" conclusion is correct as a matter of fact. See, e.g., Eric A. Posner, *Law, Economics, and Inefficient Norms*, 144 U. PA. L. REV. 1697, 1704 nn.17, 19-20 (collecting criticism). It should be noted, however, that Judge 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. Private property and freedom of contract is, in effect, a recipe for a free market, and there is no reason to think that it would not generate economically efficient results, even if the judges did not clearly understand or intend that result.

50. See Cass R. Sunstein, *Interpreting Statutes in the Regulatory State*, 103 HARV. L. REV. 405, 409, 462-508 (1989) ("The demands of the modern administrative state ultimately made it impossible for courts to sustain a theory of interpretation rooted in nineteenth-century common law.").

51. See *id*

granted by Congress, but ultimately this battle was almost completely won in the United States Supreme Court by the advocates of administrative discretion.⁵² Although the courts do still impose some procedural restraints, primarily of a constitutional nature, on administrative agencies,⁵³ American administrative law is no longer substantially different than that of civil law, where there has long been a great deal of substantive discretion on the part of regulators and little opportunity for significant judicial oversight.⁵⁴

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, it was exclusively the political superiority of the regulatory system that caused it to win the day, and it was and remains peculiarly attractive to politicians because of its ability to generate economic rents and therefore political power.

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 flexible development can flow. The doctrine of precedent was also considerably weakened by the fact that the United States Supreme Court lost interest in having its own powers restrained by a strong doctrine of precedent.⁵⁵ Once this previously self-enforced restraint was gone from the Supreme Court, there was no power that could reassert the primacy of the old idea of the

52. See *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 842-45 (1984) (requiring courts to defer to an agency's interpretation of a statute unless Congress has directly determined the issue under consideration).

53. Primarily these are the "due process" requirements of "notice" and "hearing," notions also enshrined in the federal Administrative Procedure Act. See 5 U.S.C. § 551 *et seq.* (1996). Clearly the courts are sometimes able to manipulate these procedural requirements to achieve a preferred substantive result.

54. See generally John Gillespie, *The Role of the Bureaucracy in Managing Urban Land in Vietnam*, 5 PAC. RIM L. & POL'Y J. 59, 114 n.351 (1995) (citing sources comparing the evolution of judicial review under the Anglo-American tradition with the judicial review of administrative law under civil-law traditions).

55. As Judge Bork describes it, "The New Deal Court swiftly began overruling or ignoring precedent, some of it of fifty years' standing, and often did so by five-to-four votes." ROBERT H. BORK, *THE TEMPTING OF AMERICA: THE POLITICAL SEDUCTION OF THE LAW* 156 (1990).

rule of law—especially those parts of it that had emphasized the sanctity of private property and private contractual arrangements. Accordingly, although 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 effectively lost. Along with it, the almost mystical regard for precedent that earlier courts displayed was also lost.

C. *Legal Education*

There were intellectual as well as political pressures leading the United States further away from the legal culture that had 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.”⁵⁶ 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.⁵⁷ Judges were not so disinterested as that theory held, and they manifestly understood techniques for writing new law in fact while appearing to follow precedent.⁵⁸ This cynical view of judicial efforts undoubtedly involved considerable exaggeration by the legal realists, but it had a very profound impact on the thinking of American judges, as the Realists were in effect praising this violation of traditional Austinian norms, not criticizing it. They suggested that judges could largely ignore the strictures of precedent and case law reasoning explicitly when this was necessary to reach a more desirable end result.⁵⁹

56. See generally LAURA KALMAN, *LEGAL REALISM AT YALE 1927-1960* (1986); John Henry Schlegel, *American Legal Realism and Empirical Social Science: From the Yale Experience*, 28 *BUFF. L. REV.* 459 (1979).

57. See generally ANTHONY T. KRONMAN, *THE LOST LAWYER: FAILING IDEALS OF THE LEGAL PROFESSION 170-225* (1993) (describing the development of legal realism and its critique of Langdell's Harvard method).

58. See BORK, *supra* note 55, at 69 (“The Yale thesis, crudely put, is that any judge chooses his results and reasons backward.” (quoting Arthur M. Schlesinger Jr., *The Supreme Court: 1947*, *FORTUNE*, Jan. 1947, at 201)).

59. See, e.g., Roscoe Pound, *Stare Decisis*, in *LAW FINDING THROUGH EXPERIENCE AND REASON: THREE LECTURES* 23, 42-43 (1960) (rejecting judges “serving as passive instruments through which mathematical formulas and mechanical laws realize themselves in the eternally appointed way[.]” while embracing “social engineers upon the bench and in the law schools.”) (internal quotations omitted).

Academics were even more impressed by Legal Realism's sanctioning of non-Austinian approaches than were the early judges. In their teaching and writing, American law professors began rapidly moving away from the exclusive consideration of appellate cases advocated by Langdell. In turn, the titles of books used in law classes were changed from the descriptive, Langdellian "Cases on . . ." to "Cases and Materials on . . ."⁶⁰ Because few law professors were actually trained specialists in other fields, the "materials" often tended to be an incredible mishmash of pseudo-social science, pop-psychology, vacuous moralizing, rank ideology, 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 private property and contracts.

This new attitude of the leading academics reinforced, and in time heavily influenced, the attitudes of American judges. They too came to believe that they were not and should not be 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, and generally left gaping lacunae for courts and agencies to fill. Thus, the flood of new law added to the uncertainty created by relaxed judicial standards, all with little attention paid to the economic costs of this new and largely unrationalized system of jurisprudence.

D. *The Lawyers*

This growth in the size of the corpus of law, produced both judicially and legislatively, had a heavy impact on the behavior of lawyers and judges. From the late 1960s until the present, a period of little more than 25 years, the life of a typical successful lawyer in America (perhaps outside of the criminal law area) has changed more dramatically than it did in the previous 200 years.

60. Compare, e.g., CHRISTOPHER COLUMBUS LANGDELL, *LAW OF CONTRACTS* (1879), and SAMUEL WILLISTON, *A SELECTION OF CASES ON THE LAW OF CONTRACTS* (1903), with CHARLES KNAPP & NATHAN M. CRYSTAL, *PROBLEMS IN CONTRACT LAW: CASES AND MATERIALS* (3rd ed. 1993).

Part of the success of, and nostalgia for, the old system of law was related to the small scale of the entire legal enterprise. Consistent with the free-market orientation of the older system, 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 usually 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 unspecialized legal materials.

Perhaps another way of identifying that characteristic, as was done by Judge Richard A. Posner in his excellent recent book *Overcoming Law*, is to say that lawyers did not seriously compete with one another, either in price or in the quality of service.⁶¹ Posner shows how the profession bore a great deal of resemblance to a medieval guild.⁶² This system, however, was unable to cope with the enormously increased demand for legal services resulting from the late-Twentieth Century's growth of law.⁶³ Because individuals could not greatly increase their own production of legal service, the only way the market could respond to an increased demand for legal services was by increasing the number of lawyers, typically through growth of existing law firms.⁶⁴

The five largest law firms in the United States 30 years ago each had fewer than 200 lawyers, and there were not many more that had reached the exalted ranks of firms with more than 100 lawyers.⁶⁵ Today there are several firms with more than 1,000 lawyers, and there are nearly 20 firms with more than 500 lawyers.⁶⁶ 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.

61. RICHARD A. POSNER, *OVERCOMING LAW* (1995).

62. *See id.* at 39-44.

63. *See id.* at 44-45.

64. Another characteristic of legal practice today, also probably reflecting greater economic efficiency, is a high degree of specialization. *See* KRONMAN, *supra* note 57, at 288 ("The demand for greater specialization is pervasive in the law today . . ."). Very few lawyers in the United States today are anything like the generalists of 50 years ago, and law schools have begun offering specialized degrees in various fields of law.

65. *See id.* at 274.

66. *See The Am Law 100: Record Profits and Double-Digit Growth*, AMERICAN LAWYER, July/Aug. 1997, at 7-10 (listing the number of lawyers in each of the "top 100" law firms).

With this growth in the number of providers of legal services, there was no way to prevent intense competition for business from developing. As a result, characteristics of the modern American legal profession are dramatically different from what had previously existed. The relaxed, personal relationships that once existed within the profession and between lawyers and important clients are almost a thing of the past today. The new "business" (still a pejorative term among many lawyers) attitude is reflected in such competitive phenomena as negotiated fees, great mobility of lawyers among firms, frequent movement of clients from one firm to another, advertising, firm bankruptcies, and the frequent restructuring of law firms.⁶⁷ All of this has resulted in 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, but few understand that their discomfort ultimately results from political forces that radically altered the entire legal system.

The American legal system today has traveled perhaps more than halfway from its strict nineteenth-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 often seem to be doing substantively the same thing.

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

67. For example, the venerable 126-year-old law firm Mudge, Rose, Guthrie, Alexander & Ferdon called it quits after losing 30 members of their litigation department, including a top producing partner, to Latham & Watkins. See Amy Stevens & Edward Felsenthal, *Lawyers and Clients: Mudge Rose to Meet Today on Dissolution*, WALL ST. J., Oct. 2, 1995, at B1 (attributing the collapse, in part, to the firm remaining too "passive and genteel," keeping unprofitable partners, and failing to develop business as other "large modern law firms" had). Lord, Day & Lord, Barret Smith, another venerable old firm, also recently collapsed.

well-documented.⁶⁸ Their efforts are devoted as much to training lawyers who have a "correct" set of political and ideological ideas as to training them in the traditional skills of 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. To gain the full economic benefits of a rule of law, more is required than integrity among the participants, necessary as that may be.

IV. WHERE DO WE GO FROM HERE?

The previous discussions have been efforts to establish two lessons. The first is that an effective rule of law is an extremely valuable, indeed almost essential, complement to a functioning market economy. The second is that current American legal institutions should not be taken as obvious guideposts for other countries trying to establish a more efficient free-market system through adjustments to the judicial process. In many ways, American law is at a crossroads not unlike that confronting a variety of other more-or-less capitalist regimes in the world.

The traditional and naive idea of the rule of law, as epitomized by nineteenth-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 although 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. Finally, there is no strong intellectual pressure for a return to anything like the old common-law jurisprudence.

The higher costs of the "new" legal system that has evolved in the United States will remain with us until there is some change. Business decisionmakers will confront increasing uncertainties that translate into higher costs of doing business; property

68. See, e.g., Arthur Austin, *The Top Ten Politically Correct Law Reviews*, 1994 UTAH L. REV. 1319 (1994) ("Political Correctness ('P.C.') has infiltrated legal education. Feminist politics, race consciousness, and white male trashing are as familiar as civil procedure.").

owners will continue to lose value (and therefore reduce investments) as the range of their ownership rights continues to be narrowed; contracts will have less value as their enforceability becomes more problematic. Clearly, the greatest benefit that any government in the world today could offer its citizens is a relaxation of regulatory intrusions into business decisionmaking, private 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. What a government can do to improve the functioning of its judicial process is less certain.

This does not mean, however, that there is nothing that 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 nineteenth-century system of jurisprudence, but that is out of the question, and we must seek a more feasible solution.

As described above, we do have in place some of the necessary attributes of a better system. Most commentators agree, for instance, on the desirability of political independence for all judges, and everyone agrees on the desirability of simple honesty on the part of all judges. A hierarchical system of trial and appellate courts builds in a guarantee of some significant utilization of the doctrine of precedent, because the appellate courts will, in their own self-interest, tend to force that doctrine on lower courts. Furthermore, elected legislatures should have the authority to overrule non-constitutional holdings by the judiciary and to change rules of common law.⁶⁹ That much is relatively easy.

69. We have not examined the doctrine of "judicial review"—that is, the power of any court to declare legislation unconstitutional and therefore void. It can be, of course, a powerful tool for the protection of such property and contract rights as are included in a constitution. Judicial review was a major source of protection of private property in the United States until the New Deal, but its demise at that time shows how politically vulnerable any legal device for the protection of private property may be. Nevertheless, it can be a potent protection against legislative overreaching, and the downside economic risks to a doctrine of judicial review seem small, particularly if it is used in conjunction with something like the legal system proposed herein.

The culture and the implicit rules of the Anglo-American common-law system took at least four centuries to evolve, had less than 100 years of relatively pure practice in the United States, and then largely collapsed over a period of about 30 years. The mechanism was very complex and very delicate; 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—namely, the substantive protection of property rights and freedom of contract—can be achieved judicially in other ways. Judges could simply establish, through case decisions, a set of rules of law consistent with the efficient functioning of a market economy, very much as Judge Posner suggests when he posits “wealth maximization” as the proper objective utility function of judges.⁷⁰ American legal history literature is replete with theories and data suggesting why the results reached by nineteenth-century courts were consistent with the implicit philosophy of a *laissez-faire* economy.⁷¹ However, none of these theories suggests that the judges actually understood enough economics (or even that the science of economics had developed to the necessary point) to allow them to make conscious decisions consistent with modern market economics. Thus, instead of slowly developing an appropriate set of economic laws through an evolutionary common-law system, as Hayek would probably have preferred, it might be possible to start with an idea of a free economic system in order to achieve a legal process that serves that economy’s purpose.⁷²

In effect, what is required is that courts understand and enforce only those rules that are consistent with the philosophy of a free-market economy. Generally speaking, we know the characteristics of that economy: private property, enforceable contracts, and very little economic regulation. How then should courts behave in order to develop laws consistent with these goals?

In the first place, courts would obviously be aided in this endeavor by a clear constitutional mandate for a free economy,

70. See POSNER, *supra* note 49, at 23.

71. See generally KERMIT L. HALL ET AL., *AMERICAN LEGAL HISTORY* 354 (1996) (referring to *laissez-faire* constitutionalism of the Nineteenth Century).

72. Certainly this suggestion parallels the history of the interactive development of the modern administrative state and modern administrative law.

the kind many people thought we had prior to the 1930s.⁷³ This might include an explicit provision to forbid the government from directly or indirectly taking private property or reducing its value without compensation; a guarantee of limited, proportional taxation; a provision relating to the sanctity of private agreements; and some kind of restraint on monopoly-creating economic regulation. If their enforcement could be assured, such provisions would guarantee a free-market economy. Such provisions are rarely self-enforcing, however. Accordingly, a constitution should provide specifically for judicial review of legislative and administrative actions.

Even without a logical but difficult-to-achieve 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 prerequisites would be required: first, some legislative clarification that a free-market economy was a matter of national policy;⁷⁴ 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 neo-classical economic theory. Certain fundamental ideas from this body of economic doctrine would be essential to allow a judge to function in this new legal milieu, and these tools would have to become as much a part of the current legal system as the doctrine of precedent was in the Nineteenth Century.⁷⁵ These core notions would include such standard apparatuses as demand elasticity, economic cost concepts (including opportunity cost), production functions, property rights (the economic, not the traditional legal concept—that is, the objective characteristics of “ownership”), transactions costs, the nature and formation of market prices, competition and

73. See generally MARK L. POLLOT, GRAND THEFT AND PETIT LARCENY: PROPERTY RIGHTS IN AMERICA 11 (1993) (“More than twenty provisions of the Constitution directly or indirectly concern themselves with the protection of property and economic rights.”)

74. Arguably, the courts could enforce free-market outcomes without a legislative mandate, but it would certainly be more politic to have one.

75. This approach is hardly politically feasible at present in the United States. Nevertheless, its attraction may become more obvious as the total failure of socialist ideas becomes more apparent to intellectuals.

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 training can probably be substantially accomplished in four to six weeks of intensive course work.

What would these new economists-judges be able to do? First, and perhaps most important, they would begin to understand the true function of rule of law in a free society. Judges would believe that they are not there to regulate individuals' behavior in accordance with the judge's own preferences, but rather to enforce the free choices, private contracts, and reasonable expectations of the parties. In my experience, this "philosophic" change in the attitude of judges who have studied some market economics is one of the more remarkable, and frequently unexpected, results of this kind of education. Unfortunately, this education alone, without any pressure from the legislature or strong intellectual support, may not be enough to encourage judges to recognize the value of the field of law and economics to their proper role.

Unfortunately, the truth is that in universities the world over, the tremendous analytical power and insights of market economics are unappreciated. 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, 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 influence judges and generate useful substantive 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 could fully understand the terms of such agreements. Courts have 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 them. As a result, courts may vary the terms of the agreement as they think fairness requires. 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 economic nature of contracts, competition, and market forces, however, they would have been much less willing to substitute their own views of fairness for the agreements before them. Such agreements are in fact an evolutionary result of ongoing efforts by sellers to induce buyers to deal with them, not efforts to "trick" consumers. 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 should not be enforceable because the buyer does not understand metallurgy or the physics of internal combustion engines or tire-road friction. 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.⁷⁶ Open markets, advertising, reputation, and experience are the real 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 or whatever protection against loss the person provided for himself or his family. The operative rules were in fact quite consistent with a "let-the-buyer-beware"

76. See Armen A. Alchian, *Uncertainty, Evolution, and Economic Theory*, 58 J. POL. ECON. 211 (1950).

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 insurers of consumers’ welfare.⁷⁷

What the courts did not understand was that they were requiring consumers in effect to purchase an insurance policy along with every item they bought, 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 that that person assumes and consistent with the degree of risk aversion of that individual. There is no way that a mandated system of “tying” an insurance policy with consumer goods can possibly cost as little as the older, “unbundled” approach to the problem. Because 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, whether that is what they wanted or not. 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 all but the tiny few who win lawsuits.

A third illustration is taken from the first area of law in which economic analysis was explicitly used in the law: antitrust. Indeed, antitrust 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.⁷⁸ Today most courts

77. See James P. Hackney, Jr., *The Intellectual Origins of American Strict Products Liability: A Case Study in American Pragmatic Instrumentalism*, 443 AM. J. LEGAL HIST. 446 (1995) (referring to the general adoption of strict products liability in the 1960s).

78. An early case involved IBM’s efforts to tie the sale or lease of its patented machine to the buyer agreeing to use IBM’s computer cards in those machines. See *Int’l Bus. Mach. Corp. v. United States*, 298 U.S. 131 (1936). Writing for the Court, Justice Stone held that this “tying” created a new and illegal monopoly in the cards and foreclosed competition for that business. See *id.* at 135.

understand, and conclude, that such tying can and ordinarily does have highly desirable competitive implications.

To reach the most efficient level of production of a monopolized product, we would want the seller to engage in so-called multi-part 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 full (legal) monopoly rent, but the market would do a more efficient job of signaling the appropriate allocation of input resources, and more consumers would be satisfied. Today, because of a greatly increased understanding of the economic implications of similar arrangements, most tying contracts are legal. Everyone is better off as a result.⁷⁹

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 become.

Apart from the obvious difficulties (but not impossibility) of instituting such a regime, there is a danger that when the courts believe more explicitly that it is in their power to generate "better" legal results, they may tend to become abusive of their power. However, not only is this danger probably no greater than the judicial activism we experience today, but there also would be a self-correcting mechanism that does not exist today. An understanding of the nature of a market economy by the general legal community will itself act as a constraint on judicial overreaching. Just as it happened in the Nineteenth Century with the common-law process, a sense of what constitutes appropriate craftsmanship for deciding cases will develop. Academics will have a somewhat objective test by which to criticize the work of judges. Possibly this will even affect the attitudes of legislators. This development, in turn, will constrain judicial activism (in this case, meaning the utilization of criteria other than those provided by market economic standards).

79. See ROBERT H. BORK, *THE ANTITRUST PARADOX: A POLICY AT WAR WITH ITSELF* 382-401 (1978).

V. 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 the benefits of a free society. We have seen that a "rule of law" is a complex phenomenon, that includes 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 United States in the Twentieth Century and does not promise to be revived.

From this history we can learn a great deal. We can see that certain mechanical devices, including 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, nineteenth-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 neo-classical 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 judicial sanity of the nineteenth-century common law.

