

# A PROPERTY RIGHTS APPROACH TO JUDICIAL DECISION MAKING

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## I. Introduction

Ronald Coase's discussion of the railroad train strewing sparks as it steamed its way across the English countryside has had a profound effect on the way we think about the law.<sup>1</sup> The relevance of Coase's model to torts and environmental law is clear, and it has been widely applied in those fields.<sup>2</sup> His treatment of the problem of social cost, however, provides a useful approach to a much wider range of legal problems. In this paper I briefly restate his basic points, supplement them with Harold Demsetz's theory of property rights, and apply the result to a number of different legal issues.

Professor Coase specifically examined "those actions of business firms which have harmful effects on others."<sup>3</sup> One example is the situation in which sparks from a locomotive set fire to crops along the track. Most would instinctively conclude that the railroad had "caused" the losses resulting from these fires. A court sharing these instincts and confronted with a tort action by farmers whose crops had burned would probably make the railroad pay the entire loss. When we finish reading Coase however, we know that the loss was

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<sup>1</sup>Ronald Coase, "The Problem of Social Cost," *Journal of Law and Economics* 3 (October 1960): 1-44.

<sup>2</sup>See, for example, William M. Landes and Richard Posner, "Causation in Tort Law: An Economic Approach," *Journal of Legal Studies* 12 (January 1983): 109-34; John Brown, "Toward an Economic Theory of Liability," *Journal of Legal Studies* 2 (June 1973): 323-50; Mark Grady, "Proximate Cause and the Law of Negligence," *Iowa Law Review* 69 (January 1984): 363-450; Mark Grady, "A Positive Theory of Negligence," *Yale Law Journal* 92 (April 1983): 799-830 and authorities cited in Grady, "Proximate Cause," notes 1-3.

<sup>3</sup>Coase, "Social Cost," p. 1.

“caused” just as much by the flammables along the track as it was by the sparks.

Coase showed that the configuration of crops grown along the track and the steps taken by the railroad to control spark emissions will be the same no matter how the court decides the case, as long as the costs of dealing between the railroad and the adjoining farmers are low.<sup>4</sup> Suppose the court held the railroad liable. If it were cheaper to install spark arresters than to pay the farmers to leave a strip of land fallow along the tracks, a rational railroad would install them. If the opposite were true, however, the railroad would presumably pay the farmers to leave the strip fallow.<sup>5</sup>

Suppose, however, that the railroad is absolved. If it is cheaper to leave the strip fallow than stop the sparks, the farmers will leave the strip fallow rather than have their crops burned each year. If the value of the crops that can be grown on the strip exceeds the cost of spark arresters, however, the farmers would be smart to plant the strip in crops and pay the railroad to stop the sparks.

The solution to the conflict between the railroad and the farmers need not involve all spark arresters and no strip of fallow land or vice versa. A combination of steps by both parties to reduce the cost of fires is in fact more likely. If transaction costs are low, there is no reason to suppose that the parties will not reach a solution that leaves them all about as well off as they could be under the circumstances.<sup>6</sup> When the parties improve their own positions in this way, they also increase the total wealth of society as a whole.

While Coase dealt specifically with harmful externalities, his analysis also is relevant to beneficial externalities. Either type of externality produces a misallocation of resources as compared to that which would exist if the externality could be efficiently eliminated.<sup>7</sup> To the extent that it is cost effective, therefore, judicial (and other public) decisions should try to eliminate externalities of both types.

We can extract three guides for judicial decision making from this elementary story of sparks and crops. Judicial decisions would make

<sup>4</sup>More precisely, given zero transaction costs, the allocation of relevant resources would be the same no matter how the court decided the case. See Coase, “Social Cost,” pp. 6–7. See also, Harold Demsetz, “Toward a Theory of Property Rights,” *American Economic Review* 57 (May 1967): 347–73.

<sup>5</sup>One way for the railroad to do this, of course, would be to buy such a strip of land from those who own land adjoining the tracks.

<sup>6</sup>See Elizabeth Hoffman and Mathew Spitzer, “The Coase Theorem: Some Experimental Tests,” *Journal of Law and Economics* 25 (April 1982): 73–98.

<sup>7</sup>Externalities could be “efficiently” eliminated whenever the costs of doing so were less than the benefits.

it easier for private parties to reduce the total cost of dealing with reciprocal claims to scarce resources if they (1) defined property rights precisely, (2) unambiguously assigned such rights, and (3) decided cases in ways that otherwise tended to reduce private transaction costs.<sup>8</sup>

An additional guide to decision making emerges from situations in which the costs of dealing in markets exceeds the possible gains from such transactions. A court's decision in these cases is more important than it is in cases where the parties can reallocate resources by private contract. Inefficiencies created by an "erroneous" decision will tend to persist until the legal rule is changed to produce a more efficient result. Even though an inefficient legal rule provides incentives for its future challenge,<sup>9</sup> the social cost of "wrong" decisions will be greater than in those cases where transaction costs are low enough to permit changes by private contract.

Where transaction costs are high, courts could increase society's wealth by assigning property rights as closely as possible to the way in which they would be allocated by the affected parties themselves, assuming that transaction costs were low enough to permit market exchanges.<sup>10</sup> Coase recognized that the government could act as a "super-firm" to raise the value of production in cases where transaction costs were intractably great. He noted that unless the arrangement of rights established by the legal system was the one that brought "about a greater value of production than any other," the costs of market transactions might be so great as to prevent that "optimal arrangement of rights" from being achieved.<sup>11</sup>

The specification of property rights that maximizes social wealth at one time need not produce the same result when conditions change. Harold Demsetz makes this point in his explanation of how private property rights in land developed among Indians engaged in the fur trade.<sup>12</sup> Private property in land was not common among the early American Indians. Not only have anthropologists noted the existence

<sup>8</sup>Increasing the predictability of results in future legal cases is one example of how courts could act to reduce such costs. Professor Coase states: "Of course, if market transactions were costless, all that matters (questions of equity aside) is that the rights of the various parties should be well defined and the results of legal actions easy to forecast." Coase, "Social Cost," p. 19.

<sup>9</sup>See Paul Rubin, "Why Is the Common Law Efficient?" *Journal of Legal Studies* 6 (January 1977): 51-64; George Priest, "The Common Law Process and the Selection of Efficient Rules," *Journal of Legal Studies* 6 (January 1977): 65-83.

<sup>10</sup>See Harold Demsetz, "When Does the Rule of Liability Matter" *Journal of Legal Studies* 1 (January 1972): 13-28.

<sup>11</sup>Coase, "Social Cost," p. 16.

<sup>12</sup>Demsetz, "Toward a Theory of Property Rights," pp. 349-50.

of such property among the Indians of Eastern Canada but they also have shown a close relationship between its development and the rise of the commercial fur trade.

Before the fur trade became important, Indians hunted beaver and other game on commonly held land. Since there was no general control over this hunting, no one had an incentive to invest in increasing or maintaining the stock of game. While there was clearly an externality present (hunting by one Indian could impose some harmful effects on others), it was not a serious problem because there was enough game available to satisfy local demand.<sup>13</sup>

Demsetz suggests that the rise of the fur trade significantly raised the value of furs to the Indians and sharply pushed up the scale of hunting. These changes increased the impact of the externalities associated with hunting on commonly held land. Demsetz says: "The property right system began to change, and it changed specifically in the direction required to take account of the economic effects made important by the fur trade."<sup>14</sup>

The property rights system changed so as to recognize private property rights in land. In Eastern Canada this change reduced the problems associated with overhunting:

Forest animals confine their territories to relatively small areas, so that the cost of internalizing the effects of husbanding these animals is considerably reduced. This reduced cost, together with the higher commercial value of fur-bearing forest animals [as compared with plains animals, which were not associated with private property rights in land], made it productive to establish private hunting lands.<sup>15</sup>

Demsetz suggests that "property rights arise when it becomes economic for those affected by externalities to internalize benefits and costs."<sup>16</sup> He suggests that new property rights will tend to emerge "in response to changes in technology and relative prices."<sup>17</sup> A simple example can be constructed by applying Demsetz's analysis to the case of sparks and crops discussed by Coase. An equilibrium set of property rights that might have been developed between the railroad and adjoining landowners would be upset by changes in technology that made it cheaper to build effective spark arresters. Similar effects

<sup>13</sup>Demsetz states that "these external effects were of such small significance that it did not pay for anyone to take them into account." *Ibid.*

<sup>14</sup>*Ibid.*, p. 350.

<sup>15</sup>*Ibid.*, p. 351.

<sup>16</sup>*Ibid.*, p. 352.

<sup>17</sup>*Ibid.*, p. 348.

would result, for example, from the advent of diesel engines, relative increases in the demand for crops, changes in agricultural productivity and other similar developments.

The effects of these changes would be taken into account by the private transactions of the affected parties if transaction costs were relatively low. If transaction costs were high, however, a change in legal rules would be necessary to reallocate resources efficiently in response to changes in underlying technological or demand conditions. As always, these changes in legal rules would increase social wealth to the extent that they replicate the allocation of resources that would result from the choices of the affected parties themselves, assuming that transaction costs were low enough to permit such choices to be expressed in market exchanges.

*It is useful to apply these ideas to some current problems in anti-trust law, to the question of judicial review of economic regulation, and to some free speech problems under the First Amendment.*

## II. Property Rights and Antitrust Analysis

I want to apply the analysis sketched above to the antitrust law governing relationships between suppliers and their resellers—a law that has been confused and inconsistent for a long time.<sup>18</sup> To lead into that discussion, however, I want to show that the principles outlined above were operative at the very beginning of Sherman Antitrust Act jurisprudence and, indeed, even prior to that time, in the common law of restraint of trade. Once this fact has been demonstrated, it will be evident that the application of these principles to modern antitrust problems is part of a long-honored tradition. It is not simply a recent invention of so-called Chicago economists.

### *The Early Law*

In developing the Ancillary Restraints Doctrine in *Addyston Pipe & Steel*,<sup>19</sup> Circuit Judge William Howard Taft noted that at one time the common law had proscribed all restraints of trade. After a time, however, “it became apparent to the people and the courts” that trade would be improved if certain restraints of trade were enforced. Taft discussed five specific restraints:

<sup>18</sup>See *White Motor Company v. U.S.*, 372 U.S. 291 (1963); *U.S. v. Arnold, Schwinn & Co.*, 338 U.S. 365 (1967); *Continental T.V., Inc. v. GTE Sylvania, Inc.*, 433 U.S. 36 (1977); Wesley J. Liebeler, “Intrabrand ‘Cartels’ Under GTE Sylvania,” *UCLA Law Review* 30 (October 1982): 1–51.

<sup>19</sup>*U.S. v. Addyston Pipe & Steel Co.*, 85 Fed. 271 (6th Cir. 1898).

1. A seller's agreement not to compete with a buyer of a business so as to protect the transfer of good will;
2. An agreement by dissolving partners not to compete in such a way as to reduce the value of partnership assets distributed amongst them;
3. An agreement of partners not to compete with each other or the partnership pending the existence of the partnership;
4. A buyer's agreement not to use property transferred by a seller in competition with the seller;
5. An employee's agreement not to compete with his employer after the end of the employment.<sup>20</sup>

Two important points emerge from Taft's discussion of this change in the common law. First, the recognition of property rights is based on a cost-benefit analysis. Each of the property rights created when the five types of contracts which Taft discussed came to be enforced reduced externalities. By enforcing these contracts, the law permitted the returns from certain activities to be obtained by those who engaged in them, thereby encouraging those activities to be undertaken. These property rights would not have been enforced, however, if the courts had not been able to conclude that the social benefits of the activities encouraged by such enforcement exceeded their social costs. This conclusion flows not only from the reasons that Taft gave for generally enforcing these contracts but also from the reasons that he gave for not enforcing either "naked" restraints of trade or certain of the above contracts when it appeared that they were being used to create a "monopoly."

In considering Taft's explanation of why the common law came to enforce the above contracts, consider first a seller's contracts not to compete with buyers of his business. Taft wrote:

It was of importance *as an incentive to industry and honest dealing in trade* that, after a man had built up a business with an extensive good will, he should be able to sell his business and good will to the best advantage, and he could not do so unless he could bind himself by an enforceable contract not to engage in the same business in such a way as to prevent injury to that which he was about to sell.<sup>21</sup>

The inability to create a property right so as to transfer goodwill in connection with the sale of a business would prevent both buyers and sellers from obtaining full returns from their investments. The

<sup>20</sup>Id. at 280-81.

<sup>21</sup>Id. at 280; emphasis added.

sellers would not be able to transfer the goodwill they had created while operating the businesses. This would reduce the number of businesses sold and reduce the investment in producing customer satisfaction that creates goodwill in the first place. The inability of buyers to obtain a return on their investment in purchased goodwill would reinforce both of the effects just described. The existence of these externalities would reduce consumer welfare. It appears that the benefits of a system of property rights that eliminates these externalities without producing other harmful effects exceeds its costs.<sup>22</sup>

The cost-benefit underpinnings of property rights also are shown by the types of arrangements that the law refused to countenance. Taft noted that contracts to sell a business and its goodwill or to create a partnership or corporation would be illegal if they were “only part of a plan to acquire all the property used in one business by one management with a view to establishing a monopoly.”<sup>23</sup> The mere tendency of the provisions of a contract to restrain competition, however, was not enough to make it illegal. There had to be an actual intent to monopolize; the restraint of competition had to be the main purpose of the contract and “the transfer of property and good will, or the partnership agreement, . . . merely ancillary and subordinate to that purpose.”<sup>24</sup>

Taft also held naked restraints of trade to be illegal. Naked restraints were those not ancillary to the main and lawful purpose of a contract or those that were broader than necessary to protect the parties in effecting that main purpose. Today these arrangements are illegal per se; they have a potential to restrict output and do not have any significant efficiency creating capacity.

<sup>22</sup>The fact that the recognition of property rights turned on the outcome of a social cost-benefit analysis also appears from Taft’s treatment of agreements not to compete among partners who were dissolving their relationship. He wrote: “It was equally *for the good of the public and trade*, that when partners dissolved, and one took the business or they divided the business, that each partner might bind himself not to do anything in trade thereafter which would derogate from his grant of the interest conveyed to his former partner.” *Id.* at 280; emphasis added.

Enforcing contracts like this eliminated externalities. Taft’s focus on “*for the good of the public and trade*” clearly indicates his view that the common law came to enforce such contracts between dissolving partners because the effect was to reduce net social costs or to increase net social benefits. Similarly, enforcement of agreements between partners not to compete pending the existence of the partnership was justified on the grounds that it would promote the formation of businesses “useful to the community.” *Id.* at 280–81.

<sup>23</sup>*Id.* at 291.

<sup>24</sup>*Id.*

Agreements aimed at monopoly of the type discussed above<sup>25</sup> and naked restraints of trade have one thing in common: It is almost certain that their social costs will exceed their social benefits. Their very purpose is to create external harmful effects that would be eliminated if transaction costs were low enough to allow the interests of all affected parties to be taken into account. In holding them to be illegal, the law eliminated externalities and moved toward a more efficient allocation of resources.

The second important point to emerge from Taft's discussion is that the common law changed in response to underlying social and economic conditions in ways that were consistent with Demsetz's hypothesis that "property rights arise when it becomes economic for those affected by externalities to internalize benefits and costs."<sup>26</sup> As Taft noted, "After a time it became apparent to the people and the courts that it was in the interest of trade that certain covenants in restraint of trade should be enforced."<sup>27</sup> Taft did not mean by this that hitherto obscure ideas had suddenly become clear. He meant, rather, that conditions had changed so that the benefits of enforcing these contracts—at least where monopoly was not involved—came to exceed the costs.<sup>28</sup>

It is not hard to see the general nature of these changes. Society's movement from farms and villages to towns and cities, from *Gemeinschaft* to *Gesellschaft*, had the same kinds of effects as the rise of the fur trade had on the Indians of Eastern Canada. Covenants not to compete so as to facilitate the transfer of goodwill were not needed when the business was handed down from father to son, generation after generation. Indeed, goodwill itself is an asset of greater value in an impersonal society (*Gesellschaft*) than in one where the relevant actors have known each other most or all of their lives and expect to deal with each other again and again in the future (*Gemeinschaft*). Goodwill, or brand-name capital, is a method of providing information about expected future performance. It is not as important in the

<sup>25</sup>Taft seems to have referred to a monopoly whose main purpose is the restriction of output. It is one formed by acquisition and merger, not one that developed through "natural" growth. It must be shown that the acquisitions were only part of a plan to establish a monopoly, and the actual intent to monopolize must appear. If its main purpose is the restriction of output, its costs, by definition, will exceed its benefits. See Oliver Williamson, "Economies as an Antitrust Defense: The Welfare Tradeoffs," *American Economic Review* 58 (December 1968): 18–36; Wesley J. Liebeler, "Market Power and Competitive Superiority in Concentrated Industries," *UCLA Law Review* 25 (1978): 1260–61.

<sup>26</sup>Demsetz, "Toward a Theory of Property Rights," p. 352.

<sup>27</sup>85 Fed. at 280.

<sup>28</sup>*Id.*



village as it is in a society where dealings span wider horizons and where the number of localized repeat transactions is likely to be fewer.

The movement away from the close-knit, traditional relationships of earlier common law times toward a more impersonal, market-oriented society made the older rules *inefficient, just as the development of diesel engines would prompt a revision of the relationship between the railroad and the adjoining farmers. New externalities developed or became more pronounced. As a result new opportunities for gains from trade appeared; it became economic for the affected parties to internalize benefits and costs. The common law changed its views on the value of certain restraints of trade because their social value had in fact changed.*

We can see from *Addyston Pipe* that from the very beginning of antitrust jurisprudence, the question of what property rights the legal system would recognize was resolved on the basis of cost-benefit analysis. Property rights would be recognized when the social benefits of the activities encouraged by such recognition exceeded their social costs. Another way to view the process described by Taft is to say that the law recognized those property rights that tended to internalize the costs and benefits of economic activities. By doing this the law enabled people to increase consumer welfare by their own voluntary exchanges.

The problems raised by restricted distribution systems are similar to those Taft confronted in *Addyston Pipe*. This is an important point, and once it is understood, attempts to loosen the antitrust strictures against restricted distribution arrangements can be seen as part of an antitrust tradition going back to the very beginnings of American antitrust law.

### *Restricted Distribution Systems*

Lester Telser first described the central economic problem that suppliers attempt to solve by limiting the behavior of their resellers.<sup>29</sup> The clearest legal recognition of this problem appeared in *Continental T.V., Inc. v. GTE Sylvania, Inc.*<sup>30</sup> In this case the Supreme Court noted that restrictions on distributors could be used to induce investment in "promotional activities or to provide service and repair facilities necessary to the efficient marketing of their [the manufacturers'] product."<sup>31</sup> The Court said:

<sup>29</sup>Lester Telser, "Why Should Manufacturers Want Fair Trade?," *Journal of Law and Economics* 3 (October 1960): 86-105.

<sup>30</sup>433 U.S. 36 (1977).

<sup>31</sup>433 U.S. at 55.

Because of market imperfections such as the so-called “free-rider” effect, these services might not be provided by retailers in a purely competitive situation, despite the fact that each retailer’s benefit would be greater if all provided the services than if none did.<sup>32</sup>

The “so-called ‘free-rider’ effect,” of course, is an externality. In Telser’s paradigm, one retailer provides point-of-sale product information to a consumer, and the consumer takes it and buys the product from another retailer who offers lower prices because it does not incur the costs of providing such information. The case of *Klor’s, Inc. v. Broadway-Hale Stores, Inc.*<sup>33</sup> provides a striking example of this effect. In this case the Broadway maintained a showroom to display major household appliances. Klor’s sold the same appliances next door, from a store that had nothing in it but catalogs. No extended explanation is needed to understand the problem created by this arrangement.<sup>34</sup>

The free rider problem can be solved if some sort of property right can be created in the product information produced by individual distributors. The externality can be eliminated if resellers who produce information can exclude other distributors from its use.

It is a mystery why the law has made this so difficult to do, but it has.<sup>35</sup> Manufacturers seek to induce the production of product information by retailers because they believe that some consumers wish to purchase it. There is no reason to suppose that resources used to produce such information are inherently less productive than resources devoted to the production of consumer satisfaction (goodwill) in general.<sup>36</sup> Even if there were such a reason, it would not make sense for the law to prevent parties from obtaining a full return on their investment in the former. Only by facilitating such a return can we

<sup>32</sup>Id.

<sup>33</sup>359 U.S. 207 (1959).

<sup>34</sup>Problems such as this one will be more severe—that is, will cause greater externalities—as consumer products become more complex and as consumer income increases. Other things being equal, high-income consumers will be more likely than lower-income consumers to buy product information than produce it for themselves. The Demsetz theory of property rights suggests that changes such as this (increased product complexity and increased value of consumer time) will tend to prompt a change in the property rights system in locally produced product information. This may help explain the persistence that suppliers seem to demonstrate in getting their resellers to produce this sort of information.

<sup>35</sup>See, for example, *Monsanto Co. v. Spray-Rite Service Corp.*, 104 S.Ct. 1464 (1984).

<sup>36</sup>The problem of “monopoly” or “naked restraints of trade” is no more likely to be present in the latter case than in the former. There is, therefore, just as much reason to recognize property rights in locally produced product information as in general goodwill.

even know how much “promotional activities” at the retail level consumers actually desire, or if they desire any at all.

The approach that Taft used in *Addyston Pipe*, therefore, readily solves the economic problem presented in the restricted distribution cases. When this approach is fully understood, it also becomes clear that that case is legal precedent for the general legality (enforceability) of contracts that parties make to create property rights in local product information. Indeed, *Addyston Pipe* can be viewed as general support for the legality of all business arrangements aimed at eliminating externalities.

### III. Property Rights and Judicial Review of Economic Regulation

The history of the decline of economic due process is too familiar to need recounting here.<sup>37</sup> Many constitutional scholars who otherwise strongly favor market processes oppose significant expansion of judicial involvement in such matters. This is partly because they believe there are no intelligible standards to assess the constitutionality of economic regulation. In the absence of such standards, judges would simply be substituting their own views about the desirability of particular pieces of economic regulation for those of the legislature.

The lack-of-standards argument could be a considerable objection to a renaissance of judicial scrutiny of economic regulation if it were true, but it is not true. In this section I will sketch the standards for judicial review of economic regulation that are implicit in the property rights approach described above.

#### *Standards for Judicial Review of Economic Regulation*

Suppose the Supreme Court applied the same *verbal* standard in reviewing economic regulation that it now applies to regulation of speech and the press.<sup>38</sup> Government restrictions on economic freedom would be unconstitutional unless the government could show that they served a compelling state interest.

Our problem is to provide operational content for the expression “compelling state interest” as applied to economic regulation. It is hard to see how there can be a compelling state interest in adopting

<sup>37</sup>See Bernard H. Siegan, *Economic Liberties and the Constitution* (Chicago: University of Chicago Press, 1980), pp. 3–23. Siegan offers a powerful argument that the courts should expand the scope of their review of economic regulation.

<sup>38</sup>Under the present view, these and other so-called fundamental liberties are thought to be more important than the right to try to earn a living in the calling of one’s choice. See, for example, *City of New Orleans v. Dukes*, 427 U.S. 297 (1976).

an economic regulation that could not make the affected parties better off *in their own view of the matter* than they would have been without the regulation. If this is true, then the first standard that emerges from the analysis outlined above is that there cannot be a compelling state interest in regulation that prevents people from expressing their own choices in situations where there are no persistent, significant third-party effects. There will not be any such effects where affected parties are able to conduct market exchanges at relatively low costs. If the railroad and the adjoining landowners could readily deal with each other on the issue of sparks and crops, there would be no legitimate reason for the state to interfere.

This first standard would outlaw economic regulation unless it addressed situations characterized by significant external costs or benefits and intractably high transaction costs. While this conclusion is perfectly straightforward from an analytical standpoint, its effect is quite far-reaching. It would invalidate an enormous amount of existing regulation and prevent a great deal more. The list of government acts that would be thrown out by this first standard is so long that it makes one ask again if the analysis that leads to it is correct. It is.

A second standard emerges from Coase's suggestion that it might be efficient for government to act as a "super-firm" when there are significant externalities and intractably high transaction costs. Government would make the affected parties best off in such cases if it allocated resources in the same way the parties would if there were zero transaction costs.

This formulation suggests that economic regulation could not be justified unless it produced results roughly consistent with those that the affected parties would reach through private bargains, assuming zero transaction costs. This does not mean that courts should second-guess the state on the general terms of regulation that plausibly meets this test. It does suggest, however, a considerable difficulty in discovering a compelling state interest in regulation that could not plausibly claim to produce effects resembling those that would have emerged from private bargains among the affected parties, assuming zero transaction costs.

This standard implies the existence of three categories of regulation, each of which, interestingly, has an analogue in antitrust law.

Regulation in the first category is like private agreements that are illegal *per se*. It resembles a negative sum game in that it necessarily reduces the total wealth of society. Because it has such an effect, this type of regulation, by definition, could not emerge from dealings between the affected parties in a hypothetical world of zero

transaction costs. Not only is there no compelling state interest in this type of regulation but there is no legitimate state interest in it at all.

A second category of regulation applies to situations in which private transactions might not necessarily take place even in the assumed zero-transaction-cost environment. That is, there may not be any gains from trade available even if transactions could be made at no cost to the affected parties. It differs from the first category of regulation, in which it is known a priori that no mutual gains from trade would be available from private transactions among all affected parties that produced results similar to the regulation, even assuming zero transaction costs. In this second category of regulation, the availability of gains from trade is an empirical question: Such gains may or may not be available. The antitrust analogue is the category of private arrangements the legality of which is assessed under the rule of reason.

Regulation in the third category applies to situations in which significant zero-transaction-cost gains from trade are clearly available. The antitrust analogue here consists of private arrangements that would be legal per se or not be a matter of antitrust concern at all.

The nature of these categories can be made clearer by citing some examples. Regulation in the first category would include state laws which prohibit automobile manufacturers from establishing new dealerships or relocating existing ones without giving notice to existing dealers within the market area. If any of those dealers object, the manufacturer must obtain the permission of a state agency to open the new dealership.<sup>39</sup> Another example is the North Dakota statute requiring a corporation operating a pharmacy to have a majority of its stock owned by registered pharmacists actively engaged in its management and operation.<sup>40</sup> Still another is the Maryland statute prohibiting major refiners from operating retail service stations in that state.<sup>41</sup>

The above regulations were all recently upheld by the Supreme Court, in spite of the fact that the obvious purpose in each was to

<sup>39</sup>See *New Motor Vehicle Board v. Fox*, 439 U.S. 96 (1978). At least 17 other states have adopted similar statutes. For an empirical estimate of the welfare loss prompted by these statutes, see Richard Smith II, "Franchise Regulation: An Economic Analysis of State Restrictions on Automobile Distribution," *Journal of Law and Economics* 25 (April 1982): 125-58.

<sup>40</sup>See *North Dakota State Board of Pharmacy v. Snyder's Drug Stores, Inc.*, 414 U.S. 156 (1973).

<sup>41</sup>See *Exxon v. Maryland*, 437 U.S. 117 (1978). This case, the two cases cited in notes 39-40, and other similar cases are discussed in Siegan, *Economic Liberties*, pp. 191-203.

protect a narrow special interest group from competition. Such regulation creates externalities by establishing a property rights system that necessarily inflicts harmful effects on some *without producing equalizing benefits for others*.<sup>42</sup> Regulation like this involves more than a wealth transfer from one group to another. Like the traditional private cartel that is illegal per se under the antitrust laws, it necessarily produces a net social loss.<sup>43</sup> Coase's description of the government's role as a "super-firm" that could internalize naturally occurring external effects is as far as it could be from the role of the state in adopting this type of regulation.

An example of regulation in the second category may be found in *Linmark Associates v. Township of Willingboro*.<sup>44</sup> This case involved a successful challenge to the constitutionality of a local ordinance that prohibited the posting of "For Sale" or "Sold" signs on property within the township. The existence of condominiums or private subdivisions where developers offer provisions even more restrictive than the *Willingboro* ordinance suggests that gains from trade might have been available to the affected parties (had they been able to interact in our hypothetical zero-transaction-cost world).

The third category includes regulation dealing with situations in which significant gains from trade are clearly available, again assuming zero transaction costs. Properly designed regulation in this context would conform to Coase's concept of the "super-firm" that attempts to allocate resources efficiently where both transaction costs and external effects are high. Environmental pollution is perhaps the most obvious example.

My analysis does not answer the question of which, if any, of these three types of economic regulation the courts "should" hold unconstitutional, and this question is certainly one on which reasonable people could legitimately disagree. I do not address the question in detail here because my principal purpose is simply to show that a property rights approach provides considerable guidance to the kind of standards that could be applied to constitutional review of economic regulation were the courts to move in that direction.

<sup>42</sup>It might be appropriate in these cases to view the regulations as a transaction between the benefited special-interest group and the state. The "others" on whom harmful external effects were visited would be those whose interests were not fully taken into account in the transaction by which the regulation was "purchased."

<sup>43</sup>This type of regulation produces allocative losses identical to those produced by private cartels. Indeed, regulation in this first category could be viewed as a cartel established by the state.

<sup>44</sup>431 U.S. 85 (1977).

If the scope of judicial review were expanded, however, regulation in the first of the three categories described above would be, to say the least, a most attractive candidate for increased scrutiny. If the same standard were applied to economic regulation that is now accorded to the so-called fundamental liberties, most or all regulation in the second category and some in the third category would also become constitutionally suspect.<sup>45</sup>

It is hard to disagree with Professors Bernard H. Siegan and Richard Epstein that some expansion of judicial review of regulation that deprives us of important freedoms is in order. The analysis that I have outlined above suggests that state action which produces the same or more harmful effects as private arrangements that would be per se illegal under the antitrust laws would be a good place to start.

#### IV. Property Rights and the First Amendment

Many free speech cases raise the same problem confronted by the railroad and the adjoining landowners. In both types of cases the parties compete for the use of a scarce resource. In Coase's paradigm the railroad wants to emit sparks, which the adjoining landowners do not want. In many free speech cases the parties at whom the speech is aimed view it in the same way that farmers view sparks from the locomotive. They do not want to receive the speech any more than the adjoining landowners want to receive sparks. The problem in all these cases is to find a solution that minimizes the social cost of these encounters.

Coase's solution is just as relevant to free speech cases as it is to the railroad case. Where transaction costs are low, courts should define and assign property rights to assist private parties reach a solution that is most satisfactory to all those involved. Where transaction costs are high, courts should assign rights so as to approximate

<sup>45</sup>Cases in the third category are the only ones that would involve a balancing problem of constitutional dimensions. Cases in the second category, such as *Willingboro*, also will involve balancing, but only on the question of whether the regulation produces net social gains. The constitutional balancing issue will arise only if the existence of such gains is clear and they are significantly large. Here it will be necessary to make some kind of tradeoff between freedom and increased efficiency, and there clearly will be times when the claims of increased efficiency will be paramount over those of freedom. No sensible society, for example, would leave its members free to drive heavily polluting automobiles until it is on the verge of having everyone wear gas masks to survive. At the margin these tradeoffs will be difficult to make. How much economic gain would justify how much restriction of freedom is a question of judgment about which economic analysis has little or nothing to say. My own view is that freedom counts for considerably more than economic efficiency. Happily we do not often have to make the choice between the two.

the result that the affected parties would produce through private bargains in a zero-transaction-cost world.

In this section I consider examples of each case, in the order described above.

#### *Accommodation Where Transaction Costs Are Low*

A series of cases extending from *Marsh v. Alabama*<sup>46</sup> to *PruneYard Shopping Center v. Robins*<sup>47</sup> raises questions about the extent to which owners of company towns and shopping centers can exclude those who wish to speak, picket, or otherwise express themselves. In *Marsh* the Supreme Court held that the owners of a company town could not prevent a Jehovah's Witness from distributing leaflets on its streets. It extended this rule to a privately owned shopping center in *Food Employees Local 590 v. Logan Valley Plaza, Inc.*<sup>48</sup>

The Court later backed away from the proposition that the First Amendment guarantees speakers access to privately owned shopping centers, overruling *Logan Valley* in *Hudgens v. NLRB*.<sup>49</sup> In *Prune-Yard*, however, the Court affirmed the California Supreme Court's holding that the liberty of speech clauses of the California constitution "protect speech and petitioning, reasonably exercised, in shopping centers even when the centers are privately owned."<sup>50</sup>

The Court reasoned quite formalistically in these cases, and as a result it never confronted the underlying conflict that exists between different parties for the use of scarce resources. The majority in *Marsh*, for example, thought the important question was whether the company town was enough like "any other American town" to justify applying the rules governing attempts by municipalities to restrict speech on public property. For example, Justice Hugo L. Black wrote:

Except for [ownership by a private corporation] it [the company town] has all the characteristics of any other American town. The property consists of residential buildings, streets, a system of sewers, a sewage disposal plant and a "business block" on which business places are situated. A deputy of the Mobile County Sheriff, paid by the Company, serves as the town's policeman. Merchants and store establishments have rented the stores and business places on the business block and the United States uses one of the places as a post office from which six carriers deliver mail to the people of Chickasaw and the adjacent territory. . . .<sup>51</sup>

<sup>46</sup>326 U.S. 501 (1946).

<sup>47</sup>447 U.S. 74 (1980).

<sup>48</sup>391 U.S. 308 (1968).

<sup>49</sup>424 U.S. 507 (1976).

<sup>50</sup>23 Cal. 3d 899, 910, 592 P.2d 341, 347; 153 Cal. Rptr. 854, 860 (1979).

<sup>51</sup>326 U.S. at 502-03.



The existence of a sewage system has little to do with the issue. No more relevant was the language in *Logan Valley*. The Court noted the similarities between *Marsh's* business block and the Logan Valley shopping center and concluded that "[t]he shopping center here is clearly the functional equivalent of the business district of Chickasaw involved in *Marsh*."<sup>52</sup>

These similarities are beside the point. Suppose we have two towns identical in all respects except that in one of them the shopping area, streets, and similar resources are "privately" owned, in the sense that their owner can maximize returns from them—that is, will respond to the perceived market demands of interested parties. In the other town those resources are "owned" by the municipality, the representatives of which do not have a direct financial incentive to allocate those resources to their most highly valued uses.

In terms of deciding cases such as *Marsh* and *Logan Valley*, this difference between the two towns is more important than their similarities. When property rights are precisely specified and held in a few hands, transaction costs are likely to be lower than if such rights are not clearly specified or are widely held. Since the owner of the "common areas" of the privately owned town can obtain any increase in value of those resources prompted by his actions, he will act to improve such value until the marginal cost of improvement equals the marginal revenue therefrom. If proselytizing by Jehovah's Witnesses increases the value of the town, the owner of the common areas has a direct incentive to permit it. If not, he has an equally strong incentive to prohibit it.

These direct incentives will not exist where changes in the value of common areas are not visited directly on some utility maximizing entity. They will not, accordingly, be present (or will be reduced) in the usual case, in which common areas are owned by a municipal corporation administered by elected officials. These officials have no particular incentive to determine whether the residents of the town value their peace and quiet more than the Witnesses value their efforts to convert, or vice versa. An optimum resolution of the possible conflict between residents and putative speakers, therefore, is less likely when the common areas are owned by the municipality than when they are privately owned.

If common areas are privately owned and the cost of transactions between that owner and the residents are relatively low, it is hard to see what legitimate interest the government has in intervening. Why would the owner of Chickasaw, Alabama, exclude Jehovah's

<sup>52</sup>391 U.S. at 318.

Witnesses if the affected parties valued the presence of the Witnesses more than their absence<sup>53</sup>

This market system for deciding between the claims of speech and repose is even more relevant to the shopping center cases, in which transaction costs appear even lower, than in the case of the company town. The shopping center tenants want the shopping center to be attractive to prospective customers. If the customers value being accosted by Jehovah's Witnesses while shopping, the stores have every incentive to let their landlord know. Since the shopping center owner wants his tenants to be happy, as long as the benefits of that joy exceed its costs, there is no reason why the landlord would not admit the Witnesses to the shopping center. If these parties believe, however, that shopping will be more pleasant without the Witnesses, as seems likely to be the case, social costs are minimized by their exclusion. The Witnesses are free, of course, to compensate the shopping center and its tenants for the costs that their presence imposes on others, and if they do so, these profit maximizers could be expected to respond accordingly.

It might be argued that the social interest in free speech overrides the above analysis. As a fellow traveler of the libertarians, I have no interest in opposing free speech, but I do believe that the free speech protected by the First Amendment must be speech offered by a willing speaker to a willing audience. That is what Congress may make no law abridging. The First Amendment does not require anyone to listen to a Jehovah's Witness or anyone else.

The problem presented by such cases as *Marsh* and *Logan Valley* is essentially an economic one. It is a problem of measuring choice. The problem arises because audiences are not perfectly divisible. If we could somehow distinguish the shoppers who want to be approached by Jehovah's Witnesses from those who do not, and segregate them in some way so that only those who so desired would be exposed to the Witnesses' message, everyone would agree that no First Amendment problems were involved. No one wants to prevent those who want to receive the message from receiving it. The problem is to avoid the costs that arise when those who do not want to receive the word are accosted.

<sup>53</sup>Suppose the owner is a devout Catholic who places a negative value on the message of Jehovah's Witnesses. He might want to exclude them even if their presence would increase the value of his property, that is, even if the residents on balance prefer to have them present. The owner's vote, however, counts too. Are not the affected interests properly measured if the owner values excluding the Witnesses more than his residents value their being present and he, accordingly, does exclude them? The owner pays for his preferences by forgoing an increase in the value of his property.

Where transaction costs are low and property rights can be precisely specified, the market will solve this problem of allocating scarce resources better than any other method. The decision as to whether to admit the Jehovah's Witnesses is no different in principle from the decision on how best to lay out the location of the stores in the mall. In both cases the shopping center owner and the tenants want to make their customers as happy as possible, as long as the costs of doing so do not exceed the benefits.

The market cannot operate unless the relevant property rights are assigned to some party who can either include or exclude the activity that produces conflicting costs and benefits. A legal requirement that all speakers be admitted to the shopping center creates a situation in which no one has the right to exclude that activity. No matter how much the shopping center owner, the tenants, and the customers want to exclude either speakers in general or particular speakers, they cannot do so. There is no way that private arrangements of any kind can resolve these conflicting claims to the same scarce resource. This suggests that *Marsh*, *Logan Valley*, and *PruneYard* (in the California Supreme Court) were all wrongly decided. The Supreme Court was right when it overruled *Logan Valley* in *Hudgens*.

The foregoing analysis has one other important implication for cases such as *Marsh* and *Logan Valley*. The interests of putative speakers on the one hand and customers or residents on the other could better be accommodated if we permit distinctions between speakers on the basis of the content of their speech. A market in which consumers can buy Rice Krispies in individual boxes rather than by 24-box cases is obviously more efficient than one in which they cannot.

Shoppers in different towns and shopping centers will have different tastes for speech just as they have different tastes for other goods. We all might be happy with the League of Women Voters seeking to register new voters. Responses to the American Nazi Party would be more negative. Other speakers would produce different responses in different places. These varying demands for different kinds of speech cannot be accommodated unless the law is capable of making distinctions on the basis of content.

An approach that bans such distinctions makes sense when applied to encounters between willing speakers and a willing audience. That is where true First Amendment problems arise. It does not make sense where we are trying to minimize the social costs of encounters such as those described above. We would recognize immediately the error of a rule prohibiting the railroad from emitting any sparks, coupled with a ban on contracting between the railroad and the

adjoining landowners. So too with a rule that banned contracting and permitted the railroad to emit as many sparks as it wished. If left to contract freely, the railroad and the adjoining landowners would often reach a result in which the railroad reduced its sparks somewhat and the adjoining landowners took some precautions, too.

If the analogy between the railroad paradigm and the conflict between speakers and unwilling listeners is correct, then everyone could be better off if the parties were left to make these decisions on their own. People's preferences will be more nearly matched if we let the market reflect their views on different types of speech.

The shopping center discussion is just one example of the property rights approach to speech issues. For another, consider a problem posed by my colleague Steve Shiffrin, who asks whether, without liability, Mercedes Benz could truthfully advertise that Frank Sinatra drives a Mercedes automobile or whether *Time* could advertise that Sinatra is a regular reader of that periodical.<sup>54</sup> Shiffrin answers his own questions as follows:

Assuming enough disclosure to avoid deception, I think Mercedes Benz and Time, Inc. should have the right to tell the public which public figures buy their products and that the public has a right to be told that information without the permission of the public figure. Few would seriously regard these as intimate details of a public figure's private life. The issue is whether public figures should be able to license (or worse, not license) use of this true information by commercial entities. In the absence of deception, what is being weighed is the freedom to communicate the truth against the creation of a property interest allowing the public figure to control the dissemination of truth for his or her own profit. For those concerned about the "unjust" enrichment of the vendors, I counter that it is "unjust" only if one views the name selling business as more important than freedom of speech. There are good reasons, I think, to create private property rights in items from clothing to cars; and there are good reasons to be debated about the creation of the private property in the means of production. But the creation of a commercial appropriation or right of publicity tort in examples one and four [the Mercedes Benz and *Time* cases] seems to be a clear case of limiting freedom of speech in pursuit of excessive capitalism.<sup>55</sup>

The issues here should not be posed in terms of weighing freedom of speech against the name-selling business (something done for profit). Passing this pejorative formulation, Shiffrin's case involves

<sup>54</sup>Steven Shiffrin, "The First Amendment and Economic Regulation: Away From a General Theory of the First Amendment," *Northwestern Law Review* 78 (December 1983): 1212-83.

<sup>55</sup>*Ibid.*, pp. 1257-58, n. 275.

nothing more than two groups competing for the use of scarce resources, just like the railroad and the adjoining landowners. Sinatra cannot have his privacy at the same time that the public is told about his driving and reading habits. The relevant question in this case is not about free speech; it is whether consumers value the information more than Sinatra does or vice versa. Mercedes Benz and *Time* are middlemen between Sinatra and the public. If *Time* could make more money by advertising that Sinatra reads the magazine, it would be willing to pay almost all of it to Sinatra to get his permission to run the ad. Sinatra will refuse if he values his privacy more than *Time*'s consumers value information about his reading habits (measured roughly by the amount of money *Time* would make by running the ad). That should be the end of the story, but the end can be reached only if Sinatra is given a property right to prevent the use of his name by others.

#### *Accommodation Where Transaction Costs Are High*

Not much need be said about this case, since the analysis parallels the one sketched in Section II above. Courts deciding speech cases involving unwilling parties and high transaction costs should try to reach results consistent with those the affected parties would reach if they could make exchanges in a hypothetical zero-transaction-cost environment.

It is worth noting that the argument against prohibiting content-based distinctions outlined above applies as much when transaction costs are high as when they are low. A legal approach that treats an American Legion parade down the main street of Skokie, Illinois, in the same manner as it treats a Nazi parade is blind to the basic issues involved. I am not suggesting that the Nazis could be prevented from hiring a hall in Skokie and delivering their message to those who might wish to attend.<sup>56</sup> While there are no doubt some externalities involved in that case too, there is no direct attempt to impose a message on unwilling listeners as would be involved in a Nazi march down Main Street. Permitting distinctions based on content would *allow the interests of affected parties to be more closely accommodated than if such distinctions were proscribed.*

## V. Conclusion

It is not surprising that a property rights approach to judicial decision making can help resolve difficult issues in antitrust or in

<sup>56</sup>Content regulation is inappropriate where speakers have taken reasonable steps to protect unwilling listeners from being subjected to the undesired message. The property rights problem is effectively solved by the self-selection process involved in either going to the hall or remaining absent.

reviewing economic regulation. It is more surprising, however, that this cost-benefit approach to establishing legal rules can illuminate difficult free speech issues as much as it does. This approach is as general as it is powerful. The three areas discussed above are only examples of its reach.

Aside from being useful, the property rights approach is attractive because it focuses on voluntary exchange between private parties. Even where transaction costs are too high for such private exchanges to occur, the approach leads courts to try to replicate the result that would occur if such exchanges were possible. It not only provides a mechanism for resolving competing claims to scarce resources but it does so on the basis of individual integrity and personal choice. It is hard to think of an approach for which more could be claimed.

# PROPERTY RIGHTS AND THE JUDICIARY

*Louis De Alessi*

## Introduction

In his paper Professor Liebeler considers judicial decisions that affect the definition, assignment, and exchange of rights to the use of resources.<sup>1</sup> Noting that a decision that facilitates the flow of these rights to their highest-valued use increases the wealth of society, he proposes that the courts apply three criteria to reduce externalities. First, if transaction costs are negligible, the courts should enforce voluntary contracts. Second, if transaction costs are significant, the courts should assign (and enforce) property rights the way the parties themselves would have chosen if transaction costs had been low. Third, if circumstances change, perhaps because of an increase in the demand for some rights or a decrease in the cost of enforcing them, the courts should take account of the change and decide cases with the objective of reducing transaction costs to private parties. Liebeler illustrates these criteria within the context of antitrust and freedom-of-speech cases and argues that legal precedent supports the adoption of his policy recommendations.

Liebeler's application of economic theory is well grounded and straightforward, leaving little scope for critical commentary. Accordingly, after the almost obligatory caveat regarding the distinction between positive and normative economics, this comment will turn to an important issue not addressed by Liebeler: the nature and consequences of the property rights that characterize the judiciary itself.

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<sup>1</sup>Liebeler (1985).

## Positive and Normative Issues

Liebeler's paper is concerned with both positive and normative issues. Keeping them separate avoids two possible pitfalls: (1) rejecting positive analyses on the misconception that they reflect normative values, and (2) accepting normative prescriptions on the misconception that they represent positive conclusions.

Consider first the range of positive analyses, defined simply as the application of economic theory to predict or explain the economic consequences of a change in circumstances.<sup>2</sup> Following Coase (1960), Liebeler examines the effect of differences in transaction costs on the exchange of rights to the use of resources that are fully allocated and privately held. This analysis does not contain any value judgments among its axioms or conclusions. Thus it is purely positive in scope and intent. Following Demsetz (1967), Liebeler next examines the effect of changes in the state of the world on the evolution of institutions used to control the definition, assignment, enforcement, and exchange of rights to the use of resources. This application of economic theory is also value free and represents a simple exercise in positive economics.

On the other hand, consider Liebeler's proposal that the courts, in the presence of significant transaction costs, assign the rights to the use of resources so as to reduce externalities. The assignment of private property rights to one party rather than another affects the welfare of the individuals. Accordingly the proposal clearly entails a value judgment. As Liebeler recognizes, therefore, whether or not the courts should accept the proposed criteria is a normative judgment about which economic theory is silent—keeping in mind, of course, that positive economics generates much of the information used for normative purposes.

Value judgments are a necessary ingredient of any choice. All choices, whether private or collective, ultimately pivot on the subjective value that each chooser attaches to each of the alternatives at hand. Liebeler's proposal that economic efficiency be taken as the dominant criterion in judicial decision making is offered as an alternative to the present welter of special interest regulations and diverse value judgments by judges and other regulators. Viewed from this perspective, the proposal can be attractive, particularly within the context of antitrust whose objective presumably is economic efficiency.

A brief aside on free speech may be useful. Much of the continuing confusion regarding the boundaries of free speech seems to arise

<sup>2</sup>See, for example, De Alessi (forthcoming).



from the failure to distinguish between (1) the governmentally unrestricted right to acquire, through voluntary exchange, the use of resources with which to present a viewpoint to a willing audience (the right, for example, to hire a hall from a willing owner and give a talk to those who choose to attend) and (2) the governmentally enforced right to be given the use of resources with which to express that viewpoint (the right, for example, to be given access to a public building to give a talk or the right to equal time on television). The First Amendment presumably is concerned with (1) rather than (2), a position consistent with Liebler's approach on this issue.

### Property Rights, Incentives, and Judicial Discretion

This section explores the property rights that characterize the judiciary and thus affect the criteria that judges in fact choose to apply in making their decisions. That is, it attempts to answer the question: What are the nature and consequences of the structure of property rights, embedded in judiciary institutions, that determine the incentive structure faced by judges?

The choices of decision makers within business and government organizations are subject to constraints ultimately enforced in the economic or political marketplace (De Alessi 1980). Accordingly individual preferences typically are subordinated, in varying degrees determined by the structure of property rights and the costs of transactions, to the achievement of organizational goals (De Alessi 1982). Constraints within the judiciary appear to be weak and organizational goals unclear, implying that judges enjoy broad discretionary authority.

Consider first the constraints on the federal judiciary (Landes and Posner 1975). Federal judges are appointed by the executive branch; have life tenure, with turnover typically occurring only at death or retirement; receive salaries that are independent of individual performance, whether the latter is measured by case load, quality of decisions, or any other criterion of productivity; and are subject to relatively weak monitoring by the legislature and executive branch, with gross malfeasance or dereliction of duty effectively being the only grounds for disciplinary action or removal.

Although individual performance does not affect the relative salaries of judges within the same cohort (district court judges, for example) it may affect the probability of promotion of lower court judges to a higher court, with the attendant higher income and prestige. The evidence on this point is not clear. Higgins and Rubin (1980) have shown that the probability of being reversed on appeal, a measure of performance, does not provide a constraint. Promotion,

however, is not determined by judges who sit in the higher court and who would view the reversal record of a candidate as an index of the threat he or she would pose to the existing majority coalition. Rather, promotion is determined by government employees within the executive branch who would view a judge's decisions—and reversals—as either good or bad depending upon whether they facilitated or hindered the administration's policies. As Samuels (1975) notes, courts are a political phenomenon.

The formal constraints faced by state and local judges are only slightly more binding than those faced by federal judges (Landes and Posner 1975). State and local judges may be elected rather than appointed, typically have shorter terms of office (only one state has life tenure), typically earn salaries that are independent of performance and lower than those received by federal judges, and are subject to relatively weak monitoring by the legislature and the executive branch. To the extent that a judge comes up for reelection or reappointment, he or she may be expected to be more sensitive to the desires of the appointing authority or the electorate. A recent econometric study of congressional voting behavior, for example, indicates that as reelection time approaches, U.S. senators are more likely to vote according to the wishes of their constituents than according to their own preferences (Kalt and Zupan 1984). Thus state and local judges may be expected to be more responsive than federal judges to political pressure, although they still have considerable scope for discretionary behavior.

The comments so far suggest that pecuniary rewards within the judiciary effectively are divorced from judicial performance. This separation lowers the cost of nonpecuniary sources of utility, and, predictably, judges will consume more of them. Such sources of utility include prestige, power, and the advancement of a judge's own view of the public interest.

In practice the exercise of discretionary authority by federal judges and, at least, state judges seems to be constrained by the legal precedents that characterize a case. New precedents evolve slowly, and typically they are justified at length as correcting a deviation from the proper line of precedents and in any case as reflecting what the law had meant all along.

The maintenance of precedent in the absence of a change in underlying conditions decreases uncertainty and is clearly a "good" produced by the judicial system. Indeed, the establishment and maintenance of precedent is an important capital investment (Landes and Posner 1980). Higgins and Rubin (1980), however, have found that the probability of reversal does not affect the probability of

promotion; thus it is not clear why individual judges have the incentive to be constrained by precedent. Conjectures include competition from other jurisdictions (for example, among federal courts and between federal and state courts) and from the legislature, as well as the existence of nonpecuniary sources of utility, such as prestige. That nonpecuniary considerations matter is suggested by the observation that at least federal and higher-court state judges could receive much higher pecuniary rewards in private practice. Further research, including studies using data provided by the growing use of private judges (Cooter 1983, Rubin 1983), would be useful in providing better insights into judicial behavior.

A number of scholars have examined the extent to which the common law, reflecting judicial interpretation, is efficient in the sense that its rules evolve to yield a more efficient allocation of resources.<sup>3</sup> The findings, however, are mixed and provide little confidence that, at least in recent times, the common law has moved toward efficient rules.<sup>4</sup>

There is also a very extensive literature concerned with the extent to which the law ought to adopt criteria of economic efficiency (for example, the Hofstra Symposium 1980). Much of the debate over efficiency has stemmed from the failure of many legal scholars to grasp the distinction between normative and positive economics (at least some writers appear to view all economics as normative). The debate also has stemmed from the enthusiasm of other legal scholars for the beacon that efficiency provides in an otherwise uncharted and tempestuous sea of ad hoc legal doctrines, from the fascination of economists with welfare criteria, and from some general confusion over the meaning and relevance of efficiency (De Alessi 1983).

Finally, the reason for an independent federal judiciary deserves closer study. It especially should be noted that the degree of independence decreases as the jurisdiction shifts from broader (for example, federal) to narrower (for example, local) levels (Landes and Posner 1975). The importance of an independent judiciary was recognized as early as 1776 by Adam Smith. Such a system, said Smith, would help insulate judges from politics and "make every individual feel himself perfectly secure in the possession of every right which belongs to him" (p. 681). Landes and Posner (1975), meanwhile, have conjectured that an independent judicial system is intended to enforce special interest legislation. Buchanan (1975), commenting on their

<sup>3</sup>See, for example, Posner (1971), Rubin (1977), Priest (1977), Goodman (1978), and Landes and Posner (1980).

<sup>4</sup>See, for example, Komesar (1980).

paper, concurs that the purpose of independence, whatever it may be, is not to provide “unique guardians of some mystical ‘public interest’” (p. 903), and he adds that “ethical norms should not be determining factors in judicial decisions” (p. 903). In a recent conversation with the author, R. J. Staaf built on Smith’s insight and the seminal work by Buchanan and Tullock (1962) to suggest that an independent judiciary effectively enforces fundamental rights through an implicit rule of unanimity: A single dissenting citizen can sue to have a majority-supported legislative act declared unconstitutional.

An independent judiciary, of course, does not imply that judges’ compensation must be independent of performance. Thus, for example, Smith (1937, pp. 677–81) proposed that judges be paid out of fees charged for administering justice. The fees would be collected after a decision had been rendered (thereby providing incentive for speedy decisions) and put into a fund from which each judge would be paid in proportion to the amount of time spent on judicial activities, such compensation apparently being in addition to a small base salary. Smith added that “Public services are never better performed than when their reward comes only in consequence of their being performed, and is proportioned to the diligence employed in performing them” (p. 678).

## Conclusion

The analysis presented in this comment suggests that judges enjoy considerable discretionary authority. Accordingly the instruments available to affect the quality of judicial decision making—especially at the federal level—seem clear: Revise the existing institutional framework to provide a preferred structure of incentives and, more important in the short run, appoint judges whose track record reveals the desired view of the public interest.

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