

## **The Market for Law<sup>1</sup>**

Consider a society in which the production and enforcement of law is entirely private. Individuals contract with rights enforcement firms to protect their rights and arrange for the settlement of legal disputes to which they are a party. Each pair of enforcement firms contracts with an arbitration agency, a private court, to settle disputes between their customers, agreeing to accept and enforce the verdicts. That agreement is enforced by the discipline of constant dealings; an enforcement firm that refuses to accept a court decision against its customers will find few other firms willing to play a game of “heads I win, tails we roll again.”

I described such a set of institutions many years ago,<sup>2</sup> and sketched an economic analysis of the result. Central to that analysis were two claims:

1. The institutions will tend to produce an economically efficient set of legal rules.
2. The stability of the system will depend in part on the number of enforcement agencies, which will in turn depend on up to what size of agency there are net economies of scale. With two few agencies, there is a risk of coordinated action among them to reestablish government with themselves in control.

The purpose of this essay is to expand on those claims in three ways. First is a more precise explanation of the mechanism for generating an efficient outcome. Second is a discussion of inefficiencies to be expected, forms of market failure on the market for law. Third is a discussion of one important source of economies of scale, and its implication for the stability of the set of institutions under different circumstances.

### **I: The Market for Legal Assent**

Consider a potential change in the legal rules prevailing between two enforcement agencies that would yield net benefits to their customers and thus improve the efficiency of the legal system. If the change benefits both sets of customers, it is in the interest of the enforcement agencies either to persuade their arbitration agency to make the change or to shift to one that follows the superior set of rules. If it benefits the customers of one agency but imposes costs on the customers of the other, with net costs smaller than net benefits, it is in the interest of the two agencies to agree to the change, with the loser compensated either directly or by some other change elsewhere in the legal rules. In practice, since it is the arbitration agencies that specialize in legal rules, we would expect them to try to identify all such improvements and include them in the legal codes they offer to their customers.

This argument suggests that any change in the existing set of codes that would produce a net improvement will occur. The result should be a set of legal codes that are economically efficient in the conventional sense.<sup>3</sup>

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<sup>1</sup> Considerable parts of the argument of this essay can be found in “Anarchy and Efficient Law,” a chapter by me in *For and Against the State*, Jack Sanders and Jan Narveson ed.

<sup>2</sup> Friedman (1973), Part III.

That result must be qualified in several ways. To begin with, in a world of non-zero information and transaction costs, an enforcement agency does not perfectly internalize the welfare of its customers, since it cannot engage in perfect discriminatory pricing. Furthermore, negotiations between enforcement agencies are not costless, so some opportunities for mutual gain may go unexploited. What we would expect is not a perfectly efficient set of legal rules but a set of legal rules with tendencies towards efficiency. Where a legal change benefits almost everyone we would expect to see it, but where it generates both substantial benefits and substantial costs, we would expect the system to do an imperfect job of balancing costs and benefits, and thus to at least occasionally get the wrong answer. An additional source of inefficiency will be the subject of part II of this essay.

### **Competition or Monopoly**

Readers familiar with the economic literature on efficiency may notice that my argument owes more to Coase than to Marshall. I have relied on the idea that parties will negotiate towards efficient contracts rather than on the conventional analysis of a competitive industry. The reason is that this marketplace, despite the very large number of buyers and sellers, is not competitive in the sense necessary for the standard economic proofs of efficiency.

To see why, eliminate the intermediaries, the enforcement and arbitration agencies, and consider the market for legal agreement in terms of the individual producers and consumers of that good. Each individual wishes to buy the assent of every other individual to some legal code or codes, in order that future disputes between them, if they occur, may be peacefully resolved. Each individual is thus both a buyer and a seller of legal assent, buying from and selling to every other individual.

The reason that the large number of buyers and sellers does not produce a competitive market is that the goods they are selling are not substitutes. I desire legal agreement with both A and B; if I am equally likely to be involved in a dispute with either, I may have the same value for legal agreement with each. But getting A's agreement to apply some legal rule in disputes with him does not eliminate the value to me of B's agreement with regard to disputes with him, so the two are not substitutes. Unlike the case of an ordinary good, I cannot simply agree with A on a price and then buy all the agreement I want from him. Despite the large number of participants, the interaction is essentially one of bilateral monopoly. Only A can sell me his assent to legal rules between me and him, and only I want to buy it.

Because of this, a conventional analysis of a uniform good sold at a single price by all sellers and to all buyers does not work for this market. One way of seeing this is to try to construct such an analysis:

Consider a legal change that shifts the rule from strict liability to negligence for some class of cases, benefitting defendants at the expense of plaintiffs. If total benefits are

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<sup>3</sup> For one explanation of economic efficiency, see Friedman (1990) Chapter 15.

larger than total costs, summed over all plaintiffs and defendants and including not only direct costs and benefits when litigation occurs but also all of the associated indirect benefits and costs,<sup>4</sup> then the change increases economic efficiency.

When A and B agree to a negligence rule for disputes between them, they are agreeing to two things: that A's liability will depend on A's negligence when A is the defendant, and that B's liability will depend on B's negligence when B is the defendant. For purposes of analysis, those are separate agreements; one could imagine one without the other.<sup>5</sup> We may think of A buying from B (at a positive price) B's assent to the rule for cases in which A is the defendant and B the plaintiff, and B buying from A (at a positive price) A's assent to the rule for cases in which B is the plaintiff and A the defendant.

Assume, for simplicity, that every pair of individuals is equally likely to become involved in a dispute<sup>6</sup> and that the nature of the potential disputes is the same across individuals, so that the value to A of legal assent from B is the same as the value to him of legal assent from C, D, etc. Parties differ, however, in their value for consuming and cost of producing legal assent. Thus A may be willing to pay, if necessary, up to two dollars each to buy agreement from B, C, D, ... to a negligence rule that will apply when A is the defendant. B may be similarly willing to pay up to three dollars to each of the others. Meanwhile, A may be willing to sell his assent, to agree to a negligence rule in cases where he is the plaintiff, for any price above one dollar, and B similarly for any price above two dollars. Following the analogy to an ordinary good, we would say that A values the assent of others at \$2 per person, B values it at \$3 per person. A's cost of producing assent is \$1 per person, B's cost is \$3 per person. The efficient rule is for each party to sell his assent to anyone who values it at more than its cost, thus maximizing the gains from trade. If B values assent at more than its cost to A (as he does:  $\$3 > \$1$ ) it is efficient for A to agree to accept a negligence rule if he sues B. If A values assent at less than its cost to B (as he does:  $\$2 < \$3$ ) it is efficient for B not to agree to accept a negligence rule if he sues A.

Suppose, in analogy to an ordinary market, that each seller specifies a price at which he will sell assent to anyone willing to pay and each buyer then buys assent from anyone selling it at a price less than the buyer's value. Will this produce the efficient result?

It will not. Consider the situation from the standpoint of A. If he offers to sell his assent at \$1 to any buyer, the result will be efficient, since any buyer who values it at more than \$1 (A's cost) will buy it. But A will get no benefit from the transaction, since he is selling the good for its cost to him; all of the gain from trade is going to the buyer. If A raises his price to \$2, some potential sales (to buyers with a value between \$1 and \$2) will be lost,

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<sup>4</sup> Such costs and benefits include costs of precautions taken by parties to avoid liability and benefits due to accidents prevented by such precautions.

<sup>5</sup> In many legal systems, legal rules are not symmetrical between parties. Even in our legal system, that is true if one of the parties is a government protected by sovereign immunity, or a minor, or some other party with special status.

<sup>6</sup> If one wanted to drop this assumption, one could do so by introducing a "quantity"  $[p_i]^{ij}$ , representing the probability of a dispute between  $i$  and  $j$ . A uniform price  $P$  for legal assent would then be per unit, making the price at which  $i$  bought assent from  $j$   $P[p_i]^{ij}$ .

but the remaining sales (to buyers with a value greater than \$2) will be made at a gain for A of \$1 each. Exactly what price maximizes A's net gain will depend on the distribution of values among the other sellers, but it will be more than \$1. So the result will be inefficient: buyers who value A's assent at more than its cost but less than its price will not buy.

This is the familiar deadweight problem of a single price monopoly. A monopolist maximizes his profit at a price above his cost, eliminating some efficient transactions. It seems out of place here because we seem to be dealing with a market of many buyers and many sellers. But one seller cannot substitute for another, so it is actually a market with a very large number of bilateral monopolies.

One could reverse the form of the transaction by having sellers state a price and buyers decide whether to buy or not. The result would be the same. Buyers would state a price below their real value, giving up some (efficient) transactions in order to increase their gain on the remaining transactions. This time we would call the situation monoposony instead of monopoly.

It follows that conventional models of perfect competition do not apply to the market for legal agreement. It is more appropriately modeled as bargaining among the parties buying and selling legal assent, as in the previous section. Such a model implies an efficient outcome subject to the limits imposed by bargaining costs.

A number of features of the situation are likely to hold down those costs. In many cases, the optimal rules (*ex ante*, before an actual dispute has occurred) are the same for almost everyone. This is particularly likely to be the case if the bargaining is over symmetrical rules. My agreement to accept a court that operates under negligence rules makes me worse off when I am the plaintiff, better off when I am the defendant. If negligence is a significantly more efficient rule, it is likely that most people will prefer it.

A second reason is that I must pay for the advantages of a favorable legal rule not only in the process of negotiating it but also in the price of transactions with others who will be bound by it. Suppose, for example, I manage to get a "favorable" legal rule for conflicts between me and any attorneys I hire: if they advise against settling and I lose the case, I can sue them for malpractice with a good chance of winning. One consequence of that rule will be to raise the cost to me of hiring a lawyer. In this and in many other cases, a "favorable" legal rule, like a "favorable" term in a contract, must be paid for in every transaction it applies to, and if it is inefficient the price is likely to be more than it is worth.

These arguments suggest that the bargaining problems implied by the bilateral monopoly nature of the market for legal assent should not be insuperable, that bargaining among enforcement agencies representing groups of customers ought to be able to produce something close to an efficient outcome. Absent some theoretical structure more powerful than Coasian bargaining, it is hard to be more precise than that.

## II: Market Failure on the Market for Legal Assent

For the reasons I have just sketched, we can expect the legal rules agreed to between A and B to maximize their joint welfare. In the more realistic model in which bargaining is between enforcement agencies on behalf of their customers we can expect, subject to qualifications already offered, that the rules will maximize the net welfare of all of the clients of the two agencies agreeing to them. But we cannot expect the rules to maximize the joint welfare of everyone, including customers of other enforcement agencies not involved in the bargaining. It follows that the rules will be optimal only when the legal rule between A and B produces no net third party effect on C, C being a customer of some other agency.

In many cases this seems plausible, at least as a reasonable approximation. The rule that determines what happens if A breaks his contract with B, or breaks into B's house, or breaks B's arm, should have relatively little effect on C.<sup>7</sup>

Consider, however, intellectual property law. When B agrees to respect A's intellectual property, the result is an increased incentive for A to produce such property, which may benefit others who use it. Such benefits will not be taken into account in the negotiations that determine whether or not B makes such an agreement. The result will be a lower than optimal level of intellectual property law.

Indeed, the result may well be no protection for intellectual property at all. To see why, imagine that A, a producer of intellectual property, is bargaining with B, a consumer, for protection. If they agree on protection, B will be liable to pay A \$10 for each copy of A's computer program that B makes. What are the cost and benefits of such an agreement? The most obvious benefit is that A will receive \$10/copy. This, however, is exactly balanced by the cost to B of paying \$10/copy. If these were the only costs and benefits, agreement and disagreement would be equally efficient.

There are at least two other costs and one other benefit. One cost is that B will make fewer copies of the program than if copying were free--perhaps he will put a copy on his desktop machine but not on his laptop. Perhaps he will buy copies of two of A's programs, but not a third, since it is worth only \$5 to him. This cost is the familiar deadweight cost of copyright--the inefficiency due to the difference between the (positive) price of making an addition copy to the user and the (zero) marginal cost of permitting an additional copy to the copyright owner, resulting in an inefficiently low number of copies. A second cost is the cost of enforcing the agreement. Keeping track of what copies A has made will be costly, perhaps impossible, and any resulting dispute will lead to expensive litigation.

To balance these costs there is an important benefit: The incentive that A has to write computer programs if he will be paid for them and does not have if he will not. If we

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<sup>7</sup> Little, but not none. A might break B's arm without first ascertaining B's enforcement agency. If so, the fact that C's enforcement agency has obtained severe penalties for assault in its negotiations with A's agency may provide some protection to B.

were considering the question of requiring or not requiring all consumers of A's intellectual property to pay for it, that benefit might well outweigh the costs we have described, making copyright protection for programs economically efficient; if A does not write any programs there will be nothing for B to copy.

But we are considering the question not with regard to the whole world but only with regard to B. The additional revenue A will receive as a result of B being covered by his copyright is very small and so will produce only a very small increase in output. That increase will benefit everyone who uses A's programs, but only the small part of that benefit that goes to B will be relevant to the negotiation between them. It follows that the benefit is vanishingly small, implying net costs, hence no protection.

The result is similar if we consider negotiation not between individuals but between agencies. B's agency will take into account not merely the benefit to B from the increased output due to B being bound by A's copyright, but the benefit to all of its customers due to the increased output from all of them being bound by A's copyright. The result is still only a small fraction of the total benefit from copyright law, assuming that there are many enforcement agencies, each serving only a small fraction of the population. The fraction becomes larger if we allow for the possibility of copyright negotiations among groups of enforcement agencies, with each agreeing to recognize the copyrights of the customers of all of the others if they will all agree similarly. Such negotiations would be analogous to the negotiations among nations by which international intellectual property rights are now established.

Even allowing for the possibility of such multiparty negotiations, our result, although weaker, still remains; we would expect an inefficiently low level of protection for intellectual property. We might well get no protection at all.

Similar problems will arise with pollution law, where A's right to sue B for polluting his air results in a reduction of B's emissions and thus an external benefit for A's neighbor C. They may arise in other important contexts as well. In all of these cases, we would expect the legal rules generated by the private market to be inefficient, although not necessarily less efficient than the rules currently generated by courts and legislatures.

### Baselines and Economies of Scale

In my discussion of bargaining between enforcement agencies I have implicitly assumed the existence of a baseline, some initial set of legal rules from which bargaining begins. While the location of that base line does not affect the argument for the efficiency of the eventual equilibrium legal rules, it does affect the distribution of wealth in that equilibrium. Many steps in the process of bargaining towards efficiency will involve some parties agreeing to a legal change that makes them worse off in exchange for a balancing benefit. If we start with a rule of strict liability, to take an example discussed earlier, a shift to negligence may require individuals who prefer the latter rule<sup>8</sup> to pay

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<sup>8</sup> Perhaps something about their circumstances makes them particularly likely to be accidental (but not negligent) tortfeasors.

individuals who do not for their assent. If we start with a rule of negligence, a shift in the other direction will require payments the other way. So although the baseline does not determine the efficiency of the outcome, it may well affect the associated distribution of income.<sup>9</sup>

It is not obvious what that base line would be.<sup>10</sup> If two enforcement agencies fail to agree on a mutually acceptable arbitrator to settle their dispute, after all, the result is not that the dispute is resolved according to the UCC or the Delaware Commercial Code but that it is resolved by force. It follows that the ultimate baseline is the solution to a bilateral monopoly bargaining game among the agencies. Each agency can threaten to refuse to agree to any arbitrator, subjecting both to the costs of occasional violence or at least of ad hoc negotiation to avoid violence. Each knows that the other would prefer even a rather unfavorable set of legal rules to no agreement at all. Each knows that if no agreement is reached, they are both at risk of losing their customers to other agencies that have been more successful in negotiating agreements.

The situation is analogous to a union management negotiation or the negotiations determining borders, trade policies, and the like between neighboring countries. While there is no good theoretical account of exactly what determines the outcome of bilateral monopoly bargaining, experience suggests that some tolerably stable equilibrium usually exists. Most unionized firms manage to settle their differences without lengthy strikes, and most nations are at peace with most of their neighbors most of the time.<sup>11</sup>

We may imagine the market for law as starting out with a set of default rules between each pair of protection agencies, representing the result of bargaining backed by threats of refusal to agree on an arbitrator. From there, the agencies bargain to an efficient set of rules. The distributional outcome is the result of an implicit threat game between the agencies; the allocational outcome is the result of a (logically subsequent) bargaining game to move the agencies (and their customers) from the starting point to the Pareto frontier.

We can think of enforcement agencies as producing two different products with different production functions. One is the service of protecting rights and arranging the settlement of disputes. The other is the ability to use or threaten the use of force against other agencies. The former determines the value to their customers of the service they produce, the latter the share of the surplus from the peaceful settlement of conflict between customers that each agency obtains.

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<sup>9</sup> Imagine, for example, the baseline rules with regard to race that we might expect if an anarcho-capitalist society had somehow been established in the American south in the 1840's. Even if the agencies succeeded in bargaining their way from the pre-existing legal system to the (efficient) outcome of freedom for slaves, it would presumably be freedom on very unfavorable terms.

<sup>10</sup> This problem was first called to my attention by James Buchanan in a perceptive review of Friedman (1973). See Buchanan (1974).

<sup>11</sup> For one approach to understanding how the solution to such conflicts is determined and maintained, see Friedman (1994,2).

Insofar as one can judge from analogous services provided at present, both by governments (police and courts) and by private firms (security and arbitration), the former product does not seem to exhibit economies of scale going up to the size of a firm serving a large fraction of a national market.<sup>12</sup> On the other hand, there seems quite a lot of historical evidence that with some, although not all, military technologies, economies of scale in the use and threat of violence by one state against another do run up to the size of current nations, indeed are one of the factors that has determined that size. Hence it might turn out that an agency large enough to serve a substantial fraction of the population of a current nation would have significant advantages in the use and threat of force over smaller agencies.<sup>13</sup>

As already mentioned, one factor determining the stability of the set of institutions I have described is the number of enforcement agencies. If the suggestions of the previous paragraph are correct, that might depend on the relative importance of the two products that such an agency produces. If the success of an agency depends largely on its ability to threaten other agencies, and if that in turn is an increasing function of size up to a point at which an agency serves a large fraction of the population of the society within which the institutions exist, the equilibrium might be a small number of agencies, hence a serious risk of collusion among them intended to eliminate the voluntary nature of their relation to their customers. This might be a particularly serious problem at the point when the institutions of private law were coming into existence, hence when there was no obvious status quo ante to serve as a baseline from which to bargain.

Experience suggests that there is enormous inertia in mutual threat games of this sort. National boundaries do not move half a mile one way or the other each time one nation becomes a little richer or a little more powerful. Hence the problem should become less serious once a system of private law is established and functioning, built not so much on an ongoing mutual threat game as on a mutual threat game played out in the distant past. Once the initial equilibrium has been established, the success of a protection agency should be based mainly on its ability to produce protection for its customers, not its ability to defeat rivals in open warfare. If so, and if that ability does not exhibit too great economies of scale, the system once established should be stable against collusion.

It is always possible for one firm to threaten to withdraw from its arbitration agreement with another unless the terms are renegotiated *de novo*, but such threats are unlikely to be either common or successful. Other agencies have a strong incentive to insist on basing their bargaining on the existing rules in order to prevent the costs both of continual renegotiation and of violence when negotiations break down.

The stability of such a status quo in part reflects the influence of Schelling Points, outcomes recognized by both parties as unique, upon the outcome of bargaining.<sup>14</sup> Where

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<sup>12</sup> This comment is based on casual empiricism. References to research supporting or contradicting it would be appreciated by the author.

<sup>13</sup> One obvious qualification to this point is the potential for small agencies to form alliances for dealing with threats by other agencies. A similar pattern is described in Gosch and Hammer (1975), where several criminal firms function independently for most purposes, but pool resources to bribe police and judges in order to defend themselves against the state legal system.

<sup>14</sup> Friedman (1994), Schelling (1960).



the alternative to agreement is costly, almost any agreement is better than none, so both parties have an incentive to look for alternatives that they can converge on. This suggests that if anarcho-capitalist institutions evolve out of an existing state-run legal system, the rules of that legal system might function as the status quo from which further bargaining preceded. Whether or not such rules are efficient, they are familiar to the parties and they specify answers to most of the relevant questions. They thus provide a potential point of initial agreement from which to conduct further bargaining.

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