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Decentralized Law for a Complex Economy

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As the economy grows in complexity, the constraints of information and motivation tighten on centralized lawmaking. Specialized business communities develop their own norms, which I call the "new law merchant." Decentralized lawmaking involves selectively enforcing those norms. Selection should be based upon the incentive structure which caused the norm to evolve, which I call the "structural approach to adjudication." The structural approach to adjudication uses economics to revive and modernize the old conception that judges should find law, not make it. Norms evolve when players have incentives to signal that they are following a cooperative strategy which will increase the supply of local public goods. The obligations imposed by social norms are efficient in the absence of spill-overs, but the level of informal enforcement is deficient.

I. LEGAL CENTRISM

Central planning is a way of making law, as well as commodities. Officials must have the power to allocate resources to implement the central plan. To possess this power, the orders issued by planning officials at the top must trump the rights of property and contract enjoyed by people and enterprises at the bottom. Thus public law crowds out private law. The paradigm for centralized lawmaking is a decree, in
which government officials formulate the state’s goal, embody the
goal in a rule, and force people to conform to it. Information and
motivation move along a one-way street from the top to the bottom.

Only communist dictatorships have practiced central planning as
a total system. However, democracies have at times adopted proce-
dures similar to central planning to solve specific economic problems.
To illustrate, when Professor Richard Stewart stepped down recently
from his position as the highest ranking environmental lawyer in the
United States Department of Justice, he remarked that “America’s
environmental laws are based upon Soviet style centralized plan-
ning.”¹ He meant that America tries to control pollution by quotas
imposed upon businesses by federal officials. Such procedures have
been called “command-and-control regulations” or “legal centrism.”²

Many scholars have detected movement in modern history to-
wards centralized law.³ Many intellectuals believe that centralized law
is inevitable, just as they once believed that socialism is inevitable. In
fact, centralized law, like socialism, is not plausible for a technologi-
cally advanced society. The forces that reversed the trend towards
socialism and destroyed central planning are also undermining legal
centrism. An advanced economy involves the production of too many
commodities for anyone to manage or regulate. As the economy de-
velops, the information and incentive constraints tighten upon public
policy. These facts suggest that, as economies become more complex,
efficiency demands more decentralized lawmaking, not less.

Lawmaking can proceed from bottom to top rather than top to
bottom. Decentralized lawmaking has several forms. One form of de-
centralized lawmaking is to induce people to create a market by as-
signing property rights to them. To illustrate, environmental officials
in the United States are now creating tradable emission rights so that
the market for emission rights will determine each firm’s level of pol-

¹. Personal communication with Professor Don Elliott of Yale University (1993).
². See generally Stephen Breyer, Regulation and Its Reform (1982); Charles
Schultze, the Public Use of Private Interest 7-8 (1977).
³. Salmond concluded that customary law is important in the early stages of legal develop-
ment, but gradually cedes its place to statutes when “the state has grown to its full strength.”
article, Claus Ott and Hans-Bernd Schäfer point out that modern German Law has moved away
from customary law and towards statutes. Claus Ott & Hans-Bernd Schäfer, Emergence and
Construction of Efficient Rules in the Legal System of German Civil Law, presented to the Euro-
pean Law and Economics Association Meeting (Aug. 1991). In making these remarks, they are
describing history, not passing judgment upon it.
The subject of this lecture is another form of decentralized lawmaking: enacting custom. For example, courts may determine fault and liability for accidents by applying the norms of the community in which the accident occurred.

II. NEW LAW MERCHANT

The modern economy creates many specialized business communities. These communities may form around a technology such as computer software, a body of knowledge such as accounting, or a particular product such as credit cards. People develop relationships with each other through repeated interactions in a community, and norms arise to coordinate their interaction. The formality of the norms varies from one business to another. Self-regulating professions, like law and accounting, and formal networks like Visa, promulgate their own rules. Voluntary associations, like the Association of Home Appliance Manufacturers, issue guidelines. Informal networks, such as computer software manufacturers, have inchoate ethical standards. I refer to all such norms of business communities as the “new law merchant.”

The new law merchant arises outside of the state’s lawmaking apparatus. However, lawmakers are pulled into the affairs of business communities by insiders who look to the state to resolve their disputes and make their laws. Lawmakers are also pushed into the affairs of business communities by outsiders who seek to regulate private wealth and power. How should the state respond? The traditional account of the “law merchant,” from which the phrase the “new law merchant” is adapted, provides a model. The merchants in the medieval trade fairs of England developed their own rules, and in some cases, their own courts. However, as the English legal system became stronger and more unified, English judges increasingly assumed jurisdiction over disputes among merchants. The English judges did not know enough about these specialized businesses to evaluate alterna-

4. For a review of theory and practice, see Tom Tietenberg, Environmental and Natural Resource Economics (3d ed. 1992). Other examples of law inducing markets are patent and copyright law.

5. The Visa payments network is actually divided into two corporations with different operating rules, one for American transactions and another for international transactions.


7. The term has also been applied more restrictively to norms of international trade invoked in arbitration and mediation.
tive rules. Instead of imposing rules, traditional history asserts that English judges tried to find out what practices already existed among the merchants and enforce them. By this process, the law merchant was allegedly absorbed into English common law. The pinnacle of this process was the development of the law of bills and notes in the eighteenth century by Judge Mansfield.

III. Structural Approach

According to this history, the English judges dictated conformity to merchant practices, not the practices to which merchants should conform. Modern lawmakers should respond to the new law merchant much like the English common law courts responded to the old law merchant. However, the process of discovering and enforcing social norms needs to be updated in light of modern economics. The adjudication of the new law merchant should typically involve three steps. First, lawmakers should identify the actual norms that have arisen in specialized business communities. Second, lawmakers should identify the incentive structures that produced the norms. Third, the efficiency of the incentive structures should be evaluated using analytical tools from economics. Those norms should be enforced that arise from an efficient incentive structure, as ascertained by tests that economists apply to games.

I call this procedure the "structural approach" to adjudicating social norms. The structural approach conflicts with the economic analysis of law in two respects. First, lawmakers following the structural approach infer the efficiency or inefficiency of a norm, rather than measuring it directly. In contrast, much of the economic analysis of law commends the evaluation of legal rules by cost/benefit techniques. For example, at the end of his classic article entitled The Problem of

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8. Personal communication with Wolfgang Fikentscher (1993) (“The decisions of the Munich traffic court of appeals concerning motor vehicle accidents improved markedly after the judges learned to drive.”).

Ronald Coase recommends that judges choose among alternative liability rules by comparing their costs and benefits.\footnote{10}

Second, my structural approach applies to norms, not regularities. To illustrate the difference, men take off their hats when they enter a furnace room or a church.\footnote{12} Taking off your hat to escape the heat is different from taking off your hat to satisfy an obligation. The former is a regularity and the latter is a norm. A regularity results from an inclination, whereas a norm imposes an obligation. Economic models seldom distinguish between an equilibrium sustained by inclination or obligation. However, people respond differently to changes in incentives, depending upon whether they are motivated by inclination or obligation. To explain why, I will sketch the theory of norms that underlies the structural approach to adjudication.

IV. EVOLUTION OF NORMS

A norm imposes an obligation on the people subject to it. For example, a formal law exists when the state imposes an obligation upon its citizens. Similarly, a custom exists when a community of people reaches an informal consensus about what its members ought to do. The existence of customs challenge theorists to explain why some games create or evoke a sense of obligation in the players concerning the strategies that they follow. I will sketch an answer to this question.

In many games the players can signal their intentions. The signal conveys information to others concerning the strategy being followed. Sometimes everyone has an incentive to transmit the same signal. To illustrate, imagine a sequential game involving two players and two moves. The first player chooses to invest or not. Subsequently, the second player cooperates or appropriates. Cooperation is productive, whereas appropriation redistributes the value of the investment. The first player will not invest unless he believes that the second player will cooperate. Therefore, the second player wants the first player to believe that he will cooperate, regardless of what he actually plans to do. Consequently, the second player will endeavor to signal "cooperation."

\footnote{11} An exception to the enthusiasm for judicial cost/benefit analysis is Richard Epstein's view that judges should not have so much discretion. See Richard Epstein, The Rule of Risk/Utility, 48 Ohio St. L.J. 469, 469-70 (1987).
\footnote{12} Equivalently, men put on a hat in a snowstorm or a synagogue.
Now imbed this two person game in a market with many participants. The participants consist of many "first players" who want to invest, and "second players" who want to find an investor. After finding an investor some second players cooperate and others appropriate. However, all second players endeavor to signal cooperation. A game in which everyone follows the same strategy has a "pure equilibrium." In this game, everyone follows the same signalling strategy. Thus, my example concerns a game with a "pure signaling equilibrium."

The signal represents the player as following a particular strategy. A player who represents himself as following one strategy may actually follow another. Specifically, a player who represents himself as cooperating may actually appropriate. In a "mixed equilibrium," some players cooperate and others appropriate. Some people cooperate in order to form enduring relationships and secure a modest payoff in many rounds of the game. Some people appropriate in order to secure a large payoff in a few rounds of the game, even though their relationships continually break up and they receive no payoff in most rounds. In equilibrium, both strategies earn the same average rate of return. Thus my example concerns a game with a "pure signaling equilibrium" and a "mixed behavioral equilibrium." In other words, there is a consensus about what people ought to do, but some people do not do it.

Cooperation by one player in a game often conveys benefits that spill-over to the other players. To illustrate, more cooperation in the investment game will elicit more investment, which benefits all the players. These external benefits, which everyone who plays the game enjoys, can be called "local public goods." Thus, the investment game has an equilibrium in which the players signal that they will supply a local public good.

Since the community benefits from local public goods, people concerned with its welfare will want to increase their supply. These people will say that everyone ought to cooperate, and they will condemn those who appropriate. Saying that all people ought to cooperate, and condemning people who appropriate, can signal that the speaker will cooperate. If everyone follows this signaling strategy, a consensus will arise in the community that people who play the game

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13. By definition, an evolutionary equilibrium exists when all strategies actively played earn the same average rate of return.
ought to follow a cooperative strategy. In other words, a norm will evolve.

To summarize, the fact that everyone has an incentive to signal the same strategy creates a consensus in the community of players. Following this strategy creates a local public good. Consequently, the consensus expresses itself as a judgment about what people want to do. Generalizing, I formulate the alignment theorem: A social norm will evolve in a community when private incentives for signaling align with a local public good.

V. Efficient Social Norms

The person who supplies a public good does not capture the benefits that he conveys to others. Social norms try to correct for the under-supply of public goods. When a norm evolves, most people will conform to it and some people who violate it will suffer a social sanction. Insofar as the sanction discourages violations, the existence of the norm will increase the supply of local public goods. Viewed functionally, a social norm is a device for increasing the supply of local public goods.

The proposition that social norms contribute to efficiency belongs to the utilitarian tradition, which has recently received a forceful re-statement from Robert Ellickson. After studying social norms concerning cows and whales, Ellickson offered this generalization:

14. Notice that if all players say that everyone ought to cooperate, the fact that one player says it provides no basis for distinguishing him from anyone else. In other words, the communication carries no information. Even so, denying that everyone ought to cooperate would convey information that no one wants to transmit about himself.

15. Robert D. Cooter, Structural Adjudication and the New Law Merchant, in International Review of Law and Economics (forthcoming 1994). The alignment theorem can be distinguished into weak, strong, and very strong forms, depending upon whether the alignment of private incentives for signaling with a local public good is a sufficient, necessary, or necessary and sufficient condition, respectively, for the evolution of a social norm.

16. Bentham, the first systematic utilitarian, asserted that people do what is socially efficient, and avoid doing what is socially inefficient. See generally Jeremy Bentham, An Introduction to the Principles of Morals and Legislation (1948).

“Members of a close-knit group develop and maintain norms whose content serves to maximize the aggregate welfare that members obtain in their workday affairs with one another.”

Game theory can provide a theoretical foundation for Ellickson’s empirical generalization. Many games have a cooperative solution which is efficient, and a non-cooperative solution which is inefficient. The non-cooperative strategy often dominates when the game is played only once, whereas the cooperative strategy often dominates when the game is played repeatedly. When a game is repeated, the players can punish non-cooperators by using strategies such as “tit-for-tat” and exiting from the relationship. The alignment theorem adds that in order for a norm to evolve, most people must have an incentive to signal conformity with it.

VI. Normative Failure

So far I have discussed how social norms contribute to efficiency. There are circumstances, however, under which particular social norms harm society as a whole. The problem typically arises when a public good for one community is a public bad for another community. In other words, the problem arises when behavior creates an external benefit in one community and an external cost in another community. To illustrate, the members of a business cartel can benefit each other by keeping prices high. From the viewpoint of the cartel, discounting the price is “cheating.” However, discounting benefits people outside the cartel more than it harms the members of it. Consequently, discounting is socially efficient, whereas the cartel is socially inefficient.

The case is weak for enforcing social norms that create a benefit for one community at the expense of another. Rather than enforcing social norms blindly, judges would do better to enforce them selectively. The selection should be based upon the incentive structure in the underlying game. When applying the structural approach to adjudicating the new law merchant, a persistent problem is distinguishing between social norms that lubricate commerce by increasing the scope of cooperation, and social norms that inhibit commerce by imposing monopoly restrictions.

18. See Ellickson, Order Without Law, supra note 17, at 167.
VII. Conclusion

Many scholars regard customary law in post-industrial society as a vestigial organ, like the human appendix. This view misinterprets the path of social change. People can often create a surplus by cooperating together, provided they can agree upon its distribution. Although, business communities continually generate social norms to solve this problem, informal enforcement of social norms does not deter enough people from violating them. Thus, by enforcing social norms, judges typically increase the amount of cooperation within the community where it arose. However, some norms benefit one community at the expense of another. Accordingly, adjudicators should examine the incentive structure that caused a norm to evolve in order to distinguish local public goods from harmful spill-overs.

The structural approach can revive and modernize the old conception that judges should find law, not make it. Reviving and modernizing this conception grows more urgent as the economy's complexity increases and the information constraints tighten upon adjudication.

19. For example, Salmond thought that customary law, though originally important, naturally yields to statutes as the state acquires power. See Salmond, supra note 3, at 189-212.