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Decentralised Law

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As the economy grows in complexity, the constraints of information and motivation tighten on centralised lawmaking. Specialised business communities develop their own norms. Decentralised lawmaking involves enacting into law those community norms that pass a structural test of efficiency and fairness. The obligations imposed by these norms are efficient in the absence of spillovers or non-convexities. However, the level of informal enforcement is often inefficient.

1 INTRODUCTION

The Soviet magazine *Crocodile* published a cartoon that depicted a cart containing one gigantic nail being pulled by some men, one of whom was saying to a bystander, "What's it for? We don't know what it's for, but it satisfies our nail quota for the month." This cartoon epitomises the economic critique of central planning, according to which a planned economy does not generate the information or motivation required for economic efficiency.[1] Like the workers in the cartoon, the people and enterprises under socialism often lack the knowledge and the will to produce valuable goods.

Central planning is a way of making law, as well as commodities. To implement the central plan, officials must have the power to allocate resources. 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.

Only communist dictatorships have practiced central planning as a total system. However, democracies sometimes adopt procedures 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 on Soviet style centralised planning".[2] He meant that America is trying to control pollution through a system of quotas imposed on businesses by federal officials.

Such procedures have been called "command-and-control regulations".[3] The

1 This critique was developed in the 1930s in the debate between Lange and Lerner. See O Lange, "On the Economic Theory of Socialism" (1936) 4 Review of Economic Studies 60-66; O Lange and F M Taylor, On the Economic Theory of Socialism (U Minnesota Press, Minneapolis, Minn, 1938); A Lerner, The Economics of Control (The Macmillan Company, New York, 1944), Chapter 3.

2 I am grateful to Professor Don Elliott of Yale University for this quotation.

3 S Breyer, *Regulation and Its Reform* (Harvard UP, Cambridge, Mass, 1982); C Schultze, *The Public Use*

imperative theory of law, which has a long history in legal philosophy, defines "law" as a command backed by a threat.[4] This tradition builds on the fact that many laws impose obligations and attach sanctions to their violation. Similarly, the paradigm for centralised 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.

Rather than proceeding from top to bottom, lawmaking can proceed from bottom to top. Decentralised lawmaking has several forms. One form of decentralised lawmaking is to enact custom. For example, Courts may determine fault and liability for accidents by applying the norms of the community in which the accident occurred. Or arbitration Courts can enforce good practices of international law as recognised by bodies like UNIDROIT.

Many scholars have detected movement in modern history from decentralised to centralised law. Salmond concluded that customary law is important in the early stages of legal development, but gradually cedes its place to statutes when "the state has grown to its full strength".[5] In a recent article, Ott and Schafer point out that modern German law has moved away from customary law and towards statutes.[6] Many intellectuals believe that centralised law is inevitable, just as they once believed that socialism is inevitable.

In fact, centralised law, like socialism, is not even plausible for a technologically 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 develops, the information and incentive constraints tighten on public policy. These facts suggest that, as economies become more complex, efficiency demands more decentralised lawmaking, not less.

2 NEW LAW MERCHANT

A community of people forms a social network whose members develop relationships with each other through repeated interactions. The modern economy creates many specialised 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. Wherever there are communities, norms arise to coordinate the interaction of people. The formality of the norms varies from one business to another. Self-regulating professions, like law and accounting, and formal networks like Visa,[7] promulgate their own rules. Voluntary associations, like the Association of Home Appliance Manufacturers, issue guidelines.[8] Informal networks, such as the computer software manufacturers, have undeveloped ethical

of Private Interest (Brookings, Washington DC, 1977).

4 Alternatively, this tradition defines a law as an order backed by a threat. For a review of this tradition, see J Raz, *The Concept of a Legal System* (2nd ed, Oxford UP, New York, 1980).

5 J W Salmond, *Jurisprudence* (12th ed, London, Sweet & Maxwell, 1966). See his discussion of the issue on pp 66 and 67.

6 C Ott and H-B Schafer, "Emergence and Construction of Efficient Rules in the Legal System of German Civil Law" (Paper presented to European Law and Economics Association meeting, Copenhagen, August 1991). In making these remarks, they are describing history, not passing judgment upon it.

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

8 D Hemenway, *Industrywide Voluntary Producer Standards* (Ballinger, Cambridge, Mass, 1975).

standards. I refer to all such norms of business communities as the "new law merchant".[9]

3 MODEL OF ADJUDICATION

The new law merchant arises outside of the state's apparatus for making law. 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, and lawmakers are pushed into the affairs of business communities by outsiders who seek to regulate private wealth and power. The economic analysis of social norms aims to develop a theory to guide the appropriate response of the state's lawmakers to these pulls and pushes.

The traditional account of the "law merchant", from which the phrase the "new law merchant" is adapted, provides a model for how lawmakers might respond. 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 specialised businesses to evaluate alternative rules.[10] Instead of imposing rules, the traditional history asserts that English Judges tried to find out what practices already existed among the merchants and enforce them. Thus, the judges dictated conformity to merchant practices, not the practices to which merchants should conform. By this process, the law merchant was allegedly absorbed into English common law. The pinnacle of this process is the development of the law of bills and notes in the 18th Century by Lord Mansfield.[11]

I propose that modern lawmakers should respond to the new law merchant much like this response of the English common law Courts to the old law merchant. However, modern lawmakers should take explicit account of insights from modern economics. Many legal reformers such as the English utilitarians and the French exegetic school have sought to replace common law with systematic statutes.[12] The theory underpinning these reform proposals asserts that custom is regressive and statutes are, or can be, progressive. HLA Hart noted that custom is not under anyone's rational control, so it cannot be directed to serve the ends of policy makers. Customs arise, whereas laws are made. He concluded that custom tends to be static and inefficient.[13]

This argument is unconvincing on its face. Why not argue that customs are dynamic and efficient because they can disappear without being repealed, and they can change without being amended? Hart's understanding of custom resembles a socialist's understanding of markets. Socialists observe that prices arise,

9 The term has also been applied more restrictively to norms of international trade invoked in arbitration and mediation.

10 Wolfgang Fikentscher once remarked: "The decisions of the Munich traffic court of appeals concerning motor vehicle accidents improved markedly after the judges learned to drive."

11 The traditional theory is developed by J Holden in *The History of Negotiable Instruments in English Law* (Athlone Press, London, 1955). Holden is criticised in J Baker, "The Law Merchant and the Common Law Before 1700" (1979) 38 CLJ 295. A revised view, which stresses that Mansfield immersed himself in the minutiae of business practice in order to extract the best principles from it, is found in J Rogers, *The Early History of the Law of Bills and Notes: A Study of the Origins of Anglo-American Commercial Law* (Cambridge UP, Cambridge, forthcoming). I am grateful to Jim Rogers for discussing these points with me.

12 For complete references on the French exegetic school and the lex mercatoria, see F Dely, *International Business Law and Lex Mercatoria* (North-Holland, Amsterdam, 1992).

13 H L A Hart, *The Concept of Law* (Clarendon Press, Oxford, 1961), pp 89-96.

whereas plans are made, and conclude that markets must be inefficient because prices are not determined by deliberation and reasoning. This conclusion results from confusion about the difference between individual rationality and social efficiency. Individual rationality generally requires deliberation and planning, but social efficiency does not. Research in industrial organisation shows that the efficiency or inefficiency of markets is often determined by their incentive structure.[14] Similarly, the efficiency or inefficiency of custom often depends on the incentive structure that produced it. In the language of game theory, the payoff matrix often determines the possible equilibria.

These facts suggest how lawmakers, especially Courts, should respond to the new law merchant. First, the lawmakers should identify the actual norms that have arisen in specialised business communities. Second, the 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 which arise from an efficient incentive structure, as ascertained by structural tests that economists apply to games. I call this procedure the "structural approach" to adjudicating social norms.

The structural approach conflicts with much writing in 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 Social Cost",[15] Ronald Coase recommends that Judges choose among alternative liability rules by comparing their costs and benefits.[16]

Second, the structural approach that I develop applies to obligations, not regularities. To illustrate the difference, men take off their hats when they enter a furnace room or a church.[17] Taking off your hat to escape the heat is different from taking off your hat to satisfy an obligation. A mere regularity results from an inclination, not an obligation. Economic models seldom distinguish between an equilibrium sustained by inclination or obligation. However, people respond differently to changes in incentives, depending on whether they are motivated by inclination or obligation, as I will show.

4 EFFICIENCY OF NORMS

I will use the alignment theorem to develop a theory of efficient norms. Many games have inefficient equilibria, which are sometimes called "evolutionary traps".[18] Social norms evolve through a process of discussion, which often exposes evolutionary traps. Evolutionary traps often occur because the best strategy for each individual benefits him less than it harms other players. According to the alignment

14 One of the intellectual foundations of American antitrust law is the distinction between industry structure, the conduct of firms, and economic performance. See J Bain, *Industrial Organization* (2nd ed, Wiley, New York, 1968) and R Caves, *American Industry: Structure, Conduct, Performance* (3rd ed, Prentice Hall, Englewood Cliffs, NJ, 1972). This distinction came under attack as game theory was applied to industrial organisation. My term "structural approach" refers to the incentive structure of games, not the competitiveness of markets.

15 R Coase, "The Problem of Social Cost" (1960) 3 Journal of Law and Economics 1.

16 An exception to the enthusiasm for judicial cost benefit analysis is Richard Epstein's view that judges ought not to have so much discretion. See "The Rule of Risk/Utility" (1987) 48 Ohio State Law Journal 469, 470.

17 Equivalently, men put on a hat in a snowstorm or a synagogue.

18 See below n 24.

theorem, a community will not develop social norms supporting strategies that harm its members. Once exposed, a strategy leading to an evolutionary trap may be censured by a community, or tolerated, but not encouraged. In other words, a consensus will not arise in the community that its members *ought* to follow a strategy leading to an evolutionary trap. Consequently, many of the inefficient strategies in games cannot be supported by social norms. This fact gives human communities, which have morality, an advantage over animal communities, which lack morality.[19]

However, there are special circumstances in which a community may develop a social norm that harms its members. Decentralised processes economise on information by making local improvements. One kind of evolutionary trap occurs when local progress is global regress. To illustrate, suppose that some climbers try to ascend a mountain in a fog by following the rule, "Always go up". If the mountain has a single peak, this rule will get them to the summit. If the mountain has several false peaks, this rule will get the climbers to a local peak, but not necessarily to the summit. In technical terms, local improvements lead to a global maximum on a convex surface, whereas local improvements lead to a local maximum on a non-convex surface.

An historical example shows the problem that non-convexity creates for decentralised law. Everyone in a country drives on the same side of the road, but historical accident determined whether it is the left as in Britain or the right as in most other countries. Given a world economy, it would be better for the British to drive on the right like almost everyone else. However, driving on the left is a stable equilibrium which will not change without central direction. Large non-convexities hide traps from people, which can cause the wrong norm to emerge.[20] The critics of the common law claim, in effect, that it is a vast collection of rules similar to "Drive on the left".

The alignment theorem uses the phrase "local public good" to refer to benefits that an actor conveys on other members of the community in which a norm arises. However, sometimes the norms of one community affect another community. A community norm has positive or negative spill-overs when obeying it conveys benefits or costs to neighbouring communities. Communities often develop norms that benefit their members at the expense of members of other communities. To illustrate, suppose a consumer writes a large cheque that is diverted by accident or fraud, resulting in a large loss that must be borne by the consumer or his bank. Since the lost cheque is large, its value may exceed the value of the future relationship between the bank and its customer. Under these circumstances, a bank may wish to shift the loss to its customer. Foreseeing such possibilities, an association of banks may proclaim that its members should hold customers liable for large cheque losses. In general, norms regulating liability may externalise the costs of one community on another.

19 An interesting discussion of the extent to which animals have morality is found in J Goodall, "Order Without Law" (1982) 5 J Social & Biological Structures 353. Also see F B M de Waal, "The Chimpanzee's Sense of Social Regularity and Its Relation to the Human Sense of Justice" (1991) 34 American Behavioral Scientist 335.

20 An interesting discussion of business communities becoming committed to the wrong standards due to lack of information is in A O Sykes, *Policing Technical Barriers to Trade in Internationally Integrated Goods Markets* (Brookings, Washington DC, forthcoming). See his discussions of technical incompatibilities. Sykes is optimistic that private businesses can overcome these problems in time by voluntary standard setting, whereas he is pessimistic that governments can improve the situation by compulsory regulations.

Another example concerns monopoly practices. A cartel can maximise the total profits of its members by setting the same price as a monopolist. If a member of the cartel "cheats" by secretly discounting prices, the cheater's profits will increase by less than the fall in profits of the other cartel members.[21] In response to this fact, a cartel may develop norms to sanction cheaters. These norms will help the "community" of producers in the cartel to maximise their profits. However, the gain in profits to sellers is less than the fall in consumer's surplus to buyers. Such monopoly practices are inefficient from the perspective of the society as a whole.

Racial discrimination in markets provides a sinister example of such a cartel. Discrimination permits one community to reduce competition from another, which benefits the dominant group at the expense of the subordinate group. However, each individual member of the cartel can profit from violating the norm requiring them to discriminate. For example, if the racial cartel reserves certain high-paying jobs for the dominant group, an employer can profit from hiring qualified workers in the subordinate group to do the same job for less pay. To deter such "cheating", the racial cartel must punish members who violate its norms. Like other cartels, racial cartels attempt to overcome their natural instability by enacting their norms into law.[22]

The preceding discussion of efficient norms is incomplete in a variety of ways.[23] Nevertheless, I reach the tentative conclusion that *strategies which evolve into social norms in a free business community will be efficient in the absence of non-convexities or spill-overs to other communities*. I call this theorem "weak utilitarianism".[24]

5 STRUCTURAL APPROACH TO ADJUDICATING SOCIAL NORMS

I have developed a theory of the evolution and efficiency of social norms. According to this theory, specialised business is often organised so that norms will emerge from repeated transactions. These norms impose an obligation on members of the community to follow strategies that benefit its other members. Self-interest compels everyone to enforce these norms by such means as tit-for-tat and exit. However, the benefits of enforcing these norms diffuse throughout the community, so self-interest results in under-enforcement. The tendency of individuals to free-ride on the enforcement efforts of others is partly overcome by internalisation of the norms. Internalisation causes people to go beyond self-interest in expending resources on enforcement. However, informal enforcement often stops short of the optimal level, where the marginal cost of enforcement equals the marginal benefit. Optimal deterrence requires

21 Otherwise the cartel is not setting the price that maximises the total profits of its members.

22 R Cooter, "Market Affirmative Action", Conference on Richard Epstein's Forbidden Grounds, San Diego, December 1992, to appear in San Diego Law Review.

23 A perplexing question is how norms prescribing the subordination of a group of people arise in the community to which they belong. I have sexual discrimination in mind. I suspect that in order for a discriminatory norm to arise in a community that includes its victims, the injurers must monopolise the discussion from which the norm emerges. Another omitted topic is "stranger norms". Many significant norms exist in society that arise from repeated games in which the players remain strangers to each other. For example, driving on the highway involves interactions with unidentified motorists. A crucial fact is that each driver may be the injurer or the victim in an accident. Apparently, symmetry can generate efficient social norms in an anonymous repeated game. This process requires explaining.

24 "Strong utilitarianism" would hold that every efficient equilibrium in a game will evolve into a social norm.

supplementing informal sanctions with legal sanctions.

This theory suggests the correct role of the state with respect to custom. The Court can benefit business and improve its efficiency by enforcing its norms against violators. The role of the state in a decentralised legal system is to elevate appropriate social norms to the level of law. Elevating a social norm to the level of law involves issuing an authoritative statement of the norm and backing it with the state's coercive power. "The adjudication of social norms" describes the process by which officials decide which social norms to elevate to the level of law.

I envision three steps in adjudicating business norms. First, lawmakers should identify the actual norms that have arisen in business communities. A norm exists in a community when there is a consensus about what its members ought to do. Identifying a social norm involves finding evidence that people have internalised an obligation, especially their willingness to enforce it on violators. Second, lawmakers should identify the incentive structures that produced the norms. Identifying the incentive structure requires constructing a model that characterises the norm as an equilibrium in a game, and testing the model against the facts. Third, the efficiency of the incentive structure should be evaluated using analytical tools from economics. When the incentive structure is efficient, the social norm imposes an obligation to follow a co-operative strategy that results in repeated transactions. Furthermore, the payoff sets are convex and the effects of the obligatory strategy do not spill-over beyond the community in which the norm arose. Those business norms should be enforced by the state that arise from an efficient incentive structure.

The structural approach conflicts with much writing in the economic analysis of law in two respects. First, the structural approach applies to obligations, not mere regularities. In contrast, most economic models do not distinguish equilibria sustained by obligation from equilibria sustained by inclination. Second, 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.

6 CONCLUSION

"Is the price and quantity of shoes efficient?" A direct answer can be found by a cost-benefit analysis of shoe production. However, economists know that the necessary information is unavailable to perform such an analysis.[25] Consequently, economists try to answer the question indirectly, by discussing market structure and firm behaviour. Unfortunately, the proponents of economic analysis do not show the same respect for information constraints applicable to law. "Is a community standard of precaution efficient?" Theorists typically commend that Judges answer this question by applying cost-benefit techniques like the Hand Rule. The application of cost-benefit techniques requires more information about cost than Courts usually possess. Economic specialisation constantly widens the information deficit for Courts. To overcome the deficit, adjudication requires a structural approach. In a structural approach, the Courts decide whether to enforce a social norm by inquiring into the incentives by which it arose, rather than attempting to weigh costs and benefits directly. A structural approach is more decentralised, because lawmakers must

25 Indeed, even powerful regulators have difficulty obtaining reliable information on costs from regulated industries. To illustrate, the electric power industry has strong incentives to misrepresent the cost of electricity to its regulator, who sets prices.

rely on social institutions to create social norms for themselves.

The structural approach bears on an old debate in jurisprudence about whether Judges make law or find it. Scholars generally accept that American Courts make law in light of public policy. The older conception that Judges find law has been largely abandoned. The theory of games and norms can revitalise the older conception of common law. According to the theory developed in this article, a common law Court should find that a social norm is law if it evolved from an appropriate incentive structure. An appropriate incentive structure is one in which incentives for signalling by individuals align with the public good (long run relations, convexity, no spillovers). Social norms that evolve from an appropriate incentive structure already have the community's authority in them. Recovering this conception grows more urgent as the economy's complexity increases.

Note on this paper: This paper concerns themes presented by Professor Cooter at the annual meeting of the New Zealand Law and Economics Association and at various Universities in June 1998. The paper abbreviates:

"Structural Adjudication and the New Law Merchant: A Model of Decentralised Law" (1994) 14 International Review of Law and Economics 215-231.

Other papers by Professor Cooter developing this theme include:

"Decentralised Law for a Complex Economy: The Structural Approach to Adjudicating the New Law Merchant" (1996) 144 University of Pennsylvania Law Review 1643-1696.

"The Theory of Market Modernisation of Law" (1996) 16 International Review of Law and Economics 141-172. A version of this paper was reprinted as "Market Modernisation of Law: Economic Development Through Decentralised Law" in J S Bhandari and A O Sykes (eds), *Economic Dimensions in International Law* (Cambridge University Press, Cambridge, 1997), 275-317; with comment by W Kovacic, ibid, 317-323.

"The Rule of State Law Versus the Rule-of-Law State: Economic Analysis of the Legal Foundations of Development" in M Bruno and B Pleskovic (eds), *Annual World Bank Conference on Development Economics, 1996* (The World Bank, Washington DC, 1997), 191-218: reprinted in E Buscaglia, W Ratliff and R Cooter (eds), *The Law and Economics of Development* (JAI Press Inc, Greenwich, Connecticut, and London, England, 1997), 101-148.

"The Normative Failure Theory of Law" (1997) 82 Cornell Law Review 947-979.

"Law From Order: Economic Development and the Jurisprudence of Social Norms" in J M Olson and S Kahkonen (eds), *A Not-so-dismal Science: A Broader, Brighter Approach to Economies and Societies* (Oxford University Press, Oxford, 1998), forthcoming.

"Expressive Law and Economics" (1998) 27 J Legal Studies 585-607.

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