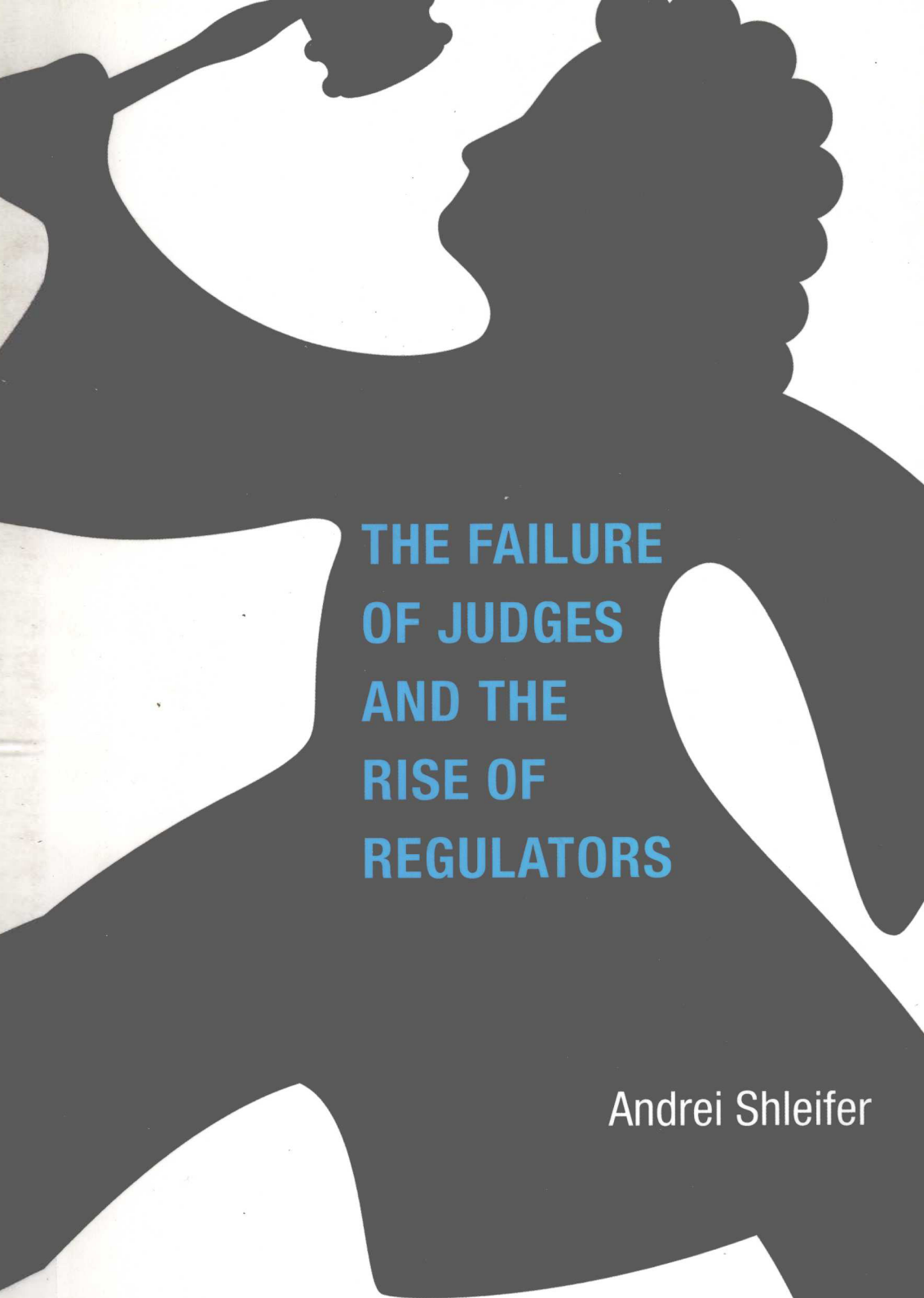

THE FAILURE OF JUDGES AND THE RISE OF REGULATORS

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Acknowledgments

The ideas presented in this book have been developed with several collaborators, as reflected in joint authorship of all but the introductory chapter. Most importantly, the central idea of this book—that regulation emerges as an alternative strategy of social control of economic life in response to the failure of courts—was developed together with Edward L. Glaeser. This idea of course is not entirely new: both Woodrow Wilson in his *New Freedom* program and James Landis in his classic 1938 defense of regulation *The Administrative Process* emphasized the failures of courts to deal with the problems of modern society. Yet the insight appears to have been lost in modern regulatory economics, and we attempted to bring it back, theoretically, historically, and (with Simon Johnson) empirically.

A key part of the argument is the failure of courts to deal with modern problems, which has led me to an effort to understand judicial behavior. The notion that judges exercise enormous discretion leading to unpredictability of litigation is again not new; it has long been known in American jurisprudence as *Legal Realism* and has recently been beautifully articulated by Judge Richard A. Posner (2008) in his *How Judges Think*. Nicola Gennaioli and I tried to revisit some of the fundamental questions of legal realism formally in the chapters presented in this book. Judge Posner, Anthony Niblett, and I then joined forces to examine empirically whether the widely accepted belief in the long-run convergence and predictability of common law is accurate. We found that it is not, at least in one key area of tort law.

One way to understand how litigation or regulation is chosen is to look across jurisdictions. Some of the most exciting evidence on regulatory styles comes from comparing patterns of regulation and litigation across countries from different legal traditions. For over a decade, I have been involved in research in this area with Simeon Djankov,

Rafael La Porta, and Florencio Lopez de Silanes, which continued earlier work with Robert Vishny on *Law and Finance*. Some of the research on comparative regulation appears in this volume. More recently, Casey Mulligan and I have argued that there are increasing returns to regulation, so that more populous jurisdictions should have more of it.

I am extremely grateful to all of my coauthors for allowing me to reprint our joint work in this book. I am also grateful to Nicolas Ciarcia, Virginia Crossman, Lori Reck, and Benjamin Schoefer for help with producing this volume. Last but not least, I am grateful to my hosts for the Walras-Pareto Lectures at the University of Lausanne, Professor Alberto Holly and Claudine Delapierre Saudan, for hospitality in their beautiful city.

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1 Ubiquitous Regulation

The American and European societies are much richer today than they were 100 years ago, yet they are also vastly more regulated. Today, we work in jobs extensively regulated by the government, from hiring procedures, to working hours and conditions, to rules for joining unions, to dismissal practices. We live in houses and apartment buildings whose construction—from zoning, to use of materials, to fire codes—is heavily regulated. We eat food grown with approved fertilizers and hormones, processed in regulated factories, and sold in licensed outlets with mandatory labels and warnings. Our cars, buses, and airplanes are made, sold, driven, and maintained under heavy government regulation. Our children attend schools that teach material authorized by the state, visit doctors following regulated procedures, and play on playgrounds built under government-mandated safety standards.

Government regulation is extensive in all rich and middle-income countries. It transcends not only levels of economic development, but also cultures, legal traditions, levels of democratization, and all other factors economists use to explain differences among countries. There is surely a lot of variation across countries, but it pales by comparison with the raw fact of ubiquity. Why is there so much government regulation? Why has it grown?

I begin this chapter by reviewing the standard theories of economic regulation, and arguing that they fail to account for the basic facts of regulation. I then propose "The Enforcement Theory of Regulation," which sees regulation as one of several alternative strategies of social control of business, of which the most prominent is dispute resolution by courts. Because such resolution is often costly, unpredictable, and

ineffective, regulation, with all its faults, emerges as the more efficient strategy for enforcing desirable conduct.

2 Theories of Regulation

The standard Pigouvian, "public interest" or "helping hand" theory of regulation is based on two assumptions. First, unhindered markets often fail because of the problems of monopoly or externalities. Second, governments are benign and capable of correcting these market failures through regulation. This theory of regulation has been used both as a prescription of what governments should do, and as a description of what they actually do, at least in democratic countries. According to this theory, governments control prices so that monopolies do not overcharge, impose safety standards to prevent accidents such as fires or poisonings, regulate jobs to counter the employer's monopsony power over the employee, regulate security issuances so investors are not cheated, and so on. The public interest theory of regulation has become the cornerstone of modern public economics, as well as the bible of socialist and other left-leaning politicians. It has been used to justify much of the growth of public ownership and regulation over the twentieth century (Allais 1947; Meade 1948; Lewis 1949). It has also been the bedrock of modern anti-market rhetoric (Stiglitz 1989).

The public interest theory of regulation has been subjected to a number of criticisms, associated mostly with the Chicago School of Law and Economics. These criticisms proceed in three intellectual steps. First, contracts and private orderings can take care of most market failures without any government intervention at all, let alone regulation. Second, in the few cases where markets might not work perfectly, private litigation can address whatever conflicts market participants might have. And third, even if markets and courts cannot solve all problems perfectly, government regulators are incompetent, corrupt, and captured, so regulation would make things even worse. Consider these three lines of argument in order.

The first line of attack criticizes the public interest theory for exaggerating the extent of market failure, and for failing to recognize the ability of competition and private orderings to address many of the alleged problems. Competition for labor, the argument goes, itself assures that employers provide safety and good working conditions for employees. If an employer failed to do so, his competitors would offer the more efficient packages, and thereby attract better workers at

lower wages. Likewise, private markets assure the efficient safety levels in a variety of products and services, such as trains, houses, or cars. Sellers who fail to deliver such levels of safety lose market share to competitors who run safer trains, build safer houses, or produce safer cars. The competition criticism also maintains that what looks like a monopoly to would-be regulators is subject to potential entry and competition. Moreover, cartels typically break up after a short time because their participants cheat to make windfall profits.

Even when competitive forces are not strong enough, private orderings work to address potential market failures. Neighbors resolve disputes among themselves, without any government intervention, because they need to get along with each other over long stretches of time (Ellickson 1991). Industries form associations that guarantee quality, and penalize cheaters among themselves to assure that, in the long run, customers continue their patronage (Greif 1989; Bernstein 1992). Families, cities, and ethnic groups establish reputations in the marketplace, and thereby control any possible misconduct by their members.

The thrust of these arguments is that the domain of market failure or socially harmful conduct that is not automatically controlled by impersonal forces of competition is extremely limited, and therefore so is the scope for any desirable intervention by the state. But this, of course, is only the first step in a much broader assault on regulation.

The second step, originating in the work of Coase (1960), maintains further that, in the few cases where competition and private orderings do not successfully address market failures, impartial courts can do so by enforcing contracts and common law rules for torts. Employers can offer workers employment contracts that specify what happens in the event of an accident, security issuers can voluntarily disclose information to potential investors and guarantee its accuracy, and so on. As long as courts enforce these contracts, market outcomes are efficient. Indeed, even when there are no contracts, efficient adjudication by courts restores efficiency through appropriate tort rules. When courts award damages to harmed plaintiffs correctly, potential tortfeasors face exactly the right incentives to take the efficient level of precaution (Posner 1972). With well-functioning courts enforcing property rights and contracts, the scope for desirable regulation—even by a "helping hand" government—is minimal.

Coase's logic has proved extremely powerful, both as a technical critique of regulation and as a libertarian manifesto. Following Coase,

the Chicago School has gone much further. The third, and crucial step in its critique of regulation is to question the assumptions of a benevolent and competent government. This is the essence of Stigler's capture theory (Stigler 1971; Posner 1974). As forcefully summarized by Peltzman (1989), this theory consists of two basic propositions. First, the political process of regulation is typically captured by the regulated industry itself. Regulation not only fails to counter monopoly pricing, but is to the contrary used to sustain it through state intervention. Second, even in the cases where, under the influence of organized consumer groups, regulators try to promote social welfare, they are incompetent and rarely succeed. Thus the scope for government regulation is minimal at best, and such intervention is futile and dangerous even in the rare cases where there is scope.

The Chicago critique of public interest regulatory theory is one of the finest moments of twentieth-century economics. The pioneers of this critique not only provided new theories for thinking about the role of government, but also delivered predictions that in many cases have been supported by the evidence—particularly the evidence of pervasive regulatory failure. Yet the Chicago critique cannot be the final answer, for at least two important reasons.

At the most basic level, the Chicago tradition has failed to come to grips with the fundamental facts described in the first paragraph of this chapter, namely that today we live in a much richer, more benign, but also more regulated society, and that as consumers we are generally happy with most of the regulations that protect us. We are happier knowing that trains and airplanes are safe than we would be savoring the thought of a fortune that our loved ones would collect in a lawsuit should we die in a fiery crash. In securities markets, investors prefer a regulated, level playing field to the prospect of loss recovery through litigation. Indeed, there is strong evidence that regulation benefits the development of financial markets and public participation in them (chapter 7; La Porta et al. 2008). A more nuanced theory, which incorporates the powerful Chicago critiques of the public interest approach to government, but also recognizes the benefits of regulation in some circumstances, is clearly needed to keep the logic and the facts together.

Second, the Coasian logic runs into contradictions as a description of reality. In Coase's view, contracts are a substitute for regulation. If potential externalities are contracted around, no regulation is necessary. Yet, contrary to this prediction, we see extensive government

regulation of *contracts themselves*. Employment terms are delineated in contracts, yet these contracts are heavily regulated by the government. Purchases of various goods, from homes, to appliances, to stocks, are governed by detailed contracts, yet these contracts too are restricted by government mandates. The regulation of contracts goes much beyond mandatory disclosure, which suggests that asymmetric information is not at the heart of the problem. The fact that contracting itself is so heavily regulated undermines both the public interest theory of regulation and its Coasian critique. The public interest theory is undermined because market failures or information asymmetries do not seem to be necessary for regulation, yet those are seen by the theory as the prerequisites for government intervention. The Coasian position is undermined because free contracts are expected to remedy market failures and eliminate the need for regulation, yet regulation often intervenes in and restricts contracts themselves, including contracts with no third party effects. The puzzle of ubiquitous regulation remains.

This book argues that to understand ubiquitous regulation, one needs to take a broader perspective on how societies enforce desirable conduct by their members. This perspective recognizes that enforcement is not free, but instead requires resources (Becker and Stigler 1974). Private orderings, litigation, and regulation are all examples of strategies of enforcing desirable conduct. Over time, there is some pressure for societies to gravitate toward the more efficient, or less expensive, strategies of enforcing socially desirable conduct. In some spheres of activity, these efficient strategies require minimal government involvement: private orderings work extremely well. In other instances, nothing but the full control of the activity by the government would meet social goals: imagine the contracting out of keeping nuclear weapons. Away from these extremes, an intermediate form of government involvement is necessary, with two principal forms being litigation and regulation. Litigation, central to the Coasian logic, emphasizes dispute resolution by courts; regulation emphasizes the enforcement of rules by the executive. Of course, in many instances, the two are combined.

The key point of the enforcement theory is that the choice between regulation and litigation often depends on which one is the more efficient strategy of addressing externalities and torts. The fundamental assumption of Coase's argument is that courts, as a rule, effectively enforce contracts and efficient tort remedies, creating a strong presumption against regulation. Because courts are needed both to enforce

contracts and to provide remedies for torts, they are central to the basic private mechanisms for curing market failures. In so far as courts resolve disputes cheaply, predictably, and impartially, the efficiency case for regulation is difficult to make in most areas. Efficient regulation would be an exception, not the rule. But when litigation is expensive, unpredictable, or biased, the efficiency case for regulation opens up. Contracts accomplish less when their interpretation is unpredictable and their enforcement is expensive. Liability rules do not cure market failures if compensation of the victims is vulnerable to the vagaries of courts. The choice between regulation, litigation, or a mixture of the two is then a choice of the efficient strategy of enforcement of socially desirable conduct. In this book, I argue that the superiority of courts is far from clear cut. And when courts fail, regulation emerges as the more efficient approach.

In what follows, I show that this theory explains not only the ubiquity of regulation, but also its growth over the last century. The enforcement theory also helps shed light on the patterns of regulation and litigation across activities, as well as across jurisdictions. I am not suggesting that regulation is universally desirable; regulators often suffer from far deeper problems than judges. The point is that there are tradeoffs between the two. Indeed, if this theory is correct, it suggests that the growth of regulation reflects an efficient institutional adaptation to a more complex world.

3 Perfect Courts

To fix ideas and to illustrate the arguments, consider the example of workplace safety regulation, an important area of government intervention in markets. Workplace safety is especially informative because the traditional transaction-cost objection to the Coase Theorem, namely that contracting is impractical because many parties are involved (as with pollution), does not apply. Nor is it plausible that asymmetric information between firms and their workers, who are specialists and interact over time, limits contracts (or has third party effects). Indeed, the puzzle of ubiquitous and growing regulation is most dramatic in areas, such as workplace safety, where there are no obvious limitations on or externalities from contracts and tort law is well developed.

The explosion of workplace safety regulation is indeed puzzling from the Coasian perspective. To begin, market forces should work in this area, even with spot labor markets and without complex contracts.

Because wages adjust in risky occupations, employers have an economic incentive to control accident risks so as to reduce the wage premium they have to pay. Firms would also want to establish reputations as safe employers to attract better workers, and to pay them less. Competition for labor provides strong incentives to maintain a safe workplace.

Extensive contracting opportunities are available as well. Employees, through collective bargaining agreements or even individual employment contracts, can require firms to take safety precautions. Firms can likewise require certain levels of care from their employees by specifying that they follow safety procedures. Private insurance is available to both workers and firms to insure the damages to health and property resulting from accidents. Insurance companies can then demand, as part of the insurance contract, that firms and workers take specific precautions. With knowledgeable firms, knowledgeable workers, and knowledgeable insurance companies, one would think correct incentives could be worked out. Moreover, the parties interact over time, and are able to learn where the risks are, mitigate them, and adjust their contracts accordingly. It seems compelling, in this context, that private solutions provide parties with correct incentives to take efficient precautions.

Should one of the parties fail to follow the terms of the contract, the other can go to court. Indeed, it can do so even before an accident occurs if contractual terms regarding precautions are violated. After an accident, likewise, the victim can demand in a lawsuit a contractually specified compensation for damages. Courts can then enforce the contracts, by requiring the insurance company or the firm to pay, or alternatively by finding that the worker had not taken contractually agreed upon precautions. No governmental authority beyond courts is needed.

If the necessary contracts are too elaborate to negotiate up front, insurance companies and industry associations can produce recommendations for safety standards, and contracts can incorporate those. An individual firm, a union, or even a worker bears few incremental costs of figuring out what is appropriate by opting into industry standards. Standardization also reduces the costs of compliance by specifying standard safety equipment or safety procedures.

Finally, even if contracts do not cover some eventualities, tort law deals with accidents not covered by contracts. Courts develop precedents and guidelines for addressing questions of liability and damages, and can also rely on industry standards for reaching conclusions. As

the law develops over time, these precedents and other rules developed by courts cover more and more situations, leaving ever smaller uncertainties. Indeed, as courts complete the law, they eliminate the need for actual litigation since parties know what to expect and settle without it.

With so many protective mechanisms for both workers and firms available through markets and courts, and so many incentives for efficient precautions provided by these mechanisms, why would anyone need regulation?

Once the puzzle is framed in this way, it becomes clear where to look for the answer. Start with the forces of competition on the spot markets, without contracts or insurance. It is probably true that, in the world of well-heeled and well-established firms, with access to capital markets and expectation of long-run survival, the savings from taking efficient precautions outweigh the immediate costs. But many firms operate in a very different world, in which capital is scarce, downward pressure on prices is relentless, and incentives to cut costs today are strong. In such a competitive world, the firm may face huge pressure to undersupply precautions relative to the efficient level and to accept incremental accident risks. Should an accident happen, the firm might be able to fight its liability in court, settle for a small sum with a desperate victim, or go bankrupt. To hold the firm accountable for causing accidents, there need to be effective courts. Competition without courts and contracts does not do much for safety.

If competition does not lead firms to take efficient precautions, it must be contracts, including insurance contracts, as well as tort rules, that do the job. But contracts and torts fundamentally rely on enforcement by courts. Suppose for concreteness that the firm and its employees have agreed on a contract that delineates the precautions that need to be taken, and suppose further that the firm has taken out an insurance policy compensating workers who are harmed. After that, an accident happens. Neither the insurance company nor the firm wants to pay the victim, so the victim has to sue for damages. Most accidents occur because of some combination of bad luck and lack of precautions on the parts of both the employer and employee (or, to make it more complex, an employee other than the one who got hurt). Each litigant blames the other, often sincerely. And even if the "true" facts of the case are clear to an omniscient observer, and even if the litigants know what happened, they each have a story for why it is not their fault, but the other party's. The insurance company likewise has a story for why the

particular accident is not covered, or if covered not to the full extent of the damages. A court, or some substitute such as an arbitration board, has to ascertain the facts and interpret the contract or apply the law. The question then becomes how cheaply, predictably, and impartially the court can do so.

Consider this question in steps. Begin with courts as assumed in law and economics. In those courts, 1) judges are motivated to exert effort to enforce contracts and laws, 2) judges are knowledgeable enough to verify the facts, and 3) judges are impartial. I argue later that all three of these assumptions are dubious descriptions of reality, and that the failure of each gives rise to a distinct argument for regulation. But for now consider this extreme example of knowledgeable, motivated, and impartial judges.

One might think that, in this case, courts could easily deal with a workplace accident. But even here several issues hamper adjudication and make it uncertain. First, judges do not witness the accident and need to figure out what happened. They can only do so imperfectly. The litigants have different perceptions of what happened, even if they are honest, and the judge needs to piece the story together. Litigants, or their lawyers, often lie, or at least shade the truth in their own favor. With conflicting testimony, even ideal judges would have trouble figuring out what actually happened.

To protect the system from manipulation by the litigants, legal procedure is itself heavily regulated and burdensome. Discovery is extensive, invasive, and expensive, including both the collection of records and the examination of witnesses. Chapter 5 examines the regulation of legal procedure and efficiency of courts in 109 countries by focusing on the simplest cases: the eviction of a non-paying tenant and the collection of a bounced check. Based on surveys of legal experts in these countries, the evidence shows that the judicial procedures governing such litigation are extremely cumbersome and time consuming, yielding highly uncertain payoffs to plaintiffs.

Second, the contract may not cover the exact facts of the dispute: in an accident, both litigants are often at fault. Moreover, language is often unclear and vulnerable to alternative interpretations. What are best efforts, for example? With incomplete contracts, the litigants disagree on how the contract allocates the costs of an accident. The judge has to decide what the contract means.

Third, both contractual interpretation and tort liability are governed by multiple conflicting principles, and judges need to pick which ones

to apply. Judges reason by analogy to precedents, and a case is often analogous to multiple precedents with conflicting results. Lawyers argue that the precedent favoring their clients is the closest one. Judges then decide. It might be difficult to tell in advance which of the potentially governing precedents the judge will pick, especially when the facts are close to the line.

With factual, contractual, and legal uncertainty, the judge must exercise at least some discretion in resolving a dispute. Aspects of such discretion have been called fact discretion, referring to the judge's flexibility in interpreting facts, and legal discretion, referring to room to maneuver in applying the law to the facts. Pistor and Xu (2003) aptly call this "incomplete law." Posner (2008) refers to this as "open area" uncertainty. Posner recognizes the existence of such uncertainty, but seems to believe that this open area is usually small.

The bottom line is that, even assuming that judges are unbiased, knowledgeable, and properly motivated, judicial discretion imposes risk on the litigants. Judicial discretion, which follows from legal, contractual, and factual uncertainty, is an essential feature of litigation, and one from which many consequences follow.

Recent research has begun to uncover systematic evidence of judicial discretion. A large empirical literature discussed by Posner (2008) documents the effect of the judges' political party affiliations on their decisions. Chang and Schoar (2007) use a sample of 5,000 Chapter 11 filings by private companies in the U.S., and find that in their motion granting practices, some bankruptcy judges are systematically more pro-creditor than others. Niblett (2009) examines interpretation of very standard arbitration clauses in contracts by California appellate courts. He finds that judges make arbitrary distinctions in their contract interpretation even in the simplest of cases, for instance focusing on the size of the print or the location of the arbitration clause in the contract. This evidence is noteworthy because the cases Niblett selects are so similar.

Beyond judicial decision making, there is also the problem of enforcing decisions. A firm, especially a small firm, might not have the money to pay to compensate the employee, might not have bought insurance, and might even go bankrupt. In fact, such a firm might ex ante choose to skimp on precautions and go bankrupt after an accident occurs. This problem, identified by Summers (1983) and Shavell (1984a), plagues contract and tort law enforcement. Even without bankruptcy, damage payments for negligence might be high, especially when they are jacked