The Legal Foundations of Free Markets

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FOREWORD

Free markets do not exist within a vacuum, but need a legal framework that protects property, enforces contracts and allows free exchange to flourish. This statement would tend to be accepted by most economists and, increasingly, forms the basis of meaningful discussions of development economics. This type of statement also leaves many of the most important questions unanswered, however. What should this legal framework look like? What are its limits? What systems should we use for determining it? And, perhaps most importantly, who should determine it? After all, if freely transacting parties within a market are capable of designing contracts and even designing very detailed systems of private regulation, such as those that used to be found within stock exchanges before government regulation took over, then why cannot freely transacting parties design systems of law that are widely applicable?

In particular, those involved with development economics and issues of bad governance within poor countries would like urgent and simple answers to these questions. But there are no simple answers, and our understanding of many of these problems is cloudy. One especially important question stands out. Do legal frameworks evolve naturally within societies or can they be designed, at least in outline, and imposed from above? If it is possible to impose effective legal frameworks within which free exchange can take place, then perhaps we can solve problems of underdevelopment fairly rapidly: at least where there is an absence of war and conflict. Provisionally, however, it seems as if the evidence points to the conclusion that many aspects of effective legal frameworks have to be allowed to evolve within communities – a process that can take time.

In this excellent collection, put together by Stephen Copp, and containing chapters by many of the leading law and economics scholars in the world, many of the authors deal with subjects related to the questions posed above. In one of the early chapters, Peter Leeson asks quite simply whether free markets need government. The relative merits of common law versus codified law systems; the relationship between government law and natural law; whether concepts such as limited liability need to be defined by government law; and whether environmental protection requires state regulation or can be attained through private legal actions are then addressed in an engaging and straightforward style by the authors.

Even upon settling these issues, there remain many questions on which free-market economists legitimately disagree. The other authors in this book deal with some of these questions. How should we deal with monopolies and cartels? If courts have a responsibility to enforce obligations agreed in contracts, how should they do this in practice? What is the relationship between law, regulation and economics? Should human rights and economic freedoms be protected in a special way, such as through treaties and constitutions? And has an obsession with human rights undermined economic freedom?

The importance of the subject area of law and economics is being increasingly recognised – though it still does not have the prominence it deserves in the UK. This collection is an important contribution to the debate in this field. It is important both for economists who wish to understand more about the origins and purpose of law and regulation, but also for lawyers who need to understand more about the economic foundations of sound legal systems.

The views expressed in this monograph are, as in all IEA publications, those of the authors and not those of the Institute (which has no corporate view), its managing trustees, Academic Advisory Council members or senior staff.

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July 2008

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5 ECONOMICS AND THE DESIGN OF REGULATORY LAW

Anthony Ogus

Introduction

For a book entitled *The Legal Foundations of Free Markets* it may seem somewhat perverse to write a chapter on regulation. Arguably, regulated markets are the very opposite of 'free markets'.[1] Nevertheless, an understanding of why and how governments regulate and the interaction between regulatory law and market activity is of the greatest importance.

'Regulatory law' is an imprecise term. Here I use it to refer to legal instruments used by governments to induce economic actors to outcomes that would not have been reached if they had been allowed to engage freely in market activity (Ogus, 2004a: 1–4). During the last fifty years or so, there have been immense changes in the substance of this area of law; even more importantly, perhaps, there have been immense changes in the way this area of law has been perceived by economists and in their influence on the design of it.

A quick glance at the pronouncements of some of the greatest economists might suggest a uniform hostility to, and distrust of, regulation. The arguments are at times couched in the language of freedom (for example, Hayek, 1960); others (for example, Friedman, 1962) have focused on the inefficiencies, both allocative and productive, to which regulation typically gives rise. The degree of conviction with which these views are held should not, however, be allowed to distort the more constructive role that economics has played in relation to regulation, and

1 I refer, of course, to markets regulated by government rather than through private mechanisms.

that from a variety of perspectives and with a variety of methodologies.

The task I have set myself in this chapter is to review different economic approaches to regulation and to speculate on how these approaches have, or might have, influenced the design of regulation. Since my own background is in law, I shall focus on the legal dimensions of regulation: the legal forms that are used to achieve regulatory ends, and the legal institutions and procedures that govern the process. Although my approach will not be chronological, I nevertheless take a historical perspective, because economic approaches to regulation have evolved over time.

Public interest analysis

Someone seeking to gain an impression, during the 1960s and 1970s, of the key features of economic and social regulation[2] in the United Kingdom, or other western European countries, would have observed the following:

- *With regard to economic regulation:* Important branches of public law concerned to authorise and control economic activity of the state in the form either of public enterprise or of public institutions investing in, or directing, private enterprise – what the French call *le droit public de l'économie* (Delvolvé, 1998) – and a relative absence of public law and public institutions to encourage and maintain the competitiveness of markets.
- *With regard to social regulation:* A solid core of principles and processes administered by public agencies concerned to protect citizens, particularly employees, against risks to health and safety and a fast-developing array of rules protecting consumers against inadequate quality in goods and services purchased.

2 For the distinction between the two types of regulation, see Ogus (2004a: 4–5).

The focus of this chapter is on social regulation, but it cannot be disassociated from economic regulation, which reflected both strong ideological trends, prevalent in Europe in the post-World War II period, and the continuing strengths of Keynesian macroeconomic theory (Robson, 1960). Microeconomic theorists may have had less of an impact on regulatory policymaking, but the lines of orthodox reasoning were clear (Skuse, 1972).[3] Market failure was assumed to be widespread. Technological change had generated large-scale externalities (primarily risks to public health and safety); it had also widened the information gap between supplier and consumer. It was assumed that interventionist, regulatory measures were both necessary and adequate to deal with these phenomena and hence overcome market failure.

Legal theorising about the British regulatory state during this period was weak[4] (public lawyers were obsessed with constitutional arrangements and the power of the courts to constrain the executive) and intellectual links with economic analysis are hardly discernible. It is, nevertheless, striking that such legal literature as did exist on general regulatory institutions and strategy reveals some interesting parallels with economic theorising. The key author was the German émigré Wolfgang Friedmann. In his classic text *Law in a Changing Society* (1959; see also Friedmann, 1971), he chronicled the rapid growth of public-law incursions on private law, including land-use planning on private property rights; state welfare provision on family-law entitlements; social insurance on tort liability; and health-and-safety regulation and consumer protection on contract. The justification for much of this was articulated in terms of what economists call transaction costs

3 Institutional economics, with its focus on the 'power' behind market and other institutions, and represented particularly by the work of John Commons (1924), was apt to support interventionist policies but had been largely neglected, at least on this side of the Atlantic.

4 With the possible exception of publications emanating from the London School of Economics (e.g. Laski et al., 1935), there had been nothing in the UK to match analysis like that of Ernst Freund in the USA, particularly his *Standards of American Legislation* (1917) and *Legislative Regulation* (1932).

and information costs, as these affect the capacity of the private law to address the problems of industrialisation. But there was also recognition of redistributional goals, the need for governments to overreach disparities of wealth and bargaining power, as well as some concessions to paternalism (although this word was studiously avoided), that governments should make decisions for individuals where the latter cannot be relied on to make wise decisions in their own best interests.

In retrospect, it is surprising that the analysis, which was so copious on market (or private-law) failure, paid such little heed to the possibility of government failure (Demsetz, 1969). True, there were concerns about the effectiveness of the implementation of regulatory programmes, but these were seen to arise from weaknesses in the institutional frameworks, rather than from any limitation in the capacity of governments to address the problems.

The theoretical input for challenging this capacity could have been sought in two major contributions to the economic literature. The first, by Hayek, had grown out of the Austrian tradition, with its subjectivist notion of information and hence suspicion of attempts to meet social preferences by centralised institutions. In the three-volume *Law, Legislation and Liberty* (1973–79), Hayek drew a sharp contrast between two systems of social organisation: 'spontaneous order', largely dependent on decentralised information and in which guiding principles evolve gradually over time in response to changes in that information; and 'rational constructivism', in which centralised rule-makers attempt to dictate outcomes on the basis of the (limited) information available to them. The pricing system of the market and the common law epitomise the first; a planned economy and regulatory law the second.

The other, if less obvious, theoretical input was that of Ronald Coase. His 'Problem of Social Cost' (1960) contained two insights relevant to the design of regulatory law. The first is the perception that conflicts in resource use can be, and will be, resolved by negotiation between the affected parties, provided that transactions costs and the law allow them to do so. The normative implication of this is that public centralised and coercive interventions to resolve such conflicts are likely to be less effective than private consensual approaches. The second insight was to expose the fallacy that misallocations arising from negative 'externalities' should always be corrected by internalising the costs to the actors 'responsible' for them, because other solutions may resolve the conflict at lower cost. I discuss the legal implications of this at length elsewhere (Ogus, 2006: ch. 6). Suffice it here to observe that, for this reason, regulatory interventions may not always be optimal.

Private interest analysis

In the late 1970s and early 1980s the expression 'regulatory failure' gained currency (Sunstein, 1990). Many regulatory regimes were perceived to be unduly complex, excessively burdensome and poorly targeted. Why should this have occurred? Political scientists had suggested that regulatory agencies were vulnerable to 'capture' by the regulated industries (Bernstein, 1955). Some economists developed this into an 'economic theory of regulation'. Regulation was a commodity made available in the political 'marketplace' and 'supplied' by politicians and bureaucrats by reference to the demand of those who would benefit from its promulgation, the price being some form of political, generally electoral, support (Stigler, 1971; Peltzman, 1976). While different groups could furnish political support, the transaction was most likely to be secured by those groups that could coordinate their influence at lowest cost, thus tending to favour, for example, producers over consumers (Olson, 1965).

Private interest economic theory was adept at showing how interventionist measures that were ostensibly designed to protect consumers (or other largely dispersed groups, such as environmentalists) in fact served to protect specific producer interests. This was generally achieved by restricting the entry of newcomers. The obvious example is a licensing system that purports to restrict supply to 'safe' or 'reliable' producers, but which, because of the barrier to entry, often serves simply to enhance the profits of incumbents (Maurizi, 1974). This is so also where a regulatory

regime decrees by means of a so-called 'grandfather clause' that certain standards should apply only to new producers (Breyer, 1982: 115). A third example occurs where the regime adopts measures the compliance cost of which does not vary with output, thereby discriminating against small firms and removing competitive pressure from larger firms (Ogus, 2004a: 172).

Of course, not everyone is prepared to accept the assumption that politicians and bureaucrats are driven exclusively or even predominantly by self-seeking motives; ideology and altruism may be equally important (Farber and Frickey, 1991). Nevertheless, private interest theory has had a profound impact on the way we think about regulation and the regulatory processes, not least because, as the Virginia School of Public Choice has made clear, it has important normative implications (Tollison, 1982). Their main point is that the resources devoted to the campaigns to acquire regulatory wealth transfers – what Virginians refer to as 'rent-seeking' – are, from society's point of view, entirely wasted: they do not contribute to a wealth-enhancing activity (Tullock, 1967).

Clearly, to the extent that private interest analysis is sustainable and that rent-seeking behaviour leads to adverse consequences, regulatory policymaking processes should be designed to minimise such behaviour (Ogus, 1998: 490). More than this, the analysis underlines the importance of the availability of information as to the distributional consequences of regulatory measures. 'We need to know who wins and who loses and by how much, when thinking about public policy. Not only is this a necessary part of strategic public management, it is crucial to a normative consideration of whether the legislation is in the public interest' (Mashaw, 1989: 145).

Renewed public interest analysis

An observer returning to the United Kingdom (or western Europe) during the last 25 years would have been struck by the fundamental changes to economic and social regulation (OECD, 1992).

- *With regard to economic regulation:* The primary model of economic regulation, involving public ownership of monopolistic services, has been replaced by one in which the majority of those services have been privatised, but subject to price and quality regulation, at least for so long as the relevant market remains insufficiently competitive. A more vigorous competition law has impinged on other markets.
- *With regard to social regulation:* There has been some shift away from traditional command-and-control instruments, replacing some of them with financial incentives, and setting more general objectives, leaving it to the industry or individual firms to devise particular rules to meet these objectives, hence the notion of 'co-regulation'.[5] Some form of regulatory impact analysis is generally undertaken as part of the policymaking process.

Mainstream economic theorists have both contributed to, and fed on, these changes. Understandably, this has been most marked in relation to economic regulation, which is concerned with the desired degree of competition within markets and, where necessary, the appropriate principles for price control. Economic analysis was at the forefront both in revealing the weaknesses of the public ownership model (Swann, 1988) and in devising appropriate principles and processes for price controls (Littlechild, 1983). Even more significant, perhaps, has been its contribution to the debate on the liberalisation of energy markets, showing how it would be possible to segment the supplying industries in order to minimise the dimension, normally the transporting of the product, for which it was economically beneficial to retain a monopolistic undertaking (Vickers and Yarrow, 1988).[6]

Some economists use language that suggests that for them 'regulation' is only concerned with prices and competition.[7] But if the interaction between economic theory and social regulation has been less pronounced, it has not been unimportant. Most influential, perhaps, has been a group of scholars whose work is described in Susan Rose-Ackerman's paper 'Progressive law and economics – and the new administrative law' (1988). The epithet 'progressive' is intended to distinguish them from other economists, notably those emanating from Chicago, whose analysis has led them to condemn as inefficient most forms of regulation, and instead to adopt a more constructive approach to interventionist measures. As Rose-Ackerman observes, the group is:

> … similar to Chicagoans in recognising the value of markets in promoting efficiency and the importance of economic incentives in both the private and public sectors. They are trying to get the economic incentives right, not eliminate them. (Ibid.: 344)

We can here briefly survey different features of this work.

Comparison of instruments

Central to the revitalised public interest analysis of social regulation has been an exploration of the cost-effectiveness of different regulatory instruments (Dewees, 1983). With the regulatory objective, such as the level of safety for an activity or product as a given, how can the costs of achieving that goal be minimised? The important dimensions to this inquiry extended beyond the compliance costs to industry, which, in terms of British regulatory policy, were for political reasons given undue prominence (Froud et al., 1998). They included also the costs of obtaining the information necessary for the formulation of standards and other rules and the costs of administering the system, including notably monitoring for compliance and enforcement. Equally important, though less easy to appraise, are indirect costs – for example, the welfare losses from

5 A system in which public regulators oversee rule-making by associations representing private regulatees: Gunningham and Rees (1997).

6 The so-called 'natural monopoly' conditions, where very large-scale economics prevail.

7 A survey of 'regulatory economics' in the previous twenty years in Crew and Kleindorfer (2002) does not even mention social regulation!

inhibiting technological development and restricting competition (Ogus, 2004a: 152–5).

Institutional arrangements

Analysis of this kind has had a major influence on the developments to social regulation, most significantly as regards the substitution of more general principles for specific rules and the absorption of co-regulatory systems, both of which reflect in particular an appreciation of the information costs attendant on the more traditional approaches. Questions concerning the institutional arrangements for implementing more general principles have been, perhaps, less well treated in the economic literature. The problem here has been that although there has been economic modelling of the principal-agent problem as it applies within a public bureaucratic context (Spiller, 1990), exponents of it have been almost exclusively American and their work is heavily influenced by the separation-of-powers constitutional arrangements that are to be found in that jurisdiction (Spiller, 1998).[8]

Regulation at a European or a national level?

In contrast, the ever-continuing debate, within the European Union, on the extent to which regulation should be made, or perhaps harmonised, at a European level, rather than at the level of member states, has been subjected to penetrating economic analysis (Sun and Pelkmans, 1995), derived from Tiebout's seminal paper on the economics of federalism (1956). The starting point is the recognition that local decision-makers can best meet local preferences regarding regulatory objectives and that, assuming some degree of mobility of individuals and firms, competition between regulatory systems can broaden choice and stimulate innovation. While, obviously, for the purposes of trans-boundary trade there are economies of scale in having a single set of rules, experience has shown that it might be very costly to establish such rules, particularly between jurisdictions with different legal cultures (Teubner, 1998). Moreover, any barriers to trans-boundary trade may be surmounted by a system of mutual recognition,[9] whereby the authorities in one jurisdiction accept compliance with the other jurisdiction's legislation as being equivalent to compliance with its own (Pelkmans, 1987).

It has not been difficult to invoke other arguments for European legislation overreaching localised diversity, but whether, in aggregate, they are powerful enough to justify this solution depends on their relative strength, which may vary from sector to sector, and on whether solutions other than harmonisation are available at lower cost. So, the fact that one jurisdiction's legislation – for example, that on environmental protection – may generate externalities in the sense that it has consequences for those in other jurisdictions does not necessarily mean that a pan-European measure imposing a common level of protection is optimal. The electorates in different jurisdictions may have different preferences regarding the level of protection, and where these collide a bilateral negotiated compromise may be more appropriate than a multilateral solution (Cohen, 1996).[10] Take, next, the assertion that regulatory competition will lead to a 'race to the bottom', meaning that member states will lower their regulatory standards in order to attract industry to their jurisdiction. Within the European Union, there is little evidence that diversity in standards has led to such consequences (for tax, Huizinga and Nicodeme, 2006; for employment, Dehejia and Samy, 2006; for the environment, Janicke, 2004). This should not be

8 With a more pronounced constitutional separation of powers, regulatory agencies must seek to satisfy three 'principals': the legislature, the executive and the courts. Under a 'Westminster' approach, the legislature is largely controlled by the executive and the courts play a more passive role in relation to judicial review.

9 This may be by legislation or by judicial practice, applying the familiar Cassis de Dijon [1979] ECR 649 principle.

10 The fact that in practice there will usually be some degree of negotiation and compromise between the jurisdictions involved in trans-boundary externalities suggests that the optimal arrangements might be some mixture of cooperation and competition – what Esty and Geradin (2001) call 'co-opetition'.

surprising. Location decisions are made by reference not only to regulatory compliance costs but also to considerations such as the quality of a jurisdiction's infrastructure and its labour force, and these are likely to be found in countries whose citizens have preferences for higher regulatory standards (Revesz, 2001).

In the 1970s and 1980s, the strength of ideological commitment manifestly adopted by some European politicians led to a programme of harmonisation that paid little heed to these arguments.[11] Some reversal to that policy is evident in the more recent adoption of the subsidiarity principle, and this has been influenced, or least underpinned, by the economic analysis (Van den Bergh, 1998).

Sanctions and enforcement

In the last decade, attention has focused on the incentive effects of regulation and on the methods of inducing compliance. At the time of writing, the Regulatory Enforcement and Sanctions Bill is before Parliament. Largely implementing Macrory's Cabinet Office review (2006), this will (if enacted) make radical changes to UK policy and practice of regulatory enforcement, including the widespread use of administrative financial penalties outside the ambit of the criminal justice system. Undoubtedly economic analysis has had a major influence in this area.

The economics of law enforcement, derived from Becker's classic (1968) paper, has provided the necessary input (Ogus, 2004b). This revealed the inadequacy of deterrence when a relatively modest criminal penalty was combined with a low rate of prosecutions, a consequence of the high cost to the prosecuting authorities of meeting the elevated evidentiary standards of the criminal process. A system of administrative penalties can solve the problem, given the higher rate of imposition,

11 Economic private interest theory can also be invoked to explain these developments, some key interest groups being stronger, relative to other groups, at a European level, compared to a national level, and thus applying pressure for a harmonisation policy on which they can exert their more powerful influence: Noam (1982).

although some trade-off must be made with the increased incidence of error costs that will arise, given the absence of the criminal justice standards of proof (Hylton and Khanna, 2007).

Regulatory impact assessment

The mode of economic analysis of regulation that has had the highest profile is undoubtedly regulatory impact assessment (RIA). In one form or another, it has been adopted by most industrialised countries as a mandatory bureaucratic investigation of the likely impact of regulatory proposals. In its most developed form, following the model established by Reagan's Executive Order 12,291, it is a full cost–benefit analysis (Heimann et al., 1990).[12]

The extent to which RIA has actually influenced regulatory policy, in the sense of leading to changes in the legislation made, remains unclear (Hahn et al., 2000). Furthermore, a cost–benefit analysis cannot provide a determinative judgement on whether a proposal should be implemented. This is not only because of the familiar difficulties of assigning a value to some of the key benefits of social regulation, such as the value of life or of a clean environment (McGarity, 1991); it is also because the mere fact that aggregate benefits exceed aggregate costs (the Kaldor-Hicks efficiency criterion) does not necessarily mean that the proposal is socially desirable (Ogus, 2006: ch. 7). Politically, or morally, it might be inappropriate to impose costs on some members of the community to improve aggregate welfare.

Nevertheless, RIA has become an important part of regulatory policymaking. Its primary value lies in its capacity to provide systematic information on important issues (Posner, 2001a), to render transparent the regulatory process and to impose a discipline on officials preparing policy proposals, forcing them to address key questions in a coherent manner (Froud et al., 1998).

12 For a survey of national developments, see Radaelli (2004).

Behavioural law and economics

The final area of economic input into regulatory policymaking to which I wish to refer should certainly be considered public interest analysis. I treat it separately from other types of that analysis because, drawing on social psychology, it distances itself from the assumptions of conventional microeconomics. Indeed, its very *raison d'être* is to predict consequences where individuals do not behave rationally (Sunstein, 2000). Although this obviously has important implications for regulatory policy, the analysis seems, so far, to have made little impact on policymakers. Here I shall deal with two questions on which, nevertheless, it has potentially much to offer: irrational attitudes to risk; and paternalism.

Risk management

A major dimension of modern social regulation involves risk management and control. Much of it is controversial, as there are difficult questions, such as how to value life and limb (Jones-Lee, 1989) and how to respond to phenomena such as climate change and terrorism, which are both uncertain in their incidence and fraught by political considerations (Sunstein, 2002). Clearly, these events can impose huge costs on society if, and to the extent that, they materialise. But, equally clearly, stringent regulatory measures taken to constrain them – for example, those taken to implement the so-called 'precautionary principle'[13] – are also very costly, particularly if governments aim at a level of protection that significantly exceeds what is socially optimal.

Determination of what is socially optimal involves targeting regulatory measures to the level of protection at which the marginal costs approximate to the marginal benefits, the latter involving principally reduced damage costs. That determination is often weakened by inadequate data, but the principle remains clear – that it should involve an objective, scientific assessment of the nature of the risk and of the means

13 On which see Majone (2002) and Sunstein (2005).

of controlling it, on the basis of such evidence as is available at reasonable cost.

The crucial difficulty here is that lay perceptions of risk often differ widely from the objective assessment made by experts. Behavioural economics, drawing on social psychology empirical studies (Noll and Krier, 1990), indicates that ordinary people will, in particular:

- overestimate risks identical, or analogous, to those arising from events receiving much media attention ('availability heuristic');
- overestimate risks that have already materialised ('hindsight bias');
- overvalue the benefit of preventing (or reducing) risks from new activities or technologies ('status quo bias').

By way of topical illustration, empirical studies have shown that, relative to what is suggested by objective evidence, Americans attribute a high value to the probability of a terrorist attack[14] and a low value to the possibility of climate change (Sunstein, 2007). Such phenomena give rise to a delicate policy question: to what extent should policymakers adjust safety regulation upwards from optimal safety standards as reflecting expert assessments to meet the preferences implicit in the lay perceptions?

Mainstream welfare economics would seem to give a straightforward answer to this question. Lay perceptions can be treated simply as examples of risk aversion. The object of economic decision-making is to maximise utility. Even if the lay perceptions of risk outlined above are 'irrational', they cause disutility, and those who are risk-averse will pay more than those who are risk-neutral to alleviate the disutility, by reducing the risk or engaging in self-insurance (Cicchetti and Dubin, 1994). Assuming that regulatory policy aims at mimicking the market transactions that would have taken place without heavy coordination

14 In the period after 9/11, 88 per cent of Americans believed that it was 'likely' or 'somewhat likely' that another terrorist attack would occur within the next few months: Sunstein (2007: 516).

costs, there is therefore a justification in making safety policy meet standards higher than those required by expert assessments.

Adopting this approach meticulously would, however, lead to disproportionate responses to flawed and irrational risk perceptions and seriously inhibit technological development (Viscusi, 1998). Nor does economic reasoning ineluctably lead to such a conclusion. As we have already seen, Coase's 'social cost' paper (1960) teaches us to be sceptical of normative propositions that the *active* creators of risks should always be expected to modify their conduct; in some situations the potential 'victim' is the cheaper cost-abater. If, and to the extent that, attitudes to risk are based on inadequate information or fallacious understanding, it can be argued that the disutility to which these give rise may more easily and cheaply be contained by the better informing and educating of public opinion (Ogus, 2004c). Take, for example, terrorism (Ogus, 2007). A different regulatory strategy can be adopted, the focus shifting from attempts to control the risk of terrorist acts to alleviating fear, which is the consequence of such risk (Posner, 2002). The strategies might include not only the provision of information and public reassurances but also efforts to 'normalise' the risk of terrorism, for the psychological evidence shows that the longer people are exposed to a risk the better they adapt to it and the less the fear that it engenders (Posner, 2001b).

Paternalism

Paternalism, the overriding of individual choice on the ground that individuals cannot be trusted to make decisions wisely, would seem to lie behind a large number of regulatory measures, including social insurance; the compulsory wearing of seat belts and safety helmets; and 'cooling-off periods' enabling consumers and investors to withdraw from contractual undertakings. They also include, more generally, prohibiting or controlling certain risk-generating products and services, as an alternative to providing information and risking leaving it to consumers

to decide whether they wish to purchase the product or service. Yet, perhaps because of political correctness, the topic is rarely discussed openly and analysis of when paternalistic justifications for regulation should be invoked are hard to find.[15] This is to be regretted and, in this final section of the chapter, I seek to show how such analysis can make a valuable addition to regulatory policymaking.

We should note, in the first place, that many apparently interventionist measures, overriding individual preferences, can be rationalised economically without reference to paternalistic arguments. Most obviously and importantly, some unwise individual decisions generate negative externalities. Thus, insistence that a safety helmet or an equivalent protective device be worn by those at risk may reduce injuries and thus also the healthcare costs borne by taxpayers and health insurance contributors. Alternatively, it can be justified on grounds of information asymmetry; this is conceptually distinct from paternalism, which can apply even where these is perfect information.

Genuine paternalistic arguments are founded on presumed irrationality and, as we have seen, the work of behavioural economists provides some rich insights as to when this is likely to occur. With the aid of this evidence, it is possible to identify situations in which many, perhaps most, individual decision-makers select options that would not reflect their preferences if they had been responding rationally to the information available. The benefit of a legal intervention forcing an individual to adopt the rational choice may then be expressed as the difference between the utility gained from complying with the legal requirement and the utility that would have been gained from exercising the preferred option. The social benefit of the measure would then be the aggregate of such increases in utility for all those subject to the requirement – though some deduction would have to be made for imperfect enforcement of the law – and these can then be compared with costs of the regulatory measure (Zamir, 1998).

15 Exceptions are Zamir (1998) and Camerer et al. (2003), in addition to my own paper (Ogus, 2005) on which this section is based.

Of course, these variables cannot be quantified with any precision, but policymakers could on this basis adopt an analytical framework for reviewing paternalist measures, taking the following steps (Ogus, 2005):

- Are there plausible traditional justifications (externalities, information failure, inadequate competition) for the measure, operating independently of paternalism?
- If not, and taking account of the insights of behavioural economics, is the regulated activity one with regard to which a significant proportion of the agents make decisions that are unlikely to reflect their real preferences?
- If so, are the likely costs of the regulatory measure proportionate to the likely benefits and/or could the same outcome be reached at lower cost by an alternative instrument?

Conclusion

This chapter reaches no simple, or provocative, normative conclusions regarding the level or character of regulation. My principal mission has been to convince my readers not only that economic analysis has a large and critical function in relation to regulatory law, but also that this function is positive as well as negative.

For a variety of reasons, economic and non-economic, we will always have regulation. Public interest economic analysis provides us with guidance on how regulatory law might be designed at minimum cost to society; private interest analysis alerts us to the dangers of regulatory goals being subverted and how we should respond to this risk. Finally, behavioural economics responds to the problems of 'bounded rationality' and indicates how regulation might adapt to them.

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6 ECONOMIC RIGHTS

Norman Barry

Introduction

It is noticeable that in all the febrile debate about rights which has emerged in recent years there has been little discussion about economic rights – that is, the right to property, contract and all the other procedural requirements that go to make up a market society. The *civil* rights to non-discrimination, free discussion, religion and so on have been to the fore in political and philosophical argument. It is true that in America certain economic liberties have emerged as almost accidental by-products of these concerns, such as the right to advertising, which has been protected as a necessity for the right to free expression, guaranteed by the First Amendment to the Constitution, but for most of the time, in all countries, economic rights have been at the mercy of legislatures throughout this and the last century, with little or no protection from the courts or written constitutions.

This is partly due to philosophical reasons, the shift in the meaning of liberalism away from economic freedom towards a more socially oriented doctrine that permits redistribution and excessive liberty-reducing regulation, and also involves a redefinition of liberty. This last point has involved the abandonment of the essential *unity* of liberty, in which economic liberty flows directly from an all-embracing concept of freedom, towards the promotion of particular *liberties.* In that taxonomy economic rights have not been regarded as of overwhelming importance, or of any real value at all. There is scarcely any recognition of the intimate connection between economic rights and all the other more fashionable notions.