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Simple rules for a more inclusive economy

Vlad Tarko[1]

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Abstract
This paper explores some of the reasons why capitalism experiences periodic crises of legitimacy and asks whether Richard Epstein's "simple rules" heuristic can help. The current legitimacy problem is exacerbated by the fact that we are also in a low growth situation. This means that some policy instruments that could have been used to increase legitimacy may no longer be available. The "simple rules" heuristic can help as a guide to reforms that would simultaneously address the legitimacy problem, while avoiding making the growth problem worse.

Keywords Legitimacy · Inequality · Economic disruption · Growth · Rule of law · Generality norm

JEL Classification D63 · K10 · K20 · P16

1 Introduction

Capitalism is perpetually on the verge of a crisis of legitimacy, but every once in a while, the crisis becomes more serious. We are currently in such a state of affairs, but to understand the legitimacy crisis, we must look beyond the details of the moment and consider why this crisis is recurring. There are two main reasons: (1) The core institutions of capitalism are difficult to legitimize because they generate various unpleasant or unjust side-effects (in terms of uncertainty, social-economic disruption, income distribution and environmental failures). (2) Damaging institutions and policies (from protectionism to misguided regulatory policies and dysfunctional federalism) are relatively easy to legitimize because they appeal to commonly held moral intuitions.

In this paper I'm revisiting Richard Epstein's *Simple Rules for a Complex World* from the perspective of the capitalist legitimacy crisis. Epstein's argument is about the gradual undermining of the core institutions of capitalism. He has argued that

✉ Vlad Tarko
vladtarko@arizona.edu

[1] Department of Political Economy and Moral Science, University of Arizona, Tucson, AZ, USA

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the complexity of most present-day laws is creating compliance, uncertainty and enforcement costs that far exceed the benefits. He proposed relying instead almost exclusively on "simple rules" for property, contracts and basic public goods, which would enable the operation of a high growth economy and a high diversity society.

Why do we have too much legislative complexity? Epstein argued that this is only partly due to special interests, but, more importantly, it is due to misguided attempts to achieve error-free justice and due to misguided intuitions created by our experience with social norms. The pursuit of error-free justice leads us to create ever more detailed rules designed to take every possibility into account. The analogy to social norms leads us to underestimate the knowledge requirements of detailed rules, as social norms operate mainly between people with personal knowledge of one another, while laws are concerned mainly with interactions between strangers.

In this paper I am generalizing this argument. Our concerns with justice and our social intuitions are key factors leading to a perception of illegitimacy of the capitalist system, but other sources of illegitimacy also exist. Inefficient policies toward greater complexity have been adopted as attempts to increase the legitimacy of the system, often in the aftermath of some serious crisis. Policies that addressed the legitimacy problem in the past had a social cost in terms of reduced growth rates. Epstein's argument is today more relevant than ever. The current problem is more serious because, while in the past growth could be traded-off for more legitimacy, we are currently in a situation of both low legitimacy and low growth. Typical policy solutions are less viable and more dangerous because it is unclear if the system remains sustainable if growth rates decline even more.

2 What is a legitimacy problem?

2.1 The concept of legitimacy

The concept of legitimacy I am employing here is subjective, related to popular *perceptions*, rather than being defined in relation to some philosophical theory of justice. Generally speaking, we can talk about the legitimacy of (a) specific actions or activities, (b) political leaders, as well as of some other elites (e.g. intellectual), (c) some organizations performing specific tasks and (d) the institutional framework as a whole. An action or activity is legitimate, in the sense used here, if there is broad agreement that the agent performing it has the right to perform it. Rights are defined by the normative expectations prevalent in society, i.e. by what most people, for various complex reasons, accept as appropriate or inappropriate behaviors in different social contexts. A person or organization is legitimate if their main activities are legitimate. An otherwise legitimate organization can, nonetheless, sometimes engage in illegitimate activities; but if the bulk of the activities are illegitimate, the organization as a whole is illegitimate.

An institutional system as a whole is legitimate if it is widely agreed that it establishes and enforces the correct rights and obligations to various groups, organizations and institutional positions. There is always a certain distance between people's views about how society should be and how society actually operates as a consequence of its enforced institutions. The institutional structure is illegitimate if the distance between the prevalent normative views, on one hand and the actual enforced rights and obligations, on the other hand, is large. An illegitimate system is one that persists only because people lack the power to contest it and change it. A legitimate system, by contrast, persists primarily because people comply with it voluntarily – the rules are perceived to be close to what they should be.

Capitalism can be understood as an institutional system that enables a market economy to operate. This system includes specific rules about property rights, contracts and the relationship between governments and private actors (for a good overview see, e.g., Hodgson 2015). As defined by economists, a "capital" good is any good that is used to produce a stream of income. Capital*ism* is the system in which capital goods and the streams of income they produce, are privately owned. In addition, capitalism involves governments that allow relatively unregulated voluntary trades in goods, service, labor and capital (i.e. financial markets), both within countries and between countries. Finally, capitalism is also often described as a system geared toward mass production, rather than luxury goods. All these characteristics set capitalism aside both from socialism (in which capital goods are owned either collectively or by the state) and from earlier systems like feudalism (which, e.g., lacked contractual labor relations) or mercantilism (which was based on establishing widespread monopolistic, rather than competitive, markets).

The institutions that underpin modern capitalism lead to certain economic outcomes, in terms of growth, income inequality, uncertainty, etc., as well as certain social outcomes, e.g. a more individualized society and weaker family bonds and cultural outcomes, e.g. some traditions may be undermined, while others may be enhanced (Cowen 2002, 1998). Depending on whether these outcomes are perceived as desirable or fair, the institutional system itself will be perceived to be more or less legitimate. As such, every time we get some periodic cluster of bad consequences happening at the same time, the legitimacy of the system comes under serious doubt and the institutions of capitalism receive more public and intellectual contestation than usual.

2.2 A brief history of the legitimacy crises of capitalism

The proximate cause of the current crisis of legitimacy is the 2008 financial crisis. The crisis itself revealed the system was more fragile than previously expected and the political reaction to the crisis, in particular the bailouts, created an impression of deep unfairness in which the regular people suffered, while the financial institutions that had caused the crisis were saved by the government. From Occupy Wall Street to the Tea Party, from Alexandria Ocasio-Cortez to Donald Trump, the legitimacy crisis has found expression on both the left and the right of the political spectrum.

It is easy to get caught up in this recent drama and forget about the past legitimacy crises. This type of problem is not new. Consider for instance the Google N-Gram of the words "socialism" and "Socialism" as an imperfect quantitative indicator of the

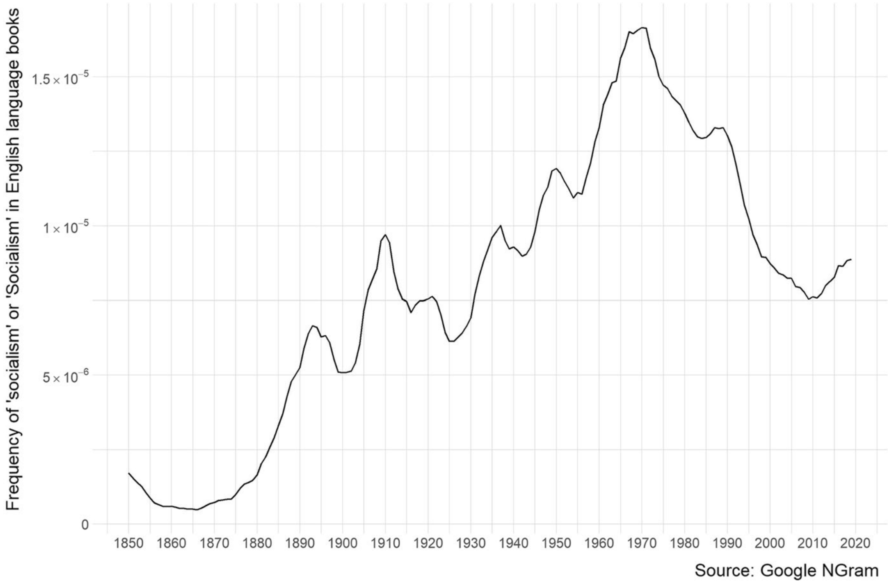

Fig. 1 *N*-Gram of words "socialism" and "Socialism"

perceived illegitimacy of the capitalism (Fig. 1).[1] The ups and downs match a common narrative account. We also see the recent uptick in interest for socialism since 2010, matching the current legitimacy crisis.

The nineteenth century anti-market movements were responses to the perceived failures of early capitalism – various forms of socialism, as well as the German Historical School, were counter-reactions to the liberalism of the classical economists. Over the twentieth century, at least two other major episodes of legitimacy crisis have occurred in United States: one in the 1930s, in response to the Great Depression and one in the 1960–1970s, as a consequence of the Vietnam war, the civil rights struggle and, later, the stagflation problem. The stagflation problem of the 1970s led to the rise of a relatively successful pro-market counter-reaction in both United States and Europe (successful both politically and culturally). The 1980s and 1990s were a period of high legitimacy for the market economy, especially following the collapse of the Soviet Union. As shown by Fig. 1, by mid-2000s the interest in socialism declined to a level not seen for a century.

But this was not to last. The existence of the Soviet Union had helped mask the true extent of the underlining legitimacy problem. Setting aside the reaction to terrorism, which has provided an entire new type of justification for the expansion of government, by the late 2000s certain economic problems became obvious. Many of those problems have their source in a deeper problem that has started in the 1970s

[1] Until 1950 the capitalized version of the word was more prevalent. I thank a reviewer for the suggestion to check the N-Gram.

but did not become fully evident until enough data has accumulated: The slowdown in productivity since the 1970s has not only undermined the standard of living expectations, but it has also put a serious strain on the financing of public services (more on this in Sect. 4).

3 The main sources of illegitimacy

As mentioned, market economies are sustained by a set of core institutions establishing property rights, contract protections and some public goods, such as security and large-scale transportation networks. These core institutions generate various unpleasant or "unjust" side-effects. The competitive environment generates uncertainty and potentially large social-economic disruptions. The income distribution does not always match perceptions of "merit" and economies of scale and network externalities often generate high levels of income and wealth inequality. Negative externalities are often difficult to address leading to various environmental failures.

On top of the core institutions, all advanced capitalist democracies have numerous additional institutions, which may bring further social benefits, on top of the basic productivity gains generated by markets. These non-core institutions include welfare and regulatory policies and the allocation of responsibilities between different levels of a federal system.[2] It is debatable which *exactly* are the core institutions of capitalism and which additional institutions are truly beneficial, rather than damaging. But we don't need perfect agreement on our preferred public policies in order to be able to discuss the main sources of legitimacy problems faced by the market system.

Apart from the problem that the core institutions themselves are a source of illegitimacy, by generating various "unjust" emergent outcomes, some damaging institutions beyond the core are easy to legitimize because they appeal to commonly held moral intuitions. Epstein (1995) notes that such damaging policies are accompanied by an unnecessary increase in rules complexity, which further enables bad policies. In the present discussion, one worry is whether Epstein's simple rules, which provide the institutional framework for markets, lead to various perceived problems precisely *because* they are simple. In Sect. 5 I am arguing that the simplicity heuristics might actually help. Part of the attraction of simple rules is that (1) it makes it harder for special interests to bias the outcomes in their own favor, hence, increasing the sense of fairness and (2) it makes it more difficult to implement damaging non-core institutions.

As argued by Hayek (1960), the social order of a large-scale commercial society is in many ways at odds with our basic social and moral intuitions, which are designed to guide us in small-scale interactions. Epstein highlights the same issue:

[2] The "varieties of capitalism" literature explores this diversity of capitalist systems (Aligica and Tarko 2014a; Coates 2005; Hall and Soskice 2001; Hancké, Rhodes and Thatcher 2007; Menz 2018; Pryor 2010).

> The move from voluntary small groups to large political associations is a move from close connections to impersonal relationships. So profound a shift leads to major changes in the basic dynamics of the situation. The elements of trust and reciprocal dealing, the network of informal rights and informal sanctions, dwindle in effectiveness once that shift is made. Other mechanisms for decision must be found or invented. As the complex network of informal constraints inevitably breaks down, what ought to take its place? (Epstein 1995, 45).

These small groups are relatively egalitarian, have small uncertainty and coordination is made possible by the use of knowledge about personal matters and specific context. In a small group, "each member knows a lot about the people he or she cares about … [which] makes it possible to anticipate what others are likely to want and how they are likely to respond" (Epstein 1995, 43). This is no longer possible in a large-scale commercial society like our own, but the small-scale intuitions lead us to underestimate the difficulty of acquiring the relevant knowledge for managing a large-scale society. People underestimate what a central authority can do and fail to realize that.

> [t]he level of social problems can only increase if the law responds to social diversity by lodging greater power in the center. A far better approach is to encourage the development of a network of voluntary transactions in which individuals deal on their own behalf with trading partners of their own choice. For the legal system to succeed at its task, it needs to adopt legal rules that are in harmony with its own intrinsic limitations. (Epstein 1995, 48–49).

These legal rules are what I called the "core institutions of capitalism".[3] But the issue is that these rules have large scale social-economic consequences that are often at odds with our basic social and moral intuitions.

3.1 The uncertainty of creative destruction

Economic disruption is essential for growth and it is perhaps the main mechanism for unsettling rent-seeking, but it always comes with large social costs for those caught on the wrong side of the disruption. More generally, capitalism requires living with the idea that one's life is embedded in an unpredictable "spontaneous order". This means that one's personal life can be affected at any time by large scale events beyond one's control, indeed beyond *anyone's* control. As such, one's life can be massively disrupted with no fault of their own.

In contrast, political promises of "controlling" the system and "taming" capitalism have widespread popular appeal, even when they are illusory or straight-up deceitful. Epstein's "simple rules" enable the potential of creative destruction and they are *by design* preventing any attempts of rent-seeking incumbents to protect themselves from the disruption.

[3] Epstein overviews these rules is greater detail in part II of the book. See also Williamson (1985).

The problem of the uncertainty created by economic disruption is hard to address by means of public policies and the negative consequences of bad policies in this area are potentially very large. Some attempts involve the use of vocational training,[4] and the existence of a safety net. This being said, too much of a safety net, e.g. a very generous Universal Basic Income program, can undermine incentives for work.

An integral part of the illegitimacy problem associated with creative destruction is the (often justified) perception that the system is corrupt – the rich get shielded from uncertainty, while the poor are left to fend for themselves – capitalism for the poor, mercantilism for the rich. Unfortunately, "mercantilism for the rich" is relatively easy to rationalize by purported concerns about the poor. Economists have, of course, emphasized this ever since Adam Smith, but that has done little to dissuade people's protectionist intuitions (e.g., see Caplan 2008). The attempts to curtail creative destruction can lead to stagnation, if we enable an ever-expanding spiral of rent-seeking designed to protect inefficient incumbents (Olson 1982). The good news here is that policies that reduce this type of corruption are also likely to increase growth. This is perhaps the only case in which the policies that increase legitimacy are also increasing growth.

3.2 Inequality, fear of personal responsibility and the appeal of social insurance

People like freedom, but don't like to take responsibility for the bad consequences that often follow from their decisions. As a consequence, many inefficient policies socializing risks are quite popular. Capitalism, by contrast, largely functions by matching freedom of choice to personal consequences.[5] Too much socialization of risks undermines the market system – which is a system of profit *and loss*. Maintaining freedom of choice while socializing risks enables free riding and large-scale negative externalities. This is true both in terms of welfare state policies and in terms of corporate welfare and of policies that shield firms from the consequences of their decisions.[6]

Conversely, policies that reduce such free riding by limiting freedom of choice (rather than by requiring responsibility) undermine markets by reducing competition. Supporters of markets often have little more to say than "tough luck", but people don't want to hear "tough luck". The fact that viable, non-illusory alternatives to "tough luck" are difficult (impossible?) to find creates part of the legitimacy problem.

[4] The problem with state-run vocational training programs, as opposed to the regular decentralized training provided by firms, is that it is hard to predict what *kind* of training should be delivered.

[5] The successful entrepreneur can get massively rich, but the failed entrepreneur ends up miserable. The student who chooses the "right" major enjoys a successful professional life, while the one that choose the "wrong" specialization is stuck with massive debt. Etc.

[6] For example, environmental problems are often made more likely by caps on damages. This is an example of socializing the risks (e.g. if an oil spill occurs, tax payers pay most of the cleaning costs, rather than the firm), while privatizing the benefits (if the accident doesn't happen, the firm gets to keep the profits).

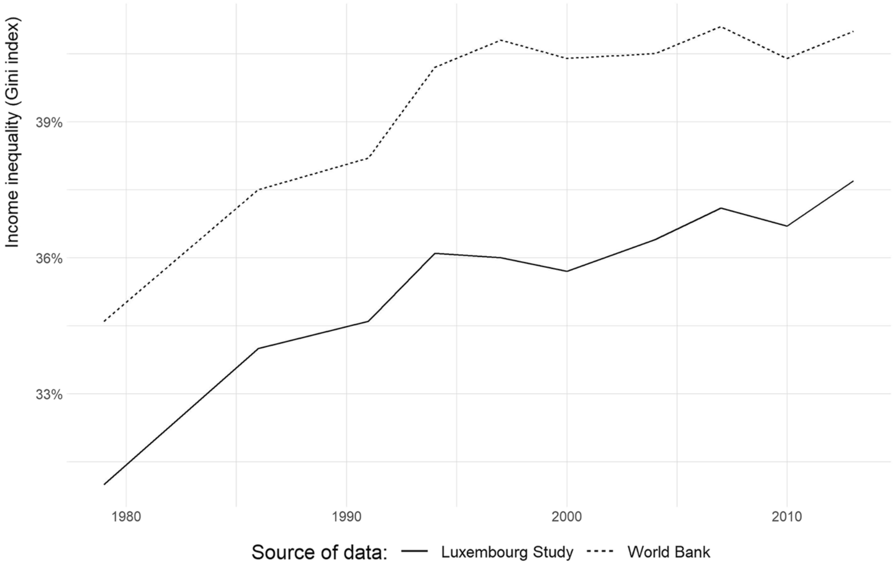

Fig. 2 Inequality of income in United States

We have a deep intuition that we should collectively help those who suffer misfortunes, but this can lead to unsustainable levels of redistributive transfers, as well as hampering incentives to work and redistributive government institutions might replace more efficient civil society or private institutions. Limited redistribution might be beneficial, but overreach is easy.[7] Inequality does indeed look like it has increased since 1980 (Fig. 2).

As noted by Mancur Olson (2000, 190) "subsidizing industries, firms and localities that lose money, even if it is due solely to bad luck, at the expense of those that make money, even as a result of pure chance, is typically disastrous for the efficiency and dynamism of an economy" because "the value of a society's output will normally be much greater if some resources are shifted from money-losing to the money-making activities". This efficiency criterion is, however, at odds with the aforementioned intuitions about fairness. Olson makes the distinction between "social insurance for groups" and "social insurance for individuals". By being more

[7] This has long been recognized even by some of the strongest supporters of social democracy. For example Paul Samuelson has noted that "[w]hen the good-intentioned state increases in scope so as to command that more than 50 percent of the GDP passes through state hands – even in the form of transfer payments for people to spend and taxes for them to pay but with no old-fashioned socialism in the sense of government ownership of factories and the other means of production – then the system somehow becomes (a) increasingly inefficient, (b) non-responsive to the human needs that we do-gooders extoll and (c) possibly infringing on important *human* freedoms (which does not mean *business* freedoms)." Furthermore, he noted that "[h]istory shows … how difficult it is for a welfare state not to *over-reach* itself in the attempt to correct gross inequalities" (cited by Farrant and Tarko 2020).

restricted in scope and more disconnected from rent-seeking, the latter is far less damaging, while still addressing fairness concerns.

Most discussions about the "crisis of capitalism" focus on these concerns, perhaps because they are easiest to address by means of public policies. One can consider various welfare state policies like transfers, subsidized education, healthcare and pensions, etc. as addressing this source of illegitimacy. One problem here is that these policies are also reducing growth. It may well be the case that alternative, more efficient policies for achieving the same goals are available and, yet, these alternatives lack the *intuitive appeal* of these straightforward welfare state policies. For example, the opportunity cost of the US Social Security system is immense: if one would invest their contribution to Social Security in an index fund, instead of having to pay it to the government, one would end up with a far larger private pension after several decades (compared to the Social Security benefits).[8] And yet, Social Security is much more popular than private pensions because of the market-related uncertainty associated with the latter. By contrast, the government-related uncertainty due to size of Social Security benefits seems to be under our conscious (collective) control.

3.3 The problem of meaning and personal identity and the appeal of secular collectivist ideals

Consumption satisfies basic preferences, but people have deeper needs for meaning. Some of the most important factors for happiness and meaning are not available for buying and selling. Division of labor and specialization can also deepen this problem, by trivializing the meaning that one might get from their work.

Perhaps the most psychologically reliable source of personal meaning is to be part of something bigger than yourself. But some of the collectivist ideals that one might embrace in search for meaning, like nationalism, socialism, environmentalism, self-sufficiency, communitarianism, etc., can imply very damaging economic policies and lead to political disasters. The appeal of collectivist ideals also goes hand in hand with promises to reduce the uncertainty associated with capitalism – replacing the "spontaneous order" with a "planned order".

Economists have recently started to pay a little bit more attention to this problem due to the increase in "deaths of despair" and the decline of life expectancy (Case and Deaton 2020). Does US capitalism deliver material goods, but undermine meaning for a large fraction of the population? It is also worth pointing out that some of the safety net programs, offered in response to other concerns about the operation of capitalism, can *exacerbate* the problem of meaninglessness. For example, happiness studies show that unemployment is associated with profound dissatisfaction that goes beyond lack of money (Di Tella, MacCulloch and Oswald 2001; Ouweneel 2002). This dissatisfaction is related to a feeling of meaninglessness associated with not participating in any productive activity. As such, policies that increase

[8] Use https://github.com/vladtarko/growth-scenarios to explore various investment scenarios.

Table 1 Average yearly growth rates for United States

Period	GDP (%)	Labor productivity (%)	Average income (%)
1950s	3.50	2.20	1.80
1960s	4.20	2.40	2.90
1970s	3.20	1.10	2.20
1980s	3.50	1.70	2.50
1990s	3.80	2.50	2.60
2000s	2.00	1.80	1.00
2010s	2.20	0.80	1.40

Source of data: Total Economy Database.

unemployment may offer some material relief, but at the cost of undermining deeper forms of happiness.

The main individualist alternative for solving the problem of meaning is the idea of an ethics of personal growth and development. The basic idea is that one's life is more meaningful and satisfied if one is working toward realizing one's potential and toward expanding their potential. As such, an inclusive version of capitalism should go hand with personal meaning as it enables more people to try to achieve whatever they see as their potential. But maybe this perspective on meaning is not universally appealing.

The most prominent attempt to build such an individualist and pro-capitalist theory of personal meaning is Ayn Rand's,[9] but it has largely been a failure in the sense that it has appeal only to a small fraction of people. Rand's contribution to the moral justification of capitalism may even have done more damage than good by putting forth a theory that is so profoundly distasteful to many and implying that the only way to support capitalism is by adopting such a point of view. This being said, Rand's project highlights a possibly very important point: the legitimacy of capitalism is not purely a matter of economic policy – it may also involve the need for some philosophical justification and the wide-spread adoption of a particular ethics.[10]

3.4 The problem of unrealistic expectations

Finally, we can observe a strange phenomenon: the periods of discontent seem to follow periods of high growth: 1920s, 1960s and 1990s were all periods of high growth (Table 1).

As such, the following phenomenon may be at play: High growth creates unrealistic expectations and, when these expectations are not met, there is a backlash against the very institutions that created the growth. Furthermore, theories about

[9] E.g., see Rand and Branden (1964). For other perspectives on individualist theories of meaning see Nietzsche (1967), Ortega y Gasset (1932), Michael Polanyi (Polanyi and Prosch 1975) or, more recently, Irwin (2015).

[10] See also Buchanan (1994) for an account of how norms of work ethics can affect economic growth.

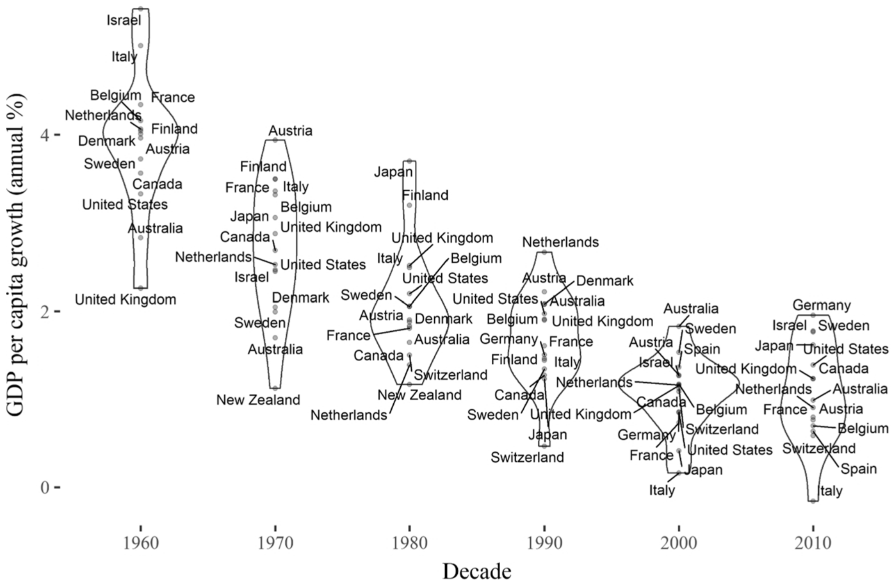

Fig. 3 GDP per capita growth in richest countries

“unbalanced growth”, “rational exuberance” or the Austrian business cycle theory argue that the growth rates may have been artificially increased to some extent, leading to an unavoidable correction. In other words, the creation of unrealistic expectations may be partly due macroeconomic policy mistakes that incentivized irresponsible behaviors.

This phenomenon of unrealistic expectations can also explain the backlash against “neoliberalism” despite its spectacular outcomes globally (Easterly 2019; Grier and Grier 2020). The recent backlash against capitalism in Chile or Eastern Europe also follows a period of high growth.

This problem of unrealistic expectations is exacerbated by observed inequality, which leads to a (more or less justified) perception of unfairness. It’s one thing if the expectations X turn out unrealistic in the sense that *no one* gets X and another if *some* get access to X, while many others don’t. The fact that we don’t have flying cars, although many expected them, doesn’t create a legitimacy problem for capitalism, because no one has flying cars. But the fact that some have access to excellent schools or healthcare, while others don’t, or the fact that structural racism hasn’t declined as fast as people were hoping, does create a legitimacy issue.

4 The decline of growth: The *other* crisis of capitalism

At present, the United States is experiencing the worst labor productivity slowdown since 1950, even worse than what it has experienced in the 1970s (Table 1). This is associated with a recent decline of GDP growth, growth of average individual incomes and a stagnation of median household incomes. The Total Factor

Productivity, a measure that attempts to capture all causes of productivity other than labor and capital, such as technology or organizational innovations, has also been declining. This decline in growth has affected not only United States, but all richest countries (Fig. 3).

The exact causes are still debated (Cowen 2011, 2017; Gordon 2016; Vollrath 2020). Dietrich Vollrath argues that the news is not all bad. The decline is primarily explained by falling birthrates and the switch from manufacturing to services. On one hand, baby boomers are retiring, but they had relatively fewer children, meaning we now have fewer workers per retiree. This issue could be addressed via more immigration, but that is politically problematic at the moment. On the other hand, for services, it is inherently more difficult to increase labor productivity because they involve one-on-one personal contact, e.g. a nurse can only care for so many people in a day, there's not much that can be done to increase their productivity. Vollrath also argues that some commonly assumed culprits, like growing market power, inequality, regulation, trade with China or declining technological innovation, have played little role in the decline. In other words, the growth decline is the emergent result of the choices Americans have made—we are "victims of our own success".

Wages for service jobs can still increase, despite a lack of growth in labor productivity, *if* the service sector is competing for workers with another sector that experiences rising labor productivity (Helland and Tabarrok 2019). For example, the wages of university professors have increased despite little to no increase in their labor productivity, because universities have to them pay enough to attract them from other lucrative (industry) jobs. But, if the service sector expands too much, the competition for workers with the sector/s that have rising labor productivities diminishes. Instead, we have service providers competing for workers with other service providers. Furthermore, if a big sector with rising labor productivity exists, those workers have rising incomes and, hence, can afford to pay more for the services they buy. This closes the circle, allowing service providers to increases the prices of services and earn large enough revenues to pay for their workers' increasing wages. By contrast, this doesn't happen if the entire economy is overwhelmingly a service economy with stagnating productivity. As such, the switch to a service economy can, indeed, partially explain the decline of growth.

Regardless of the exact *causes*, the growth decline has negative *consequences*. One of the most important ones is that a lot of public services depend on the growth rate being high enough (unclear how small is still "enough"). For example, Social Security payments would have to decline if the growth rate and with it, the per capita tax revenues decline. Many of the possible policy solutions proposed to alleviate some of the legitimacy problems would involve increases in government spending, as well as further declines in growth. This means that, if the low growth rate persists, many imaginable government interventions for alleviating various problems would become increasingly more constrained. If some of these interventions are *necessary* for regaining legitimacy for the system, the system will be, hence, in trouble.

Welfare states have expanded for a variety of reasons, not all necessarily related to the legitimacy crises (e.g. Meltzer and Richard 1983). But this expansion, regardless of its causes, has contributed in the past to reducing the legitimacy problem by creating a (more or less justified) perception of greater inclusivity. The current situation differs

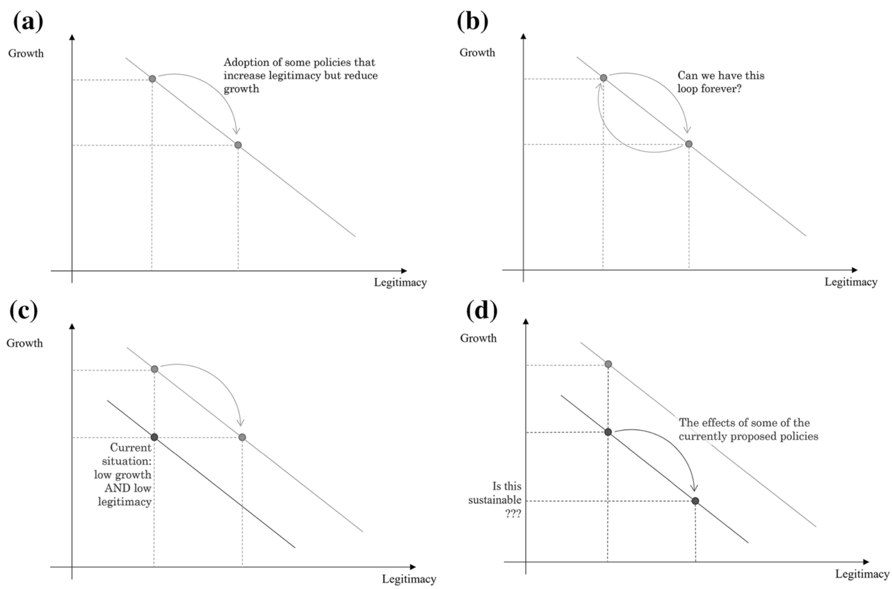

Fig. 4 The trade-off between legitimacy and growth**,** (**a**) The New Deal: 1930–1950s, (**b**) Post WW2: 1950–1960s, (**c**) What people imagine can be done VS the actual situation, (**d**) Present day dilemma

from previous low-legitimacy situations (of the 1930s and 1960–70s). The most important difference is that the current situation is simultaneously a low-legitimacy *and* a low-growth situation (Fig. 4). As such, policy instruments that may have been available in the past are no longer available. This problem appears to be largely neglected in current discussions of the "crisis of capitalism".

The problem of decreasing growth rates thus overlaps with the other problems of legitimacy. The low growth makes the current situation different than the previous crises of legitimacy, because it limits the range of policies available to us. But worryingly, the vast majority of current proposals to address the crisis of legitimacy are entirely disconnected from the problem of low growth, or even argue that low growth is desirable.

5 Is simplicity a good heuristic for re-legitimizing capitalism?

Is it possible to re-legitimize capitalism in a way that also addresses the low growth problem, or at least doesn't make the low growth problem worst? Of the factors discussed in Sect. 3, reducing rent-seeking seems to be the only policy change that would avoid the trade-off described in Fig. 4.

5.1 The generality norm

The main institutional proposal for limiting rent-seeking is what Hayek (1944, 1960) called "rule of law" and Buchanan referred to as the "generality norm" (Buchanan and Congleton 1998). Buchanan (1980, 11) pointed out that.

> [r]ent seeking emerges under normally predicted circumstances because political interference with markets creates *differentially advantageous positions for some persons* who secure access to the valuable "rights". From this fact we may derive a "principle". *If political allocation is to be undertaken without the emergence of wasteful rent seeking the differential advantages granted to some persons as a result of the allocation must be eliminated*. (emphasis added).

He notes that there are only two ways in which this can be done, which would make it possible to have "political allocation without rent seeking": One way would be to divide the rents equally among all people. The other way would be to divide them randomly. Both these methods would defeat the purpose of rent seeking and, hence, eliminate it. This unrealistic conclusion serves as a *reductio* showcasing that political allocation, in fact, serves discriminatory purposes.

In contrast, a general constitutional rule requiring that any law applies the same to everyone, would eliminate the possibility of rent seeking by eliminating the ability to secure differential advantages.[11] Unfortunately, the "rule of law" criterion is very hard to implement in practice because many discriminatory rules can be written in a language that sounds universal (Rajagopalan and Wagner 2013). For example, a rule may specify that every power plant needs to have a pollution filter with certain specific characteristics. This may sound perfectly objective and universal, but, in practice, the characteristics may be selected in such a fashion that the rule favors only a few producers of such filters or a few power plants that already have those filters. The variety of such faux-universal rules is limited only by the ingenuity of legislators and their legal advisors.

Such tricks are clearly at odds with the spirit of the generality norm. But even beyond such tricks, the generality norm remains too vague. For example, is proportional taxation compatible with it? Does it imply a flat tax or a head tax? The norm is not sufficiently well specified to answer such questions, although the *purpose* of the norm – i.e. reducing rent seeking – is clear enough. The vagueness of the norm makes it a weak policy tool for actually fulfilling its purpose.

This being said, Epstein (1995) has also argued that rent seeking may not be the most serious problem.[12] As he put it,

> Why the constant push to legal complexity when its returns are so low, if not negative? In part the explanation lies in the inexorable pressure exerted by innumerable special-interest groups. But in addition, ideas are at work that

[11] Olson (1965, 1982, chap. 2) made the same point, that for a group to be established, the members of the group must be able to gain some advantages by participating in the group, that non-members don't have access to.

[12] Caplan (2008) also makes a similar argument.

> lead the vast mass of disinterested people to keep a receptive ear open to the claims of regulation[:] … the innocent but often fatal impulse to achieve perfect justice in the individual case … [and] … the false belief that the complex forms of regulation which work within small, voluntary groups can be duplicated in larger, impersonal social settings. (Epstein 1995, 37).

Let me first define more clearly what Epstein means by "simplicity", describe his theory of optimal degree of complexity and then evaluate whether it might work to address the problems highlighted in Sects. 3 and 4.

5.2 What is a simple rule?

Epstein builds his account of "simple rules" upon the work of Peter Schuck (1992), which he reinterprets from an efficiency perspective. Schuck defined complexity in terms of "density, technicality, differentiation and indeterminacy or uncertainty" (Epstein 1995, 24). *Density* refers to how many details are covered by the rule: "who may participate, what forms must be used; what terms are allowed; what approvals must be obtained" (Ibid.) *Technicality* refers to whether one needs expert knowledge to understand what the rule says and how to apply it. *Differentiation* refers to the number of overlapping decision centers that govern the situation.[13] Finally, *uncertainty* refers to how hard it is to find out whether a given rules applies to a given situation.

Epstein notes that all these criteria (and maybe others as well) can be reduced to a question about the *costs of compliance*. A rule is complex if the cost of compliance is high: "the *minimum* condition for calling any rule complex is that it creates public regulatory obstacles to the achievement of some private objective" (Epstein 1995, 27).

> [A] complex rule is one that, in addition to meeting Schuck's criteria, has *pervasive application across routine social activities* and is not directed solely to the dangerous activities of people who live at the margins of society. Legal complexity is not merely a simple measure of the inherent or formal properties of legal rules. It is also a function of how deeply they cut into the fabric of ordinary life. With these qualifications, then, Schuck's four tests appear to provide a rough measure of the costs of private compliance and hence of the relative measure of complexity, with which we have to deal. *The fewer and the more accessible the inputs needed to make any legal decision, the simpler the legal system and, all other things being equal, the better its operation.* (Epstein 1995, 29 emphasis added).

Epstein also emphasizes that it is "a dangerous mistake to think of a rule as simple just because it is short" (p. 28). A rule is not just its expression on a piece of paper, but also its mechanisms for monitoring and enforcement. If those are complicated, the rule is complicated, even if it can be expressed in just a few words.

[13] This is similar to the concept of polycentricity Aligica and Tarko 2012.

As such, some commonly used empirical measures of regulatory burden, like the number of pages in the Federal Register, do not capture Epstein's concept very well.

Empirically, Epstein's concept sounds more similar to World Bank's *Doing Business* data, which evaluates the costs (in terms of money and time) that it takes to do various activities legally. But even this captures only part of Epstein's concept. He defines legal simplicity as the cost of compliance with legal rules, which includes *both* the cost suffered by those subjected to the rules (what *Doing Business* measures) *and* the costs encountered by the enforcers and monitors of the rules. Furthermore, for present purposes, the *Doing Business* measure is also not particularly useful as it shows United States as nearly perfect.

Before moving forward, exploring reasons why we might favor some increases in legal complexity, it is worth mentioning a different concept of complexity. Gaus (2019) proposes that we can evaluate how complex a set of rules is by looking at how various outcomes of interest vary when we vary the rules. Simple systems are predictable: a small change of rules leads to a small change of outcomes. By contrast, in a complex system, non-linear interactions between rules may cause the outcome to vary a lot when rules change only a little. Gaus's point is that, if the rules are complex in this sense, policy and institutional design becomes very difficult or near impossible, as the policy-making process is overwhelmed by uncertainty.

5.3 The optimal degree of legal complexity

Epstein notes that anarchy could be seen as the simplest system, as it has, by definition, zero legal compliance costs. But this doesn't mean it is also desirable. If we evaluate the performance of legal systems on utilitarian grounds, i.e. "the maximization of social utility becomes the objective of a sound system of legal rules" (Epstein 1995, 30), "legal simplicity has some role, for it reduces the costs necessary to achieve any agreed-upon end. But how much simplicity is required? To answer this question, it is essential to consider *the great trade-off, namely, that between social incentives and administrative costs*." (Ibid., emphasis added) Good legal rules set up a structure of costs and benefits for individual behavior that encourages desirable social outcomes, "the social function of law is to minimize the sum of the administrative (including error) costs and the costs associated with the creation of poor incentives for individual action" (Epstein 1995, 32).

But in designing or reforming such incentive structures, errors are unavoidable:

> The only question for the legal system is how it will make its errors, not whether it will make them. Simple rules are adopted by people who acknowledge that possibility of error up front and then seek to minimize it in practice. Complex rules are for those who have an unattainable vision of perfection. (Epstein 1995, 39).

This matches the Epstein-simplicity with the Gaus-simplicity. If systems of rules are simple in the Gaus sense, they are also easier to reform, as the causes of errors can be traced back more easily. The difficulty, as Epstein notes, is to resist the temptation of trying to eliminate all errors by building an overly detailed system of rules. The problem with such attempts is that they will create a Gaus-complex system of rules, hence increasing uncertainty about both outcomes and the causal mechanisms at play. Epstein argues that the reason we have this over-optimization temptation is because our intuitions are built for operating in small groups in which the knowledge and trust problems are much lower and, hence, our intuition doesn't fully grasp how extraordinarily different the managerial challenges are in large groups.

The literature on institutional resilience also highlights the problem of "highly optimized tolerance" (Aligica and Tarko 2014b; Carlson and Doyle 2000), i.e. the fact that as we optimize a system of rules to account for *past problems* we can inadvertently create *new weaknesses* that did not previously exist. In the attempt to prevent the recurrence of past problems, the system is over-optimized – it will cope well if those same problems occur again, but it would fare far worst if any new problems occur. Such over-optimized systems of rules can tolerate *only* the problems they were specifically designed to encounter and fail badly if anything else occurs. Highly optimized tolerance is, hence, the wrong way of learning from past mistakes.

We can see Epstein's simplicity heuristic as a rule-of-thumb to counter the temptation to over-optimize:

> Simple legal rules should, then, establish a presumption that can be overcome for good cause, not an absolute imperative that leads to untenable extremes. It is then necessary to identify those factors that drive us back to a certain level of complexity. A universal manifesto is thus reduced to a simple rule of thumb: When in doubt, choose the simpler of two alternatives. (Epstein 1995, 33).

There is another possible benefit of legal complexity, not discussed by Epstein. This relates to Schuck's criterion of differentiation and the logic of Tiebout competition. As argued by Tarko and Farrant (2019) the presence of multiple overlapping regulators can actually enable deregulation, rather than over-regulation. If the overlapping regulators coordinate with one another, the problem can get serious creating a need for permission from multiple agencies in order to perform a certain activity. This is what Schuck and Epstein are concerned about. However, if the overlapping agencies grow in an uncoordinated fashion, as a consequence of their own internal drive for mission-creep, the result can be different. Instead of the need for permission from several agencies, this uncoordinated bureaucratic growth can enable a system of regulatory arbitrage, i.e. the agent in need for permission can shop around for the most convenient regulator and, then use the permission from *one* agency as a legal shield against other agencies or courts. This can enable a type of Tiebout competition between regulatory agencies, but without the need to move geographically, leading to deregulation, rather than over-regulation and may explain the puzzling fact that as the number of regulations and regulators in both United States and Europe has increased continuously over the decades, various indices of regulatory burden (e.g. the Fraser Institute *Economic Freedom of the World* regulation component) show a move toward deregulation.

5.4 Using the simplicity heuristic

If we are trying to "minimize the sum of the costs of administration and error in running a huge social system" (Epstein 1995, 40), the following question arises: Can we achieve the same outcomes in terms of errors, but with much lower administrative costs?

I think this is how the Epstein simplicity heuristic could help us address the legitimacy of capitalism problem. The Hayek-Buchanan "generality norm" heuristic is not only impractical policy-wise, but it is also at odds with people's intuitions about fairness. Setting up the same rules for everybody does not address the inequalities of opportunity. By contrast, Epstein's simplicity heuristic is more flexible.

The problem I've highlighted in Sect. 4 (Fig. 4) is that many of the policies proposed to address the legitimacy problem would further reduce growth and it is questionable how sustainable the American welfare state system would be with even lower growth rates. The simplicity heuristic can offer a path to reforming the welfare state such that it becomes more compatible with growth and better at addressing its sources of illegitimacy.

In practical terms, the simplicity heuristic leads to policy suggestions like the following:

> Expand the Earned Income Tax Credit (EITC) system (which provides cash transfers), while eliminating the in-kind welfare system. In other words, using the money currently spent on in-kind programs (i.e. subsidies for various specific goods and services) to increase the cash transfers. The over-head administrative costs of the in-kind welfare bureaucracies are a few percentages of the total cost of those programs (and, hence, the savings on administrative costs are not spectacular), but such changes would also increase the dignity and freedom of choice of the recipients.[14] Many of the problems and uncertainties faced by the poor and the lower middle class are cash-flow problems. Expanding EITC reduces such cashflow problems, while the in-kind subsidies do not.

A great deal of uncertainty is associated with healthcare costs. Reforming the US healthcare system is a Gargantuan task, made difficult by the existing rent-seeking interests. The main stumbling block is reducing costs by increasing supply: e.g. allowing nurses to perform more tasks that are now reserved to doctors, making it easier to open new hospitals and clinics and enabling competition across state lines on health insurance, making the drug approval system easier, etc. But aside from such (necessary but politically difficult) cost-reducing reforms, some things could be done to address the uncertainty problem directly. For example, provide everyone who doesn't have health insurance a health insurance voucher, which could be used to buy health insurance from any existing provider. The voucher is a system with

[14] One can argue that a Negative Income Tax (NIT), which would provide an unconditional safety net, would be a superior policy to the EITC. This is indeed true in some regards and it would also be an even simpler rule, but it may be more difficult to accept politically.

minimal bureaucratic overhead and minimal information requirements on the part of the government, as it outsources the decisions to individuals and firms.

Currently, individuals can buy health insurance on their own only at higher rates than via their employer because of (a) adverse selection and (b) the tax benefits firms get if they provide health insurance (i.e. the tax system distorts the market against individuals buying health insurance). The problem of adverse selection exists because the health insurer cannot tell for sure why you are buying the insurance – maybe you are a responsible person or maybe you have some serious medical issue you're keeping secret. By contrast, when firms buy health insurance for all their employees, the adverse selection problem is minimal to non-existent.

A health insurance voucher would address the adverse selection problem directly: an individual buying health insurance with the voucher would do so because there's nothing else they can do with the voucher, not because they might have some hidden health cost. The voucher can thus help (a) provide universal health insurance coverage and (b) switch the system from employer-provided health insurance, to individual-bought health insurance. To fully enable this switch, the tax code benefits to firms would also have to be amended. If this switch is enabled, labor mobility would be increased (by decoupling employment from healthcare, the uncertainty of searching and moving to a new job is reduced) and, hence, wages would rise faster (more labor mobility implies firms will have to compete harder for workers).

These are just two examples of how the simplicity heuristic could guide reform proposals that would address uncertainty and inequality and, hence, address some of the sources of the problem of legitimacy. This is obviously not a silver bullet that would entirely solve the issue, but one should not expect any such silver bullet to exist.

6 Conclusion

The main institutions of capitalism, responsible for its engine of growth and innovation, are also responsible for a variety of social-economic consequences that many people find hard to accept. The welfare state and regulatory systems offer some palliative solutions to those problems and, hence, contribute to increasing the legitimacy of the system. This being said, the decline of growth in recent decades makes the current legitimacy problem a lot more difficult, as fewer resources are available for public services. Furthermore, the welfare and regulatory state may be partially responsible for the decline of growth. In other words, we are currently facing greater constraints and greater dangers, in our attempt to re-legitimize capitalism by means of various public policies.

Epstein's concept of simple rules may offer an alternative approach to the current legitimacy problem. Instead of facing a *trade-off* between legitimacy and growth, it may be possible to turn them into complements of each other. The simple rules are designed to offer an institutional foundation for a return to a higher growth society, allowing for a larger degree of permissionless innovation (Thierer 2016), while at the same time providing a greater degree of fairness, by eliminating the possibility of specially granted privileges. This type of fairness would be rooted more in a concept of equality of opportunity, rather than of equality of outcomes.

The concept of simple rules may also provide a useful heuristic for building more robust welfare state policies. A great deal of the current inefficiencies of welfare state policies are associated with their highly complex nature, as a result of policy-makers attempting to produce overly specific outcomes. Such attempts are generally bound to fail because people adjust their behaviors to the policies and, the more complex the policy is, the harder it is to actually predict the human responses. By contrast, simpler policies, focused on expanding opportunities, rather than on delivering specific outcomes, will probably be more efficient and more likely to succeed in actually helping.

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