1974

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Recommended Citation

Victor P. Goldberg, *Institutional Change and the Quasi-Invisible Hand*, 17 J. L. & ECON. 461 (1974).
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INSTITUTIONAL CHANGE AND THE QUASI-INVISIBLE HAND*

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THE fundamental principle of economics is that people will pursue their own self-interest within a given institutional framework. The economist's basic policy premise is that (so long as certain "market failures" do not arise) this self-interest will, like an Invisible Hand, guide resources to their proper usage; when market failures arise the usual policy prescription is to amend the rules (for example, by breaking up monopolies, placing an "optimal" tax on pollution, or redefining property rights) to make the marginal private costs and benefits equal to the marginal social costs and benefits so that the free play on self-interest will again achieve desirable results.¹ But this picture imposes an arbitrary demarcation on the boundaries of self-interest: not only will people pursue their self-interest *within* the rules; they will also allocate resources toward *changing* the rules to their own benefit. When the full implications of this seemingly modest extension are understood, normative economics enters an Alice-in-Wonderland world in which policies that are desirable in the truncated model lose much of their appeal.

To be sure, economists have not totally ignored the role of self-interest in determining the institutional structure. Stigler, for example, states: "Any portion of the society which can secure control of the state's machinery will employ the machinery to improve its own position."² Consequently, Stigler

*I would like to thank the following people for their constructive criticisms of earlier drafts: Jack Ayer, Robert Boyd, Brian Burwell, Richard Cornwall, John Cupps, Race Davies, Bruce Glassburner, Robert Goldfarb, Kenneth Goldin, Rodolfo Gonzalez, Eric Gustafson, Thomas Lenard, Frank Levy, Blair Lord, Thomas Mayer, William Moss, Lloyd Musolf, Richard Nelson, Alan Olmstead, Jim Roumasset, Werner Schink, David Tacy, Elias Tuma, Kenneth Watt, Aaron Wildavsky, and the participants in the Industrial Organization Workshop at the University of Chicago. Part of my research was financed by a grant from the National Science Foundation (G.I.-27).

¹This simple approach has been considerably complicated in recent years by the economist's belated discovery of transactions costs and uncertainty.

²George J. Stigler, *Director's Law of Public Income Redistribution*, 13 *J. Law & Econ.* 1 (1970). See also George J. Stigler, *The Theory of Economic Regulation*, 2 *Bell J. Econ. & Man. Sci.* 3 (1971). Lance Davis & Douglass North, *Institutional Change and American Economic Growth* 10 (1971), make self-interest the prime mover of their *predictive* model of institutional change. "[E]conomic institutions are innovated or prop-

and others (for example, Coase³ and Buchanan⁴) argue that this is one more point in favor of using the market and against governmental intervention. Their conclusion, however, does not follow from the proposition. The argument cuts both ways; in some instances, we shall argue, Stigler's proposition should enhance the desirability of government action.

As an example of the influence of self-interest on institutional choice and the difficulties it creates for policymakers, consider the problem of the "standard form contract." Consumers regularly enter into contracts with the terms specified by the producer—they are what we might call "contract term takers." When a customer parks a car in a parking lot he enters into a contract specifying liability for theft or damage and a number of other terms. Bargaining over the terms of the contract is usually not possible; neither the lot attendant nor the customer would normally be capable of preparing a valid agreement and lawyer's fees would make redrafting out of the question. The lot owner who will enter into a large number of agreements will find it in his best interest to have a lawyer "mass produce" a standard contract: this contract should reflect the owner's interests in the best possible manner. If customers could band together somehow and spread the costs they might be able to render the contract terms more favorable to themselves. There are a number of ways to effect this. One method would be to use lawsuits to obtain a judicial narrowing of the lot owner's discretion in stating contract terms (financing for the suit might come from a single martyr or an automobile association); another would be to establish legislative restrictions on the terms of the contracts; a third would be to leave adjustment of contract terms to a parking lot licensing or regulating agency. Lot owners have an incentive to avoid these solutions, maintain maximum control over contract terms, and make legal action as expensive as possible for the customer (for example, attain the right to hold the customer's car until the litigation is settled).

While such a solution might prove ideal for the lot owner, it might prove to be too expensive, politically, to bring about. The owner will have to decide

erty rights are revised because it appears desirable for individuals or groups to undertake the costs of such changes; they hope to capture some profit which is unattainable under the old arrangement." The Davis-North approach is quite different from the one suggested here; for a further discussion of the Davis-North model, see Alan L. Olmstead & Victor P. Goldberg, *Institutional Change and American Economic Growth: A Critique of Davis and North*, in *12 Explorations in Entrepreneurial History* (forthcoming, Spr. 1975). A clear linkage of self-interest and institutional choice is made by Samuels; his approach is similar in spirit to that of the present paper. See Warren J. Samuels, *Interrelations Between Legal and Economic Processes*, 14 *J. Law & Econ.* 435 (1971); and *Welfare Economics, Power and Property*, in *Perspectives on Property* 61 (Gene L. Wunderlich & W. L. Gibson, Jr. eds. 1972).

³ R. H. Coase, *The Federal Communications Commission*, 2 *J. Law & Econ.* 29 (1959).

⁴ James M. Buchanan, *The Bases for Collective Action* 15-16 (1972).

at what point stacking the deck in his favor is no longer worth the resources he must use to do so. (Competition between producers facing "contract term takers" will also constrain the lot owner's ability to stack the deck. For a number of reasons developed below in Section VI such competition will be only partially successful.) By allocating fewer resources he might attain results nearly as good by, for example, supporting a regulatory agency which would be structured to be sympathetic to the lot owners' position. The customers (or their representatives) will have to make similar allocational decisions. The conscientious policymaker must decide how much the balance should be tilted in favor of one group; a judge, for example, might have to determine whether the terms of the contract were to be taken literally or, if not, how to determine what the contract actually does promise. A legislator must consider how much statutory determination of the terms is necessary to give the consumer a "fair" deal and whether the costs in terms of efficiency of imposing these terms (if indeed there are any costs) are worth these gains.⁵ In addition, the policymaker must consider the reactions of the parties to his attempted intervention. If attempts to restructure the rules against one side (say, the lot owners) will induce that side to employ resources to prevent that change, at what point are the gains outweighed by these costs? If the policymaker forecloses one set of alternatives will the lot owner choose a more objectionable path instead—one that the lot owner and the customer both find inferior?

The standard form contract is not an isolated problem despite its nearly complete absence from the economics literature; Slawson suggests that 99 per cent of the contracts a consumer enters into are standard forms.⁶ The problem will be discussed in more detail in Section VI. In the next four sections a theoretical framework for analyzing institutional change will be developed. Section II presents the theory under a number of restrictive as-

⁵ In recent years there has developed a substantial literature analyzing the implications of the pursuit of self-interest by government officials—legislators (see Anthony Downs, *An Economic Theory of Democracy* (1957) and bureaucrats (see William A. Niskanen, *Bureaucracy and Representative Government* (1971)). By ignoring this subject we do not mean to imply that no problem exists; we are only assuming that the "degree of venality" of public officials can be treated as given. It should be noted in passing that virtually all economic analyses of the incentives of government officials focus on legislators and bureaucrats, ignoring judges. (For exceptions see Gordon Tullock, *Public Decisions as Public Goods*, 79 *J. Pol. Econ.* 913 (1971); and Martin A. Levin, *Urban Politics and Judicial Behavior*, 1 *J. Leg. Studies* 193 (1972).) Yet judges, at least in this country, are either elected officials or are appointed by elected officials; they are, like legislators or bureaucrats, human beings with the same types of motivations. Their behavior is determined in the same manner, in part by their role perceptions and in part by their own self-interest.

⁶ W. David Slawson, *Standard Form Contracts and Democratic Control of Law-making Power*, 84 *Harv. L. Rev.* 529 (1971).

sumptions; in the ensuing sections some of the restrictive assumptions will be dropped. The primary purpose of the theory is *not* to develop testable hypotheses, although with a few extensions it could profitably be used in this manner;⁷ the purpose is avowedly normative—to determine how extending the domain of self-interest to the determination of the rules themselves changes the relative desirability of certain institutional arrangements.

It is convenient at this juncture to introduce the notion of a social engineer: an individual who is attempting to manipulate the rules “in the public interest.” The social engineer can be an ivory tower academic or a legislator, judge, or other policymaker. It is important to note that economists regularly cast themselves in the role of a social engineer asking: when is regulation or government action *justified*; when do markets *fail*; what is the *optimal* level of pollution? In the context of this paper, Milton Friedman is a social engineer attempting to change the rules (volunteer army, freely fluctuating exchange rates, free trade, voluntary unions, etc.) to advance the common weal. We stress this point only because some readers of earlier drafts were very uneasy about the social engineer and feared that we were advocating the creation of a new powerful official.

Before proceeding, one final caveat is in order. If the rules were *completely* determined by self-interest there would be no room for public policy. The working assumption of this paper is that there is a substantial amount of slack in the system which will give the social engineer some room to bend the rules toward producing desirable outcomes. That is, the extended self-interest model suggests not an inexorable process, but certain tendencies—tendencies not revealed by the truncated model. These tendencies, while weak enough to grant the policymaker some leeway, will be of sufficient strength so that ignoring them will yield misleading policy guidance.

I

In this section the outlines of a theory of institutional change will be sketched. It will be convenient to begin with three simplifying assumptions: (1) individuals either act independently or in monolithic coalitions (like the firm of neoclassical theory)—to simplify exposition we will hereafter simply refer to groups, noting that a group may have only one member; (2) groups have a single resource—financial wealth—to allocate toward influencing institutional choice; and (3) the information available to any group concerning the effects on it of a given institutional change is both imperfect and taken as given—manipulation of the information stream is not permitted. (In a similar manner, tastes concerning outcomes and the legitimacy of certain in-

⁷ See Alan L. Olmstead & Victor P. Goldberg, *supra* note 2.

stitutions are taken as given and not subject to manipulation.) These assumptions will be relaxed one at a time in the next three sections.

The group faces the usual allocation decision: how should it use the scarce resources at its disposal to maximize its utility? In the usual model in which institutional structure is taken as a given, the answer is that the marginal benefit of the last dollar spent on each good purchased should be equal. This rule can be extended so that the expected marginal benefit of the last dollar spent on influencing institutions in any particular subject area will be equal to that of the last dollar spent on other influence and the last dollar spent on any good: marginal benefit will be equal to marginal cost.⁸

The net benefits of expenditures on influence depend on the expenditures of opposing groups. If these other groups would be harmed by a certain change (or they perceive that they will be so) they will allocate resources to prevent it. The more opposing groups spend to prevent a change (or to direct change in a different direction), the fewer benefits a group will gain from a given level of spending. Convincing a legislator, by lobbying activities, bribes, or whatever, will be more costly if someone else is trying to influence him in another direction. Thus, A's allocation of its budget toward institutional influence depends on how B, C, and D allocate their resources. And their allocations depend on how A allocates its resources. More precisely, these allocations will depend on guesses concerning the strategy of the other actors.

Strategic interdependence is clearly an important facet of the problem. Yet useful insights can be gained by assuming it away. Suppose that: (1) group A takes the predicted expenses of opposing groups as given and that these predictions are not too far off the mark; (2) the relation between these expenses and the decline in A's benefits is also specified; (3) the benefits can all be measured in dollars;⁹ and (4) units of influence can be defined.¹⁰ Figure I can be used to illustrate A's choice problem.

⁸ The terminology—"maximization" and "the equation of marginal benefit and cost"—should not be taken too seriously. Clearly, ignorance about the benefits of various institutional changes will be pervasive. All we mean to say is that individuals, frequently acting through groups, will pursue their own interests as best they can given what they perceive to be the benefits and costs of their actions.

⁹ The gains sought are often much more complicated than simply "more income." Groups can try to determine what shall be considered "economic goods," or, more generally, the groups can attempt to alter the relative prices of goods. For example, suppose that Smith feels worse off if anyone wears blue shoes; under current rules the "price" to him of purchasing the "good" that other people not wear blue shoes is prohibitive. Even if there were a large number of people like Smith who disapproved of blue shoes, these people would find it virtually impossible to get together and collectively bribe others to not wear blue shoes. If, however, there existed a commission that approved the types of clothing that people might wear, Smith and his allies might find it possible to make their weight felt—the price of satisfying this taste is lower under this new set of rules.

While blue shoes might not be a particularly interesting social problem, the structure

Figure I

MB^* represents the marginal benefits to A if there were no opposing expenditures.¹¹ It is downward sloping since A will attempt to use its influence first where it yields the greatest payoff. MB^* represents the maximum incre-

of the problem is the same as many other more controversial questions. Suppose Smith disapproved of other people watching low quality television programs, or reading pornography, or living in racially segregated neighborhoods, or building structures along a previously undeveloped coastline. Under one set of rules the price of satisfying any of these preferences is virtually infinite. Under other sets of rules the price can be substantially lower; indeed, one rule change is to give Smith the "property right" (or a share of the collective property right) and require those who want to read pornography, despoil the coast, or whatever, to pay him.

¹⁰ This is an heroic assumption. The only justifications for it are (1) it facilitates exposition and (2) economists regularly make such assumptions—for example, in the standard treatment of public goods the horizontal axis is used to represent such nebulous concepts as units of "national defense" or "enforcement of the law" (two areas that most economists are willing to put in the near-pure public good category).

¹¹ We assume for convenience that the curves are continuous.

mental net benefit that A can achieve for a given increment of influence. Thus, if \$1000 is spent on influence, the best strategy might be the pursuit of a higher tariff (a). However, further increases in tariffs (b) might yield smaller rewards than alternative strategies, say, opposing consumer protection legislation (c).

If other groups are permitted to spend money for opposing group A, then the benefits to A of each spending strategy decline (or remain the same).¹² The relative decline in benefits for each strategy will depend on the *ease* of opposing the change (which depends on the initial rules and the apparent legitimacy of the change),¹³ the financial *ability* to oppose change, and the *importance* of opposing change—whether the opponents stand to lose a lot by the change; a change making A better off without making anyone else worse off (that is, a Pareto-optimal change)¹⁴ will presumably engender little or no opposition, while a purely redistributive one will entail substantial resistance. So, in Figure II, the value of redistributive strategy a might fall to c with the opponents spending their optimal amount, while Pareto-optimal strategy b will not be opposed and will be as valuable as before. In the diagram, the second strategy would now be adopted earlier than the first; the

¹² If there were other groups benefitting from a given change, there could be an increase. For Pareto-optimal changes (discussed later in the paragraph) we would expect no decline in benefits to A and quite likely an increase if others (who also benefit) are also willing to support the change. It is convenient (but not necessary) to treat other groups as strictly competing so that the expenditures of others do not increase the benefits to A.

¹³ The influence of the initial rules is obvious. For example, if the required electoral majority is raised from one-half to two-thirds, A would have to spend more to achieve a given change while B would have to spend less to prevent it.

The cultural milieu in which choice takes place is an important determinant of the ease with which change takes place. The milieu confers varying degrees of legitimacy on tactics, rules, and outcomes, making some strategies relatively more desirable than others. If a large number of people believe that the airwaves belong to the public, then they will resist changes which remove the airwaves from the public domain. The widely-held belief that a man should be able to do what he wants with "his property" raises the costs of establishing an institution that infringes upon these "rights," for example, open housing or zoning. (And, conversely, it lowers the costs of opposing these changes or of introducing new changes that are compatible with this position.) It might, therefore, be worthwhile for groups to invest in influencing the cultural milieu; this possibility is discussed in Section V.

¹⁴ Given that the world is characterized by high transactions costs and woefully incomplete information, Pareto-optimality becomes a very ephemeral concept. If individuals who will be made worse off *perceive* that they will not be worse off because they are not capable of evaluating the results, is the change Pareto-optimal? Is a change Pareto-optimal if the *expected* change in utility for all parties is non-negative, or should the results be judged *ex post*? In this paper a Pareto-optimal change will be one in which *most* parties will not be made worse off, *ex post*. By concentrating on Pareto-optimal change we will avoid the difficulties of determining whether a given *arrangement* is Pareto-optimal—that is, one from which no further Pareto-optimal changes can be made.

Figure II

points b' and c' on MB (which represents the marginal benefits accruing to A given the optimal level of expenditure by the opposition) illustrate this new ranking.

A 's optimization decision depends on its costs as well. The costs include not only expenditures on such activities as lobbying for legislation or for favorable treatment by bureaucrats, but also the expenditure of the group for *using* the rules—for example, legal fees for using the courts to enforce a claim under the rules or to prepare legal contracts that are within the established rules.¹⁵

¹⁵ The preparation of private contracts can be viewed as a delegation of legislative authority from the state to the private parties. See John R. Commons, *Legal Foundations of Capitalism* (1924); Friedrich Kessler, *Contracts of Adhesion—Some Thoughts About Freedom of Contract*, 43 Col. L. Rev. 629 (1943); and W. David Slawson, *supra* note 6. This view contrasts sharply with that implicit in most economic analysis (and explicit in some—see James M. Buchanan, *supra* note 4) that private contract is the norm and individuals will delegate tasks to a government if private contract proves inappro-

The group's wealth and ability to borrow limit the amount of influence it can buy. As funds become more expensive, the cost of further influence rises (hence the upward slope of the MC curves in Figure III). One reason for this is that as the size of the loan rises relative to the group's assets, the risk of non-repayment increases; lenders will require a greater premium for this risk or will simply refuse to make funds available.¹⁶ A second, more political, explanation of why *some* groups might face a rising cost of funds curve is that lenders will be reluctant to lend funds for institutional influence unless that influence is in a direction that they (the lenders) prefer. (Tenant unions, for example, might find funding difficult to come by.) Those trying to influence the rules in a manner generally unfavorable to the financiers¹⁷ will in some cases find themselves without financial resources or will have to resort to attaining their financing from secondary (higher priced) sources; their costs will be higher than groups whose goals are consistent with those of the financiers—their costs would be MC_3 rather than MC_2 in Figure III. This suggests the existence of a "multiplier effect" for the power of finance capital in influencing institutional change.¹⁸

An exogenous increase in A's wealth would cause the marginal cost curves to shift outward (MC_3 will shift to MC_2 in Figure III). In general, an in-

priate. In the discussion of standard form contracts *infra* (Section VI), we will find the perspective of Commons, *et al.*, to be very useful.

The costs also would include the costs that accrue to A of changing the rule. For example, the costs of tariff protection would include A's share of the future costs of administering the tariff as well as the costs of printing and distributing the legislation. Such costs will usually be insignificant as they will be spread over a wide constituency; however, this need not always be the case. The extent to which the costs can be spread depends on the existing rules, and these rules can therefore become a significant political background.

¹⁶ This is sometimes incorrectly referred to as a problem of "imperfect capital markets." But this is precisely what we would expect a perfect capital market to do given the existence of imperfect information; see George J. Stigler, *Imperfections in the Capital Market*, 75 J. Pol. Econ. 287 (1967).

¹⁷ The financier's screening can have two different types of effects. On the one hand, a group might have only a few possible strategies that might be obnoxious to the financiers; because of the financiers' opposition these particular strategies would have a lower ranking relative to alternative strategies than would otherwise be the case. On the other hand, the group's entire platform might prove offensive to the financiers, thus weakening its position across the board.

If we drop the simplifying assumption that all benefits can be measured in dollars, then we would expect that groups that receive benefits that are not easily converted to dollars (for example, conservationists winning public control over a wilderness area) will have a higher cost curve since financiers will realize that even if the group wins, the victory will not enhance the group's ability to repay the loan.

¹⁸ This multiplier effect suggests a possible bridge between the "power elite" and the "pluralist interest group" theories of politics. For a description of these, see *The Power Elite in America* (Norman L. Crockett ed. 1970).

Figure III

crease in A's wealth will lead to its spending more (or the same amount) on influence and attaining greater (or equal) benefits. The advantages of wealth are likely to be even greater if there are economies of scale in influence. If a minimum threshold expenditure on influence must be made (say, to hire a full-time lobbyist and staff or to hire lawyers to negotiate a contract) before any rewards are forthcoming, then poorer groups might find the optimal expenditure to be zero. Thus, for MB_1 (Figure IV), A receives no benefits from influence until the threshold level X is reached. If it faced MC_1 , the threshold would make no difference; if, however, it faced MC_2 , the threshold would be beyond the group's borrowing capacity—it would not invest at all. MB_2 represents a less extreme picture of the economies of scale in influence; the group would now find some investment worthwhile if it were facing MC_2 , although if it faced MC_3 it would still find no investment profitable. In any event it is clear that the existence of substantial economies of scale in influence will accentuate the advantage of relatively wealthy groups in the insti-

tutional choice arena. This diagram also illustrates the advantages that might accrue to one party of strategies that increase the requisite scale necessary for attaining influence. Some groups, for example, will find it in their interest to bring some issues into the arena of private contract primarily because their opponents cannot afford to attain the benefits of scale economies in legal assistance.

It is useful to summarize the basic implications of the analysis to this point. There is a kernel of truth in the notion that institutions will adjust to changes in technology, tastes, or relative prices to yield new, more efficient configurations.¹⁹ This is especially true if the gains of the change to some groups are large and the costs to other groups are negligible or if there are no net losers at all. The analysis suggests that the gainers will value such changes highly and will meet little opposition spending which would make the strategy even

¹⁹ See, for example, Harold Demsetz, *Toward a Theory of Property Rights*, 57 *Am. Econ. Rev.* No. 2, at 347 (Papers & Proceedings, May, 1967); and Lance Davis & Douglass North, *supra* note 2.

more desirable relative to alternatives. However, it is also clear that these will not be the only institutional changes that take place. The group's incentives are not to maximize the size of the pie for society; the incentive instead is to maximize the rewards to the group. If the group can better its lot by "buying" tariff protection or government enforcement of entry restrictions, it will not be concerned with the antisocial effects of such a purchase. In particular, changes that benefit some groups at the expense of other groups too poor to oppose the changes effectively will be likely to occur.²⁰ The relative power of the respective parties will determine which institutional changes are adopted.

There is no reason, therefore, to treat the institutional outcomes as desirable. The pursuit of self-interest will not yield institutions which will lead to production of a socially optimal output mix; the exercise of power (that is, investment in influence) will affect the technical efficiency of production as well as the distribution of benefits.

To be sure, this result should come as no surprise. Tariffs, subsidies, and tax exemptions are all expected results of the free play of self-interest in determining the rules. This is precisely the point that Stigler and others make. But the crucial point is this: the mechanism applies equally to what we normally call the "free market"—a set of transactions governed by the general law of contract and enforced by private action through the courts. In many instances the free market solution (1) will make other groups worse off than they would be under alternative rules and (2) will not be the most efficient arrangement (for example, it might not permit the achievement of certain collective action such as pollution abatement). That is, private contract will be a preferred strategy for a group for the same reason as any other institutional arrangement—because that group stands to gain by the arrangement. It is the best one group can do, given the willingness and ability of other groups to oppose it.

In effect we are saying that the truncated model fails to follow a process through to equilibrium. This failure can best be seen by analogy. A non-economist might argue that a policy of rent control will make the poor better off by keeping down their rent; the economist knows, however, that this is not the end of the story and that a likely ending will entail a smaller housing stock for the poor. But, in the present context, the economist is essentially guilty of this same sort of reasoning. A policy to "use the market" for a given

²⁰ Lance Davis & Douglass North, *supra* note 2, at 27 find that their approach works best in the case in which there are no losers or the losers are too weak to stop the gainers.

The analysis should not be interpreted as suggesting that at any point in time the poor, unorganized groups will be suffering rule changes that make them worse off. After all, one cannot get blood from a turnip. Instead we should realize that such groups are losing in an "opportunity cost" sense—they are unable to "buy" rule changes that would help them.

problem will affect the distribution of power. The net gainers can then use their increased power to further influence the rules. Thus, to put the point as paradoxically as possible, a non-governmental solution to a problem could, after adjustment to the new power configuration was completed, entail a *net increase* in the level of governmental activity. More generally, a decision will affect the distribution of power and will therefore influence the distribution of benefits and the efficiency of production in ways that are not anticipated by the truncated model.

This analysis puts the recent literature on the politics of regulation in a new perspective. Regulation, economists have recently discovered, is subject to political manipulation by those who are supposed to be regulated. Jordan²¹ distinguishes two variants of this theme: (1) regulation is introduced for consumer protection but the regulatory process is corrupted and the regulators form an unholy alliance with the regulated;²² and (2) regulation is brought to an industry at its behest and is performed for its benefit.²³ But this literature misses a crucial point: while the institutions of regulation can be manipulated in the producer's interest, so too can those of private contract. Indeed, the firms might have been better off (and the consumers worse off) under private contract. An unregulated airline industry, for example, might attain a rule stating that the development of a new route is the production of new knowledge and the developer should be granted an exclusive right to the route for some period of time (analogous to patent or copyright protection).

The following mental exercise might prove instructive. Suppose that when regulation first appeared before the Supreme Court (1871) it was found unconstitutional and was thereafter abandoned as an infeasible strategy. What then would firms have done with the resources that would have otherwise been used in attaining regulation or in influencing its course? How might the rules of private property, contract, and procedure (for example, standing to sue) have developed over the following century with producers' resources now concentrated in this arena? It is not likely that consumers would have fared very well in this case, especially in view of the Supreme Court's strongly pro-business orientation that persisted until the middle of the New Deal.²⁴ This is not to say that regulation was the most desirable alternative in all cases. The point is simply that the current critical literature makes a specious com-

²¹ William A. Jordan, *Producer Protection, Prior Market Structure and the Effects of Government Regulation*, 15 J. Law & Econ. 151 (1972).

²² See, for example, Marver H. Bernstein, *Regulating Business by Independent Commission* (1955).

²³ See, for example, George J. Stigler, *The Theory of Economic Regulation*, 2 Bell J. Econ. & Man. Sci. 3 (1971).

²⁴ See Arthur S. Miller, *The Supreme Court and American Capitalism* (1968).

parison between corrupt regulation and pristine private contract as if the latter were the feasible alternative to the former. The same forces that bend the one also bend the other.

III

We have thus far assumed that each group was acting as a single individual in pursuit of the group's common goals; the group did not have to concern itself with the difficulties of achieving this joint action. But this assumption of a monolithic coalition masks some important problems. How does the group manage to channel the resources of its members toward achievement of common goals?²⁵ What factors influence the group's ability to channel these resources? How do the institutional arrangements facilitate or impede this joint behavior? In this section we will examine some of the implications of dropping the monolithic coalition assumption. After some preliminary observations we will focus on the modern corporation as a coalition for influencing institutional change.

²⁵ The discussion here substantially understates the complications that arise from dropping the monolithic coalition assumption. We ignore all the strategic problems involved in building and maintaining coalitions.

We also concern ourselves only with the group's pursuit of *common* goals. This ignores an entirely different motive for forming (or joining) coalitions: to *exploit* the other members. The individual will try to include as many other members as possible in the coalition who can be induced to pay more in taxes, dues, or fees than they receive in rewards—services, capital gains, or whatever. That is, the individual's goal will be to use the coalition for satisfying his own preferences while imposing the costs, as far as possible, on other members. Conversely, he will try to avoid coalitions in which he would be a net loser.

In a world in which individuals had perfect information concerning the payoffs from coalition membership and only voluntary coalitions were possible, this motive would not be important. However, neither of these conditions hold. As a result, most coalitions contain a mix of rewards to joint action and rewards to action at the expense of the other members. This characterization applies for voluntary as well as compulsory coalitions; it can be applied to a cartel, for example, whether the cartel is legally protected or whether it must rely on informal coordination.

One particularly interesting form of compulsory coalition is government. Individuals are included in a wide range of overlapping jurisdictions ranging from the national government down to a vast array of special districts. In recent years the division of labor between various levels of government has drawn increasing attention from economists and a literature on "optimal decentralization" has emerged; for a summary, see Robert L. Bish, *The Public Economy of Metropolitan Areas* 35-62 (1971); and Wallace E. Oates, *Fiscal Federalism* 31-63 (1972). Essentially this literature asks: how should jurisdictions be established so that individuals can best satisfy their preferences by following their own self-interest within these jurisdictional rules? But this ignores the fact that people will be trying to change these jurisdictions in their own self-interest (gerrymandering is an obvious example). We suspect that an integration of the self-interest motive in defining the rules (jurisdictions) with the optimal decentralization literature will lead to a substantial revision of that literature; however, investigation of this conjecture will be deferred to a future paper.

All collective action is subject, to some degree, to the "free rider" problem. If benefits are to be conferred on the entire group whether or not each member contributes, then each member has an incentive to be a free rider—to reap the rewards while others pay the costs. If everyone tries to be a free rider, however, there will be no benefits. In general, individuals in a coalition will first have to guess how much other members of the group will pay to achieve a given goal and then have to decide how much to allocate toward achieving that goal.

The amount of resources that a group will have to influence rule changes will depend, therefore, on its ability to induce (or force) potential free riders to contribute to the group.²⁶ The group's success at influencing the results will depend not only upon its ability to constrain its own free riders, but also upon the ability of the opposing groups to constrain their free riders. This ability to constrain free riders will depend upon the rules concerning coalitions. *Any* rules facilitating or inhibiting joint action will have concomitant effects on the distribution of benefits—income, wealth, or the output mix. Thus, the rules affecting coalition building, like other rules, both define the existing environment for choice and provide an arena for conflict—there are significant rewards to restructuring the rules regarding coalitions in one's behalf.

For example, consider the situation in which a firm inflicts a small amount of damage on a large number of people (for example, a single polluter in an air basin or an automobile mechanic who makes unnecessary repairs); the firm will have a strong incentive to have this problem handled on a case-by-case basis in the courts. In most instances, the costs to each victim of using the courts will exceed the expected benefits of victory; consequently, under such an arrangement the victims will seldom have an incentive to make their case. The victims would therefore try to attain alternative institutional arrangements that would better enable them to combine their resources in the collective pursuit of their individual interests. They might, for example, press for a liberalization of the rules governing class action suits (either by legislative enactment or by judicial decree); alternatively they might attempt to have some sort of collective enforcement through government intervention. The two groups will, therefore, be willing to invest resources in changing (or preventing the changing) of the rules regarding collective action. We can also anticipate that an exogenous rule change enhancing the victim's ability to engage in collective action will affect the relative benefits from various strategies to both groups; the liberalization of rules governing class action

²⁶ See Mancur Olson, Jr., *The Logic of Collective Action; Public Goods and the Theory of Groups* (1965).

suits would likely lead the firm to find the courts a relatively less attractive jurisdiction while the victims would find the courts relatively more attractive.

The modern corporation can be viewed as a coalition of individuals seeking the attainment of some specific goals—goals which can be attained either by influencing institutional change or by working within the existing rules. This view of the firm yields a very different picture of the merits of various policy options than does the conventional view. The outlines of this picture will be sketched in the remainder of this section. The modern corporation is a coalition that has successfully managed to marshal the members' resources in their joint interest. Rewards are structured to be roughly proportioned to the contributions of the members—stockholders receive a return related to the number of shares they hold and managers receive a return that is (less closely) related to the skill and effort they provide.²⁷ The structuring of rewards is not perfect and managers do have some opportunity to use the corporation's resources in their own behalf; managers could, for example, sell trade secrets to competitors or quit their jobs and either begin their own firms or join with competitors, taking specialized knowledge or customer good will with them. Restrictions on such managerial behavior will make the coalition more successful. And many such restrictions do exist. An extensive body of law has developed defining the fiduciary duties of managers; contracts restricting an individual's ability to reenter a given industry for a given period are common; laws prohibiting industrial espionage and insider trading are on the books and are enforced, to a degree, by the government. In general, the rules governing the modern corporation are such as to make it a very effective political instrument.²⁸

The firm's effectiveness as a political instrument is limited to certain problems. It can be very effective in lobbying for tariffs, special tax breaks and other issues directly related to the firm's economic well-being. It will be much less effective in lobbying for other issues, for example, social causes. The corporation's power, like the power of any coalition, cannot be wielded uniformly across the board; it is very important in some policy areas and virtually useless in others.

The firm's political effectiveness depends on the amount of resources it can bring to influencing the rules: the larger the firm, the more power it has;²⁹

²⁷ In a study of management compensation, Wilbur G. Lewellen & Blaine Huntsman, *Managerial Pay and Corporate Performance*, 60 *Am. Econ. Rev.* 710 (1970), find that managers' rewards are related to profitability.

²⁸ We are concerned here with the *single corporation* as a political instrument, not with the behavior of a large number of firms acting as a unified political force—for example, the political power of big business.

²⁹ Robert Goldfarb has suggested to me that increased size might in some instances

the firm will utilize its power to structure the rules in its favor. The social engineer has a number of possible responses to this. One is simply to ignore it. Such a "laissez faire" policy will permit the corporations to make substantial gains at the expense of their more poorly organized opposition (for example, customers, labor, and future competitors).³⁰ The firms will try to attain tariff protection, entry restrictions, minimal liability for product failure and industrial accidents, rules that will further weaken their opposition in the future, and so forth. Such a policy is, in short, not particularly attractive. But a brief description of the alternatives will indicate that they do not unambiguously dominate this policy. That is, the social engineer's choice is from among a number of very imperfect alternatives. No effort will be made here to determine which alternatives might be best in a particular context; instead we shall be content to indicate the complexity of the social engineer's problem.

The alternative approaches can be divided into two categories: conduct and structure.³¹ The former consists of attempts to change the rules without altering the corporation's relative political power; the latter aims directly at influencing that power. In either case, the social engineer will find that the firm will oppose such changes and that resources must be expended to overcome this opposition; such costs can help direct the social engineer in determining which alternative should be chosen.

lead to a *decrease* in power for the firm. The larger it is, the more visible it is and, therefore, the greater is the likelihood that it will be scrutinized. That is, the firm will find public opinion a more difficult obstacle to overcome simply because the firm is recognized as being potentially more powerful.

On the other hand, the large firm will also be able to invest more resources for enhancing its image (see Section V, *infra*) and these expenditures would have an opposite influence.

In any event, it seems reasonable to say that over some substantial range increases in a firm's size will produce increases in its power and part of the social engineer's task will be to structure the framework (rules and cultural milieu) so that the increased size will *not* yield the increased power.

³⁰ Customers will in many instances be large firms; in such cases the seller is unlikely to have a significant advantage.

³¹ A third policy is exhortation or propagandizing—trying to induce people to act other than in their immediate self-interest or simply fooling them into acting otherwise. Much of the economist's role in institutional choices has been of this propagandizing nature: tariffs (or minimum wages or farm programs) are not good for society, and therefore beneficiaries *should not* use their resources to buy them. The economist's recommendation is usually based on the implicit assumption that tastes (defined over goods) are not to be tampered with. That is, if the utility function were $U = U(X, I)$ where X is goods and I is institutional changes, the economist chooses to maximize $U^* = U^*(X)$ using the preferences for institutional change as a policy variable. There is a nice irony in finding that the economist's policy prescriptions based on given consumer tastes are grounded in the implicit assumptions that (1) some tastes do not count at all, and (2) some tastes are fair games for manipulation "in the social interest." For a further discussion of this ambiguous treatment for the preference for institutional change, see Victor P. Goldberg, *Public Choice—Property Rights*, 8 J. Econ. Issues 555, 559-61 (1974).

The primary difficulty with the conduct approach is that it can degenerate into a fire-fighting strategy. As one rule change is achieved (say, lowering a tariff) the corporation's power is manifested in another direction. It is often a case of dealing with symptoms rather than the root cause of the problem.⁸² A classic example of the futility of limiting the firm's power by this approach is the judicial treatment of insurance contracts in the first half of this century. Kessler observes:

[C]ourts have made great efforts to protect the weaker contracting party and still keep "the elementary rules" of the law of contracts intact. . . . The law of insurance contracts furnishes excellent illustrations. Handicapped by the axiom that courts can only interpret but cannot make contracts for the parties, courts had to rely heavily on their prerogative of interpretation to protect a policy holder. To be sure many courts have shown a remarkable skill in reaching "just" decisions by construing ambiguous clauses even in cases where there was no ambiguity.⁸³

The response of the insurance companies was predictable. In Llewellyn's words, "the greater bargainer, defeated once and again, recurs to the attack. After each case he can redraft and fight again. A single victory, if achieved, has good chance of being permanent."⁸⁴ Ultimately, the judicial approach was abandoned with the legislature taking a more active role in defining the terms of insurance contracts.

There are a number of different structural strategies for equalizing power. One is to enhance the power of opposing coalitions—"a countervailing power" approach;⁸⁵ the rules could, for example, be structured to encourage the formation of strong labor unions. A second approach would be to keep firm size small—by placing size limits on firms, by a restrictive merger policy, or by lowering the size at which diseconomies of scale appear (for example, making it legal for managers to sell trade secrets). A third approach (which has thus far been assumed away) would be to enhance the value of resources

⁸² The choice of terminology deliberately borrows from the standard industrial organization paradigm (see F. M. Scherer, *Industrial Market Structure and Economic Performance* 3-6 (1970)). The general thrust of the industrial organization literature is that basic structural characteristics influence conduct and, therefore, performance. Policy, consequently, requires structural modification—getting to the root of the problem rather than treating symptoms. In the present context, however, economists' policy recommendations have been almost exclusively directed at the symptoms (conduct) rather than the root (structure).

⁸³ Friedrich Kessler, *supra* note 15, at 633.

⁸⁴ Karl N. Llewellyn, *What Price Contract—An Essay in Perspective*, 40 *Yale L.J.* 705, 732-34 (1931).

⁸⁵ See John K. Galbraith, *American Capitalism: The Concept of Countervailing Power* (1956).

other than financial wealth for influencing the rules.³⁶ For example, the value of the number of bodies in the coalition (votes) would be enhanced relative to financial wealth by rules placing limits on campaign spending.

To be sure, the structural approach entails costs to society which might be substantial. Strong unions, besides their likely influence on production costs, can in many instances find a common interest with the firm and join forces in a more powerful coalition against some third party (union support of tariffs and quotas is an example). A policy restricting firm size might entail forgoing significant scale economies.

Note that the firm's power does not depend on its being large within a particular market. It is possible for firms even in atomistic industries to possess substantial power. Industry structure will, however, influence the areas in which the firm will likely be successful in manipulating the rules. In an atomistic industry the gains from changing a certain rule will often accrue to all firms in the industry. The members of the industry will then be faced with the free rider problem, and might well find that no one is willing to make the expenditure; but there are many cases in which the gains can accrue solely to one firm. For example, a firm competing in an atomistic national market might be able to convince the local government to provide it with publicly financed police services or garbage collection. The more atomistic the industry, the more the firms' efforts will be concentrated in such areas in which the free rider problem is not important.³⁷

The point is this: firms are political instruments—it is in their self-interest to be so—and they are *very good* political instruments. In the absence of strategies to constrain conduct or alter structure, firms will be able to tilt the rules substantially to their advantage and produce a world that is a far cry from the apolitical ideal of economists. It is naive to expect otherwise. Why would an organization that is actively seeking profits *within* the rules of the game not seek further profits by *altering* the rules of the game as well—especially when its structure makes it likely that it will succeed? The restraining strategies (like minimum wages, prohibitions on conglomerate mergers,³⁸ or limitations on patent exploitation) must be evaluated not against the standard of the apolitical competitive market but against what the unconstrained firm would otherwise have attained. This is no mean task. It is

³⁶ These other resources are introduced into the analysis in the next section.

³⁷ The members of the atomistic industry might also fight for rules which permit the members to enhance their ability to work together toward common goals—for example, the legalization of trade association activities.

³⁸ For an analysis of conglomerate merger policy using the approach developed here, see George Berger & Victor P. Goldberg, *Conglomerate Merger Policy: A New Approach*, (Inst. Govt. Affairs, Univ. of Calif., Davis, Res. Rep. No. 28, 1973).

much easier to analyze a policy on the assumption that all other rules will not be affected by the policy and that all these rules are, in some sense, "okay." But if this assumption is wrong, as the preceding analysis suggests, then prudence requires that the additional complications be in some manner integrated into the evaluation process.

IV

Groups will have many other resources beside financial wealth at their disposal both to influence institutional change and to enhance the outcomes from the various institutional arrangements. A group's ability to use physical force is one obvious resource. The ability to withhold services—for example, strikes or threats of plant closings—is another.³⁹ The ability to vote is a third. Extension of the list is bounded only by the imagination of the reader.⁴⁰ A given institutional framework will reward some resources more than others. These resources are differentially distributed—some groups will have a substantial bankroll but few voters while others will have a very different endowment. Outcomes will depend on the institutional structure. So, self-interest would dictate that the participants direct their efforts at influencing this set of rules also. Groups will attempt to have their affairs governed by rules that reward the resources with which they are relatively well endowed.

Changing the rules to make financial power relatively less important than another resource, say votes, will not necessarily result in dramatic changes in outcomes. For one thing, the wealthy groups will adjust to the rule change and try to attain the best deal possible under the new rules given their stock of resources; such an adjustment might take the form of using the financial wealth to influence voters thus offsetting to some degree the group's relative disadvantage. Second, the endowments of the various resources will often be closely correlated. A group that can muster substantial financial support for an issue (relative to its opponents) can often muster substantial electoral support (again relative to its opponents). For example, producers who stand to gain substantially from a tariff will frequently find it worthwhile to vote

³⁹ This includes a wide range of action. A baseball club owner can threaten to move the franchise if the local government will not pay the costs of improving the stadium; a firm can threaten to move if property taxes are not kept low; or a more subtle threat can be made—the firm will move into a jurisdiction only if certain tax concessions are made.

⁴⁰ Warren F. Ilchman & Norman Thomas Uphoff, *The Political Economy of Change* (1969), list six resources that influence an individual's well-being; economic goods and services, status, information, force, legitimacy, and authority. Michael Lipsky, *Protest as a Political Resource*, 62 *Am. Pol. Sci. Rev.* 1144 (1968), discusses "protest" as a political resource of the poor. It should be clear that these nonfinancial resources are a very loosely defined lot. Fortunately, the discussion here does not require much rigor.

for candidates solely on this issue; consumers will find the gains from opposing any given tariff too small to be a major determinant of their vote and the producers will, therefore, remain the relatively stronger party.⁴¹ This does *not* mean that the outcomes will be insensitive to the rules governing the relative value of resources; it simply means that we should neither be so naive as to expect miracles from such rule changes nor should we hold the results of such rule changes up against some mythical unattainable standard: what would have happened if producers (or economic actors in general) were not acting in their own interest.

A number of studies show that political participation is positively associated with socio-economic status. Summarizing this literature, May notes:

In general, people who are effective in private life are effective in public life, people with more education know more about politics, people who care about what happens in politics participate more, people who engage in some political activities are highly likely to participate in others, and people of higher socio-economic status are more likely to possess the characteristics which lead to high rates of participation.⁴²

Whether dollars or votes are to be rewarded, the poor will lose. Publicly provided education, library services, garbage collection, police protection, and other services will generally be better for the wealthy than for the poor.⁴³ But a social engineer interested in redressing the balance in favor of the poor might still find public provision the superior policy. The voting power of the poor might be *relatively* stronger than its financial power. More important, however, is the group's potential power. Suppose some political entrepreneur were to come along to mobilize this latent coalition. If the rules primarily rewarded dollars, the coalition's power would be scarcely enhanced; however, if votes were rewarded the story would be quite different—the rewards to organization *can* be a substantial increase in the relative power of the poor.⁴⁴

⁴¹ This is, of course, not necessarily true if the customer is another business firm.

⁴² Judith V. May, *Citizen Participation: A Review of the Literature 2* (1971); May provides a detailed summary of the literature at 40-59.

⁴³ For a case study of the distribution of public services, see Frank S. Levy, Arnold Meltsner, & Aaron Wildavsky, *Urban Outcomes: Schools, Streets and Libraries* (1974).

⁴⁴ One reason suggested by May for the low participation of the poor is that this is a rational adjustment to their expectations of results. The system is structured so that they do not receive rewards and therefore participation would not yield rewards; hence, non-participation is a sensible strategy. If, however, an entrepreneur (like a Saul Alinsky) can mobilize the group and deliver some results, the group's participation would increase. If this rational adjustment model does explain a good bit of the poor's lower participation rates—it is by no means clear that it does—then this further enhances the rewards to the poor of having institutions which reward voting power relative to financial power.

V

Institutional choice takes place under great ignorance. The results stemming from the establishment of new institutions or modifications in existing ones are seldom known precisely and are often widely divergent from the original expectations. Individuals often do not know the rules for attaining results through the existing institutions or for modifying the rules in their favor; they are also subject to varying degrees of ignorance concerning the existence of potential members of their coalition. Resources can be allocated toward partially dispelling this ignorance. Institutional choice can be made, therefore, with the intention of manipulating the flow of information.

There are economies of scale in providing information and the institutional framework will determine in part who the beneficiaries of these economies are. For example, reliance on private contract enhances the value of legal expertise, thereby favoring the specialists providing such expertise—lawyers—and those with the resources to buy the specialist's services. As before, groups will try to attain institutions which reward the resources with which they are relatively well endowed.

Equally important, the flow of information can be manipulated to influence outcomes. Politicians will make promises or spread rumors about their opponents to influence election results; lawyers will use impassioned oratory to sway jurors; community organizers will convince slum dwellers that they have problems (and resources for ameliorating those problems).⁴⁵ The rewards to the provision, distortion, and concealment of information can be substantial. The obvious implication of this is that a group should allocate resources toward the manipulation of information to induce favorable results. Rather than using up scarce political resources fighting for a tax loophole, for example, the group might find that the same result can be achieved by convincing enough political opponents that the issue is not "tax loopholes" but "preventing unemployment." Such rephrasing can yield substantial "cost reductions" to the group.

⁴⁵ In describing Saul Alinsky's method of community organization, Silberman writes: "Quite frequently . . . the apathy that characterizes the slum represents what in many ways is a realistic response to a hostile environment. But realistic or not, the adjustment that is reached is one of surrender to the existing conditions and abdication of any hope of change. The result is a community seething with inarticulate resentments and dormant hostilities repressed for safety's sake, but which break out every now and then in some explosion of deviant or irrational behavior. The slum dwellers are incapable of acting, or even of joining, until these repressed resentments and hostilities are brought to the surface where they can be seen as problems—i.e., as a condition you can do something about. . . . And so Alinsky pleads guilty to the charge of being an agitator, of arousing dormant hostilities or rubbing raw the sores of discontent. . . ." See Charles E. Silberman, *Crisis in Black and White* 334-35 (1964).

Implicit in this example is the notion that preventing unemployment will be received more favorably than creating a new tax loophole. This, however, depends on society's value structure—on the legitimacy of these two goals—which suggests a third point: resources can (and will) be allocated toward altering societal values. That is, the cultural milieu is not completely exogenous. In essence, the self-interest model can be further extended to include changes in social values.⁴⁶ Harsanyi, for example, argues:

[Social values] change because there is a shift, real or apparent, in the balance of the advantages and disadvantages associated with alternative forms of behavior. Social values change because people find that they will be better off by not conforming to the old social values than they would be by conforming to them.

* * *

[A]n important disincentive is expected opposition and possibly even actual sanctions, from some other members of the society.⁴⁷

Extension of the analysis to include the manipulation of information and values would take us too far afield, but it is at least worth noting that such manipulation will be an important aspect of the political process and will make the social engineer's problem that much more complex.

VI

To demonstrate how the social engineer might take into account the implications of the expanded self-interest model, it is useful to return to the problem of the standard form contract. The truncated self-interest model treats the problem by assuming it away. If people voluntarily enter into contracts it is because it is in their best interest to do so. If the terms of one producer are unsatisfactory, the customer will shop around for others; if information on contract terms were costlessly available (and could be analyzed costlessly) he would continue shopping until he received precisely the desired combina-

⁴⁶ The legal rules can be viewed as a subset of all society's devices for influencing behavior: duty, extra-legal force, trust, ethical codes, etc. Behavior can be effectively constrained if an action is considered unethical, even if it is not illegal. (Conversely, activities that are illegal will be difficult to constrain if they are not considered unethical.) Most behavior is constrained well within the bounds of the law by such non-legal devices. See John R. Commons, *supra* note 15; Kenneth J. Arrow, The Organization of Economic Activity: Issues Pertinent to the Choice of Market Versus Nonmarket Allocation, in U.S. Cong., Joint Economic Comm., Subcomm. on Economy in Government, *The Analysis and Evaluation of Public Expenditures: The PPB system* 62 (1969); and Stewart Macauley, *Non-Contractual Relations in Business: A Preliminary Study*, 28 *Am. Socio. Rev.* 55 (1963).

⁴⁷ John C. Harsanyi, *Rational-Choice Models of Political Behavior vs. Functionalist and Conformist Theories*, 21 *World Politics* 513, 527-29 (1969).

tion of price, quantity, and other contract terms. This, implicitly, is how economists have handled the problem. Additional sophistication occasionally creeps in by the recognition of costs of attaining, processing, and evaluating information; the consumer then would engage in such information processing to the point at which the expected marginal benefits of the additional information are equated to the marginal costs of its acquisition.⁴⁸

Suppose, however, that rather than view the standard form contract as a voluntary agreement, we view it instead as private legislation; the legislature in effect delegates the lawmaking process to private parties.⁴⁹ The previous analysis suggests the bias that this "legislation" might have. We will first stipulate that we are interested here only in the "hidden" terms of the contract—those beside the basic price and quantity terms.⁵⁰ While such terms could be tailor-made for each contract, there are substantial economies to be gained by spreading the costs of producing (and analyzing the impact of) these terms over a large number of contracts.⁵¹ The firm, which regularly enters into the same type of transactions, will be able to achieve these economies (either by itself or by purchasing the service from specialists—lawyers); the consumer, generally, will not. The standard form contract therefore will be legislation produced in an arena which rewards the resources held by one party—the firm. The result, in Llewellyn's words "has seemed even in such highly competitive spheres as installment sales, residence leases, investments, and commercial banking to be . . . [the] accumulation of seller-protective instead of customer-protective clauses."⁵²

⁴⁸ See George J. Stigler, *The Economics of Information*, 69 J. Pol. Econ. 213 (1961).

⁴⁹ Some readers of earlier drafts of this paper did not like this characterization. We might alternatively argue that firms invest resources in the political market for the purpose of keeping certain activities (that is, those covered by standard form contracts) in the private market arena. Such an approach would entail some differences in the analysis, but the conclusions should remain unaffected.

⁵⁰ The terms are sometimes literally hidden: warranty agreements for packaged consumer products are often placed *inside* the box; insurance policies are usually not sent to the buyer until *after* the insurance is purchased; yet the warranties and policies are considered to be contracts. These examples are discussed in W. David Slawson, *supra* note 6, at 540-1.

⁵¹ For a brief description of the economies of scale in contract term standardization, see Friedrich Kessler, *supra* note 15, at 631-32, and W. David Slawson, *supra* note 6, at 530-31.

⁵² Karl N. Llewellyn, *supra* note 34, at 734. Standardized terms are usually used to cover the distribution of risks between buyers and sellers, for example, the possibility that the borrower might default on an installment contract. Slawson describes typical terms in such contracts: "Standard credit agreements commonly allow the lender to call the entire unpaid balance, plus costs of collection, should even a single payment be a moment late, or, not uncommonly, should the lender just wake up some morning feeling 'insecure.'" (W. David Slawson, *supra* note 6, at 531-32.) Clearly, someone has to make decisions as to how these risks (or others) ought to be distributed. The argument here

We might expect competition in the market to constrain the firm's power in this arena. After all, the firm makes its price in this arena too, and if the industry is reasonably competitive we would expect that this competition would shield the price taker from the firm's power. Why will not competition among producers protect the contract term taker as well?⁵³ The answer is twofold. On the one hand the cost of acquiring and processing information on contract terms is much greater than for price; unless the firm intentionally makes the particular term an important selling point—as is sometimes the case with the length or inclusiveness of the warranty—few, if any, customers will perceive the existence of variations in terms. Any movement toward contractual equilibrium due to the aggressive bargain-seeking of a few customers will be slow indeed due to both (1) the fewness of customers who will find it worthwhile to pay the costs of acquiring information, and (2) the ease with which a producer can “contract term discriminate”—renegotiate the terms for the few aggressive customers while keeping the high information barrier for other customers virtually intact.⁵⁴ The second answer is that the “aggressive bargain-seeking customer” is usually just a minor figure in the equilibrating process. More important, in general, is the role of new entry (or exit) of producers. If the firms in an industry are making profits because they have written standardized contract terms that are very favorable to them, they will attract new entrants into the industry. The entry will continue until excess profits are bid away. The benefits to the firms of the standardized terms will be capitalized into the firms' value. Thus, while competition between producers is simply that standardized private contracts do not in general permit the customer to influence this distribution.

⁵³ The analysis assumes that the terms are completely hidden from the consumers; but this is an extreme case. Some terms are less hidden than others. Some terms can be changed and will react to market conditions; for example, in a very loose housing market we would expect that a number of restrictions on tenants would either be eliminated or honored in the breach. We would also anticipate that firms would be reluctant to enforce terms which would jeopardize customer good will—to some degree, at least, the customers will be able to discipline the firms by shifting their purchases to other firms. But we still maintain that most of the terms that would be covered in a standardized contract would be too difficult for the customer to comprehend and, therefore, would be rather insensitive to market discipline.

The oppressiveness of the standardized terms is somewhat attenuated by the fact that the firms often do not enforce them. The consumer can discipline the producer who attempts to enforce the oppressive terms by shifting his future patronage to other producers or by giving the firm negative publicity. The firm has to judge whether the benefits of enforcement in a given instance will outweigh these costs. These defenses, of course are still available to the consumer if contract terms are produced by the government rather than the firm.

⁵⁴ In a study of residential leases in Ann Arbor, Warren Mueller found that some tenants were able to modify the fine-print terms of their standard form leases, although most tenants did not try; see Warren Mueller, *Residential Tenants and Their Leases: An Empirical Study*, 69 Mich. L. Rev. 247 (1970).

will in the long run yield zero profits, the firm will be able to attain a capital gain (or prevent a capital loss) by choosing the appropriate standard contract terms.

This does not necessarily mean, however, that the industry as a whole will be better off or that the industry's gains will come at the expense of the consumer. It might well be that the equilibrium terms arrived at are optimal for both producers and consumers, but there is no reason to presume this to be true. Consider, for example, the following scenario. Assume a competitive insurance industry with minimal government intervention. Firms in the industry compete by lowering their price and then compensate for this by decreasing the coverage (in as hidden a way as possible) with other firms being forced to cut also in order to remain competitive. A sort of "Gresham's Law" of bad policies driving out good would ensue. Both the quality of insurance contracts and the total sales of the industry are likely to fall.⁵⁵

This is not the end of the story. Both producers and consumers will have incentives to search for methods for improving upon this result. Ignoring solutions relying on an active government (to which we turn below) a number of solutions might arise. Brand names and advertising might be used as indicators of product quality in general (including the terms of the contract);⁵⁶ consumers might take price as an indicator of quality; or private producers of information might appear. While such private market solutions will, to some extent, ameliorate the Gresham's Law problem considered in the previous paragraph, there is no reason to believe that the market will negate the standard form contract problem.⁵⁷

If the government's role is restricted to passive enforcement of private contracts, then there will be many standard form contract terms produced which are, in effect, legislation produced by a single party. The consumer need not necessarily suffer as a result, but his protection by market forces will in many instances be weak. Indeed, if we could argue that standard forms inevitably led to the enrichment of producers at the expense of consumers, the task of our social engineer would be considerably simplified. But this is not the case.

⁵⁵ See, for example, George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q.J. Econ. 488 (1970).

⁵⁶ Without reading the fine print of a sales contract, the consumer can be assured that an item purchased at store X will be returnable if there is a defect. In many instances the retailer's good name will be an adequate substitute for reading the contract.

⁵⁷ For an optimistic evaluation of the market's ability to deal with problems of product quality, see Michael R. Darby & Edi Karni, *Free Competition and the Optimal Amount of Fraud*, 16 J. Law & Econ. 67 (1973); for a more pessimistic discussion see Victor P. Goldberg, *Consumer Choice, Imperfect Information, and Public Policy* (Inst. Govt. Affairs, Univ. of Calif., Davis, Res. Rep. No. 26, 1973). Posner argues that standard form contracts will not present a problem, so long as there is competition; see Richard A. Posner, *The Federal Trade Commission*, 37 U. Chi. L. Rev. 47 (1969).

In some instances all parties will benefit from the standard forms while in others all parties will be hurt. In many instances some consumers will benefit while others will be harmed. (For example, harsh terms will, in equilibrium, yield lower prices; those who would prefer the harsh term-low price combination will benefit at the expense of those who would have preferred an easier term-higher price combination.⁵⁸) Thus, the social engineer faces problems in identifying situations in which parties are likely to be helped by intervention and a further set of problems in balancing the anticipated benefits to some groups against the losses of others.

How should the courts react to the standard form contract? If they were to adopt the economist's faulty idealization of the contracting process, courts would accept the terms of the contract without question and hold the parties to them. Courts have essentially stuck to this approach⁵⁹ although (as noted in the discussion of insurance contracts in Section IV) they have often resorted to very liberal interpretations of the contract to reach what they regard as a fair result.⁶⁰ A number of commentators⁶¹ have argued that only by divorcing themselves from the fiction that the standard form contract is no different from the idealized contract between equals will courts be able to come to grips with the problem. Slawson, for example, argues that the court must decide what the consumer could reasonably have been expected to consider as part of the transaction. This alone the court should accept as the contract to which the consumer has manifested agreement.⁶² The other terms must then be judged against some reasonable standards; essentially, all goods sold with a standard form have an "implied warranty of fitness for intended purpose."⁶³ Even if an express warranty is included in the standard form it

⁵⁸ People might *think* they preferred the low price arrangement because they did not fully understand the contract terms. It does not make sense to treat such individuals as being worse off if they are prohibited from entering into such contracts. For further discussion of this, see Victor P. Goldberg, *supra* note 57.

⁵⁹ "[C]ourts generally purport to enforce all terms in standard forms because they regard standard forms as contracts." W. David Slawson, *supra* note 6, at 562.

⁶⁰ "This is not to say that courts presently enforce all standard forms, no matter how oppressive. The Uniform Commercial Code expressly empowers a court to ignore terms in a contract which are 'unconscionable.' Even without statutory authority, courts commonly 'construe' or disregard written contractual terms in order to reach a result which they believe equitable." W. David Slawson, *supra* note 6, at 561.

⁶¹ See W. David Slawson, *supra* note 6; Friedrich Kessler, *supra* note 15; Warren Mueller, *supra* note 54 and W. Friedmann, *Law in a Changing Society* (1964).

⁶² The consumer's manifested agreement is not sufficient according to Slawson if the contract is a "contract of adhesion." Basically, these are contracts in which the consumer has little real choice because the producer enjoys a monopoly position. For a more complete discussion of the concept and of Slawson's method of dealing with it, see W. David Slawson, *supra* note 6, at 549-61.

⁶³ W. David Slawson, *supra* note 6, at 546.

will not be treated as part of the contract if the court finds it inconsistent with the implied warranty.

This is not the place for a detailed analysis of Slawson's proposal. Clearly, courts will differ substantially in determining what part of a standard form contract has been agreed to and what part must pass the reasonableness test; they will further disagree as to what ought to determine reasonableness. The point, though, is that it is possible for judges to abandon the mythology of freedom of contract and to put limits on the ability of the firm(s) to produce private legislation in the form of standard contracts.

While the courts might in the future be induced to take a more pro-consumer stance in litigation, this will likely prove of only marginal assistance to most consumers.⁶⁴ Lawsuits are expensive, risky affairs with the expenses frequently in excess of the expected gains to the single individual were he to win. Realizing this, firms would have little incentive to remove unenforceable terms from their contracts. (Many contracts carry unenforceable waivers of liability; a consumer when shown he had "agreed" to this provision would likely give up rather than bring the matter to a lawyer.⁶⁵) So, while some relief for the consumer might be possible in the judicial arena, it is doubtful that this in itself would be of much value.

One possible response to the standard form contract problem would be to provide consumers with an agent who would aid in the production of standardized terms.⁶⁶ The government can fill the role of agent; assume initially an ideal government attempting to fill this role faithfully. The legislature could suggest terms that the parties might include in their contracts if they so agree, set terms that will hold unless the contract explicitly replaces them,⁶⁷

⁶⁴ One intermediate step between individual legal actions and governmental intervention is the class action suit. For a discussion of some of the issues involved in extending class action suits to consumer protection, see American Enterprise Institute for Public Policy Research, *Consumer Class Action Legislation* (Legislative Analysis No. 23, 1972).

Lest the reader misinterpret Slawson, he is not arguing that only the courts should have jurisdiction. Indeed, Slawson argues that statutory enactments should be regarded by the courts as authoritative standards in determining whether the implied warranty terms are reasonable.

⁶⁵ Warren Mueller, *supra* note 54, at 280. Mueller provides examples of such clauses in apartment leases; he found that about half the tenants surveyed considered specific unenforceable clauses to be enforceable, *id.* at 272.

⁶⁶ In the employment context the union fills this role: it should be clear that much of the argument here is applicable to the employment relationship. Reversing the analogy, it would be possible to have consumer organizations, perhaps with compulsory membership, that would be recognized bargaining agents for a group of consumers (for example, tenant unions). Such non-governmental agents will not, however, be considered here.

⁶⁷ This option might be of little value to consumers since producers can simply ignore the legislature's advice and continue to produce terms which the consumer accepts in ignorance. There are a couple of reasons, however, for thinking that even these optional

prohibit the inclusion of certain terms, or set terms which cannot be altered by the parties. Alternatively the legislature might choose to delegate the task to a regulatory agency (or other nonlegislative body). This arrangement permits an ongoing review of contract terms; the agency can adjust terms in light of past experience and can bargain with the producers concerning possible innovations.

Not all consumers will benefit equally from the agent's efforts. Indeed, in most instances some consumers are likely to be worse off, receiving protection from a clause that affected them little or not at all in exchange for a higher price. Given that the agent's costs must be spread over a large number of consumers with different preferences, it is inevitable that the agent must regularly engage in making interpersonal comparisons in producing contract terms. To be sure, the same is true without government intervention where the firm (or the market) in effect plays the role of agent in producing and modifying standard form contract terms.

It should come as no surprise that the agent will be at least in part a "double agent." Producers will seek a voice in determining who plays the role of agent and will ultimately try to influence the nature of the terms produced, the penalties for noncompliance, and the extent of public enforcement. The results will be substantially less favorable to consumers than those of an "ideal government." But how might they compare to the "no government" case in which the legislature delegates the task of determining the standardized terms directly to the firm?

If we confine our analysis to the relative political power of the parties, then it is by no means clear that the consumer has less power in the governmental solution; indeed, it is quite likely that the opposite is the case. Relative power in itself says little about the nature of the outcomes. The consumer might still be better off with a private market solution in which he has no effective political power. But it is at least important to note that there is no reason to presume that moving from a *laissez faire* rule to a governmental arrangement leads to an increase in political power for the producer.⁶⁸

terms might be of some value to the consumer. First, the production of contract terms is not costless and firms might well find it less expensive to adopt a "free" terms from the government rather than producing their own (or purchasing it from lawyers). Second, firms cannot be sure that all terms in their contracts will prove valid in court; they can lessen the threat of a lawsuit (and the risks of losing it or simply of fighting it, which might entail the loss of customer good will) by adopting a terms produced by the government. The desirability of adopting government-suggested terms would be enhanced if the courts were to adopt Slawson's approach—the use of government-suggested terms would be *prima facie* evidence of reasonableness.

⁶⁸ Note that in the *laissez faire* situation, the relatively powerful party is the individual producer, while in the case of governmental intervention the consumer is faced

To further complicate the social engineering problem, we must note two additional features of governmental intervention. On the one hand, the legitimate need for a government agent in determining contract terms can be used as a rationale for promoting arrangements which will benefit the producer⁶⁹—for example, price determination or entry restriction. On the other hand, promoting consumer interests will often go hand in hand with promoting producer interests as the earlier Gresham's Law example indicated; governmental intervention might prove a simple, effective way of short-circuiting that problem.

The point of this discussion is twofold: first, a case can be made for governmental intervention on the consumer's behalf in dealing with standard form contracts; second, the issue of relative political power which would normally be used against intervention cuts both ways—the relative power of the consumer might well be greater in the case of government intervention. We are not arguing that governmental intervention *should* be the rule. Such a determination would require further analysis. With this discussion we hope that we have shown that the approach developed in this paper will be useful in guiding that further analysis.⁷⁰

The standard form contract problem is representative of a wide range of problems with similar characteristics: decisions are made in an arena which rewards almost exclusively the resources held by one party (the firm); the costs of dispelling the other party's ignorance by individual action are very high, if not prohibitive; and it is likely that the other party can spread the costs of acquiring information and negotiating contracts through collective action. One example is the determination of liability for accidents. (Indeed, this is one of the problems that producers will often include in standard form contracts.⁷¹) McKean,⁷² to some degree, and Buchanan,⁷³ to a much greater

with a *group* of producers. One important determinant of outcomes ignored in this discussion is the ability of producers to coordinate their behavior in *both* cases.

⁶⁹ See Victor P. Goldberg, *supra* note 57. If these other goals would have been attained regardless of this rationale, then this is not a cost properly attributed to governmental intervention in standard form contracts.

⁷⁰ For further discussion of these issues, see Victor P. Goldberg, *supra* note 57.

⁷¹ For example, the following term was included in the leases in at least three apartment complexes in Ann Arbor (cited in Warren Mueller, *supra* note 54, at 280): "The automobile parking space, laundry drying space, children's play areas, or other facilities . . . shall be deemed gratuitously furnished by the Landlord and . . . if any person shall use the same, such person does so at his or her own risk and upon the express understanding and stipulation that the Landlord shall not be liable for any loss of property through theft, casualty, or otherwise, or for any damage or injury whatever to person or property."

⁷² Roland N. McKean, Products Liability: Trends and Implications, 38 U. Chi. L. Rev. 3 (1970).

⁷³ James M. Buchanan, In Defense of Caveat Emptor, 38 U. Chi. L. Rev. 64 (1970); see also Walter Y. Oi, The Economics of Product Safety, 4 Bell J. Econ. & Man. Sci. 3

degree, argue that, in general, the courts should place liability on the customer unless he explicitly contracts out of liability. The customer, they argue, should not be deprived of the choice of attaining a product at a lower price with a concomitantly greater risk of accident. The argument here suggests that in most instances this is no real choice at all. How, for example, is the consumer to ascertain whether a firm's soda bottles will explode one time in ten million, twenty million or a hundred million?⁷⁴ Producers will, in effect, be able to write legislation determining who is to bear the risks of accidents. The customer will in many cases be better off either by having the courts move the liability towards producers⁷⁵—as they have, in fact, been doing—or by legislating alternative rules or product standards. We are under no illusions that legislators will act solely in the consumer's interest or that bureaucrats will enforce standards with the consumer's interests foremost in their minds.⁷⁶ The point is that as badly as the consumer is likely to fare in the legislative arena, he is likely to be *relatively* better off than if he were "free" to negotiate voluntary agreements to determine liability.

VII

More than a decade ago, Stigler argued that "the professional study of economics makes one politically conservative,"⁷⁷ conservatism being a predisposition toward the private market and a general skepticism toward government intervention and privately imposed constraints on the individual (compulsory unions, for example). Such conservatism, Stigler noted (approvingly), influences both the types of problems to which economists devote their professional

(1973); for a contrary argument, see Victor P. Goldberg, *The Economics of Product Safety and Imperfect Information*, 5 *Bell J. Econ. & Man. Sci.* 683 (1974).

⁷⁴ One of the important decisions leading toward the establishment of strict liability did involve the explosion of a soda bottle; see *Escola v. Coca-Cola Bottling Co.*, 24 Cal. 2d 453, 150 P.2d 436 (1944).

⁷⁵ The question of the proper placement of liability is a very complicated one. There are many instances in which consumers as a group are likely to benefit by not placing the liability on the producer. For an interesting discussion of the complexities involved, see Guido Calabresi, *The Costs of Accidents: A Legal and Economic Analysis* (1970).

⁷⁶ Not only can the bureaucrats be unresponsive to consumer interests in determining and enforcing standards, but standards they set can be used to facilitate oligopolistic coordination. For a detailed discussion of the anti-competitive use of product standards (either set by governments or by trade associations), see John Ferguson *et al.*, *Consumer Ignorance as a Source of Monopoly Power: FTC Staff Report on Self-Regulation, Standardization and Product Differentiation*, 5 *Antitrust Law & Econ. Rev.* No. 2, at 79, No. 3, at 55 (Winter & Spr. 1972).

⁷⁷ George J. Stigler, *The Politics of Political Economists*, 73 *Q.J. Econ.* 522 (1959). Stigler was, to be sure, quite cavalier in generalizing about all economists. But we think most economists would concur that he painted a reasonably accurate picture of mainstream economics.

attention and the policy prescriptions of economists. It provides the ideological lenses through which the economist perceives his world. An underlying theme of this paper is that this conservative bias does indeed exist and that it is nurtured by the economist's failure to link the prime mover of his system—self-interest—with the institutional structure in which the economy operates. The implication of this linkage, as traced out in the previous five sections, is that the economist's *Weltanschauung* leads him to ignore or answer incorrectly a number of important questions that should rightly come in his domain—the allocation of resources.