

CHAPTER ONE

Introduction

1.1 Practice and Discipline

Economists and legal scholars have had an abiding interest in the question of why so many laws languish unimplemented. But an even more intriguing and philosophically troubling question is its obverse. Why are so many laws so effective, being both enforced by the functionaries of the state and obeyed by the citizens? After all, a law is nothing but some words on paper. Once one pauses to think, it is indeed puzzling why merely putting some “ink on paper” should change human behavior, why a new speed limit law recorded in a book should prompt drivers to drive more slowly, and the traffic warden to run after the few who do not, in order to ticket them.

Traditional law and economics dealt with these questions by avoiding asking them. The purpose of this book is to take on this conundrum of ink on paper triggering action frontally. In the chapters that follow I spell out and explain the enigma, and then go on to provide a resolution. This forces us to question and in turn reject the standard approach and replace it with a richer and more compelling way of doing law and economics. The new approach, rooted in game-theoretic methods, can vastly enrich our understanding of both why so many laws are effective and why so many laws remain unimplemented, gathering dust. Given the importance of law and economics for a range of practical areas, from

competition and collusion, trade and exchange, labor and regulation to climate change and conflict management, the dividend from doing this right can be large. This monograph contributes to this critical space that straddles economics and law, and is thus vital for understanding development and peace, and, equally, stagnation and conflict.

The hinterland between different disciplines in the social sciences is usually a rather barren space. Despite proclamations to the contrary, multidisciplinary research remains sparse, its success hindered by differences in method and ideology, and a touch of obstinacy.

The confluence of law and economics stands out in this arid landscape. Ever since the field came into its own in the 1960s, with the writings of legal scholars and economists showing recognition of the existence of and even need for one another, the discipline of law and economics has been gaining in prominence. The need for this field was so obvious and immense that it did not brook the standard hindrances to interdisciplinary research. Laws are being created and implemented all the time; one does not have to be an economist or a legal scholar to see that a poorly designed law can bring economic activity to a halt or that a well-crafted law can surge it forward. For this reason the confluence of law and economics was an active arena of engagement even before the field had a name. In the United States, for instance, concern about collusion among business groups dates back to the late nineteenth century. The Sherman Antitrust Act in 1890 and later the Clayton Antitrust Act of 1914 and the Robinson-Patman Act of 1936 were landmarks in the use of the law to regulate market competition and deter collusion.

As so often happens, practice was ahead of precept. While there was no subject called law and economics then, small principles were being discovered and acted upon by policymakers and practitioners. It was, for instance, soon realized by American lawmakers and political leaders that while curbing collusion was good for the American consumer, it handicapped US firms in the global space. In competing against producers in other nations and selling to citizens of other nations, it may be useful to enable your firms to collude, fix prices, and otherwise violate domestic-market antitrust

protections. This gave rise to the Webb-Pomerene Act of 1918, which exempted firms from the provisions of laws that ban collusion, as long as they could show that the bulk of their products were being sold abroad. Japan would later learn from this and create exemptions to its Antimonopoly Law, exempting export cartels from some provisions.

The realization of the power of the law to affect markets was in evidence when, soon after the defeat of Japan in the Second World War, the Allied Forces quickly imposed a carefully designed anti-trust law on Japan. This was the so-called Antimonopoly Law 1947. Japan would later modify it to reinvigorate its corporations.

Not quite as directly as with the American experience but nevertheless with important implications for everyday life, the *practice* of law and economics goes much further back into history. Human beings were writing down laws pretty soon after they learned to write anything. The most celebrated early inscription was the Code of Hammurabi. Written in Akkadian, the language of Babylon, these laws were developed and etched on stone during the reign of the sixth king of Babylon, Hammurabi, who died in 1750 BCE. Ideas in this code survive today, such as the importance of evidence and the rights of the accused. It also gave us some of our popular codes of revenge, the best-known being “an eye for an eye.” The codes survived, but not without contestation. It is believed that it was Gandhi who warned us, nearly four thousand years later, “an eye for an eye will make the world blind.”

Indeed, it is possible to argue that the idea of law existed even before we invented writing. This took the form of conventions passed on by word of mouth. And some would argue that, in this broad sense, law predates humans (see discussion in Hadfield, 2016). Laboratory experiments show that capuchin monkeys give evidence of a sense of fairness and, by extension, the propensity to punish those who play unfairly. In the present book, however, I stay away from such a broad, all-encompassing notion of law.

The origins of law and the question of what law is and why people abide by it are matters that have long been debated. Much of this discourse was fueled by the enormously influential debate for and against “legal positivism” (see Kelsen, 1945; Hart, 1961; Raz, 1980), which was in turn a response to Austin (1832), who argued

that “a proposition of law is true within a particular political society if it correctly reports the past command of some person or group occupying the position of sovereign in that society. [Austin] defined a sovereign as some person or group *whose commands are habitually obeyed and who is not in the habit of obeying anyone else*” (Dworkin, 1986, p. 33, my italics). But why such commands are obeyed and how the sovereign can get away without obeying anyone else (to the limited extent that these are true) were poorly explained by not just Austin but also later legal scholars and philosophers.

While Austin and Hart were both legal positivists, Hart distanced himself from Austin’s view of law as “command” to the idea of law as “rules,” thereby suggesting that they may not need enforcement by a sovereign or a higher authority. There is an element of obligation naturally built in. Underlying this notion of law is an innate sense of justice and fairness.

For the purpose of this book it is not necessary to have a formal definition of law (and anyway one does not exist). It is often the case that it is possible to talk about a discipline and develop it further without having a formal definition for it. The same is true here. It is enough to note that the law consists of rules of legitimate behavior in a society, and a law-abiding society or a society where the rule of law prevails is one where members of society abide by the law. I do not assume that the law innately possesses qualities of fairness and justice. In this discourse it is just as possible to have an unfair law and an oppressive law, as a noble law and a just law. In fact, what I hope to achieve in this book is to show that some of the early debates and contentions were not necessary. Once we have developed the new approach to law, rooted in game theory, we will see that some of the debates may have been spurious, grounded in methodological flaws, and constrained by a limited vocabulary. With the rise of modern game theory, we are able to create concepts and terms that facilitate debate and remove some of the controversies that flourished because of the linguistic coarseness of discourse. It is not always appreciated that a large part of the advance of science is predicated on the granularity of grammar and vocabulary.

The new approach will give us an understanding of how a society becomes law-abiding. Gordon Brown, former British prime

minister, is believed to have said (World Bank, 2017, p. 95), “In establishing the rule of law, the first five centuries are always the hardest.” Gordon Brown’s observation is often treated as a joke, but it is not. It makes the important point that for the law to develop roots and the rule of law to prevail requires ordinary people to believe in the law; and to believe that others believe in the law. Such beliefs and meta beliefs can take very long to get entrenched in society. This is a matter that will be important for my thesis.

By way of digression, I may remark that, while the above quote is commonly attributed to Gordon Brown, there seems to be no actual record of his saying it. The only reason to believe he did is that he has not contested the attribution. But then again, put yourself in his shoes. If such a memorable quote were attributed to you, it is not clear that you would go out of your way to challenge the attribution.

Returning to the question of origins, the law, as we know it today, took concrete form in ancient Greece. Solon in Athens and Lycurgus in Sparta are often viewed as “founders of Western legal and political thought” (Hockett, 2009, p. 14). Solon, born in Athens in 638 BCE, became chief magistrate, when the city-state was in disarray. He played a role in creating one court for all citizens but, more importantly from the perspective of this book, he paid attention to laws that made economic life possible, encouraging specialization and exchange, and taking explicit positions on trade, allowing commerce for some commodities but banning it for others, showing that not just international trade but even protectionism has a long history.

Solon’s counterpart in Sparta was Lycurgus, often treated as the founder of the Spartan Constitution, the *Rhetra*. To him are attributed ideas and rules concerning social equality and even wealth redistribution. When he rose to power, wealth had become extremely unequal and, it is said, he set about devising rules to equalize landholdings. Among these important economic rules, he also slipped in some idiosyncratic ones such as the need for men to eat in public in large groups. The trouble with getting into much detail about Lycurgus is that he believed that laws ought not to be written down but held mentally as a code to abide by. An inevitable consequence

of this is that many have questioned the existence of Lycurgus's laws¹; and, to make matters worse, some historians have questioned the existence of Lycurgus.

1.2 The Emergence of "Law and Economics"

The emergence of the discipline of law and economics, luckily, does not give rise to such existential questions. There is reasonable consensus that the birth occurred in the 1960s, marked by some iconic papers, most prominently those by Coase (1960), Calabresi (1961), and Becker (1968), even though the roots of the discipline go much further back.² Within years it was evident that this was a hugely influential discipline. As Sunstein (2016, p. 53) recently observed, "The field of 'law and economics' has revolutionized legal thinking. It may well count as the most influential intellectual development in law in the last one hundred years. It has also had a major impact on how regulators in the United States, Europe, and elsewhere deal with anti-trust, environmental protection, highway safety, health care, nuclear power and workers' rights." It is easy to go on and draw attention to the power of law and economics in many other areas, from shaping regulation relating to finance and banking, to fiscal policy and laws to regulate the fiscal deficit. It is clearly a subject that deserves attention.

Yet there have been problems that we have encountered in applying the lessons of law and economics that should have alerted us to all not being well. One of the biggest challenges lies in the implementation of the law. A perennial problem faced by a host

1. This is in contrast to the belief often held by game theorists that the law must not just be known by all but known to be known and known to be known to be known and so on, which is referred to as common knowledge. Hadfield (2016, p. 26) makes this quite explicit. Common knowledge will play an important role in the approach to law and economics developed in this book.

2. It is arguable that the first identifiable law and economics movement goes back to the late nineteenth century, to the work of American economists grappling with the administration of interstate railroad administration and trying to promote market competition and develop antitrust regulation (Hovenkamp, 1990; Mercurio and Medema, 1997; Medema, 1998). Interestingly, this early law and economics movement, in contrast to the work in the 1960s, was much more concerned with inequality, and distanced itself from mainstream market economics.

of economies, especially emerging and developing ones, is that the law is often not implemented. In India, for instance, where the law is quite sophisticated, thanks to the country's post-independence intellectual ardor as well as its colonial history and even precolonial experience (see Roy and Swamy, 2016), a common refrain is that the law is impeccable on paper but more often than not poorly implemented. There is almost a collective looking away from the law.

The other related challenge is that of corruption. The ubiquity of corruption in many developing economies and also some advanced ones is not just distressing for civic life, but also leads to perverse and damaging economic outcomes. But what is corruption? It can take many forms but, in the final analysis, it is a form of violation of the law, perpetrated either individually or in cahoots with state officials and enforcers of the law, as happens in cases of bribery. What is it that makes some laws tick and others get violated and corrupted? The standard discipline of law and economics is unable to give a satisfactory answer.

The failure to understand corruption and, as a consequence, our ineptness in curbing it, is one of the big failures of law and economics. The chinks in the standard model were visible from the observation that those entrusted with enforcing the law are often lax or susceptible to bribery, which led to the philosophically troubling question: "Who will police the police?" This immediately leads to perplexing questions about the role of higher and higher levels of authority within the state. Quite independently of the discipline of law and economics, the economics of corruption has become a large subject today, and this book will have much to say on this once the building blocks of a new law and economics are in place.

1.3 Institutions and the Enforcers of Law

A critical counterpart of modern law is the enforcement machinery—the police, the judges, the courts. Indeed, we often draw a distinction between the law and social norms by the presence or absence of these institutions and agents of enforcement. Social norms, it is believed, are enforced without a formal machinery, whereas the modern state is a critical counterpart of the concept of law. It is the state that gives law its authority.

Some readers may perceive some of my skepticism in my use of qualifiers like “it is believed,” and they will be right. These are matters that I will return to at some length. Indeed, doubts on this score were sowed in my mind by the writings of some anthropologists, who showed how sophisticated some of these social norms were and how formal their enforcement was in some so-called primitive societies such as the Barotse of Northern Rhodesia (Gluckman, 1955; see also discussion in Hadfield, 2016).

Remaining within the confines of traditional thought, it is worth emphasizing that this presence or absence of a machinery to enforce the law has been central in discussions of international law. At one level, it is indeed true that in the domain of intercountry relationships, international trade conflicts, and currency wars, we do not have the same kind of enforcers as a conflict within a nation has. There is the International Court of Justice at The Hague, but its ability to enforce codes and laws is open to question. We have tried to mimic the courts and justice systems at the global level by creating various global institutions, but their reach is limited. For this reason, nations have frequently taken it upon themselves to create institutions to penalize global norm violations. America’s Helms-Burton Act of 1996 is a good example of this. The United States wanted to isolate Cuba (and thereby hurt its economy) and so created a law not just to ostracize Cuba but to punish even other nations that traded with and invested in Cuba. This was a form of taking the law into one’s own hand but also an attempt to create a global jurisdiction that does not exist.

International organizations, such as the International Labour Organization (ILO), World Trade Organization (WTO), and the Bretton Woods institutions, have often been created to deal explicitly with this concern, to bring a modicum of law to bear on labor practices and international trade customs and even to manage global monetary and fiscal policies. The success of these initiatives continues to be debated, but it is clear to all that there is a dearth of globally enforced law in our rapidly globalizing world. The need for this became apparent soon after long-distance sea travel became common, starting from the end of the fifteenth century with the landings of Christopher Columbus in America in 1492 and of Vasco da Gama in India in 1498. Skirmishes in

the seas heightened thereafter, the most celebrated being the seizure of the Portuguese vessel *Santa Catarina* by the Dutch in the Strait of Singapore, in the early morning hours of February 25, 1603. The lawyer called upon to defend the Dutch seizure was Huig de Groot or, as he came to be better known as, Grotius. This case led to Grotius's engagement, in 1604, with the need to codify international law and his commentary on the subject, which may well be viewed as the genesis of our intellectual engagement with international law.

With globalization and new multinational initiatives, the most important being the Eurozone and the European Union, and also some recent cases of nations trying to get out of that union, the subject of international law and its enforcement has acquired urgency.³ Though these are not matters that I address directly, this monograph being concerned with more methodological issues, I do return to some of these questions in the closing chapter.

1.4 Agenda

My interest in law and economics arose when I researched industrial organization theory and rent control and tried to understand the reach and effectiveness of antitrust and other laws.⁴ Two questions proved troubling. Why was the law effective when it was? In brief, even though citizens may have followed the law for fear that the police would catch them if they did not, and the magistrate would punish them, why did the police and the magistrate perform their duties? After all, as noted at the start of this chapter, the law is nothing but some ink on paper, rules written down on paper by a parliament or an inscription on a stone ordered by a king or some digital document in today's world.

My interest in law and economics was revived in an unusual way, from my engagement in policymaking. In 2010, as I worked as chief economic adviser to the government of India, one problem

3. I have been drawn into some of these debates in my recent work in policymaking at the World Bank, which entails multicountry engagements: see Basu (2016a), Basu and Stiglitz (2015).

4. I discussed this briefly in Basu (1993) and developed some of these ideas in Basu (2000). For the work on rent control, see Basu and Emerson (2000).

that kept crossing my desk was that of corruption. As one scandal after another broke, in addition to the more persistent and nagging ones that did not make the news but we nevertheless had to deal with, the subject loomed as an important one.

India has an extensive system of providing subsidized food to poor households. This is now enshrined as a “right to food.” But there was widespread evidence that poor households were routinely denied this right, by either being turned away or by being asked to pay a bribe to get what was their due. There is strong empirical evidence that over 40 percent of the food grain collected by the government for distribution to poor households leaks out of the system, and is sold for profit by the stores meant to feed the poor.⁵

In many other areas there was similar evidence of people forced to pay bribes for what was their due. You have taken a driving test and performed fine, and when you are about to receive your license, the official demands a bribe. You file your income tax return, but are asked to grease someone’s palm to get the final certificate. And the list goes on. While looking into the problem I learned that, according to the Indian law, namely, the Prevention of Corruption of Act, 1988, the taker and the giver of bribes are treated as equally guilty.

It was then easy to see one reason why bribery was so pervasive in India. Once a bribe had been paid, the interests of the bribe giver and the bribe taker were completely in alignment. If they were caught, both would be fined or jailed. Little wonder then that the bribe giver and the bribe taker in India collude to hide the bribery after the fact. It is this assurance that, in turn, emboldens the bureaucrat to accept the bribe. What needed to be done seemed clear to me. At least in the case where a person was being asked to pay a bribe for something he or she was entitled to—I called this a harassment bribe—we must distinguish between the guilt of the taker and the guilt of the giver of the bribe. I proposed that the 1988 law be amended by introducing an asymmetry in declaring the *giving* of harassment bribes a legal act.

Since this was within months of my joining government, with the naivety of a greenhorn, I wrote up and posted my short paper

5. See Khera (2011); also Jha and Ramaswami (2010).

on the Ministry of Finance website (see Basu, 2011b). Furor broke out, with questions asked in parliament about the immorality of my idea, and letters written by members of parliament to the prime minister and the finance minister, asking them to explain my misdemeanor.

Fortunately, I was the person entrusted with the drafting of the replies to these members of parliament. So I could stem some of the immediate crisis, but the attacks persisted in the news media and television. I have written about this in Basu (2015) and do not provide details here. But the simple upshot was I was back to law and economics, this time via a very different channel.

I had become engaged in this debate on the Indian law concerning corruption control without knowing enough of the background. So I decided that, now that I had written on the subject, it was time to read. This is what drew me into the subject in a big way. What became quickly apparent to me was how flagrant the violation of law was. It was not just bribery that led to the collusive evasion of law; I discovered a profusion of laws that existed on paper but were collectively ignored.⁶ This inevitably led to the question of why some laws were followed and others overlooked. It was obvious that we did not have an answer and, more importantly, did not have the wherewithal to understand it. The discipline of law and economics has made huge contributions to modern economic life, but it clearly also has shortcomings.

This book is about a major fault line that I believe runs the gamut of traditional or what may be called neoclassical law and economics. I referred to this as the “ink on paper” problem (Basu, 1993). This book draws attention to and explains the fault line and then reconstructs it carefully. While it is true that this is major surgery, I must stress at the outset that no accusation is being made that all our achievements of the past are flawed. It is somewhat like what has been seen in mathematics. Every now and then we hit upon a flaw in the foundations of mathematics. This usually happens when we suddenly discover a paradox or a conundrum and, in

6. Debroy's (2000) estimate is that, between the federal and state governments, India has over thirty thousand laws, a disproportionate number gathering dust and, worse, occasionally invoked to harass and use strategically.

trying to understand it, realize that it is not caused by carelessness or a typographical error but is a reflection of some deep problem lodged in the foundations of the discipline. It is arguable that we have not seen the end of this; mathematics still has flaws lodged in its foundations. What is interesting is that this means not that we have to unlearn our education but that we will hit road bumps in the future and may realize that some of what we took to be hard knowledge is not so, that some of our understandings will have to be abandoned and some modified.

It is similar with law and economics. As the fault line is corrected, hopefully we will have a more robust discipline. Some of our traditional knowledge will cease to be valid; but we will have a richer discipline, giving us certain new insights and enabling us to avert contradictions and paradoxes that we could not deal with adequately earlier.

This book is planned such that it can be read by the lay reader with no prior knowledge of law, economics, or game theory. For this reason, I shall occasionally veer to build up some of the conceptual arguments from the basics. For the trained legal scholar or the game theorist, these excursions will be redundant or at best a little diversion, but I hope that by this ploy the book will be of value to many more readers, from the beginner to the expert, who may have an interest in seeing some familiar structures being dismantled and rebuilt.

For reasons of this completeness, the next chapter begins with a short description of the standard or neoclassical model of law and economics. I then go on to demonstrate some of the contradictions on which the model is built. Thereafter, the exercise turns reconstructive—to take the best of traditional law and economics, and build on it. Rebuilding is never easy, and I am aware that the task is unlikely to be completed in this or any single volume. But I do expect to provide a fairly comprehensive description of how we ought to amend the traditional model.

I use game-theoretic arguments, starting with instantaneous or normal-form games and moving on to strategic interactions between agents played out over time—called extensive-form games. All this will be presented with a commentary on related works. There are prominent writers, both legal scholars and economists,

who have had insights into the same fault line around which this book is written. I comment on their works, pointing out the similarities and differences. Intellectual ventures are, by their very nature, group efforts.

Once this structure is in place, and occasionally alongside it, via digressions, I engage with some of the standard subtopics of law and economics, such as the differences between the Chicago school and the Yale school (see Sunstein, 2016, for a short and lucid overview of this debate), the roles of individual rationality and morality, how best to curb corruption, how to improve the implementation of the law, and so on.

Despite the effort to be comprehensive, I am reconciled to the fact that we will keep running into open-ended questions. A new model is bound to have its own open problems. I point them out as transparently as possible as we proceed, but some of these open-ended matters will have to wait for the last few chapters, where I lay them out as clearly as I can in the hope that others, more capable, will take on the challenge to complete the project.