



# Privatizing the Adjudication of Disputes

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### Abstract

Must the state handle the adjudication of disputes? Researchers of different perspectives, from heterodox scholars of law who advocate legal pluralism to libertarian economists who advocate privatizing law, have increasingly questioned the idea that the state is, or should be, the only source of law. Both groups point out that government law has problems and that non-state alternatives exist. This article discusses some problems with the public judicial system and several for-profit alternatives. Public courts lack both incentives to be customer oriented and pricing mechanisms, plus they face problems associated with the bureaucratic provision of services. When parties can choose their tribunals, in contrast, those tribunals must serve customers and be mindful about conserving resources. Competition between arbitrators also can allow for experimentation and the provision of customized services rather than a centrally planned, one size fits all system. Contracts with an arbitration clause can easily stipulate the choice of tribunal, and we argue that if government courts simply refused to overrule binding arbitration agreements, de facto privatization could easily take place. This article discusses how private adjudication of disputes could enable the market to internalize externalities and provide services that customers desire.

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### I. Introduction

Must the state provide law? Most people believe that the state plays a crucial role in creating social order. Lipsey et al. present the textbook economic view of public goods: “Even the most passionate advocates of free markets agree that government must provide for enforcement of the rules under which private firms and persons make contracts.”<sup>1</sup> And classical liberal political philosopher Capaldi writes, “The role of the government is to serve the free market economy. It does this by providing personal security, and providing a legal system for the protection of rights, most especially property rights, for the enforcement of

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<sup>1</sup> LIPSEY, RICHARD, ET. AL., *MICROECONOMICS*, 396 (10<sup>th</sup> ed, 1993).

contracts, and for the resolution of contractual disputes.”<sup>2</sup> Law, even more than national defense, appears to be the perfect example of a public good that government simply must supply if order is to exist at all. Law is non-excludable because everyone enjoys its fruits merely by living in society, and it is entirely non-rivalrous, for once the state creates a body of sound legal principles, an unlimited number of people can benefit from them at no additional cost.<sup>3</sup> Public goods theory predicts that private entities cannot provide law, and unless government provides it society cannot prosper. Social contract theorists from Hobbes and Locke to Buchanan and Tullock hold this view.<sup>4</sup>

Over the last three decades, however, researchers from across the political spectrum have questioned the idea that all law comes from the state. At one end is a group of heterodox lawyers and anthropologists who often approach things from a socialist point of view.<sup>5</sup> On the other end is a group of libertarian political economists who openly embrace markets and reject all government.<sup>6</sup> The first group of scholars writes within the tradition of what is called legal pluralism,<sup>7</sup> and the second group of scholars writes within a tradition of what is called radical libertarianism or libertarian anarchism.<sup>8</sup> But scholars from both groups have come to the same conclusion: As a factual matter, the state is not the only source of law. Researchers have documented that, despite what Thomas Hobbes and others suggest, numerous examples of polycentric legal orders do exist, and they are not as chaotic as most would assume.<sup>9</sup> The two groups of scholars approach problems from different angles, but both are critics of what can be called legal centralism, “the notion that the state and the system of lawyers, courts, and prisons is the only form of ordering.”<sup>10</sup>

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<sup>2</sup> Nicholas Capaldi, *The Ethical Foundations of Free Market Societies*, 20 J. PRIVATE ENTERPRISE 30, 37 (2004).

<sup>3</sup> JOSEPH STIGLITZ, PRINCIPLES OF MICROECONOMICS, 169 (1993). KARL E. CASE, & RAY C. FAIR. PRINCIPLES OF ECONOMICS, 392 (1989).

<sup>4</sup> THOMAS HOBBS, LEVIATHAN (London, 1651); JOHN LOCKE, TWO TREATISES OF GOVERNMENT, (Thomas Hollis ed. 1764) (1689); JAMES M. BUCHANAN & GORDON TULLOCK, THE CALCULUS OF CONSENT (1962); JAMES M. BUCHANAN, THE LIMITS OF LIBERTY (1975); GORDON TULLOCK, THE SOCIAL DILEMMA (1975).

<sup>5</sup> Dalia Tsuk, *The New Deal Origins of American Legal Pluralism*, 29 FLA. ST. U.L. REV. 189, 207 (2001).

<sup>6</sup> DAVID OSTERFELD, FREEDOM, SOCIETY, AND THE STATE: AN INVESTIGATION INTO THE POSSIBILITY OF SOCIETY WITHOUT GOVERNMENT 1-49 (1983).

<sup>7</sup> For a recent overview of the literature on legal pluralism see Paul Schiff Berman, 80 *Global Legal Pluralism*, S. CAL. L. REV. (2007, forthcoming).

<sup>8</sup> For a recent overview of the literature on libertarian anarchism see EDWARD STRINGHAM, ANARCHY AND THE LAW: THE POLITICAL ECONOMY OF CHOICE 1-17 (2007).

<sup>9</sup> Examples can be found in BRUCE BENSON, THE ENTERPRISE OF LAW (1990) and the eight case studies of stateless orders in, EDWARD STRINGHAM, ANARCHY AND THE LAW: THE POLITICAL ECONOMY OF CHOICE (2007).

<sup>10</sup> Sally Engle Merry, *Legal Pluralism*, 5 LAW & SOCIETY REVIEW 869, 874 (1988).

Legal pluralists and libertarian anarchists continue to document many examples of non-state orderings, and both groups could benefit from reading each other's work.<sup>11</sup> Research details how in primitive societies, law develops gradually from custom in the absence of any sort of government.<sup>12</sup> On occasion, primitive law gradually spreads beyond the narrow confines of a single tribe to encompass a broader community.<sup>13</sup> Early tribal Germanic law, for example, evolved into a more universal legal code in the absence of a central government.<sup>14</sup> The history was similar in ancient Iceland, ancient Ireland, and many other places.<sup>15</sup> By this process primitive law became more civilized, broadening its vision to include anonymous as well as face-to-face societies. To exist and evolve, such systems must have given rule-creating incentives to someone; in other words, at least some of the benefits were not public but exclusive.<sup>16</sup>

Legal centralists posit that legal systems must govern everyone to function at all.<sup>17</sup> If law-breakers could simply drop out of the system, law could hardly protect us from their misdeeds. And yet, history contains many instances of pluralistic legal systems in which multiple sources of law existed in one geographic region. These were much more sophisticated than primitive law. In medieval Europe, for example, canon law, royal law, feudal law, manorial law, mercantile law, and urban law co-existed; none was automatically supreme over the others.<sup>18</sup> Naturally, some jurisdictional conflicts occurred. But this system of concurrent jurisdiction overlapped with a period of economic development (c.1050-1250), not a period of chaos and impoverishment. Apparently these diverse systems did what Thomas Hobbes declared impossible: They created social order and peace in the absence of a distinct, supreme sovereign.<sup>19</sup>

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<sup>11</sup> An example of a work that relies on literature from both groups is Morris Jenkins, *Gullah Island Dispute Resolution: An Example of Afrocentric Restorative Justice* 37 J. BLACK STUDIES 299 (2006).

<sup>12</sup> Bruce Benson, *Legal Evolution in Primitive Societies*, 144 J. INSTITUTIONAL & THEORETICAL ECON. 772 (1988). As Richard Posner explains, "The remaining source of law [in the absence of the state], and the one that dominates primitive law, is custom. Custom (including customary law) resembles language in being a complex, slowly changing, highly decentralized system of exact rules." RICHARD POSNER, *THE ECONOMICS OF JUSTICE* 178 (1981).

<sup>13</sup> Bruce Benson, *Legal Evolution in Primitive Societies*, 144 J. INSTITUTIONAL & THEORETICAL ECON. 772 (1988).

<sup>14</sup> Legal historian Harold Berman explains how the process unfolds, "Violation of the peace of the household by an outsider would lead to retaliation in the form of blood feud, or else to interhousehold or interclan negotiations designed to forestall or compose blood feud." HAROLD BERMAN, *LAW AND REVOLUTION* 52 (Harvard University Press, 1983).

<sup>15</sup> EDWARD STRINGHAM, *ANARCHY AND THE LAW: THE POLITICAL ECONOMY OF CHOICE* 538-679 (2007).

<sup>16</sup> For a discussion of why law might not meet the traditional definitions of public goods see MURRAY ROTHBARD, *POWER AND MARKET* 1-9 (1970).

<sup>17</sup> AYN RAND, *CAPITALISM: THE UNKNOWN IDEAL*, 335 (1967).

<sup>18</sup> Todd Zywicki and Edward Stringham, "Competition and Consent in the History of English Law" (May 14, 2007) (working paper, on file with author).

<sup>19</sup> Some might ask whether multiple competing law enforcement agencies constitutes government. Since during this time a coercive monopoly over the use of force did not exist the system would not be classified as government using most definitions of government. For the different definitions of government see

Where some legal pluralists and libertarian anarchists part ways is over normative issues. Some legal pluralists condemn government legal systems for being an “imposition of capitalist individualism.”<sup>20</sup> While libertarians agree that those who want to opt for something more communal should not be forced into a legal system that is too atomistic,<sup>21</sup> libertarians oppose the imposition of government legal systems precisely because they interfere with individual rights and a pure capitalistic (not a state capitalistic) system. In addition, many legal pluralists limit their support to not-for-profit sources of law,<sup>22</sup> but most anarchist-libertarians embrace all sources of law as long as they are not coercively imposed on people.<sup>23</sup> The libertarian considers both not-for-profit and for-profit (informal or formal) legal systems as desirable alternatives to coercive government law. Libertarian economists tend to believe that the profit system creates incentives for firms to serve their customers, so they often talk about for-profit arrangements,<sup>24</sup> but they are open to any type of privatization arrangement as long as people agree.<sup>25</sup> To the libertarian, the private sector includes charities, religious groups, *and* businesses, so in one sense they are the ultimate legal pluralists.

In this article we consider some of the problems with government courts by contrasting them to one prevalent modern example of for-profit legal services: private arbitration.<sup>26</sup> Most commercial disputes are resolved informally without relying on a third party.<sup>27</sup> When one is desired, however, most businesses consider a private arbitrator an attractive alternative to a randomly selected government judge. A recent survey of 1,000 of the largest U.S. corporations showed that “79% used arbitration to resolve commercial disputes in the last three years.”<sup>28</sup> Thus,

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Edward Stringham, *Overlapping Jurisdictions, Proprietary Communities, and Competition in the Realm of Law*, 162 J. INSTITUTIONAL & THEORETICAL ECON., 516 (2006).

<sup>20</sup> Dalia Tsuk, *The New Deal Origins of American Legal Pluralism*, 29 FLA. ST. U.L. REV. 189, 207 (2001).

<sup>21</sup> Edward Stringham, *Market Chosen Law*, 14 J. LIBERTARIAN STUDIES 53, 64-67 (1999).

<sup>22</sup> Legal pluralism has a positive or descriptive component that simply says that multiple sources of law exist, and it often also has normative component that supports or does not supports the various sources of law. These two aspects can be separated, for just because one recognizes that multiple sources of law exist, does not mean that one endorses them. R. Meinzen-Dick and L. Nkonya, *Understanding Legal Pluralism in Water Rights : Lessons from Africa and Asia*, in AFRICAN WATER LAWS: PLURAL LEGISLATIVE FRAMEWORKS FOR RURAL WATER MANAGEMENT IN AFRICA 8-10 (B. van Koppen, J. Butterworth, and I. Juma, eds., 2005).

<sup>23</sup> Edward Stringham, *Market Chosen Law*, 14 J. LIBERTARIAN STUDIES 53 (1999).

<sup>24</sup> L.V. MISES, HUMAN ACTION, 269-272 (4th Ed., Foundation for Economic Education, 1996) (1949).

<sup>25</sup> Peter J. Boettke, and Anne Rathbone *Civil Society, Social Entrepreneurship, and Economic Calculation: Toward a Political Economy of the Philanthropic Enterprise*, The Philanthropic Enterprise Working Paper 8 (2002).

<sup>26</sup> Bruce Benson, *Arbitration*, in ENCYCLOPEDIA OF LAW AND ECONOMICS 159 (Boudewijn Bouckaert and Gerrit De Geest eds. 2000).

<sup>27</sup> Stewart Macaulay, *Non-Contractual Relations in Business: A Preliminary Study*, 28 AMERICAN SOCIOLOGICAL REV. 55 (1963).

<sup>28</sup> National Arbitration Forum, *Business-to-Business Mediation/Arbitration vs. Litigation: What Courts, Statistics, & Public Perceptions Show About How Commercial Mediation and Commercial Arbitration*

one of the central functions of government, business dispute resolution, is largely escaping the state's sphere of influence. Another example of private dispute resolution is that facilitated by the VISA corporation.<sup>29</sup> Member banks agree to keep their quarrels within the VISA family when they join the central organization. Anticipating many costly legal disputes between the system's members, the VISA corporation saw an opportunity to invent a cheaper way to resolve disagreements. It created the VISA Arbitration Committee to judge the disputes of the member banks according to VISA's own legal code. The methods are quick, lawyerless, and unbureaucratic. Compared to the slow and costly justice that the banks receive when they have to settle a conflict with a firm outside the VISA camp (and within the reach of the public courts), the VISA banks get a bargain.<sup>30</sup>

Apparently, the non-state provision of legal services is not as impossible as many theorists assume. Could private legal systems expand such that they continue to dismantle the near-monopoly of law that most governments possess? This article focuses on one important aspect of law, the adjudication of disputes, and argues that privatization of this area could occur with little difficulty. Contracts require *ex ante* agreement over the terms of the relationship, and it is quite easy to add a clause stipulating that disputes will be heard by a particular tribunal. Far from being a libertarian fantasy, the *ex ante* selection of tribunals is common when parties choose to have their case heard by private experts rather than by public courts.<sup>31</sup> But a major impediment exists. The state often restricts the types of rules and tribunals to which parties can agree. Furthermore, the state often overrules contracts even when all parties agree.<sup>32</sup> This alone prevents

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*Compare to the Litigation System*, (January, 2005),  
<http://www.adrforum.com/users/naf/resources/GeneralCommercialWP.pdf>

This is consistent with earlier academic estimates that put that the amount of commercial dispute using arbitration at 75 percent. JEROLD AUERBACH, *JUSTICE WITHOUT LAW?* 113 (Oxford: Oxford University Press, 1983).

<sup>29</sup> Todd Zywicki, *The Economics of Credit Cards*, 3 *CHAPMAN L. REV.* 79; Bryan Caplan and Edward Stringham, *Networks, Law, and the Paradox of Cooperation*, 16 *REVIEW OF AUSTRIAN ECONOMICS* 309, 316-8 (2003).

<sup>30</sup> For a brief overview, see ROBERT COOTER & THOMAS ULEN, *LAW AND ECONOMICS* 480 (HarperCollins, 1988).

<sup>31</sup> See Steven Shavell, *Alternative Dispute Resolution: An Economic Analysis*, 24 *J. LEGAL STUDIES* 1 (1995); Bruce Benson, *Arbitration*, in *ENCYCLOPEDIA OF LAW AND ECONOMICS* 159 (Boudewijn Bouckaert and Gerrit De Geest eds. 2000); National Arbitration Forum, *Business-to-Business Mediation/Arbitration vs. Litigation: What Courts, Statistics, & Public Perceptions Show About How Commercial Mediation and Commercial Arbitration Compare to the Litigation System*, (January, 2005), <http://www.adrforum.com/users/naf/resources/GeneralCommercialWP.pdf>

<sup>32</sup> For example, in her contribution to this issue, Shachar describes and supports a government restriction in Canada that prevents private parties from selecting a religious tribunal to handle family disputes in a particular way. Rather than allowing parties to have their disputes handled according to religious tradition the government mandates that family disputes be handled according to national secular law. See Ayelet Shachar, *Privatizing Justice: By Whom and for What Purpose? A Cautionary Tale from Religious Arbitration in Family Law Disputes*, *Theoretical Inquiries in Law* (forthcoming). Because the state

a pure market system with a nexus of voluntary relationships from arising. We argue that if the government stopped interfering with people's voluntarily agreed to contracts, a system of de facto privatization could come about.

A goal of this paper to help people recognize that entities independent of the state can handle adjudication. We will focus on a for-profit legal order, but the not-for-profit sector could provide many of the services we describe. Dispute resolution benefits multiple parties, so many consider it a public good. To the extent that these benefits can be internalized, however, the private sector (be it for-profit or not-for-profit) will be capable of providing this public good. Should the private sector handle other aspects of law, such as family or even tort law?<sup>33</sup> This article will conclude by proposing that any contractual relationship, including prenuptial agreements and agreements in homeowners associations, could easily include an arbitration clause by which parties agree to handle potential disputes privately rather than by government courts. This has the potential to easily take large areas of law out of government hands. Our conclusion suggests that all law should be privatized,<sup>34</sup> but even if one is not on board with the libertarian case for this, one can accept that private adjudication of disputes is possible in many areas. Recognizing this is a step toward realizing that a state monopoly over all law is not the necessity that legal centralists assume.

## **II. Public Versus Private Adjudication of Disputes**

First, let us consider some of the problems of government courts. Government attempts to portray the court system as one of speedy and impartial justice. But in reality, government courts have many problems, just like the other appendages of the bureaucracy. They are often slow at their best, and at their worst, conduits for gross injustice.<sup>35</sup> Many legal pluralists and radical libertarians agree that the "main function of law is coercive social control."<sup>36</sup> Authors such as

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prevents many types of private agreements from actually coming about the range of choices that people have in the market is severely restricted.

<sup>33</sup> For the arguments for and against this see the dozen articles on this in Section 2 of EDWARD STRINGHAM, ANARCHY AND THE LAW: THE POLITICAL ECONOMY OF CHOICE, 193-376 (2007).

<sup>34</sup> CAPLAN AND STRINGHAM

<sup>35</sup> PAUL CRAIG ROBERTS AND LAWRENCE M. STRATTON. THE TYRANNY OF GOOD INTENTIONS: HOW PROSECUTORS AND BUREAUCRATS ARE TRAMPLING THE CONSTITUTION IN THE NAME OF JUSTICE (2000).

<sup>36</sup> William Twining, *A Post-Westphalian Conception of Law: A Review of A General Jurisprudence of Law and Society*, 37 *Law & Society Rev.* 199, 215 (2003).

Rothbard provide a more in-depth treatment of the problems of government,<sup>37</sup> but the bottom line is that actual law enforcement and its portrayal in high school civics textbooks are quite different.

In the following two sections we will use economics to discuss many of their central weaknesses. Some of the problems could be solved with minor reforms. For example, court services are under-priced (usually, free), which leads to excess demand, shortages, and strategic delays by certain litigants. Presumably, if the public courts were so inclined, they could charge court fees for civil cases to ration demand. A second problem is nuisance suits. Frequently, one party is clearly in the wrong, but the battle drags into court anyway in the hope that the other side will simply give up. Government courts might be able to solve this problem by changing the indemnification rule – for example, by making the loser in a nuisance suit pay the other side's court costs.

Other problems in the public courts would be difficult to eliminate with minor reforms. First, public courts are supported by taxes and like all bureaucracies they have little incentive to serve customers or control costs. Trials take too long, appeals can make the entire process long, and labor discipline is lax. Since juries are conscripted, courts treat their labor as a free good; consequently, they use juries even when the value of their contribution to justice is small. And more seriously, public courts foster wasteful legal battles. Instead of encouraging litigants to limit their joint legal expenditures, courts give them incentives to race to out-spend each other building up bigger and bigger cases. But since the expenditures usually cancel each other out, this legal competition is rather futile. It is hard to see how the public court system could solve the second group of problems even if it wanted to. Indeed, it probably will not remedy the first set of difficulties either.

At a more fundamental level, no evidence shows that our adversarial system is the best way to solve disputes.<sup>38</sup> An ideal system might look almost nothing like the government courts of today, but since the government bureaucracy has been functioning this way for so long, many people do not even consider the possibility of alternatives.<sup>39</sup>

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<sup>37</sup> See Murray N. Rothbard, *EGALITARIANISM AS A REVOLT AGAINST NATURE, AND OTHER ESSAYS* (1974). Most other economists view government in a benign way when it comes to law. Only recently have public choice economists started applying their analysis to the legal bureaucracy. See the edited volume by EDWARD LOPEZ, *LAW WITHOUT ROMANCE: PUBLIC CHOICE AND THE U.S. LEGAL SYSTEM* (forthcoming).

<sup>38</sup> The literature on alternative dispute resolution lists many reasons why less adversarial systems may have significant advantages. See Bruce Benson, *Arbitration*, in *ENCYCLOPEDIA OF LAW AND ECONOMICS* 159 (Boudewijn Bouckaert and Gerrit De Geest eds. 2000); National Arbitration Forum, *Business-to-Business Mediation/Arbitration vs. Litigation: What Courts, Statistics, & Public Perceptions Show About How Commercial Mediation and Commercial Arbitration Compare to the Litigation System*, (January, 2005), <http://www.adrforum.com/users/naf/resources/GeneralCommercialWP.pdf>

<sup>39</sup> John Hasnas, *Myth of the Rule of Law*, 1995 *WISCONSIN LAW REVIEW* 199, 226 (1995). If a system allowed choice, it would allow certain parties to contract to have their disputes settled almost exactly like



To understand the benefits of turning over disputes to private alternatives, we must first understand why and how public courts fail. This done, we can investigate the ways in which private bodies overcome problems that the public courts cannot.

### **III. Problems with Government Courts: Under-pricing, Nuisance Suits, Input Waste, and More**

For now, let us assume that the government is right that an adversarial third party enforcement system is a good way of resolving disputes (something that should be questioned).<sup>40</sup> In addition, let us assume that government courts are providing a good for society (something which also could be questioned).<sup>41</sup> Even accepting these assumptions, government may not be doing its job as well as it could for many reasons. An excellent work detailing the failures of public courts is Richard Neely's *Why Courts Don't Work*.<sup>42</sup> As a judge with training in economics, Neely is particularly qualified to point out the many problems inherent in our court system. First, the courts underprice their services, leading to excess demand and non-price rationing (usually, waiting in line). But selling one's place in line is illegal, so the most urgent cases must wait as long as trivial ones, leading to protracted legal conflict and higher legal costs. This is particularly severe for dispute resolution because the litigants can struggle with one another ferociously while they wait to go before the judge. If courts charged user fees, people with insignificant disputes would be more likely to drop them or to try a cheaper resolution method. Yet the courts provide subsidized (free) services, often complete with juries. The whole process is expensive, but litigants only need to consider their lawyers' fees. They ignore both the cost to taxpayers of extra trials as well as the cost of justice delayed or denied to everyone waiting behind them.

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government courts handle disputes today if they viewed our current system as ideal. But a market system would allow other parties to experiment to find new ways of resolving disputes, which would allow new procedures to be discovered and allow laws to evolve for those people open to trying something new.

<sup>40</sup> This assumption can be questioned since the vast majority of business dealing does not rely on third party enforcement, and even when it does rely on third party enforcement less formal methods of resolving disputes such as mediation exist. Stewart Macaulay, *Non-Contractual Relations in Business: A Preliminary Study*, 28 AMERICAN SOCIOLOGICAL REV. 55 (1963). Peter T Leeson, *Contracts without Government*, 18 J. PRIVATE ENTERPRISE, 35 (2003).

<sup>41</sup> This assumption can be questioned since one can view government courts as inefficient producers of public goods (they are trying but do not always succeed) or one can view them as producers of public bads. This latter view is fictionally portrayed in FRANZ KAVKA, *THE TRIAL* (1925), but is also painstakingly documented by authors such as PAUL CRAIG ROBERTS AND LAWRENCE M. STRATTON. *THE TYRANNY OF GOOD INTENTIONS: HOW PROSECUTORS AND BUREAUCRATS ARE TRAMPLING THE CONSTITUTION IN THE NAME OF JUSTICE* (2000).

<sup>42</sup> RICHARD NEELY, *WHY COURTS DON'T WORK* (McGraw-Hill Book Co., 1982).

Underpricing also helps the legally well-endowed wear out their opponents. Neely writes, "Often the attractive products that the court delivers free are delay itself or a forum that provides the stronger litigant with an opportunity to wear out or outgun the opposition."<sup>43</sup> Since a longer delay gives both sides a greater opportunity to out-spend each other, delay usually favors the richer litigant. Delay also deadens the deterrent effect of damages: future damages, like other future income streams, will be discounted by the interest rate. All these issues would not be problems if court services were not essentially free.

Neely also points to a second problem that plagues the justice system: the courts give incentives to litigate non-disputes. For instance, in landlord-tenant cases or creditor-debtor cases, a "legal issue" rarely exists. Instead, as Neely explains, one side usually just refuses to fulfill its half of the bargain. "In the universe of all the routine cases that go to court, most of the time one party will be flat wrong, and he or she will know that from the beginning."<sup>44</sup> But if legal costs exceed the expected value of the judgment, then aggrieved parties may drop legitimate cases. When nuisance cases do obtain a full trial, they crowd out more substantive disputes.

Even though parties do not have to pick up the tab for court services, going to trial is still costly, which often leads potential litigations to settle before reaching trial.<sup>45</sup> One might wonder whether large trial costs are a blessing in disguise because they cause parties to negotiate their settlement without actually taking up court time.<sup>46</sup> But although settling is often a better option, the threat of an enormously costly trial does not help bring about either justice or traditional notions of economic efficiency. When adjudication is known to be extremely costly or very risky, parties will do almost anything to avoid having their dispute heard in courts of law. Their settlement reflects a desire to avoid a bad procedure and nothing more.<sup>47</sup> Many parties know the other side is clearly wrong, but choose a less than ideal settlement rather than paying for the cost of a trial (with the added risk of an unlucky outcome).<sup>48</sup> For example, many insurance companies

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<sup>43</sup> RICHARD NEELY, *WHY COURTS DON'T WORK* 165 (McGraw-Hill Book Co., 1982). With zero transaction cost capital markets this could not happen because banks would happily loan money to litigants with good cases, but strategic delay does seem to be a real problem.

<sup>44</sup> *ibid.*, p.166.

<sup>45</sup> Marc Galanter, *Worlds of Deals: Using Negotiation to Teach About Legal Process*, 34 *J. LEGAL EDUC.* 268 (1984).

<sup>46</sup> We thank David Gilo for raising this point.

<sup>47</sup> If a mutually disadvantageous trial were such a good thing, parties could simply commit to play Russian roulette to further encourage settlement without regards to finding the just outcome.

<sup>48</sup> Some of the reasons why large levels of uncertainty in trials is undesirable are given by Menachem Mautner, *Luck in Courts*, *THEORETICAL INQUIRIES IN LAW* (forthcoming).

simply pay for fraudulent insurance claims because settling is cheaper than going to trial.<sup>49</sup> Other wronged parties do not pursue what might be legitimate claims because the other party has the threat of a costly trial as a bargaining chip. So the benefits of what Galanter calls “litigation” cut both ways.<sup>50</sup>

One solution for insincere cases would be to make the loser pay both sides' legal costs – but courts are loath to try this reform. Contrast these problems with government courts to private tribunals where private parties pick up the tab. Landes and Posner argue that the public courts waste and misallocate their resources because taxpayers, not judges or lawyers, have to pay the bill.<sup>51</sup> They argue that arbitrators, on the other hand, are likely to make more efficient use of inputs because they survive on user fees and will lose business if they do not contain costs. From these assumptions, these legal economists propose the following test of the efficiency of the public courts' civil trials: the public courts are efficient if they match the practices of arbitration. Since arbitration does not use juries and sometimes not even lawyers, and the public courts do, Landes and Posner conclude that these may be inefficient, at least in civil cases.<sup>52</sup> This is input waste on a huge scale – and it very well might be that a majority of the inputs in civil cases are unwarranted. The misallocation of jury time is especially egregious, since they are conscript labor paid little – virtually a free good. While juries cost a great deal to society (including the jury members themselves, who lose work time), courts and litigants have the incentive to use them even when the benefit is negligible.

Landes and Posner use the same efficiency test for other public court practices. For example, controversy exists over the merits of the loser-pays rule for legal expenses. Arguments cut both ways: If trials occur because of over-optimism, then the loser-pays rule leads to more suits. On the other hand, if many suits are “nuisance” suits in which the party in the wrong strategically delays, then the loser-pays rule would lead to fewer suits.<sup>53</sup> It is hard to do an empirical test to everyone's satisfaction. We could reasonably predict, however, that profit-maximizing private courts would use the more efficient rule, especially if the parties pre-contract to arbitrate with a specific firm with a set indemnification rule. How does the test turn out? The

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<sup>49</sup> The annual cost of fraud to the American insurance industry is upwards of \$120 billion. PETER RAST & ROBERT STEARNS, *LOW-SPEED AUTOMOBILE ACCIDENTS: INVESTIGATION AND DOCUMENTATION*, 2 (2d ed, 2003).

<sup>50</sup> Galanter and Cahill write, “Settlement is not intrinsically good or bad, any more than adjudication is good or bad.” Marc Galanter & Mia Cahill, *Judicial Promotion and Regulation of Settlements*, 46 *STAN. L. REV.* 1339, 1388 (1994).

<sup>51</sup> Richard Posner and William Landes, *Adjudication as a Private Good*, 8 *J. LEGAL STUDIES* 235.

<sup>52</sup> Posner and Landes, *loc. cit.*, p.252. Since criminal cases are not arbitrated, we cannot know what criminal arbitration would be like.

<sup>53</sup> See Robert Cooter and Thomas Ulen, *op. cit.*, p.486.

American Arbitration Association requires the defendant to pay all legal costs if the plaintiff wins, but splits the difference if the defendant wins.<sup>54</sup> Posner suggests that this vindicates the American rule over the English; but actually this rule implies that defendants are often clearly guilty, whereas malicious suits by plaintiffs are infrequent. Or in other words, nuisance suits by defendants are more common than nuisance suits by plaintiffs (in disputes currently open to arbitration). The parties can also voluntarily change the indemnification rule: some contracts alter the standard American Arbitration Association rules, stipulating that the plaintiff pays the legal costs if he loses.

Landes and Posner bring up another interesting issue: appeals. They argue that private arbitration systems (excluding trade associations) lack appellate courts because the sole function of such courts is to formulate rules of law, not resolve disputes, and the former, unlike the latter, is a public good. Landes and Posner view the production of rules as a pure public good: society at large benefits when someone refines a legal principle, but (as is often the case with intellectual creations), it is hard to claim a property right in a precedent.

This argument may well be true, but another potential explanation exists: Private courts do not permit appeals simply because the extra costs (in time, legal fees, court services, and so on) are not worth the benefits. Both parties can gain if they agree *ex ante* to limit each other to a single hearing. But in public courts there is no way to credibly commit to limit appeals. On this theory, the lack of appeals is a benefit to both parties because it keeps dispute resolution costs low. Posner and Landes point out that trade associations permit appeals, and these appeals sometimes produce precedents. They argue that this happens because a trade association can internalize the benefit of a precedent. True, but they also concede that appellate tribunals are not universal. In all likelihood, trade associations rarely permit appeals, strictly limit their expense, or both.

As additional evidence, the VISA corporation does not permit appeals, even though the corporation's unique structure and secrecy enable it to fully internalize the benefit of precedents. Quite possibly the permission of appellate review in criminal cases makes economic sense; for as Posner suggests, the desire to avoid convicting the innocent may justify the reasonable doubt rule for evidence in criminal proceedings.<sup>55</sup> On the other hand, the behavior of many arbitration firms and trade tribunals suggests that the appeals process in civil cases has excessive costs.

#### **IV. Problems with Government Courts: Fostering Wasteful Legal Conflicts**

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<sup>54</sup> Posner and Landes, *loc. cit.*, p.252.

<sup>55</sup> RICHARD POSNER, *ECONOMIC ANALYSIS OF LAW* 433-4 (Little, Brown, and co., 1977).

Disputes occur in all societies, and in the interest of peace, these disputes must be resolved somehow. But dispute resolution entails costs, and disputants must eventually split the additional burden, often a substantial sum, on top of the costs of the dispute. From an ex ante perspective, the plaintiff and defendant have a common interest in minimizing their respective dispute resolution costs. We may infer that the parties share an incentive to cheaply resolve their conflict.

In the government court system this principle is at work when defendants settle. Yet clear inefficiencies in public courts both increase the costs of dispute resolution and make settlement more difficult. Neely's strongest criticism of the public court system is that it promotes futile but expensive strategic behavior. The outcome of a case depends not merely on the facts of the dispute, but on the respective legal expenses of the two sides. Since the disputants cannot reach a cooperative solution to the dispute itself, agreeing to limit joint legal expenditures is likewise difficult. The result is often that both plaintiff and defendant rush to outspend each other. But when both parties increase their spending the same amount the ultimately the probability of success remains unaltered because the competitive expenditures cancel one another out.

What can be done to limit wasteful expenditures? Neely's proposed solution might arouse skepticism from some economists: "What is needed is a court version of the Strategic Arms Limitation Treaty – a method for determining in advance what a reasonable investment in a particular lawsuit is, and a court order forbidding both sides from spending money for a competitive advantage that in the nature of things will be illusory."<sup>56</sup> Like statutory caps set on excessive punitive damages, this is probably a band-aid measure destined to create bureaucratic inefficiencies of its own. Hard questions present themselves. First, judicial determination of maximum legal expenditures would itself use up valuable court time. Maximum permissible expenditures would itself be an issue of legal contention. Second, active interest groups would surely struggle to adjust the ceiling in their preferred direction. Frequent defendants might very well want the cap pushed down as far as possible to remove incentives for plaintiffs' lawyers to bring suits against them. Habitual plaintiffs and their attorneys would in turn lobby in the opposite direction. (Or perhaps they would favor a cap that applied solely to defendants!) Third, it seems difficult to see how lawyers working on contingency could be dealt with under Neely's rule. Would their awards be capped? Would the courts set a ceiling for the permissible total lawyer-hours per case?

These problems seem serious – for public courts, as politics would probably prevail over economics. Private courts, on the other hand, are free to experiment with different solutions, and

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<sup>56</sup> Neely, *op. cit.*, p.185.

in fact they already limit legal expenses with marked success. Consider the following description of one type of alternative dispute resolution, Peer Review Alternative Dispute Resolution: “Peer review panels produce quick, efficient, and inexpensive results. Usually, only a few weeks pass from the time a problem arises until it is resolved. There are no complicated rules, no courtroom trappings, and no lawyers.”<sup>57</sup> In case the reader missed it, no lawyers! VISA does not even allow the parties to attend their own hearing, the parties are only later informed of the result. But the fact that some people choose these practices demonstrates that they are ex ante utility enhancing to all parties involved. On average, these practices are unlikely to harm the legal prospects of either side, but they limit the joint legal costs per case – a big plus. Since both sides typically agree to arbitrate disputes in advance, before cooperation has broken down, it is easy to pre-commit to mutually limit legal costs in future disputes.

Why has private dispute resolution worked so well in these aforementioned areas? The public courts would find it hard to administer limitations on the use of lawyers. The reason is a critical difference exist between the limitations that private and public courts place on legal expenditures. To understand it, we should turn to Ronald Coase's classic article, "The Nature of the Firm."<sup>58</sup> Managers of a firm, Coase explained, usually run it by the "command-and-control" methods that economists deplore on the economy-wide level. After hiring a worker, managers expect him to do what he is told; similarly, office supplies are likely to be centrally allocated to each department rather than sold to them. What this shows, said Coase, is that command-and-control methods (since they survive and thrive within competitive firms) must be useful to some extent; most notably, command-and-control reduces transaction costs. The problem with centrally-planned economies is that they extend command-and-control techniques far beyond their efficient point – and then eliminate the competitive pressure that checks this inefficiency. In competitive markets, a firm that grows so large that it cannot effectively manage itself starts to lose market share and profits. This gives an incentive to scale back to a less cumbersome size. Central planning by a government does not face this disincentive.

For private courts, limiting the use of lawyers, expert witnesses, and so on would be akin to any other business decision. All firms use command-and-control to some extent; what prevents inefficient command-and-control is the pressure of competition. When private courts experiment with restrictions on legal expenditures, they need merely judge the needs of their own clientele, not those of a whole society. And when they judge incorrectly, competition can

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<sup>57</sup> Sam Blank, *Peer Review Panels: Managing Conflicts in the Workplace*, GUIDANCE CHANNEL EZINE, April, 2007, <http://www.guidancechannel.com/default.aspx?M=a&index=1763&cat=16>

<sup>58</sup> Ronald Coase, *The Nature of the Firm*, in READINGS IN PRICE THEORY 331 (George Stigler and Kenneth Boulding, eds., 1952).

straighten them out. If a firm decides to limit legal expenditures, market share and profits can indicate whether or not the practice is desirable by the parties in that particular case or set of cases like it. No one ever needs to make the much more difficult judgment about what is desirable for all firms.

In contrast, the public court system is basically a centrally-planned industry. When it uses command-and-control, little or no feedback demonstrates whether its actions are sensible. And if it chooses wrongly, consumers often have no close substitute. More critically, the public courts choose not merely for a single firm; they choose for the whole society.

Government is unlikely to pick the set of policies that consumers desire both because of the lack of market feedback, and because individual preferences and circumstances differ too much for one set of rules and procedures to suit them all. Judge Neely is likely right that litigants would often be better off if they could mutually "disarm" by jointly slashing expenditures. But given the public courts' structure and political constraints, this task may be impossible.

This short list of problems in the public courts is hardly exhaustive. We might also note that judges and juries make many economically unwise rulings, motivated by emotion or politics rather than what was actually in the contract. Since courts do not have to earn their customers through the market, they can make many decisions contrary to the wishes of their subjects. For the above reasons and many more, we should allow parties to consider alternatives to government courts. Fortunately, private dispute resolution is a real and growing option. The next two sections will explore arbitration's benefits, solutions to the problems of the public courts, and feasible scope.

## **V. Benefits of Private Dispute Resolution Over Government Courts**

Many of the incidental faults of public courts would not exist (or would be less severe) under private arbitration. For example, private courts could raise fees to efficiently ration judicial services. They could experiment with indemnification rules or other methods, such as prohibiting or limiting the use of lawyers, to reduce their clients' expected legal costs. Private courts could also limit or eliminate appeals. Each of these potential solutions seems difficult for the public courts to manage: partly for political reasons, but also because public monopolies have little ability to recognize entrepreneurial opportunities.

Private courts also have important advantages at a more fundamental level. Private suppliers recognizes that consumers have different needs, and since many firms can survive in an industry simultaneously, they can sell a wide variety of services side by side. Some parties prefer

swift decisions at the cost of lower accuracy; the member banks of the VISA corporation, for example, realize that errors will even out in the end, but that adjudication costs increase with each dispute. VISA consequently has a system of rough but swift justice. Other conflicts, such as those over isolated contracts between strangers, require a more thorough investigation. Public courts have a systematic bias toward excessively slow resolution, but even if the courts were right on average as a result, they would still ignore the fact that litigants' preferences vary.

The most impressive arguments for privatizing dispute resolution have little to do with the unique attributes of the adjudication industry. Rather, they are the standard arguments for the prima facie superiority of private to public supply, namely: (1) Public bodies have no incentive to be efficient, and private ones do; and (2) Public bodies usually do not know what is efficient, while private bodies, though not omniscient, know better for reasons we will discuss below.

Why do courts lack any incentive to be efficient? First, no residual claimant with an interest in cutting costs and increasing consumer satisfaction exists. In profit-making firms, the owners have an incentive to keep costs low and make them fall over time. And the incentives of the employees in government versus private firms are different. Judges are typically either elected or appointed for life. Elections are a bad way to monitor work effort since informing oneself about each judge's attributes is a pure public good. Society at large benefits from the intelligent selection of judges, but individual diligent voters bear the costs. Life appointments take away even the meager incentive effects of voting. If we want the public courts to function well, we must rely on judges to monitor themselves. This might work sometimes, but the incentive structure of private labor markets is more sensible. While they have imperfections, private labor markets leave employment decisions to a concerned manager or entrepreneur, not the public at large. These managers reward their employees if they work well and fire them if they don't. Surely this spurs work effort better than elections or life appointments.

Second, as Hayek and others suggest, private markets allow people to utilize knowledge more effectively than public monopolies.<sup>59</sup> In markets, explicit prices measure costs and benefits.<sup>60</sup> But public bodies must estimate social costs and benefits by using (at best) surveys or (at worst) guessing.

Consider how courts might attempt to determine how to do things better. Private sector entities and a public sector monopoly are in very different positions. Private arbitration firms could cheaply explore various possibilities, such as prohibiting the use of lawyers and appeals;

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<sup>59</sup> F.A. Hayek, *The Use of Knowledge in Society*, 35 AMERICAN ECON. REV. 519 (1945).

<sup>60</sup> LUDWIG VON MISES, *ECONOMIC CALCULATION IN A SOCIALIST COMMONWEALTH* (Mises Institute, 1990) (1920).



they do so already. It is cheap and safe if one firm decides to restrict the use of lawyers, or get rid of appeals, or change the indemnification rule; even if these experiments flop, the losses are not society wide. Often an experiment proves useful, at least for one section of the consuming public. Private adjudication services would be free to experiment and see what their clientele thinks. Public courts, in contrast, rarely try new ideas. But there is perhaps a justification for this: Their error costs are terribly high because public experiments involve everyone. Perhaps public courts hold to the status quo because they fear that their experiments will fail miserably. Therefore, we need to permit experimentation, but keep it decentralized so that mistakes can be abandoned before they become disasters. And private firms are the ideal arena for low-cost experimentation. For years, academics in law and economics have speculated about the relative efficiency of different rules and procedures for trials. Rather than have the public courts try each out in succession, we could expand the scope of private courts and see which innovations evolve.

## **VI. The Potential of and Limits on Private Dispute Resolution**

To what extent does the success of arbitration depend on the existence of government courts? Posner and Landes write that private dispute resolution works best in the following two types of circumstances: "(1) those where a preexisting contract between the parties requires submission to arbitration according to specified rules for selecting an arbitrator, and (2) those where the disputants belong to an association which provides both arbitration machinery for its members and a set of effective private sanctions for refusal to submit to arbitration in good faith or to abide by its results."<sup>61</sup> When disputants are members of an association with their own effective sanctions (in circumstance 2), understanding why parties would follow arbitration decisions is relatively easy.

But when disputants are not members of the same business association, do arbitration agreements (in circumstance 1) need government courts to enforce those contracts? Posner and Landes answer with the affirmative. We, on the other hand, believe that arbitration does not require government to positively enforce contracts but rather simply not to overrule them. How could a decision be upheld if not enforceable in a court of law? Actually, many agreements are unenforceable, or the costs of enforcing them in government courts is too high, yet private parties develop methods to make these contracts self-enforcing. Economists have documented the many ways this can be done,<sup>62</sup> but to give a quick example illustrating the economic theory, consider

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<sup>61</sup> See POSNER, *ECONOMIC ANALYSIS OF LAW*, op. cit., pp.450-453.

<sup>62</sup> Arnoud Boot, Stuart Greenbaum, and Anjan Thakor, *Reputation and Discretion in Financial Contracting*, 83 *AMERICAN ECONOMIC REVIEW* 1165 (1993); Benjamin Klein and Keith Leffler, *The Role of Market Forces in Assuring Contractual Performance*, 89 *JOURNAL OF POLITICAL ECONOMY* 615 (1981);

video rentals. Before we can obtain a rental card, we must authorize the renter to charge our credit card if we do not return the video or pay our fees. Our credit card company in effect guarantees our trustworthiness, and if we break our agreement, it pays the video rental firm. If we refuse to pay our credit card bill, our company could take us to court, but this is usually so costly and ineffective that the credit card company relies on a non-governmental solution. It simply reports our bad credit to others, which in and of itself creates incentives for people to pay their bills.<sup>63</sup>

Extending this model further, one can imagine ways to enforce all sorts of contracts, including arbitration contracts, non-violently and without involvement by the public courts. History is replete with examples in which parties engage in sophisticated contracts that are unenforceable in courts of law.<sup>64</sup> Repeated interaction, game theory teaches, can substitute for enforceability.<sup>65</sup> But the interesting aspect is that repeated interaction with all of our fellow contractors is not actually necessary to make non-violent enforcement possible. One option is to merely repeatedly interact with one firm whose job it is to guarantee our payments. Another option is to rely on reputation if multiple parties are able to share information about the trustworthiness of others. So long as parties develop some kind of reputation or bonding relationship, they do not need the public courts to enforce their agreements.<sup>66</sup> The only thing that government needs to do (or to be more specific, to not do) is not overrule private decisions. Arbitration is a way to escape from the public courts, but if the public courts regulate arbitration, the "escape" is less effective. Contra Posner and Landes we believe that arbitration can work even if the public courts do not enforce it, but that it cannot work if the public courts positively disallow it.

Unfortunately, government interferes with the arbitration industry in many ways and thus distorts the market. Nathan Isaacs, a professor of business law at Harvard during the 1920s, noticed that when the government began to enforce arbitration agreements in New York in 1920, it also began to hamper them: "There is irony in the fate of one who takes precautions to avoid

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L.G. Telser *A Theory of Self-Enforcing Agreements*, 53 J. BUSINESS 27 (1980); Oliver Williamson, CREDIBLE COMMITMENTS: USING HOSTAGES TO SUPPORT EXCHANGE," 73 *American Economic Review* 519 (1983).

<sup>63</sup> We are not saying that 100 percent of credit card users ultimately pay their bills, but credit card know this and build such risks into their business model, and the system works quite well.

<sup>64</sup> Edward Stringham, *The Extralegal Development of Securities Trading in Seventeenth Century Amsterdam*, 43 QUARTERLY REV. ECON. & FINANCE, 321 (2003); Edward Stringham, *The Emergence of the London Stock Exchange as a Self-Policing Club*, 17 J. PRIVATE ENTERPRISE, 1 (2002); Peter Leeson, *Self-Enforcing Arrangements in African Political Economy*, 57 JOURNAL OF ECONOMIC BEHAVIOR & ORGANIZATION 241 (2005).

<sup>65</sup> For an overview of this literature see MATT RIDLEY, *THE ORIGIN OF VIRTUE* (1997).

<sup>66</sup> ANTHONY DE JASAY, *AGAINST POLITICS: ON GOVERNMENT, ANARCHY, AND ORDER*, 192-212 (1997).

litigation by submitting to arbitration, and who, as a reward for his pains, finds himself eventually in court fighting not on the merits of his case but on the merits of the arbitration."<sup>67</sup> Furthermore, Benson describes how arbitrators now must follow many bureaucratic procedures if they want to reduce the likelihood of public courts overturning their decisions.<sup>68</sup> This makes arbitration a less attractive alternative. Government rules also make other forms of alternative dispute resolution, such as mediation, non-binding, which eliminates much of the incentive for people to experiment with different methods of solving disputes.<sup>69</sup>

For arbitration to work as well as possible, public courts and legislatures need to step back and simply allow the market to function. Public courts should adopt a simple rule about what arbitration clauses must say if the signatories want the arbitration to be final and binding (i.e., how to make the contracts court proof), and then courts should stick to that rule. Second, courts should refuse to review the content of binding arbitration, leaving the efficiency and justice of arbitration to the parties' judgment. Third, legislatures must refrain from legally hampering the ostracism and boycott efforts of arbitration firms, professional associations, and credit card companies (for example, by banning credit ratings as an invasion of privacy). Private firms do not have violence at their disposal, so they must use subtler methods of enforcing agreements, like credit ratings and reputation. To put restrictions on these comparatively mild enforcement techniques makes it difficult for arbitration to work at all.<sup>70</sup>

The system we are proposing is simply to allow people entering into agreements to opt out of government courts if all parties involved desire it. Whenever parties choose arbitration rather than government courts, it demonstrates that arbitration is making both parties better off.<sup>71</sup> Although many people agree to arbitration after a dispute occurs,<sup>72</sup> arbitration usually works best and is clearly ex ante utility enhancing to all parties involved when stipulated in an initial contract.

So far we have discussed arbitration in commercial disputes, but all of this logic could easily be applied to arbitration of other types of disputes. Whenever two parties have a voluntary relationship, there is no reason why the default judge over potential disputes needs to be the state, since creating a relationship enables parties to stipulate the type of court and set of rules they

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<sup>67</sup> Posner and Landes, loc. cit., p.247.

<sup>68</sup> Bruce Benson, *An Exploration of the Impact of Modern Arbitration Statutes on the Development of Arbitration in the United States*, 11 J. LAW, ECONOMICS, & ORGANIZATION, 479 (1995).

<sup>69</sup> Bruce Benson, *An Exploration of the Impact of Modern Arbitration Statutes on the Development of Arbitration in the United States*, 11 J. LAW, ECONOMICS, & ORGANIZATION, 479 (1995).

<sup>70</sup> Finally, the government should refrain from making any antitrust charges against professional associations that publicize the untrustworthiness of members who refuse to arbitrate or submit to sanctions.

<sup>71</sup> Edward Stringham, *Market Chosen Law*, 14 J. LIBERTARIAN STUDIES 53, 70-76 (1999).

<sup>72</sup> Steven Shavell, *Alternative Dispute Resolution: An Economic Analysis*, 24 J. LEGAL STUDIES 1 (1995).

prefer. Interaction between people without contractual relationships brings up important issues,<sup>73</sup> but most disputes are not among strangers with no contractual relationship, and in principle disputes between people who enter into contracts could easily be turned over to the private sector. All commercial disputes, employment quarrels, creditor-debtor complaints, landlord-tenant problems, divorce, and perhaps even products liability fit the mold well.<sup>74</sup> Each party decides whether or not to enter into a relationship, and the parties can decide how they would like their dispute to be settled and by whom.

The parties need merely record their mutual decision to arbitrate future quarrels (including their preferred arbitrator if they wish), plus some sort of assurance or guarantee of compliance. Commercial disputes might rely on reputation effects; employment quarrels on the threat to fire on one hand (to exact compliance from employees) and the harm to worker morale on the other (to get employers to accept decisions); landlord-tenant relations on a security deposit. In other situations the parties might use bonding mechanisms<sup>75</sup> or credit cards to pre-commit themselves to pay up.

Consider, for example, sexual harassment. Instead of having court-enforced anti-harassment laws, we could leave firms to develop their own policies, or "law" on the matter. Firms would have to offer a set of policies that would attract employees. In the case of a dispute, either the firm itself or a sub-contractor might conduct an internal investigation with its own procedures, rules of evidence, etc. The firm could have the power to enforce the arbitrator's ruling: it might fire an offending employee, attach his wages to compensate the injured party (coupled with a threat to provide the harasser's name to a sort of "employee rating firm" if he should opt to quit), or any number of other remedies. To attract a satisfied workforce, each firm would need to compete to develop more efficient rules and enforcement techniques. And the advantage of this system would be that employees could sort themselves and choose to work for

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<sup>73</sup> When both parties do not ex ante agree to arbitrate and do not credibly pre-commit to comply, enforcing a claim non-violently may be difficult. This might be the case if one party is sure to lose in any fair trial, giving him less incentive to cooperate unless he previously made himself vulnerable to sanctions (for example, by authorizing his credit card company to pay for any damages). Second, even if two strangers agreed to arbitrate getting a fair trial might be difficult if each side engaged in forum shopping to get arbitrators, rules, procedures, etc., beneficial to its case. If the other party declined, he might be accused of "foot-dragging," of willfully delaying and stifling the resolution process. These problems make many skeptical of purely private resolution of quarrels between strangers, although some authors propose potential solutions that might make arbitration (without violent recourse) work even when both parties did not have an arbitration contract before the dispute occurred. See Gil Guillory and Brian Drake, *On the Viability of Subscription Patrol and Restitution Services*, Mises Institute Working Papers (March 26, 2006) <http://www.mises.org/journals/scholar/guillory2.pdf>

<sup>74</sup> For a discussion of how product liability can be handled contractually see Henk Folmer, Wim Heijman, and Auke Leen, *Product Liability: A Neo-Austrian Based Perspective*, 13 EUROPEAN JOURNAL OF LAW & ECONOMICS, 73 (2002).

<sup>75</sup> DAVID FRIEDMAN, LAW'S ORDER 146 (2000).

firms with rules that suited them.<sup>76</sup> Some firms might have strict rules, while other firms might have none depending on the preferences of the employees. Firms would have to weigh at least two important factors: the harm done to harassed employees, and the harm done to those mistakenly accused. In all likelihood, employers who need to compete to attract employees would better balance these two factors than politically motivated courts.<sup>77</sup>

Notice now that with sexual harassment we are beginning to enter the realm of torts. Other examples of torts also take place within communities, such as places of employment, which could easily adopt a certain set of rules. All employees choosing to work for a certain company can explicitly agree to follow a set of rules, and the same can be said for people who choose to purchase a home in a neighborhood with a homeowners' association or students who choose to enter a college with a preexisting set of rules. Historically, students who matriculated to universities essentially became citizens of their university, which had its own courts to deal with legal disputes all the way from contracts to felonies.<sup>78</sup> Although torts are more complicated than commercial contracts that have explicit arbitration clauses, Stringham has argued that in a libertarian world where all property (including streets) is private, most interaction will take place in private communities. This has the potential to make most relationships contractual even if the contracts between two customers are indirect.<sup>79</sup> For example, the two college students who have a conflict with each other have an indirect contractual relationship with each other through their college. Enrolling in the college essentially entails signing an arbitration clause, so potential torts between college students could be handled privately. Office complexes, apartment complexes, homeowners' associations, and shopping malls could also have similar agreements.<sup>80</sup> This would not easily address disputes between a trespasser and a legitimate guest, but it would address a substantial percentage of (perhaps most) disputes. Privatization would enable many of the potential externalities stemming from disputes to be internalized.

A couple questions might remain. Some may be concerned that only the rich would have justice in a world without government, and that the poor would be unprotected if the government did not provide law. Other libertarians such as Rothbard have addressed this question in more detail,<sup>81</sup> but to take a slightly different approach, we would like to point out that just because a potential problem may exist does not imply that creating a government monopoly over the use of

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<sup>76</sup> John Hasnas, *Myth of the Rule of Law*, 1995 WISCONSIN LAW REVIEW 199, 229 (1995).

<sup>77</sup> Edward Stringham, *Market Chosen Law*, 14 J. LIBERTARIAN STUDIES 53, 67 (1999).

<sup>78</sup> W.S. HOLDSWORTH, 1 THE HISTORY OF ENGLISH LAW, 175 (7<sup>th</sup> ed. 1956).

<sup>79</sup> Edward Stringham, *Market Chosen Law*, 14 J. LIBERTARIAN STUDIES 53, 68-70 (1999).

<sup>80</sup> Edward Stringham, *Overlapping Jurisdictions, Proprietary Communities, and Competition in the Realm of Law*, 162 J. INSTITUTIONAL & THEORETICAL ECON., 516 (2006).

<sup>81</sup> MURRAY ROTHBARD, FOR A NEW LIBERTY: THE LIBERTARIAN MANIFESTO, 219 (2d. ed. 1978).

force will solve it.<sup>82</sup> In the current world, government law enforcement typically mistreats the poor the most,<sup>83</sup> so the idea that government law enforcement is created to help the poor should be questioned. Legal pluralists such as Meinen-Dick and Nkonya have argued that “the poor often lose out in processes of formalization,”<sup>84</sup> and libertarian economists have argued that government is often the biggest enemy of the poor.<sup>85</sup> And there is little reason to believe that low income households would be underserved without government law. One feature of markets is that they serve all income levels, not just the privileged.<sup>86</sup> General Motors sells a lot more Chevrolets than it does Cadillacs. An apartment building for low income households would have to offer a system of rules that the customers, the low income households, actually desire if it wishes to attract and retain tenants. Regardless of their income level, the consumer is in the driver’s seat.<sup>87</sup> One should recognize that non-state legal systems include not just expensive arbitration proceedings for commercial disputes, but dispute resolution services for “the London poor” in 18<sup>th</sup> century England,<sup>88</sup> or in modern times “afrocentric restorative justice” on South Carolina’s Gullah Island.<sup>89</sup> These systems developed privately precisely because the state was not serving these groups.

The same can be said about questions regarding children. The existence of children pose interesting questions to this system and, for that matter, nearly every other imaginable liberal system. One might wonder what happens if in a fully privatized world parents opt into clubs with strict rules. The parents agreed to the homeowners’ association rules to be quiet at night, but the children were born into the situation. One can imagine many situations in which the children must follow the rules of their parents or run away. If parents are allowed to adopt illiberal rules for themselves, what about their children? If we agree that children have at the very least some rights, does that imply we need to set up a government to protect these rights? Again, the initial response should be: just because a potential problem exists does not mean government has the capability to solve it. For example, in the current world, many parents do not educate their children as much as

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<sup>82</sup> Edward Stringham, *The Capability of Government in Providing Protection Against Online Fraud: Are Classical Liberals Guilty of the Nirvana Fallacy?* 1 J. LAW, ECON. & POLICY 371 (2005).

<sup>83</sup> Michael Fletcher, *High Incarceration Rate May Fuel Community Crime*, WASHINGTON POST, July 12, 1999 at A1.

<sup>84</sup> R. Meinen-Dick and L. Nkonya, *Understanding Legal Pluralism in Water Rights : Lessons from Africa and Asia*, in AFRICAN WATER LAWS: PLURAL LEGISLATIVE FRAMEWORKS FOR RURAL WATER MANAGEMENT IN AFRICA 8-10 (B. van Koppen, J. Butterworth, and I. Juma, eds., 2005).

<sup>85</sup> WALTER WILLIAMS, *THE STATE AGAINST BLACKS* (1982).

<sup>86</sup> HERNANDO DE SOTO, *THE OTHER PATH: THE INVISIBLE REVOLUTION IN THE THIRD WORLD* (1989).

<sup>87</sup> L.V. MISES, *HUMAN ACTION*, 271 (4th Ed., Foundation for Economic Education, 1996) (1949).

<sup>88</sup> Jennifer Davis, *A Poor Man's System of Justice: The London Police Courts in the Second Half of the Nineteenth Century*, 27 *The Historical J.* 309 (1984).

<sup>89</sup> Morris Jenkins, *Gullah Island Dispute Resolution: An Example of Afrocentric Restorative Justice* 37 J. BLACK STUDIES 299 (2006).

many educated people would prefer. But even though government schools are allegedly created to alleviate this problem, many economists have made the case that government schools are so poorly run that they making the problem worse.<sup>90</sup> One can imagine a hypothetical situation in which a group of parents in the Middle East are mistreating their children, and the United States military creates a rescue team to liberate these children by taking them into custody. But one can just as easily imagine that giving the United States military the authority to invade any home in any country will create problems worse than the disease. Thinking of a dilemma and then assuming that government has the capability to solve it is what Harold Demsetz called the Nirvana approach to public policy.<sup>91</sup> A libertarian world might not eliminate 100 percent of all problems, but there are many reasons to believe that it could eliminate more problems than giving the government a monopoly over the use of force. If “men are not angels,” as many government advocates are quick to point out,<sup>92</sup> then why would we expect a government composed of actual men to be an improvement?<sup>93</sup>

A benefit of the libertarian solution is that even though bad people will likely always exist, the system is decentralized so that bad policies will not be imposed on all people. The people with bad ideas will bear the costs of their bad ideas themselves.<sup>94</sup> In the realm of business, those with bad methods of resolving disputes will lose money and will be more likely to go bankrupt. In a competitive system, providers of law that want to stay in business would always need to search for better methods of resolving disputes that fit with their customers’ desires. Like any other imaginable system, a competitive one would not eliminate all problems, but the competitive market process would reward those who come up with new solutions to the problems of settling disputes.

## VII. Conclusion

Almost all scholars regard law as a pure public good that government simply must supply. Yet many present-day and historical counterexamples exist: arbitration, the law merchant, trade associations, to name only a few. Private dispute resolution is not flawless, but works surprisingly well. Scholars are usually too quick to dismiss private courts on the grounds of

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<sup>90</sup> MURRAY ROTHBARD, *EDUCATION: FREE AND COMPULSORY* (1999).

<sup>91</sup> Harold Demsetz, *Information and Efficiency: Another Viewpoint*, 12 J. L. & ECON. 1 (1969).

<sup>92</sup> James Madison, *The Federalist No. 51*, in ALEXANDER HAMILTON, JAMES MADISON, AND JOHN JAY, *THE FEDERALIST PAPERS*, 262 (Buccaneer Books ed. 1999) (1788).

<sup>93</sup> Benjamin Powell & Christopher Coyne, *Do Pessimistic Assumptions about Human Behavior Justify Government?* 17 J. LIBERTARIAN STUDIES 17 (2004).

<sup>94</sup> Contrast with political systems that enable people with bad ideas to impose costs on others. See BRYAN CAPLAN, *THE MYTH OF THE RATIONAL VOTER: WHY DEMOCRACIES CHOOSE BAD POLICIES* (2007).

market failure, without first considering the magnitude of the market failure, or whether the government could realistically do any better. Private dispute resolution has many benefits: It allows people to select the types of rules and procedures they desire, gives parties greater flexibility, and reduces transaction costs. The lax discipline of voting and self-monitoring have failed to make public courts' decisions and procedures fair and efficient. Turning to the stern discipline of free competition is a more realistic way to deliver the goods.

For arbitration to live up to its full potential, however, government has to stop holding it back. Public courts should, as a matter of policy, respect contracts that specify final and binding arbitration. Legislatures should abolish laws that hamper ostracism, boycott, and other non-violent private enforcement methods. These small changes would make private courts much more attractive than they already are – and go a long way toward putting the public courts out of business.