TOTALITARIAN NUDGES, ILLUSORY EXTERNALITIES, AND UTOPIAN BENEFITS: REFLECTIONS ON THE 34TH ECONOMICS INSTITUTE FOR LAW PROFESSORS

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Abstract

This Essay provides a glimpse into the 34th Economics Institute for Law Professors, which took place in Estes Park, Colorado, from June 17 to 27, 2019. The Institute was hosted by the Law & Economics Center at the Antonin Scalia Law School at George Mason University, and has been previously attended by more than 850 law professors worldwide. The goal of the Institute is "to help participants enhance their understanding of economics and broaden their analytical tools in order to introduce greater economic sophistication and policy relevance to their professional work." While the Institute consisted of forty-two classes spanning ten days, the focus of this Essay will be on only three of those classes: (1) "Behavioral Law & Economics," (2) "There Ain't No Such Thing as an Externality," and (3) "Economics of Innovation and Dynamic Competition." For reasons that will hopefully become clear, I have titled my overview of these classes "Totalitarian Nudges," "Illusory Externalities," and "Utopian Benefits" respectively.

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To regulate more, or regulate less, that is the question:
Whether 'tis nobler in the mind to suffer
The slings and arrows of market fluctuations,
Or to take arms against creative destruction
And by opposing … end it?[1]

INTRODUCTION

The Law & Economics Center ("LEC") at the Antonin Scalia Law School at George Mason University seeks to ensure that "the public servants who create and shape laws possess a basic understanding of economic concepts and methods."[2] Since 1974, the LEC "has provided the classroom where federal and state judges, state attorneys general, law professors, and other legal professionals have been trained in basic economics, accounting, statistics, regulatory analysis, and related disciplines."[3] Over "5,000 federal judges and state court judges representing all 50 states and the District of Columbia, including three current U.S. Supreme Court Justices, have participated in at least one of the LEC's education programs."[4]

The LEC is comprised of six divisions, including the Henry G. Manne Program in Law & Economics Studies, which "promotes law and economics scholarship by funding faculty research and hosting policy-relevant research roundtables and academic conferences."[5] One of the events hosted by the LEC's Henry Manne Program is the Economics Institute for Law Professors. "More than 850 law professors worldwide have attended the LEC's Economics Institutes."[6]

This Essay provides a glimpse into the 34th Economics Institute for Law Professors. While the Institute consisted of forty-two classes

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[1] Adapted from William Shakespeare, The Tragedy of Hamlet, Prince of Denmark, act 3, sc. 1.

[2] *About*, L. & ECON. CTR., GEO. MASON ANTONIN SCALIA L. SCH., https://masonlec.org/about/ (last visited Mar. 1, 2020).

[3] *Id.*

[4] *Id.*

[5] *Law and Economics Center*, L. & ECON. CTR., GEO. MASON ANTONIN SCALIA L. SCH., https://masonlec.org/ (last visited Mar. 1, 2020).

[6] *34th Economics Institute for Law Professors*, L. & ECON. CTR., GEO. MASON ANTONIN SCALIA L. SCH., https://masonlec.org/events/economics-institute/ (last visited Mar. 1, 2020).

spanning ten days, the focus here will be on only three of those classes: (1) "Behavioral Law & Economics," (2) "There Ain't No Such Thing as an Externality," and (3) "Economics of Innovation and Dynamic Competition."[7] For reasons that will hopefully become clear, I have titled my overview of these classes Totalitarian Nudges, Illusory Externalities, and Utopian Benefits respectively. These phrases likely represent my sole unique contribution to this Essay, but I hope the reader will nonetheless find my reviews worthwhile.

I. TOTALITARIAN NUDGES

The Behavioral Law & Economics class was taught by Professor Kathryn Zeiler, Professor of Law and Nancy Barton Scholar, Boston University School of Law. The assigned readings were EYAL ZAMIR & DORON TEICHMAN, BEHAVIORAL LAW AND ECONOMICS (OXFORD UNIVERSITY PRESS 2018): Chapter 2, Chapter 3, and Chapter 4, and Joshua D. Wright & Douglas H. Ginsburg, *Behavioral Law and Economics: Its Origins, Fatal Flaws, and Implications for Liberty*, 106 NW. U.L. REV. 1033 (2012). This section will focus on the Wright and Ginsburg article.

Most people are familiar with at least some aspects of behavioral economics, which focuses on decision-making errors people make that might undermine conclusions of traditional economics founded on rational actors. In addition, most people are also familiar with the "nudge" policy application of these insights. While most of the media coverage of behavioral economics and the "nudge" phenomenon has been positive, Wright and Ginsburg point out that there are a number of reasons to slow down the rush to implement the accompanying policies.

Wright and Ginsburg base their critique at least in part on the following. First, biases documented in experimental laboratory settings have been shown to dissipate when confronted with real-world market discipline and incentives. Second, the presence of errors in decision-making does not necessitate a conclusion that those errors are irrational, and behaviorists have failed to make that distinction. Third, behaviorists fail to account for the costs of policy errors. Fourth, once behaviorists dismiss revealed preferences as indicative of welfare, it becomes extremely difficult, if not impossible, to justify a policy maker's determination of "true" preferences as deserving any particular deference. Fifth, even assuming all the foregoing criticisms are misplaced, behaviorists fail to account for the cost of denying individuals process freedom. Sixth and

[7] *See generally*, *Thirty-Fourth Economics Institute for Law Professors Agenda*, L. & ECON. CTR., GEO. MASON ANTONIN SCALIA L. SCH., https://masonlec.org/wp-content/uploads/2018/07/Agenda-Mason-LEC-34th-Economics-Institute-for-Law-Professors-June-2019.pdf (last visited Mar. 1, 2020).

finally, behaviorists fail to account for the risk of paternalistic government intervention in individual decision-making creating a slippery-slope to more pervasive and coercive government regulation of individual liberty. Each of these criticisms will be examined in more detail (albeit still briefly) below.

A. Documented Biases Dissipate when Confronted with Market Discipline and Incentives

Wright and Ginsburg note that "much if not most of the data suggesting cognitive biases affect individual decisionmaking are drawn from experimental settings and the bias has not been shown to persist in the presence of market institutions."[8] For example, "Charles Plott and Kathryn Zeiler demonstrate that observed gaps [between willingness-to-accept and willingness-to-pay][9] can be explained by misconceptions about experimental protocols and the experimental task; when those misconceptions are dispelled and a full set of experimental controls is employed to eliminate them, contrary to prospect theory, such gaps disappear."[10] In addition, findings from other studies "suggest framing

[8] Joshua D. Wright & Douglas H. Ginsburg, *Behavioral Law and Economics: Its Origins, Fatal Flaws, and Implications for Liberty*, 106 NW. U. L. REV. 1033, 1045 (2012) (citing Christopher Buccafusco & Christopher Jon Sprigman, *The Creativity Effect*, 78 U. CHI. L. REV. 31, 51 (2011)).

[9] *Cf.* Wright & Ginsburg, 106 Nw. U. L. Rev. at 1042 ("The key experimental finding of prospect theory is that individuals are, in many cases, reluctant to sell a good endowed to them when offered a sum greater than they are willing to pay to acquire the good.") (citing Richard Thaler, Toward a Positive Theory of Consumer Choice, 1 J. Econ. Behav. & Org. 39, 43-44 (1980); Amos Tversky & Daniel Kahneman, Loss Aversion in Riskless Choice: A Reference-Dependent Model, 106 Q.J. Econ. 1039, 1041-42 (1991)).[10] Wright & Ginsburg, *supra* note 8, at 1046–47 (citing Charles R. Plott & Kathryn Zeiler, *Exchange Asymmetries Incorrectly Interpreted as Evidence of Endowment Effect Theory and Prospect Theory?*, 97 AM. ECON. REV. 1449, 1454-56 (2007); Charles R. Plott & Kathryn Zeiler, *The Willingness to Pay-Willingness to Accept Gap, the "Endowment Effect," Subject Misconceptions, and Experimental Procedures for Eliciting Valuations*, 95 AM. ECON. REV. 530, 532–35 (2005)).

[10] Wright & Ginsburg, *supra* note 8, at 1046–47 (citing Charles R. Plott & Kathryn Zeiler, *Exchange Asymmetries Incorrectly Interpreted as Evidence of Endowment Effect Theory and Prospect Theory?*, 97 AM. ECON. REV. 1449, 1454-56 (2007); Charles R. Plott & Kathryn Zeiler, *The Willingness to Pay-Willingness to Accept Gap, the "Endowment Effect," Subject Misconceptions, and Experimental Procedures for Eliciting Valuations*, 95 AM. ECON. REV. 530, 532–35 (2005)).

effects can be reduced or eliminated at low cost without the extensive interventions proposed by libertarian paternalists."[11]

B. Behaviorists have Failed to Account for Rational Errors

Wright and Ginsburg note that even if robust evidence of irrationality in markets existed, "such evidence would have to be interpreted with care; the challenge would be to distinguish truly irrational behavior from rationally made and therefore efficient mistakes."[12] They go on to explain that "efficient mistakes" occur when "rational economic actors economize on both information and transaction costs. In short, not all errors imply irrationality because perfect decisionmaking would be costly."[13] Unfortunately, "behavioral law and economics literature . . . fails to distinguish between rational and irrational errors, assuming instead that error reduction is always efficient."[14]

By way of example, Wright and Ginsburg take on the assertion that "consumers consistently underestimate their future borrowing due to a potpourri of behavioral biases such as imperfect self-control, hyperbolic discounting, and systematic underestimation of the probability of negative consequences."[15] They go on to note that this "predatory lender" interpretation of the credit market "gives rise to several testable hypotheses about the underlying behavioral theories."[16] However, the relevant data "bear out none of these expectations."[17] Rather, "[t]he available data strongly suggest consumers make rational choices in the credit card market."[18] While there are error rates, "the upper bound of the

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[11] Wright & Ginsburg, *supra* note 8, at 1048 (citing Gregory Mitchell, *Libertarian Paternalism Is an Oxymoron*, 99 NW. U. L. REV. 1245, 1255 (2005)). *Cf. id.* at 1035 ("the behavioral law and economics regulatory agenda reflects a common philosophical source--so-called libertarian paternalism. That seemingly oxymoronic phrase . . . is intended to describe legal interventions that . . . increase the individual's economic welfare by freeing him from the limitations of his cognitive biases . . . without limiting his choices").

[12] *Id.*

[13] *Id.*

[14] *Id.* at 1049.

[15] *Id.* (citing Oren Bar-Gill, *Seduction by Plastic*, 98 NW. U. L. REV. 1373 (2004)).

[16] Wright & Ginsburg, *supra* note 8, at 1049 (offering three "testable hypotheses about the underlying behavioral theories."). These hypotheses are: "First, we should expect to see a significant majority of consumers selecting the wrong card-that is, the card that does not maximize interest-cost savings net of any annual fee paid. Second, we should expect the consumers' error rate, if it is the product of irrationality, to remain invariant to the cost of the error. Third, we should expect consumers who carry monthly balances instead of paying them off to hold cards with high rewards and no annual fee." *Id.*

[17] *Id.* at 1050 (citing Sumit Agarwal et al., *Do Consumers Choose the Right Credit Contracts?* (Nov. 2006) (unpublished manuscript) (available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=843826.).

[18] Wright & Ginsburg, *supra* note 8, at 1050.

initial error rate suggests switching costs would outweigh any potential gains consumers might realize from changing cards," and thus "the error rate is efficient."[19]

Nonetheless, as Wright and Ginsburg explain, Elizabeth Warren's asserts that "[a] high error rate implies irrationality, and irrationality implies the need for choice-reducing regulation."[20] Unfortunately, this "leap from identifying the error rate . . . illustrates what Harold Demsetz famously called the Nirvana Fallacy – the failure to ask: compared to what?"[21] This fallacy "threatens to subject consumers to a serious policy error by conflating rational choice with irrational behavior—that is, by ignoring switching and other costs incurred everywhere except in Nirvana – and by avoiding comparative institutional analysis."[22]

C. Behaviorists Fail to Account for the Costs of Policy Errors

As Wright and Ginsburg put it:

> The inevitability of policy errors derives from the insurmountable theoretical and empirical obstacles to identifying any one person's, let alone the distribution of all persons', "true preferences." One type of policy error will occur when a behavioral intervention is aimed at seemingly irrational behavior that is in fact rational for the decisionmaker in question . . . . A second type of policy error will occur when an intervention designed to improve the decisionmaking of truly irrational economic agents imposes costs, as it inevitably will, upon all those who are not irrational and for whom the same decision is not an error.[23]

Given this inevitability of error on the side of government intervention, and the concomitant costs generated by these errors, it should be obvious that one can only claim behaviorist interventions are efficient if one accounts for these expected costs. Put another way, "the question remains whether the social costs saved are greater than the social

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[19] *Id.* (citing Elizabeth Warren, *Economic Model Almost Working or Broken?*, Credit Slips (Dec. 26, 2006, 04:12 PM) (http://www.creditslips.org/creditslips/2006/12/economic_model_.html).

[20] Wright & Ginsburg, *supra* note 8, at 1051 (citing Elizabeth Warren, *Economic Model Almost Working or Broken?*, Credit Slips (Dec. 26, 2006, 4:12 PM), https://www.creditslips.org/creditslips/2006/12/economic_model_.html).

[21] *Id.* (citing Harold Demsetz, *Information and Efficiency: Another Viewpoint*, 12 J.L. & ECON. 1, 1–3 (1969)).

[22] *Id.* at 1051–52.

[23] *Id.* at 1052. *Cf. id.* at 1061 ("After ruling out revealed preferences as expressions of true preferences, the behaviorist lacks a coherent principle to identify welfare-maximizing choices.").

costs of intervention."[24] Without addressing this question, one runs the risk of the proposed cure being worse than the asserted harm. However, Wright and Ginsburg argue that an "expanding behavioral law and economics agenda largely disregards these risks."[25]

D. Who Decides a Person's "True" Preferences?

As Wright and Ginsburg point out, "behavioral law and economics' claim to welfare-increasing intervention requires one to disregard the neoclassical assumption that actual behavior reveals evidence of welfare."[26] If, as the behaviorists' argument goes, the preferences revealed by actual choices are "irrational" because they are distorted by various cognitive biases, then the claim is that, but for those biases, the individual would prefer different options, and this latter choice would be the individual's "true" preference. Government intervention is then justified to help individuals reach their true preferences. This approach, however, raises the question: "How then do behavioral economists identify true preferences?"[27]

One approach advanced by behaviorists is to posit multiple selves "with conflicting interests owing to different time perspectives."[28] However, "[e]conomics does not provide a basis for identifying which of the multiple selves' decisions expresses the individual's 'true' preferences for the purposes of welfare analysis."[29] Ultimately:

> After ruling out revealed preferences as expressions of true preferences, the behaviorist lacks a coherent principle to identify welfare-maximizing choices. Indeed, without revealed preferences, economic science simply cannot do so. The behaviorists can only declare by fiat what they expect a rational individual would or should do – thereby justifying the imposition of correct choices by a third party, contrary to the behaviorist promise to maximize economic welfare by the individuals' own lights and undermining the behaviorist claim to the prefix "libertarian."[30]

In other words, it is the paternalism that ultimately takes precedence for those advocating libertarian paternalism.

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[24] *Id.* at 1052–53.
[25] *Id.* at 1053.
[26] *Id.* at 1060.
[27] *Id.*
[28] *Id.*
[29] *Id.*
[30] *Id.* at 1061–62.

E. The Cost of Denying Individuals Process Freedom

Amartya Sen has written about "the process aspect of freedom," which includes:

> (i) decisional autonomy of the choices to be made, and (ii) immunity from interference by others. The former is concerned with the operative role that a person has in the process of choice, and the crucial issue here is self-decision, e.g., whether the choices are being made by the person herself—not (on her behalf) by other individuals or institutions.[31]

Wright and Ginsburg argue that behaviorists "in general do not place any value upon the 'the process aspect of freedom' or 'decisional autonomy.'"[32] This is concerning, at least in part, because "[l]imiting the range of decisions to be made by individuals or burdening those who would make an officially disfavored choice--not saving enough, eating unhealthful foods, etc.--tends to infantilize the public."[33] By way of evidence to support this proposition, Wright and Ginsburg point to data on rates of entrepreneurship in formerly communist countries. As they put it, "we would expect people who were raised in a paternalistic state, and hence relieved of the need to make many important decisions for themselves, to have less well-developed decisionmaking skills and to be more risk averse."[34]

> In general, "entrepreneurs . . . exhibit a particular mode of information processing, or cognitive style." They are more alert to opportunities that require linking previously unrelated information. Indeed, the experimental literature strongly tends to validate Israel Kirzner's description of the Austrian tradition, which "postulates a tendency for profit opportunities to be *discovered* and *grasped* by routine-resisting entrepreneurial market participants."
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> In a socialist state, however, resistance is futile. Uncritical acceptance of the party line is essential to survival, much less advancement. Of course, there are choices to be made: Shall I read Pravda or Izvestia? Yet the choice set has been limited by the state in a way that serves the state's ends, not those of the individual. As Milan Simecka so graphically recounted from his personal experience after the Prague Spring of 1968, the

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[31] Amartya Sen, *Markets and Freedoms: Achievements and Limitations of the Market Mechanism in Promoting Individual Freedoms*, 45 OXFORD ECON. PAPERS 519, 523–24 (1993) (as quoted in Wright & Ginsburg, *supra* note 8, at 1069).

[32] Wright & Ginsburg, *supra* note 8, at 1069.

[33] *Id.* at 1070.

[34] *Id.* at 1073.

> Communist Party of Czechoslovakia controlled the citizenry by depriving individuals of their decisional autonomy in only three respects: The state determined their housing, their occupation, and their children's education. That is why this professor of mathematics in mid-career became an operator of construction equipment.[35]

And relevant data appears to bear out the authors' concerns:

> Transnational comparisons using data from the Global Entrepreneurship Monitor produce strong evidence that, even after controlling for relevant variables, all countries with a communist past have a lower rate of entrepreneurship activity than do other countries. A recent study concludes that even now those unfortunate countries have "low levels of entrepreneurial human capital that have been engendered by decades of existence under a central planning system that tended to blunt individual incentives." As one would expect, however, the level of entrepreneurship is "significantly lower in Russia." A study conducted jointly by Russian and U.S. scholars concludes that "[t]he absence of freedom of decision-making in the most important resource – the workforce – and the 'no-choice' employment situation were two fundamental obstacles to the development of entrepreneurship" during the communist era. After the fall of communism, moreover, Russian entrepreneurs tended to be younger than was typical elsewhere; only the young were unscathed by their nation's paternalistic history.[36]

F. A Slippery-Slope to More Coercive Government Regulation of Individual Liberty

As Wright and Ginsburg note, "of course, no proponent of regulation based upon the findings of behavioral economics espouses a regime remotely as encompassing and restrictive as even the least oppressive of the late, unlamented communist regimes."[37] Nonetheless, "there is reason

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[35] *Id.* at 1073–74 (quoting Amir N. Licht, *The Entrepreneurial Spirit and What the Law Can Do About It*, 28 COMP. LAB. L. & POL'Y J. 817, 819 (2007); Israel M. Kirzner, *Entrepreneurial Discovery and the Competitive Market Process: An Austrian Approach*, 35 J. ECON. LIT. 60, 71 (1997)) (citing MILAN SIMECKA, RESTORATION OF ORDER: THE NORMALIZATION OF CZECHOSLOVAKIA 1969–1976 (A.G. Brain trans., 1984)).

[36] Wright & Ginsburg, *supra* note 8, at 1074–75 (quoting Martin Robson, *Explaining Cross-National Variations in Entrepreneurship: The Role of Social Protection and Political Culture*, 28 COMP. LAB. L. & POL'Y J. 863, 890 (2007); Ruta Aidis et al., *Institutions and Entrepreneurship Development in Russia: A Comparative Perspective*, 23 J. BUS. VENTURING 656, 657, 670 (2008); Alexander I. Ageev et al., *Entrepreneurship in the Soviet Union and Post-Socialist Russia*, 7 SMALL BUS. ECON. 365, 369 (1995)).

[37] Wright & Ginsburg, *supra* note 8, at 1075 (citation omitted).

to believe . . . they would put us on a slippery slope – or push us that much further down the slope than we have already slid."[38]

To begin, "[p]aternalistic policies are, by nature, likely to be slippery" because they "are expressed in regulations specifically adopted, at least initially, for the benefit of those regulated and, if those individuals do not want to be regulated for their own good – which is hardly unusual – the regulators will likely deem ever more stringent measures necessary."[39] In addition, "regulatory missions tend to expand; 'mission creep' assures that the government agency will require more money and more staff over time, forestalling any danger of the agency accomplishing its mission and becoming redundant."[40]

Finally, while this section began with the proposition that "no proponent of regulation based upon the findings of behavioral economics espouses . . . communist regimes,"[41] a qualification may be in order. Specifically, Wright and Ginsburg draw a line from the Critical Legal Studies ("CLS") movement to at least some modern behaviorists. Beginning with CLS, Wright and Ginsburg argue:

> Overtly a leftist movement, CLS turned out to be little more than a warmed-over species of Marxism, as it had evolved in the hothouse of radical European social theorists such as Herbert Marcuse, Jürgen Habermas, and others of the Frankfurt School of neo-Marxist critical theorists, Antonio Gramsci, a leader of the Communist Party in Italy, and Michel Foucault, Jacques Derrida, and other "poststructuralist" philosophers. The self-declared purpose of the CLS movement was "to provide a critique of liberal legal and political philosophy" that would show the "liberal embrace of the rule of law is actually incompatible with other essential principles of liberal political thinking.[42]

Particularly noteworthy in terms of connecting CLS to the behaviorists is the concept of "false consciousness." [43] Again, here are Wright and Ginsburg:

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[38] *Id.* Douglas Glen Whitman & Mario J. Rizzo, *Paternalistic Slopes*, 2 N.Y.U. J.L. & LIBERTY 411, 412 (2007).

[39] *Id.* ("[F]ederal laws protecting the occupants of automobiles provide a familiar historical example.").

[40] *Id.* at 1076 (citing Simeon Djankov et al., *The Regulation of Entry*, 117 Q.J. ECON. 1, 3 (2002); Fred S. McChesney, *Rent Extraction and Rent Creation in the Economic Theory of Regulation*, 16 J. LEGAL STUD. 101, 117 (1987)).

[41] *Id.* at 1075.

[42] *Id.* at 1082 (quoting ANDREW ALTMAN, CRITICAL LEGAL STUDIES: A LIBERAL CRITIQUE 3 (1990)) (citations omitted).

[43] Wright and Ginsburg note that the phrase "false consciousness" is often attributed to Marx, but the "phrase, if not the concept, seems actually to derive from an early

> Key to the CLS analysis was the notion of "false consciousness," meaning the "holding of false or inaccurate beliefs that are contrary to one's own social interest and which thereby contribute to the maintenance of the disadvantaged position of the self or the group." Like the presumed gap between revealed preferences and "true preferences," assuming a wedge between reality and the perceptions of others provides a space to be filled by some combination of reeducation and outright coercion. Duncan Kennedy encapsulates these Maoist tendencies in his proposal that professors and janitors at the Harvard Law School be required to trade places for one month each year. Kennedy described the ultimate goal of CLS as "building a left bourgeois intelligentsia that might one day join together with a mass movement for the radical transformation of American society.[44]

Wright and Ginsburg go on to argue that the "end of the communist era in Russia and Eastern Europe dealt a blow to CLS, as it did to all leftist movements. The worldwide triumph of socialism, which had long seemed inevitable to so many, now seemed more improbable than ever."[45] Eventually, continue Wright and Ginsburg, at least some of these scholars found a new home in behavioral law and economics, where "more than sophomoric understanding of economics was not required,"[46] and which "shares with CLS the paternalistic premise that the poor wretches to be benefitted by the insights of their governors suffer from a form of 'false consciousness.'"[47]

II. ILLUSORY EXTERNALITIES

The class titled "There Ain't No Such Thing as an Externality," was taught by Terry Anderson, John and Jean DeNault Senior Fellow at the Hoover Institution, Stanford University. The assigned reading was TERRY L. ANDERSON & GARY D. LIBECAP, *Property Rights for the Common Pool*, *in*

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translation of a letter Friedrich Engels wrote to Franz Mehring." Wright & Ginsburg, *supra* note 8, at 1082 n.230 (citing MICHÈLE BARRETT, THE POLITICS OF TRUTH: FROM MARX TO FOUCAULT 5-6 (1991)); *cf.* Wright & Ginsburg, *supra* note 8, at 1088 n.232 ("As one student of Kennedy's put it, the phrase 'implies that all those who disagree with you are stupid.'") (quoting RICHARD D. KAHLENBERG, BROKEN CONTRACT: A MEMOIR OF HARVARD LAW SCHOOL 166 (1999)).

[44] Wright & Ginsburg, *supra* note 8, at 1082–83 (quoting John T. Jost, *Negative Illusions: Conceptual Clarification and Psychological Evidence Concerning False Consciousness*, 16 POL. PSYCHOL. 397, 400 (1995); Duncan Kennedy, *Legal Education and the Reproduction of Hierarchy*, 32 J. LEGAL EDUC. 591, 610 (1982)).

[45] Wright & Ginsburg, *supra* note 8, at 1083.

[46] *Id.* at 1084.

[47] *Id.* at 1085.

ENVIRONMENTAL MARKETS: A PROPERTY RIGHTS APPROACH (Cambridge Univ. Press 2014).

Economists generally advocate for free market exchange as the efficient way to organize an economy. This preference can be understood to rest at least in part on the proposition that individuals know best what they value and are therefore best positioned to maximize the benefits of exchange. A corollary of this is that economists generally consider government intervention in the market inefficient because the interventions are likely to distort incentives in a way that results in a sub-optimal allocation of resources. However, even economists who generally favor free markets typically accept certain justifications for government interference in markets, including: (1) externalities, (2) public goods, (3) information asymmetries, and (4) monopolies.[48]

Externalities are understood to be costs (and benefits) that are not internalized by the producer. Given that capitalism rests on the proposition that free market exchange will lead to efficient resource allocation in response to pricing signals, a failure on the part of producers to internalize their costs leads to inefficient allocation of resources. Thus, so the argument goes, externalities *might* justify government intervention.[49] However, if we consider that "externalities" are simply a manifestation of a failure to assign property rights, then, when feasible and under certain conditions, assigning property rights would allow for efficient trading.[50] This would certainly undermine the justification for government intervention based on externalities. At least some of the key propositions here are as follows:

First, to assert that Person A is imposing a cost on Person B, and that this cost should be internalized by Person A, assumes that Person B has a right to be free of the asserted imposition. However, this assumption may not be able to bear the weight sought to be placed upon it by advocates of regulation in the name of externalities.[51] As Anderson puts it:

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[48] *Cf.* ANDERSON & LIBECAP, Property Rights for the Common Pool, in ENVIRONMENTAL MARKETS: A PROPERTY RIGHTS APPROACH at 54 n.3 ("[W]e combine most government interventions - regulation, tax, subsidies, and related technology and performance standards together as Coase did in describing them as the 'Pigouvian Tradition.'") (citing Ronald H. Coase, The Problem of Social Cost, 3 J.L. & ECON. 39, 54 n.3 (1960)).

[49] It could be the case that the government "fix" to internalize an externality is costlier than the externality itself. Additionally, there are alternative, market-based solutions to internalize externalities.

[50] This is the fundamental insights of Ronald Coase's seminal article on externalities and property rights. *See* Ronald H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1, 42–44 (1960).

[51] *See* TERRY L. ANDERSON & GARY D. LIBECAP, ENVIRONMENTAL MARKETS: A PROPERTY RIGHTS APPROACH 56 (Cambridge Univ. Press 2014) ("[T]he conventional

> [D]eclaring that person A's use of a resource creates an externality for person B complicates creating environmental markets by assuming that person B has a right to be free of the costs of A's use. If such a right existed, Coase asks why B is not requiring compensation from A for A's imposition of a cost on B. Why is there no market transaction? If the answer is that B does not have such a right, then the question is why B is not paying A to cease creating the cost? In summary, if there is a missing market because property rights are not defined, then there is a possibility for a market solution if they can be established.[52]

Alternatively, one might frame the issue as one of reciprocal costs:

> Coase argued that property rights assign benefits and costs and promote bargaining, but his emphasis on the reciprocal nature of costs, is underappreciated. To see the relevance of reciprocal costs . . . , consider one of Coase's parables, the conflict between the doctor whose practice depends on quiet and the confectioner whose candy production generates noise. If these two activities are located adjacent to one another, there will be conflict for use of the airspace as a medium for transmission of sound waves. The question is whether the doctor has a right to produce medical services in a quiet environment or whether the confectioner has a right to produce candy and in the process generate sound and vibration. Coase's point was that costs to one party are a benefit to the other and vice versa.[53]

Either way, the point is that there is good reason to push back on bald assertions to the effect that Person A is imposing a cost on Person B, and that therefore regulation is required to ensure Person A internalizes the cost of their activities.

Second, even assuming that we are justified in claiming that Person A is creating an externality as understood in the conventional sense, there is reason to question whether government intervention is obviously preferable to market- or bargaining-based solutions. Again, quoting Anderson:

> Our contention is that as much attention should be given to political economy issues associated with "government failure," as are given to 'market failure.' Recognition of the transaction costs

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approach diverts attention from the questions of why property rights do not exist and whether government instruments would still be preferable if rights could be established.").

[52] *Id.* at 63; *see also id.* at 68 ("Perhaps no other lesson is associated more with Coase than the idea of bargaining to resolve conflicting demands for resources.").

[53] *Id.* at 61–62.

> of government action will lead to examination of a larger range of policies that includes more local and private market solutions.[54]

Anderson's point is similar to the point that Wright and Ginsburg make when invoking the Nirvana Fallacy: while markets might produce certain inefficiencies—so do proposed alternatives such as government intervention.

Finally, granting government the role of assigning property rights and setting various "rules of the game" to reduce transaction costs does not undermine a pro-market bargaining approach as hypocritical. Anderson acknowledges that "recognition of common property and definition and enforcement of formal property rights involves government intervention, and there will be politics involved in that process as well."[55] However, "once the rights are recognized, agents can devise solutions through markets."[56]

III. UTOPIAN BENEFITS

The class on the "Economics of Innovation and Dynamic Competition" was taught by Prof. John Yun, and the assigned readings were Ginsburg & Wright, Dynamic Analysis and the Limits of Antitrust Institutions, 78 ANTITRUST L. J. 1 (2012), and BAUMOL ET AL., GOOD CAPITALISM, BAD CAPITALISM, AND THE ECONOMICS OF GROWTH AND PROSPERITY 15–59 (2007).

The general consensus is that monopolies are bad at least in part because they create what is often referred to as "deadweight loss." Deadweight loss refers to the loss of consumer and producer welfare attributable to the monopolist's expected use of pricing power to maximize its profit at the expense of consumers. In order to better understand this, we need to first understand what is expected under a model of perfect competition.

In perfect competition, prices are determined by the interaction of supply and demand. Consumers typically demand more quantity of a product as its price goes down. In the standard supply-and-demand model, this is represented by a demand curve that slopes downward to the right, with price on the vertical Y-axis, while quantity is on the horizontal X-axis. Thus, the quantity demanded is low when the price is high, and high when the price is low. On the other hand, producers are typically incentivized to increase output as price increases. This is represented via an upward-sloping supply curve, which crosses the downward-sloping demand curve at some point.

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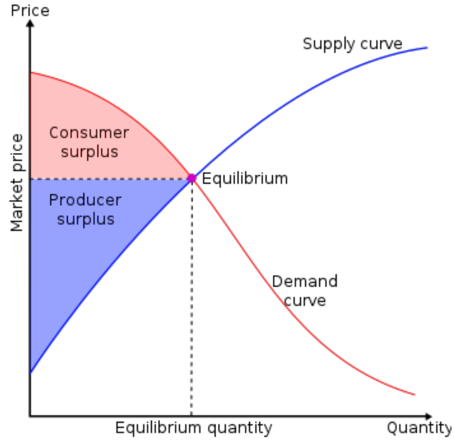
[54] *Id.* at 56–57 n.9.
[55] *Id.* at 57 n.10.
[56] *Id.*

The point at which the demand and supply curves cross (the "Equilibrium Point") is typically understood to provide us with the efficient price and quantity of a product (specifically, we draw a horizontal line from the intersect point to the price, and a vertical line to the quantity).[57] One way of understanding this is to assume that any producer that tries to charge more than the equilibrium price will lose the competition for customers to the producers selling the same product for less, while any producer that tries to undercut the competition by charging less than the equilibrium will be failing to maximize its profit, which is typically unsustainable because, among other things, investors and employers will eventually depart for the companies able to provide higher salaries and better returns.[58]

The equilibrium price/quantity creates both consumer and producer surplus. Consumer surplus is created because the area below the demand curve but above the price line represents consumers who would have paid more for the product. In other words, these consumers received more value than they paid for. Meanwhile, the area below the price line but above the supply curve represents producer surplus in that producers would have been willing to sell for less at those quantities but received more. The perfect competition model is set forth in Diagram 1.

Diagram 1[59]



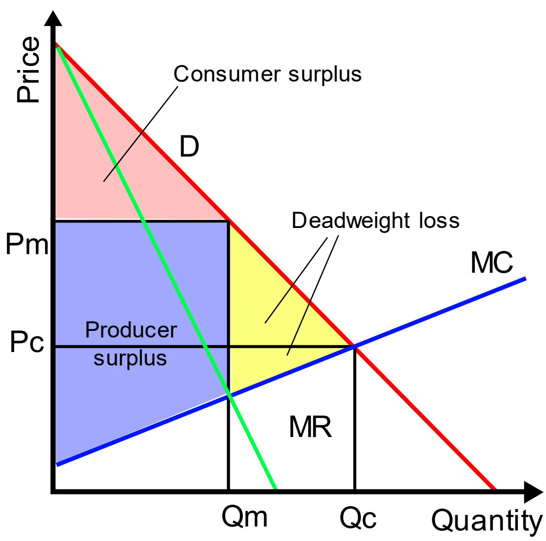
[57] *See generally Economic efficiency*, KHAN ACADEMY, https://www.khanacademy.org/economics-finance-domain/microeconomics/consumer-producer-surplus/deadweight-loss-tutorial/a/demand-supply-and-efficiency-cnx (defining economic efficiency).

[58] *Cf.* Douglas H. Ginsburg & Joshua D. Wright, *Dynamic Analysis and the Limits of Antitrust Institutions*, 78 ANTITRUST L.J. 1, 13 (2012) ("because economic theory teaches that successful predatory pricing depends upon the firm incurring certain losses in the present and somehow more than recouping those losses in the future, it is regarded as an unlikely business practice").

[59] *File:Economic-surpluses.svg*, WIKIMEDIA COMMONS, https://commons.wikimedia.org/wiki/File:Economic-surpluses.svg.

In the case of a monopoly, however, there are no competitors to discipline the monopolist—either by undercutting an excessive price, or by punishing a failure to maximize profit. This allows the monopolist to produce less, and charge more, than would otherwise be expected. The new price/quantity ("Pm" & "Qm") will be determined by the intersection of the marginal revenue ("MR") and marginal cost ("MC") of the monopolist. The details of how these new curves MC and MR interact to determine the optimal price/quantity from the perspective of the monopolist is beyond the scope of this essay, but the graphical representation is set forth in Diagram 2 below.[60] Importantly for our purposes, while there remains consumer and producer surplus (with the balance unsurprisingly shifting in favor of the producer), there has been a loss of overall social welfare, and this is represented by the deadweight loss in Diagram 2.

Diagram 2[61]



In light of the foregoing, government intervention is arguably warranted to restore efficient competition and thereby restore the lost social

[60] *See generally* Motley Fool Staff, *What Is The Relationship Between Marginal Revenue and Marginal Cost as a Company Increases Output*, THE MOTLEY FOOL (Mar. 1, 2016, 11:05 PM), https://www.fool.com/knowledge-center/the-relationship-between-marginal-revenue-marginal.aspx (explaining the interaction between marginal revenue curves and marginal cost curves).

[61] *File: Monopoly-surpluses.svg*, WIKIMEDIA COMMONS, https://commons.wikimedia.org/w/index.php?curid=5224373

welfare. However, there is reason to pause before accepting this analysis. As I stated in a blog post titled "Deadweight Loss or Utopian Benefit?"[62]:

> [T]his analysis is based on comparing the expected behavior of a monopolist with a static model of perfect competition. One of the problems with using a static model is that it fails to take into account where we've been or where we're actually likely to go. A more dynamic view might prompt questions such as, "If monopoly pricing power didn't exist, would we ever get the innovation that creates monopoly power in the first place?" Or, "If perfect competition rarely, if ever, exists in the real world, why are we using it as a benchmark for regulation?" Put another way, does it really make sense to regulate away the incentive to innovate that is created by monopoly pricing power (and the accompanying consumer and producer surplus) merely because we theorize that if we lived in the magical world of perfect competition we'd have even more surplus?[63]

In light of the foregoing, it might "be better to use 'utopian benefit' rather than 'deadweight loss' to describe the difference between what we get with monopoly pricing as opposed to what we'd expect to get with perfect competition."[64] Such a change could make sense because it is "natural to react to a 'loss' of surplus as something that should be made up, corrected, or restored – but calls to put innovation at risk in order to pursue a 'utopian benefit' might lead to more appropriate caution and humility when it comes to regulation."[65]

Having said all that, the law already takes much of this into account. As Ginsburg and Wright point out:

> [T]he principle that neither monopoly profits nor monopoly pricing is unlawful under the Sherman Act implicitly but necessarily involves the presumption that the dynamic benefits from innovation and from "competition for the market" will outweigh the deadweight losses emphasized in static analysis. In the *Trinko* case Justice Scalia made the connection to dynamic considerations explicit when he observed not only that charging monopoly prices is lawful but also that "[t]he opportunity to charge monopoly prices—at least for a short period—is what attracts 'business acumen' in the first place; it induces risk taking that produces innovation and economic growth." In this example, the presumption of dynamic benefits from innovation

[62] Stefan J. Padfield, *Deadweight Loss or Utopian Benefit?*, BUS. L. PROF BLOG (June 22, 2019), https://lawprofessors.typepad.com/business_law/2019/06/deadweight-loss-or-utopian-benefit.html.

[63] *Id.*

[64] *Id.*

[65] *Id.*

> and the introduction of new products takes the form of a rule of per se legality with respect to firm pricing decisions.[66]

Nonetheless, the next time you hear that monopolies are bad because they create deadweight loss, it might still be helpful to rephrase that statement to say instead that monopolies may be bad because they may deny us utopian benefits.

CONCLUSION

In this Essay I have attempted to give a glimpse into the 34th Economics Institute for Law Professors. The three classes I chose to focus on constitute less than 10 percent of the total, and I have only covered isolated parts of those classes. Thus, the reader should not assume they now have anything approaching a complete picture of the Institute.

The theme I have focused on here is one of questioning widely held assumptions generally understood to support government intervention in markets. The specific areas addressed were behavioral law and economics, externalities, and monopoly pricing power. While not decisive, the points raised in this Essay have the potential to add useful perspectives to the ongoing debate about government regulation of markets.

[66] Ginsburg & Wright, *supra* note 58, at 6.