

Civil Society Institute Lecture

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“The Private Production and Enforcement of Law: Past, Present, and Future”

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Transcribed by Michele Coldiron.

DAVID FRIEDMAN:

If you simply measure the division of law enforcement between public and private by the number of employees, the U.S. presently has a private law-enforcement system. That is to say, if you add up the private security guards, private burglar alarm installers, all of the private agents who are involved in selling the service of protection against crime, you get, I don't know the current figure, probably two to three times the number of police.

Furthermore, if you think about our legal system, we really have two legal systems doing roughly the same work. Under each system, someone does something bad to somebody else, there is a trial, and something bad happens to him. Therefore you don't do bad things to other people.

What legal system am I describing? I could be describing either criminal law or tort law. Criminal law has the characteristic that when somebody breaks your arm, you call a cop. The government prosecutor prosecutes the person, the government controls the case, the government theoretically gets the evidence, does or doesn't convict. When somebody breaks your window, you call a lawyer. You, the victim, are now the prosecutor. That's how tort law works. It is your job, you or the lawyer you hire, to get the evidence, haul the guy into court, present the evidence that the guy broke the window, and, if you are successful and win the case, the fine he pays goes to you and is called a damage judgment rather than a fine.

So, in that sense, we simply take for granted in the background of our legal system, a sizable element of private enforcement, though by no means a totally private system.

Let me give you a couple of other examples. Think about an ordinary contract. I hire somebody to build a house for me, and when I do that, we agree to some rules. We agree that if I don't pay by a certain date, he gets the house, or a lien against the house. We agree that if he doesn't finish by a certain day, he owes me some penalties. What we have just done is to write a law code. A contract between two people is a little tiny private law code written for that 2-person community the two of them have agreed to, and, if you think not about two people but about two firms engaged in some large and elaborate project, you can see the private law in that sense. Legal rules that are constructed by the parties in the form of contracts are very common and often very elaborate and sophisticated.

Finally, there is a whole set of private laws which all of us are bound by, which we don't call laws; we call norms. Let me take this very simple example, the question why I do not take off my jacket and shirt and undershirt at the moment. There is no law that prohibits me from stripping down to here, or even, if I were wearing a swimming suit, taking my pants off as well, and yet I won't do it, and part of the reason I won't do it is that I would suffer serious penalties, reputational penalties. So that if you think about your daily life, many of the rules, legal rules, really, in a fundamental sense, constraining your behavior are norms of behavior enforced by various sorts of social pressure, rather than formal laws enforced by the state.

So, the way I'm going to present the matter today, I'm going to first run briefly through some history that people may not be familiar with, and discuss some systems in the last 1,000 years or so that were quite a lot more private than what we're used to, and worked. Then, to talk about a few examples of private legal systems, including private enforcement and private making of laws that exist in North America at present and then I want to talk about the future.

Let me start with the history of my very favorite historical society, which is saga-period Iceland. The way I like to start it is by pointing out that the traditional history of every country begins with good strong rulers who brought that country into existence: George Washington, Alfred the Great, Charlemagne.

The history of Iceland starts that way, too--sort of. There was a man called Harald who was king of one of the small kingdoms that made up Norway in the 9th C. The story is that Harald wanted to marry a certain princess who informed him that he was too small a king for her. So Harald swore that he would neither cut nor comb his hair until he had made himself king of all Norway. And for a few years they called him Shaggy Harald, until he succeeded in his oath. He unified

Norway under his rule and then he washed his hair, cut it, and combed it, and they called him Harald Haarfagr - Harold Fairhair, for how much better he looked.

When Harald unified Norway, he not only put a lot of small kingdoms into one big one, he also established a much more powerful position for the king than was traditional in Norwegian society. Not everyone liked that change.

The chief professions of Norwegians in the 9th c. were farming, fishing and piracy; they were Vikings. The ones who didn't like it loaded up their longships with their family, friends, and as many of their farm animals as would fit, and headed off for Iceland, which had first been discovered a few years earlier. And that according to the Icelanders, is how Iceland got established.

When they got there, after about 60 years of settling in, they decided they needed a legal system. And so in the year 930, the Icelanders got together to discuss how they ought to run their legal system, and they actually sent somebody back to Norway to acquire information on Norwegian law codes. They decided that, on the whole, they were going to base their system on traditional Norwegian law. But there was just one small element of the Norwegian legal system they thought they could live without, and that was the king. And they set up quite an interesting legal system,. In many ways it was simply a well worked-out version of what you see in a lot of traditional societies around the world. But since this particular traditional society produced some of the world's great literature--we get our word "saga" from the novels, historical novels and histories that were written in Iceland in the 13th and 14th c. and some of which are still in print in English paperback translations--we know more about it than most of us know about Papua-New Guinea, or bedouins, or various other traditional societies.

So let me tell you a little bit about how the Icelandic legal system worked. The foundation of the legal system was a position called a Godi, which is usually translated as "Chieftain", but that is a very misleading translation for that suggests a tribal society, and this wasn't a tribal society. There were originally 39 and later 40 Godar, plural of Godi, in Iceland. What a Godi was was a man who owned a certain bundle of legal rights. And what were they? One of them was a seat on the legislature, one of them was the ability to appoint one out of about 36 judges to a court, and one of them was the right to be a channel through which everybody else plugged into the legal system.

So, if you were an Icelandic farmer, you picked a Godi, any Godi you liked, anywhere on

Iceland who would have you, and you became his Thingman. This was not an irrevocable choice. You could change to a different Godi, if a different Godi would have you. It was essentially a contractual arrangement such as an arrangement with your lawyer. Now when you wanted to sue somebody the first thing you did was to find out who his Godi was. There was a sort of a pyramidal system of a certain number of Godi who made up a Thing, a certain number of Things in a Quarter, and 4 Quarters in Iceland.

The closer together your Godi and his Godi were, the lower the level of the court system you could sue him at. If you were from different Things in the same quarter of Iceland, for instance, you had to go to the quarter court. So it was the equivalent of our jurisdiction system, where if you sue somebody from a different state, you have legal rules determining whether it is a state court or the federal court that you sue in, only in this case it wasn't geography, it was a voluntary association between a Godi and his Thingman, between the legal agent and his customer, as it were.

So that determined how you could sue someone. I should say, suing is the only thing you can do, for this was a system with no criminal law. If somebody cuts wood in your forest, you sue him. If he kills your brother, you sue him. You sue him for a much larger sum if he kills your brother, of course! It was like an entire civil system, completely replacing our civil and criminal system.

Somebody does you an injury and you summon him to court, and he comes or he doesn't come. The court gives the verdict - he owes you 100 ounces of silver as a fine for killing your brother, or 5 ounces of silver for cutting wood in your forest. He does or does not abide by the verdict. If he doesn't abide by the verdict, you go back to court and the court declares him an outlaw. It is legal to kill an outlaw. It is illegal, that is to say, tortious, to defend an outlaw. One way I like to put it is that I have described the judicial and the legislative branch of government, but I left out the executive branch - so did they.

This is a system with no executive branch of government. There is one part-time employee who is called a Logsofumadr, and presides over the legislature and gives legal advice and recites a third of the law code each year in public so everyone can hear it, and if he leaves something out, it's out, if no one objects. It's a fairly early form of sunset legislation.

But, in any case, in the Icelandic system, it is in principle up to the victim and his friends to enforce the judgment, and yet nonetheless judgments get enforced. This raises a number of obvious questions for people who are trying to figure out why this system couldn't work. One of

them is, what if the victim of the tort, the victim of the wrong, doesn't have any strong friends? He is an elderly man, he is not an experienced Viking, and the guy who did it has four sons who are big, famous warriors.

The answer is that, under the Icelandic legal system, tort claims were marketable property. They were transferable. So if I had a claim that would be worth 100 oz of silver if only I would enforce it, I find somebody else who can enforce it, and I sell the claim to him. All right - so he's got four big sons. Well, I sell it to someone who has six big sons plus his cousin. The result in practice is that, as a general rule, even not very powerful victims have a pretty good chance of getting something done to the person who commits the offense against him. Now if the guy is a really tough case, I may not be able to get any money for selling my claim. I may have to give someone the claim because the cost of enforcing it is about what he is going to get out of it. But I've still gotten the offender punished. I've still done as well as under our criminal system where the victim doesn't collect anything. And if it is not too hard a case, I actually get some money out of it as well.

Let me tell you another story related to how the system worked better than you might think. You might say that, what if, not only does he have four big sons but he's got friends and they have friends. Why don't you just have strong people who defy the law?

Once in a while in the sagas, somebody tries it, but it usually doesn't work, and the reason it doesn't work is that the first time there is a violent clash, some people are going to get hurt. Some might even get killed. When people get hurt, their relatives sue. The outlaw and his side lose all the cases because defending an outlaw is illegal. People who fight the outlaw win all the cases. So you have to either pay them the legally required punishment for having injured or killed their relative (injured - pay him, killed - pay the relatives) or you have to fight all their relatives, too. So, if you try to defy the law, the logic is that the coalition against you is going to expand. And the result is that, in practice, with very rare exceptions, when you are outlawed you flee Iceland. There are a few cases who didn't, and who lasted for a few years, but, basically, as a general rule, the system was pretty effective.

My favorite example of the inherent stability of the system is the scene in the Njalsaga, which is one of the most famous of the sagas, where there has been a long and bitter dispute, and it looks as though it is going to break into fighting in the middle of the courtroom. This is an open air courtroom and one of the leaders of one side is talking to a guy who is a benevolent neutral, he's friendly but he's not actually part of the dispute, and asks him, "If it comes to fighting what will

you do for us?”

The guy says, “I’ll tell you what. I’ll draw up my armed men over there, and if you’re losing, you can retreat behind them, and if you’re winning, I’ll intervene and stop the fight when you’ve killed as many men as you can afford.” The implication is that even when things are breaking down so badly that they think it might turn into violence in the middle of the courtroom, once the dust has settled, if you kill someone you’re going to have to pay wergeld to his relatives.

Wergeld is a lot of money. I’ve got some calculations in a published article which tries to estimate it, but you’re talking about many years income, a tidy sum, and, consequently, you have to be pretty restrained in your use of violence.

So far I’ve talked about courts. In fact, if you read the sagas you see that a large fraction of all decisions are arbitrated. That is to say, you’ve got a feud going on, both sides want a peaceful resolution cause you don’t like being killed, and very often they find some respected third party and they say, “We agree to abide by what you say”, and he says, “All right, here’s what is going to happen”, and that ends it.

The system lasted from 930 AD to 1263 AD. It lasted for a third of a millennium. That’s better than what we’ve done so far. The last 50 or 60 years it was breaking down, and there was what they regarded as an unacceptable level of violence. One scholar who looked at the subject tried to do a body count. We have historical sagas that describe that whole series of feuds at the end, the so-called Sturlunga sagas, so he added up the number of people who got killed in those sagas. His conclusion was that in 50 years of an unacceptable level of violence, they killed about 350 people. That’s 7 people in a year in a population of 70,000, 1 in 10,000 per year, which, roughly speaking is our murder rate, or our highway death rate.

Putting it differently, we killed about 4 times as large a fraction of our population in 4 years of civil war as they did in 50. Now, it is not a very solid number. You don’t have solid numbers for 13th c. events unfortunately, but at least it’s what we’ve got.

The system eventually broke down. I’m not going to talk about why right now because I want to go on and talk about some other things. The next case I want to give you, very briefly, is one that overlaps the Icelandic experience, and that’s the development of the law merchant. All right - 10th and 11th C. - trade starts to revive in Europe, after a long slump, after the collapse of the Roman Empire, and you’ve got a problem. You have people from different parts of Europe speaking different languages under different rulers who have to deal with each other and what

happens is the development of a system of entirely private law called the Law Merchant, which is being enforced by reputational penalties. What's going on, as far as I can tell, is a bunch of merchants come together in a trade fair, sometimes they have disputes, a court is set up at the trade fair made up of other merchants, the court may give verdicts according to what's becoming a more explicit set of rules that everyone is agreeing to. The court has no enforcement arm at all, but, of course, if you have a reputation for not keeping your contracts, and not abiding by the court's verdicts, other merchants are going to be very reluctant to do business with you, and that's a very serious cost. In practice, the courts are able to enforce their verdicts.

As in most systems of private law, and in the Iceland case, the verdicts are almost always damage payments and not attempts to lock people up or cut their heads off or something, a very wasteful thing to do with people, so it almost never happens in private lawsuits.

In fact, the law merchant is what our commercial law grew out of. Eventually the government took over the business. It looked like there was money to be made at it, and they in effect took the position that the decision of the royal court could trump the decision of the merchant court if someone didn't like it. But then, in order to keep people on at least one side bringing the case to the royal court, they had to have something reasonably similar as a legal system so you get lots of the Law Merchant appearing in modern commercial law.

Now, let me go on to another system that I'm sort of fond of, and have also written about (I haven't written about law merchant, that's second-hand). If you go on my webpage you'll find stuff on saga period Iceland, and you'll find stuff on my next case, which is 18th c. England. In 18th c. England the legal system looks just like ours. They've got civil law, where you sue people. They've got criminal law. Civil law is *Smith v. Jones*, criminal law is *Rex (the king) v. so-and-so*.

The only thing is they don't have any police and they don't have any public prosecutors. So you have a system of criminal law where theoretically the king is the injured party in criminal law, but the king is not there. So what really happened in that system was that prosecution was almost always by the victim. The legal doctrine was that any Englishman could prosecute any crime, but in practice the person who had an interest in prosecuting it was normally the victim, and it was up to the victim in 18th c. England to figure out who did it, gather the evidence, present the evidence in court, go through various legal procedures--just like a modern tort case. The only difference is that when it was over and he won his case, instead of getting damages, they hanged the defendant, they transported him to America, into penal slavery, or maybe they

pardoned him on condition of enlisting in the Army, but the one thing they didn't do is have him pay off the victim the way they would in the tort system.

That raises a very interesting question: why did anyone bother to prosecute? I think there are at least two answers. One answer is that you prosecute in order to settle. While it's true that your being hanged doesn't do me any good, it does you a good deal of harm, therefore if I can get you hanged you might be willing to suggest other alternatives that are more attractive for both of us. It was in fact illegal to have a private out-of-court settlement--it was called compounding a felony--but I think the evidence suggests that it was pretty common.

The second reason why I might prosecute is for reputation, in order to deter people from committing crimes against me. For some victims that works. Suppose that I'm a business man. I've got a big factory which dyes cloth. We've got all this valuable cloth out in the sun drying all the time, and we are really a tempting target for thieves. I have an incentive, when they catch a thief, to push the prosecution through and get him hanged if I can, so that thieves will go somewhere else.

But that doesn't work for most people, because most people aren't in enough contact with criminals to be able to build a reputation and therefore, even though in advance I'd like the criminal to think I'd prosecute him once he commits the crime, once he commits it I say why should I hurt myself twice by spending a fortune trying to get him convicted? For this problem the English in the 18th c. had a very ingenious solution. The solution was called a Society for the Prosecution of Felons, and there were thousands of such societies in various towns throughout England.

A Society for the Prosecution of Felons is about 40 to 50 reasonably well-off people who think they might be victims of crimes, who get together and each of them chips in a small annual contribution for a fund which is then available to be spent prosecuting any felonies committed against any member of the association. Then they publish the list of members of the association in the newspaper for the felons to read. So this was a very ingenious mechanism for precommitting to prosecution, for turning deterrence from a public good, which is the way we think of it - we say "Well, nobody would bother to try to convict criminals, because the deterrence benefits everybody." But when my association for the prosecution of felons gets somebody hanged or transported, that deterrence benefits me and other members of the association. It means that the next guy who is thinking about who to rob, will first look in the newspaper at the list of members of the association and go somewhere else. It was an ingenious

way of making deterrence a private good rather than a public good.

Now again, I could say a good deal more on this subject, but time is limited and, as I say, it is all up on my webpage anyway, so do a search for David Friedman and you should find it pretty easily.

Let me go on to talk a little bit about more modern kinds of law, and there are two cases I think are interesting, both of which are other people's research that I have only read. One of them is the diamond industry. There is a classic article by LISA BERNSTEIN which describes how contracts are enforced in the New York diamond industry as of, I suppose, 1980 or 1990, when she was writing. It turns out that the court system has essentially nothing to do with it. In the diamond industry there is something called the Diamond Dealers Club of New York. A large fraction of all diamond dealers are members of this club. It's a private club. Ones who aren't members are likely to go to the club to deal with people to buy and sell and negotiate and such, and the diamond dealers club requires, as a condition of membership, that any dispute with another member of the club will go to arbitration, and the club provides mechanisms for arbitration.

It is true that in principle arbitration agreements are enforceable, so, in principle, it would be possible, if I got an arbitrated verdict against you and you refused to go along, for me to then go to court. But in fact, people virtually never do. And one reason they never do is the diamond industry turns out to be an industry where people like to keep things private.

There's a lot of private information about who is dealing with whom at what prices. If you have a law case it is all going to come out. In the private arbitration all they have to give is the verdict, no other public information is released normally, so what is actually happening is that enforcement is almost entirely through reputation. That is, under their rules, what they actually do, if the arbitrator says that you owe \$20,000 to somebody and you don't pay, after ten days your picture goes up, in every diamond bourse in the world, because the New York City Diamond Dealers Club has deals with all the equivalent things in the world, and thereafter you are no longer in the diamond industry. Not because there are any rules against you being in the diamond industry, you are perfectly legal to be in the diamond industry for life, it's just that nobody will buy from you or sell to you because who wants to do business with somebody they can't trust in an industry like that, which is a very trust-intensive industry? You've got very valuable things, they are small, they are easy to steal, they may or may not be as described, hence they have what is essentially an elaborate set of institutions designed to provide private

enforcement.

There are many other industries that use private arbitration. This is a particularly striking case, and it turns out that one of the things going on, something I didn't realize until I actually went back and read the article instead of just seeing lots of second-hand discussion, is that at the point when Lisa Bernstein was looking at it, the industry was in a period of transition. In New York a decade or two earlier, essentially everyone in that industry was an orthodox Jew and it turns out that one of the Jewish laws is that you are not allowed to sue another Jew in a gentile court. That is a violation of Jewish Law and nobody will talk to you if you do. So it was the case that they did not have access to the courts as a practical matter, because it was against their religion to use it, but they had access to alternative mechanisms, particularly rabbinical courts, which had no legal enforcement power, but a very strong reputation.

By the time Lisa Bernstein studied it, however, that dominance by one ethnic group was breaking up, and part of what was interesting was that the mechanism of reputational enforcement, which originally had depended on a closed group of people who knew each other, was still being maintained, but now was being maintained on a world-wide basis, via faxes and various high-tech communications as of ten years ago or 15 years ago, by which information about the misdeeds of one person got spread around the whole industry. So it's interesting because it's easy to see how these private systems of norms work in small, closed communities, but it's interesting to see that as long as the community communicates with each other, it doesn't have to be ethnically homogeneous. It just has to have a way of knowing who are the bad guys, because at least in many industries, once you know who's the bad guy, you don't deal with him and if you don't deal with him that's a very serious penalty for him.

Let me go on to my second case, and my second case is actually only a few hours drive from here, and that's Shasta County, California. Some of you have probably driven through it up north, and a legal scholar called Robert Ellickson happened for rather odd reasons to get interested in Shasta County. The reason was that there is a legal distinction between what is referred to as open range and closed range. There are some places in the U.S. where somebody who owns cattle and grazes them has a legal obligation to fence them in, and if his cattle trespass on his neighbor's property and do damage, he's liable. That's what is called closed range. There are other areas where the person who has the crops has the legal obligation to fence out and wandering cattle. That's open range. There's a very famous article by Ronald Coase in the course of which, at one point he argues that the behavior of farmers and ranchers will be the same in both open range and closed range because even if the farmer has no legal obligation to

fence out the cattle, if it's cheaper for the farmer to fence them out than for the rancher to fence them in, then the rancher will pay the farmer to fence them out rather than fencing them in himself. So Coase's argument is that private transactions would lead to an efficient outcome whatever the legal rule is.

It turns out that, by historical accident, Shasta County is a patchwork of open and closed range. There are parts of the county which are open range, and parts which are closed range. So, Robert Ellickson said, "Wonderful, nature has given me an experiment to see if Coase is right. Let's see if people act efficiently in the two areas." Well, the first thing he discovered was yes, they acted the same in open and closed ranges. The second thing he discovered was there were no side payments, there were no bargains going on between the ranchers and the farmers, and that therefore Coase had the right conclusion for the wrong reason.

What was really going on, it turned out, was that when it came to trespassing cattle, the law of the State of California does not run in Shasta County. Why does the law of the State of California not run in Shasta County? Because Shasta County is an area where people know each other, and there is a set of norms of neighborly behavior which everybody knows and nobody invented which defines how you treat your neighbors. And guess what is the one thing you never do to a neighbor in Shasta County? Sue him. Recourse to the court is already breaking the rules, and since the potential punishment of having your neighbors never want to talk to you is pretty high, people in fact don't normally sue their neighbors.

The law still runs for murder, it's all right to arrest someone if they murder someone. But, if your cattle trespass on my farm and eat the crops, what I'm supposed to do is to call up and tell you. What you are then supposed to do is to be very apologetic, and come over as fast as you can, get the cattle out of my crops, and, if any serious damage has been done, to offer to help me replant, to do various things to make up for the injury.

Suppose you don't. Suppose the fifth time your cattle have trespassed on my field, I call you up and you say, "Uh, I'm busy at the moment. I'll be around in a couple of hours." Well, my first recourse is true negative gossip. I tell everyone else in the neighborhood what kind of s.o.b. you are, and pretty soon, your wife isn't getting invited to bridge games and your kids are finding that the other kids at school don't seem to be very friendly, and nobody wants to chat.

Suppose that doesn't work. Suppose you don't have a wife and you don't have kids, and you're a cantankerous sort who doesn't care if nobody talks to you. The next thing I do, the sixth time

your cattle wander onto my land, I drive your cattle out of my gate, I head in a direction away from your property, and I start going and I leave them 3 miles down the road, and I go home. And eventually you notice your cattle are missing, and eventually you find them, but it's quite a lot of time and trouble to search the whole of a 50 or 100 square mile area to find your cattle and you get the point.

One of the interesting things to me, it's not a point Ellickson discusses, is that one of the things the norms don't allow you to do, is what seems like the efficient solution. This is a rural county. Instead of spending a lot of time and energy driving ten of his cattle 3 miles down the road, why don't I just convert one of them to hamburger in my freezer and then call him up and tell him that nine of his cattle are trespassing?

I can't do that. I'll get in trouble if I do that. Why? Because that's a punishment that is profitable to me to impose, and this is a system where the victim is his own judge. In a system where the victim is his own judge, you don't want to have to have profitable punishments because people are likely to impose them when the other is not guilty, and even if someone doesn't, other people will suspect he does. So one of the elegant features of the system is that the punishments you are allowed to impose are ones that are costly for you and for him and therefore you will only do it when you have a good reason.

I have an article on this coming out in the JPE. at the moment, on this issue of incentives to enforcers, and the problem that some punishments--civil forfeiture is the famous case at the moment--give people an incentive to convict people whether or not they are guilty because convicting them is profitable. Interestingly enough, it turns out than in the New York Diamond Dealers Club, they do have a mechanism for penal as opposed to compensatory punishment. They have the equivalent of punitive damages, only the punitive damages don't go to the victim. The punitive damages have to be given to charity presumably to reduce the incentive of some people to pretend to be victims of some serious offense, in the hope of making money out of doing that, the standard problem in punitive damages at present.

I've given you a couple of current examples. Let me now talk a little about the future. I want to start by talking about the easy case, the one that I'm pretty sure is going to happen, and then I'll talk about the hard case, the one that I hope will happen.

The easy case is the Internet. Think a little about the problem of using conventional legal mechanisms to, in particular, enforce contracts on the internet. The first and obvious one is that

on the internet, national boundaries are invisible. Consequently, if you are doing business, you are likely to be doing some of your business with people in other countries, and although it is possible for big firms with lots of lawyers to enforce contract disputes internationally, it is an awful lot of pain if you are just buying books from Amazon.com. So from that standpoint, ordinary legal mechanisms are a pretty clumsy way of handling disputes on the internet.

Now there is a second and less obvious one, and that one I could give a whole talk on, but not tonight, but it turns out that the technology that we have available currently with computers on the net makes it possible to do business anonymously with reputation. That is, it is possible to exist online, to be able to engage in a series of transactions with people and prove you are the same person each time, without giving up minor irrelevant details such as what continent you are on, how old you are, and whether you are male or female and so forth. And there are a variety of purposes, some of them good purposes, why people might like to do that. After all, what are we afraid of? We're afraid of people getting at us, and killing us, and beating us, and locking us up. It's real hard to kill, beat or lock an online persona. As long as all they can interact with is you online, they can lie about you, but they can't do any real serious things to you.

So a very attractive defense, if noticeable parts of your life are lived online, is to put a barrier between your online persona and your real space persona, and make sure that whatever the online persona does, there's no way of linking the two. This point was first made, as far as I know, by Vernor Vinge, who is both a science fiction writer and a computing science professor, many years ago in a very fine novelette called *True Names* and it is increasingly becoming obvious that that is the way the Internet is moving.

Well clearly, if you don't know where my body is located, it's real hard to sue me. So, that's the second reason why it is hard to use conventional legal mechanisms to enforce contracts online.

There is, however, an alternative at present. If we think about how we actually enforce contracts today, most of it is not through the courts, it is through reputation. If you say you bought this jacket at Burlington Coat factory, which I did (free plug, I like them), and suppose, as for all I know they might, that they have a dollar-back guarantee if you are not satisfied, I don't think they do, but suppose they do, and suppose I go back and say, I'm sorry, it doesn't fit right, and I don't like the color. I want my money back. They know I'm not going to sue them. It isn't worth suing over a \$50 jacket. Nonetheless they'll give me my money back. Prediction.

Almost all firms will in those situations. Why? Because they want you to stay their customer,

they want your friends to stay as their customer, and they don't want the bad reputation of being seen as dishonest people and my argument is that this mechanism, the legal mechanism, works in cyberspace and the reputational mechanism works better, and it works better because the net is an enormously powerful tool for handling information. I can sit down at my machine at home and in about two minutes discover if anyone has mentioned my name on Usenet anywhere around the world in the last three days. Usenet has roughly 40,000 bulletin boards, rough guess. If I was mentioned, Deja News knows about it and they'll tell me. We have got very good mechanisms for searching for information and for spreading information much better than in real space.

The low tech version of this is what eBay is doing today. Anytime you win an auction on eBay, eBay offers you the opportunity after you get the goods you bought, to report to them on whether you were satisfied. All of those reports are available to anyone who bids on an auction by the same guy who sold it to you, so eBay is maintaining a complete, publicly accessible file of what all the customers who dealt with that guy thought of him. It's a very simple mechanism and yet it's a very nice, elegant way of giving people reputational incentives to behave well.

Let me give you the high tech version which, I don't know if it exists yet or not, but if it doesn't, it soon will. The high tech version is that you and I are engaged in some contract over something online. A substantial sum is at stake. We write our contract and we include in our contract the name of the private arbitrator we've decided to accept. We also include in the contract the public key of the arbitrator. The public key, for those of you not familiar with it, is the information necessary to check a digital signature of the person who signs it. We both then digitally sign the document, and it turns out, through the use of encryption technology it is possible to prove, to quite a high degree of confidence, who it was who really signed the document.

So we both sign the contract, and the contract contains the public key of the arbitrator. You think I cheated you so you ask for an arbitration. The arbitrator says I owe you \$30,000 in damages. I refuse to pay. The arbitrator writes his verdict saying I am the bad guy, that he ruled against me, that I agreed to accept his ruling and then reneged on that agreement. He digitally signs it and sends it to you.

You now have a package, the original contract plus the arbitrator's verdict. That package by itself in 15 seconds proves I'm a bad guy. All anyone else has to do is check the digital signatures. They check my digital signature. That tells them I signed the contract and they check the arbitrator's digital signature and that tells them that the guy I agreed to says I broke the

contract. They don't have to check the facts at all.

If you think about reputational enforcement, the crucial variable is how easy it is for interested third parties to find out who's at fault. If it's hard, reputational enforcement won't work. If it's easy, it will. In this case, once you've got that document, you post it on a website with my name all over it so that any search for my name will find that website. You e-mail it to everybody in our common business, and I am now out of the diamond industry, or whatever we are doing, because you have just made it cheap and easy for people to know that I am not to be trusted. So that is a mechanism which I expect to develop fairly rapidly in the next decade or two.

Now let me, in my final bit, get to where I started back in 1971, which is a discussion of how you have private law and law enforcement in real space, and that's a somewhat harder problem. I'm going to talk about it very briefly, but I think we have copies of *Machinery of Freedom* on sale in the back, and that discusses it at great length.

Imagine a future society in which there is no government, or the government has nothing to do with law or law enforcement. Maybe they still operate something like the Post Office. In this society, there are firms in the business of protecting people's rights--private rights enforcement agencies. Essentially everyone is a customer of some such firm. There are many, many firms, everybody's got one.

There are obviously potential conflicts when I think you have violated my rights and you deny it. But that problem is obvious to the enforcement agencies too, so the enforcement agencies have contracts in advance specifying the private court that will arbitrate any dispute between their customers. Now, how do we enforce these contracts? Aaah. The enforcement agencies are repeat players in the business with a reputation. If an enforcement agency takes the policy, when we win the case that's fine, when we lose it we go to another court, no other enforcement agency will trust it. Why do business with someone who acts like that?

So, in a sense it's like an Association for the Prosecution of Felons, it's like the Godi of Iceland, it's a case in which between the individual parties who are not repeat dealers you've got some well-established institution which is going to be there a long time, therefore has a reputation and therefore can be kept to its contracts by reputational enforcement.

Next the question arises, well, why would a burglar agree to any such agency, or why won't the burglars form their own agency which says we won't agree to any court that thinks burglaries are

a crime? A tenth century Icelander could explain to you what's wrong with that. The alternative to settlement is feud. If the burglar refuses to have any agency, then my agency says, "We have evidence you burgled him, and I don't see anyone on your side of the table." Bang! Or maybe they'll be a little more peaceful about that, they don't want to hurt any innocent bystanders, but basically we're talking about the use of force.

Human beings have disagreements and conflicts. Human beings who think they are right are willing to use force to settle those conflicts. You then have a legal mechanism in arbitration in court in order to avoid their doing it in messy ways. All right, in order to get at reasonable peaceful settlements, fine, the burglars have their own agency. The burglars' agency has a tenth of one per cent of the resources of a society and the rest of it goes to the other agencies cause very few of us want to live under a legal system that allows burglaries. So the burglars' agency refuses to accept arbitration and there is a brief war and then there's no burglar agency, which is why it never gets formed in the first place, cause the entrepreneurs who would form it can see that far ahead of themselves. So the basic logic of the system is one in which people agree through legal intermediaries on legal systems.

Why is this a good idea? Why do I regard this as a desirable rather than undesirable change? The short answer is that making and enforcing laws is too important to be left to governments. If you think about the logic of the legal system, some legal rules are better than others. Some legal rules do a good job of preventing crime, some a bad job. Some legal rules do a good job of settling disputes quickly and peacefully. Others result in a fortune being spent on lawyers and five years later it's still being litigated.

It is not at all clear that a government has an incentive to write good legal rules. Indeed, one might plausibly argue that there are at least some interest groups such as lawyers who have an interest in having complicated legal rules to make it as expensive as possible and there are always other groups that see ways of using the legal system to benefit themselves at someone else's expense. On the other hand, if the legal rules are being written by private courts and in order to get any influence or any income, those private courts have to persuade agencies that they want to agree to use them, which means they have got to persuade their customers that they would like to be under those legal rules, then they have an incentive to try to design legal rules which are on the whole legally efficient, work well, and have the kind of results people want.

Now, that's a very short discussion of something that took up a third of a book almost 30 years ago, and we can get into more of it later, but I'm working under somewhat limited time

constraints, so I think it's probably as far as I can go.

Except, I want to say one other thing. Not only are governments not competent to make and enforce laws, it's also very dangerous to have them do it because governments are already too powerful, and in particular governments, unlike the rest of us, are not liable for their mistakes. If the government arrests you, imprisons you for 20 years, and then finds out you are innocent, it might decide to compensate you. In most states it won't, but it could, but it has absolutely no legal obligation to compensate you. A government has no legal obligation to you. That's what's called sovereign immunity. It can decide to be nice. Our federal government has the torts immunity clause which says there are some circumstances under which we will let you sue us. But it's fundamentally a relationship of inequality between the ruler and the ruled. I would be much happier in a society based on the fundamental equality of people - the fact that I have a right to have my agency, you have a right to have yours, and they'll bargain it out and try to reach some mutually acceptable result. All of us know in the background, if you cannot reach some mutually agreeable result, you'll shoot at each other and none of us want to shoot at each other, so most of the time we reach a peaceful result.

Thank you.

M.C.: We have some time for questions and comments. I'm sure that David would be happy to respond to any questions. We also have copies of *The Machinery of Freedom* if you like these kinds of economic stories, and I use the word stories, not in a pejorative sense, but, interesting accounts. You may want to take a look at this or *Hidden Order*.

Questions?

Q1: In your public system you said you can't sue the government, but in the private system, can you sue the arbitrators when they make a mistake?

A: It depends what the rules are that you've agreed to. .

Q1: It seems you would need another hierarchy. .

A: Need is too strong. There are some systems of private law that have appeals court and some that don't. There's obviously a tradeoff between those two alternatives. There are examples of

private legal systems which have an appeals system, and when you're picking an agency, you're going to say, "Well what kinds of rules does that agency provide?" And, maybe you say, "Oh, they're customers of Rights of Man, Inc. and everyone knows that Rights of Man Inc. is a reliable, just, honest system, so I don't need any right to sue them. Or, maybe you say, "Well, they are reliable now, but I don't trust any system where I can't sue the arbitrator, so I'm going to buy my service from someone else, who tries to patronize the courts that agree that they themselves are liable for mistakes.

Q2: When you are talking about the arbitrators . . . you could have something as simple as a ratings system that would regulate standards . . . (unintelligible).

A: But there are two different issues. One is how you and I would pick an arbitrator. For that you would obviously have various market reputational mechanisms. The other is how does he know that I'm the bad guy? He doesn't want to have to go investigate the arbitrator. That's time and trouble and he may never have to deal with me. He wants a way that he can do it cheap and easy. But then all he has to know is that I've agreed to that arbitrator. So, whether or not he's a good arbitrator, I at least thought he was, I agreed to accept him, I broke that agreement. Maybe the reason I broke the agreement is that I was suckered into choosing a crooked arbitrator. All right, he doesn't want to deal with people who are suckered into choosing crooked arbitrators either. He's willing to accept that risk. All right? . . . (unintelligible) , , Now I'm certainly not arguing that that system or any system will never make mistakes. Obviously there are going to be cases where the arbitrator gave the wrong verdict, or where the arbitrator is himself corrupt. All I'm saying is that rather than the court being imposed upon me, when I signed my contract with you I chose a court so I'm responsible for making sure I choose an honest court.

Q3: Who are some of the allies or advocates in the real world out there who subscribe to your approach?

A: I would say that my two strongest would be Bruce Benson, who is a law professor in Florida and who has written a very interesting book called *The Enterprise of Law*, interesting in part because he makes the point which really had not occurred to me before that our system is the aberration and that a largely private system is pretty near the norm, historically, and he discusses Anglo-Saxon Law and various primitive legal systems and so forth. It certainly is true with regard to police at least, that having paid professional law enforcers is historically an unusual and not a usual system.

Another one would be Randy Barnett, who is another law professor. I'm sure there are things we pretty much disagree about, but there are other scholars who I think of as being in the same general area there. I think there are other people who are pretty sympathetic to the view but who aren't involved in it in the same sense.

Q3: What about constitutional or entities or organs that follow the theory that you . . . (promote) .

A: You know, I think the Cato Institute is happy with my views - they invite me to give talks, so I assume they like me. I'm a contributing editor of *Liberty* magazine and I speak at their editor's conference once a year. I mean those are the sort of friends and allies broadly speaking but I assume they agree with me.

One of the things I say at the beginning of *Machinery of Freedom* is that there may be two libertarians somewhere in the world who agree with each other on everything, but I'm not one of them. But, yeah, the book has lots of references to organizations and things. I would say that some versions of what I'm saying is pretty widely accepted by law and economics scholars; not as extreme as my positions, but, for example, Lisa Bernstein is now a professor of law at the University of Chicago Law School. Now she wouldn't argue for full anarchy, but she would argue that the New York diamond industry is one interesting way of enforcing and making laws, which is why she wrote about it.

Richard Posner is probably the most prominent person in economic analysis of law, in fact he is a federal appeals court judge of the 7th Circuit. I've argued with him at some length that anarchy would work for us and not persuaded him. But he thinks that Homeric Greece was in fact essentially an anarcho-capitalist system and it worked for them. He thinks that under certain circumstances feud-enforced private enforcement is a pretty good system, probably the best sort of system, but under other circumstances it's not, and he, unlike me, thinks we're now in a situation where it doesn't work. As he points out, when the king gets back from the Trojan Wars, he promptly gets murdered by the wife and her lover. Nobody calls the cops. There are no cops to call. It's up to the kin of the victim to do something about it, but the kin of the victim is Orestes, who is the son of the murdered man but also, of course, the son of the woman who murdered him and that creates a bit of a problem.

Q4: How do you handle a case where someone who could not afford a private firm to represent them and then become like . . . (unintelligible) . . . then they can afford to pay the penalty so they don't care . . .

A: First, if you can afford the penalty and the penalty really makes the victim whole then I'm not sure it's not really a problem, right? As they say, hit me, I need the money.

Q: But if he kills your brother, then . . .

A: Well, they have very high penalties for that, and I should say when I said you have cash penalties, I'm describing historical societies; I'm not saying by definition you couldn't have a death penalty for murder, my guess is you wouldn't but that's a market outcome, that's not an assumption of the system. But going back, to begin with I like to say that we're a thousand years behind the cutting edge of legal technology, because Icelanders had transferable tort claims and we don't. Well, my guess is that a sensible private system would, and that therefore a victim who can't prosecute the claim would transfer it.

If you're asking about what about someone so poor he can't afford an enforcement agency, well, I think we should raise some money and buy him a low quality but better than nothing contract. That's the same problem as the guy who can't afford to eat. Neither is very expensive. If you think about the real cost of police and courts in our system, it's very low. It's a minor part of the government expenditure. But all the poor people today are paying taxes. They're paying taxes in order to make food more expensive via the agriculture program and in order to enforce the minimum wage law so they can't have a job, and paying for lots of other ways in which we "help" poor people. So, my point is, in any society where you have inequality, there are some people who have it worse than others, but it seems to me that on the whole paying to have your rights protected and getting them protected is a better deal than paying to get them protected and not getting them protected which is the deal we now offer, at least to the inner-city poor.

Q5: Do you see . . . (unintelligible) . . .

A: Yes. Any advantages? All systems have some possible advantages. One of the important issues in the private system I am describing is the question of economies of scale. How big your enforcement agencies are. Suppose it turns out that a bigger agency can turn out a better service than a smaller one, up to the point where we have only 2 or 3 agencies in what is now the U.S. In that case there is going to be the obvious temptation for the agencies to recognize that crime pays better than protection, and turn themselves into a government, and start taxing people. That government, unlike ours, wouldn't be starting with democratic institutions, and a constitution and a set of legal rules and so forth, so it could easily be worse than ours. So one issue in

whether this works is how big are the economies of scale. My guess is that they are not that big.

Second problem is public goods such as national defense that we presently have a government to provide and one justification of that government is to defend us against foreign nations.

There are a variety of imperfect ways in which you can privately produce public goods, and that again would be a long discussion, but I do spend a chapter on it in my book. Those ways might or might not be adequate. One of the ways I'm more optimistic now than I was in 1971 is that our major enemy vanished in the meanwhile. There is no Soviet Union anymore. I suspect you can have a very inefficient mechanism for raising money for national defense, and still hold the border with Mexico.

So from that standpoint, my guess is that under current circumstances we can tolerably deal with that sort of problem. But you might not. You can imagine an environment where without coercive taxation there is no adequate way of raising the resources used battling the Soviet Union. And there are other arguments. I have a discussion, not in the book, because I didn't know it when I wrote that book, but in a chapter in somebody else's book which is on my web site, which is called "Anarchy and Efficient Law," where I discuss some forms of market failure in the market for legal assent. Whereas the normal rule in markets is that markets tend to produce the optimal outcome, there are certain cases where I can predict that we will get something other than optimal legal rules. And I discuss that problem in that chapter.

On the other hand, I have no reason to expect our present system to ever give us optimal legal rules, since it is not really a market except in a very tenuous sense. So although I certainly don't claim that I can prove that my institutions are always better than the alternatives, it seems to me that it is likely to be an attractive system.

Q6: . . . (unintelligible) . . .

A: Yes, it's on the handout. But in any case it's certainly more efficient to use search engines than to memorize URLs. You've got all of these free search engines like Google and Alta Vista. I will give you odds that if you go to google and type in "David Friedman", or better yet, "David D. Friedman", my guess is that I'll be on the first page. It's www.best.com/~ddfr.

Q7: Is there a legal system in the world that protects the individual . . (unintelligible) . .

A: Probably not. Even fairly good legal systems tend to have a soft spot for the king or the state or whoever is running it.

One very interesting issue, which I don't know the answer to, is why legal systems changed over time the way they did. One of the points Benson makes, I think pretty persuasively, is that the early Anglo-Saxon system is pretty much like the Icelandic, although the details are different. It is essentially a system in which crimes are crimes against specific people. Those victims then have a legal claim against the offender, and you have some mechanism for settlement.

Then there is a long shift in Anglo-Saxon times and even more strongly in Norman times towards treating more and more offenses as offenses against the crown. Benson thinks, and I tend to suspect, that what was driving that was a revenue grab. There was a lot of money to be made by enforcing the law because the defendant, when he was convicted, had to pay some large fines, and the king wanted a share of that.

If you look at the medieval English system, it's pretty clear that the medieval English had a much more realistic view of the relationship between law enforcement and the state than we do. They saw it as a revenue source. So one of the things you'll see happening is that some nobleman dies and his son succeeds to his position. The father had the right to control a particular part of the law enforcement of a particular area and the son pays a payment to the king in order to get that right, too. So they viewed it as a revenue stream to be bought and sold, rather than as "doing good", so to speak.

Q8: How does a private system deal with a perpetrator who doesn't have financial resources to . . . (unintelligible) . . .

A: Well, it's a little tricky. There are a number of possible answers to that question. One of them is deterrence as a private good, that is, one of them may be that they'll lock him up on the grounds that that would discourage people from committing crimes against their customers. Maybe they'll enslave him, that is have some sort of penal slavery. Maybe in a sufficiently hard-hearted society they'll execute him and sell his organs. Maybe they'll do nothing. You're really talking about market outcomes. My guess is that in a poor society they'll be pretty brutal about it because locking up someone in a poor country means someone else is starving. In a rich society like ours they are much more likely to try to think of something that isn't too upsetting, when it imposes costs on him. Get a lien on his future income, or something. As for the Icelanders, the answer is that they did indeed have a system of temporary slavery, it was called

debt thralldom, in which you owed somebody money and you worked it off. They also had informal credit arrangements in which your relatives put up the money and you were expected to do something for them in the future, and if all else failed, you ran for your life, because they gave you two weeks to get out of Iceland - something like that.

Q9: Did sagas exploit . . (unintelligible) . .

A: That's a very interesting question. There is a webbed article by somebody else - I forget his last name - an Icelander - who is a libertarian and he offers his explanation, and there are a number of possible explanations but I'm not sure what the right one is. He argues that it starts breaking down after about a century, a century and a half, essentially due to the rising power of the Church. The Church was able to get the equivalent of taxation in the form of tithes, controlled by powerful men who had control over the local church and that thus it gradually evolved into something more like a state system. I just don't know. It's also clear that the Norwegian crown in the last 50 years was heavily meddling in Iceland politics with the objective of getting Iceland for Norway, which they eventually did, and they were subsidizing one side or the other in these civil wars, but it is hard to tell. There are plausible conjectures but I'm not sure we know for certain why it broke down. On the other hand, for 333 years it was doing pretty well, historically speaking. If we set up a full flown anarcho-capitalist system in 50 years it's not going to look very similar 333 years later. I can predict that.

Q10: . . (unintelligible) . .

A: Well, they still have to have a reputation, or choose not to get it, or get it a little over price. Look, I'm the only one who can give this talk. I've got a monopoly. Benson is a very different speaker than I am (questioner unintelligible)

What? (unintelligible)

On the contrary it's a very valuable good. You just demonstrated it because ex ante you thought it was valuable because you spent your valuable time coming here. But my basic point is not that. If you think about a monopoly, like anybody else, it is still constrained to worrying about having it's goods seen as valuable. The monopolist would like as much money as possible, and if I start out believing that dealing with you gives me a choice that is worth a thousand dollars, if you have a monopoly and you're clever you can get almost a thousand dollars out of me. If your reputation goes down, and I say he's got great goods, but half the time his product breaks down and he'll never fix it, now he's only worth \$500, and that's all you're going to be able to get out

of me. So it is still, when you have a monopoly, in your interest to have the reputation of being an honest dealer and having a good product, because that reputation increases what people will pay for the good you have a monopoly over. Look, even if you had a monopoly in automobiles you would still put tires on them, because that raises the price people will pay for them by more than what the tires cost.

One more question?

Q11: You mentioned the problem of national defense. Did you ever look at whether the problem of national defense is more or less a problem if you have a monolithic legal system as opposed to a disperse . . . (unintelligible)

. . .

A: I've seen that argument and I don't find it very convincing because my guess is that if you don't have adequate mechanisms to defend yourself, the invaders will induce you to provide the infrastructure for them, for if you don't, they'll cut your throat. I can see the argument that a nice, centralized system is easier to take over, but it seems to me even a decentralized system, if it's reasonably rich and has resources you'd like to steal and has no defenses, somebody will take it over, so I don't find it too satisfactory.

But I can imagine pretty plausible ways in which in the world as it now is a society like ours could raise enough resources to defend itself against likely threats, without a government. Furthermore, if you really had a very free society you would have increased rates of economic and technological progress, and the richer we are, the lower the share of our income it takes to defend us against our neighbors. And that in part is my point about holding the Mexican border. The U.S. can not only defend itself against Mexico, it can defend itself against Mexico out of pocket change, so to speak. I did some arithmetic at the time of the Iraq war. Did you know what the odds were, counting GNP, in the Iraq war - our allies against their allies? It was just about 100:1. Total GNP of us and our allies was 100 times theirs. That's not war.

M.C.: I want to thank David on behalf of the Civil Society Institute. I also want to thank you for coming. David made a reference to the value of your time and we recognize, especially at this late date in the quarter, the opportunity cost of everybody's time is relatively high, and despite all that I wish you well, and I just want to remind you that we have some copies of David's books in the back. There are some flyers that have his website and some additional works, if you are interested in learning more about his work and related work. Thank you once again.