Wealth-increasing Law, with Applications to Egypt*

Peter H. Aranson**

Among economists and people with practical experience, the outlines of a consensus have emerged concerning the choice of public policies to foster economic growth and development. These policies include trade liberalization, monetary stability, low but certain taxes, privatization of government-owned enterprises, deregulation of private-sector industries and firms, and legal system reform. Strong disagreements prevail over the appropriate order and speed of change, as well as the preconditions that a nation must satisfy before successful change can occur.¹ These preconditions and prescribed reforms doubtless may vary from country to country. There remains enough agreement on these policies, nevertheless, to consider them a “consensus” position.

This paper explores in deeper detail the outlines of legal system reforms that promise to “work” and those that will not. In particular, it examines the effects of a legal system and distinguishes between those systems, or properties of systems, that tend to increase a nation’s wealth and those that diminish wealth. Legal systems often provide and enforce the background, or framework, on which most economic (and some non-economic) transactions occur. Hence, wealth-increasing or -decreasing properties of such systems seem likely to be small as they apply to a specific case but large in the aggregate. A well-designed legal system, it follows, can increase the wealth of a nation while it also increases the rate of wealth creation. This closer look at legal systems and their reform offers at least a few recommendations that are at odds with prevailing wisdom.

Most of the discussion here adverts to common-law systems, as I am most familiar with them. (I also, for the most part, do not discuss criminal law or constitutional law.) But code-law and common-law systems have converged to some extent (Aranson 1986). In code law systems (e.g., France), committees of judges may recommend changes to legislators, while in common law systems a certain degree of codification (e.g., The Uniform Commercial Code) prevails.² Code law countries such as

*Prepared for a conference on Growth Beyond Stabilization: Prospects for Egypt, sponsored by The Egyptian Center for Economic Studies, Cairo, February 3-4, 1999. Also presented at the University of Ghent Law School, February 9, 1999. The author thanks Charles Caldwell and Dr. Ibrahim Shihata for their comments at the Cairo meeting. He thanks as well Dr. Sahar M. Tohamy and the staff of IRIS.

**Professor of Economics, Department of Economics, Emory University, Atlanta, Georgia 30322. paranso@emory.edu.

¹ For example, on the importance of a “social safety net” as a precondition for privatization, see Tohamy (1997) and Tohamy and Aranson (forthcoming publication). Part V (Conclusion) briefly discusses the difficulties of reforming an existing legal system (e.g., Egypt) as compared with that of creating a new legal system (e.g., nations in the former Soviet bloc).

² While there is substantial work developing models of common law processes (for reviews, see, e.g., Aranson 1986, 1992; Posner 1998), there is far less work developing models of code law counterparts.
Egypt may be slower to change legal rules than are common law countries such as the United States. But legal change in code law countries, especially in those undergoing, or seeking to undergo, rapid economic development, is likely to be more spasmodic than are the smoother evolutionary changes in common law systems. Code law systems are also more likely to ignore “local knowledge” than are common-law systems. Nevertheless, because of the similarities and overlap between the two systems, I suppress the differences for purposes of exposition. I return to the matter briefly in Part V.

Part I introduces two basic models, those of Coase (1960) and Rubin (1977), to identify the potential wealth-maximizing properties of legal rules under low and high transaction cost levels, respectively. Part II describes the traditional areas of common law—contract, tort, and property. It then reviews some examples of contract law, to illustrate the wealth-regarding features of that law. Part III offers some guidance in the design and reform of legal systems, with special reference to some possible limitations on reform. Part III also attends to the problem of corruption. Part IV reflects on some subtle (and not so subtle) interrelationships among law and legislation as they affect national wealth. The principal foci are competition (antitrust) law and corporate law. Part V concludes. Throughout the paper I advert, where appropriate, to Egyptian practice, and compare and contrast it to the practices of an ideal system.

I. Coase and Rubin

Posner’s first edition of the Economic Analysis of Law (1972) cites several instances in which various rules (precedents) of the common law increase wealth by provoking appropriate future actions on the part of the litigants and all similarly situated persons. As well, it distinguishes between criminal law and private (common) law, using an economic approach to explain the differences between the two resulting bodies of law. But the first edition does not identify a mechanism by which judges at common law arrive at wealth-regarding rules. So, Posner relies on the motivation of judges, to “do the right thing.”

1. The Coase Theorem. One finds two wealth-maximizing mechanisms identified, however, in the writings of Coase (1960) and Rubin (1977). In “The Problem of Social Cost,” Coase considers two neighbors, one of whose activity harms the other. Sparks from a railroad train burn the crops of a farmer whose fields the tracks traverse.

Bentley’s (1994, Vol. II: 19) description of legal process in Egypt aptly depicts some common law elements in that nation’s code law system:

Since Egypt generally follows the European Civil Law tradition, rather than that of the Anglo-American common law, judicial decisions do not constitute a formal source of law in the sense of setting down binding rules for future conduct. Nevertheless, judicial decisions have persuasive authority. Indeed, much of Egypt’s administrative law is not found in statutes but rather is to be found in the decisions and opinions of the administrative courts of the Council of State. Not infrequently, Egyptian judges and lawyers will look to French judicial decisions for guidance.
Cattle on a ranch stray over to a farmer’s fields, destroying some of his crops. The noise from a confectioner’s machinery makes it impossible for a physician to examine his patients. All of these cases are examples of nuisances, a subset of both tort and property law. What will happen in each case? What should happen?

Suppose, first, that present law makes plain and legally enforceable which party to each conflict over competing uses has the right: the railroad or the farmer; the rancher or the farmer; or the confectioner or the doctor. Suppose, second, that these rights are alienable in the sense that their present owners legally can sell them to the other party. Finally, suppose that transaction costs between the parties to the dispute are insignificant. Coase then shows that the final allocation of rights is independent of the initial allocation, as the initial allocation is embodied in legal precedent (or legal codes). In particular, either the rights are already where they belong, with the person who values them more, or the person involved can sell such preexisting rights to the other party, who values them more.

So, suppose that the doctor holds the clear legal right to examine his patients without the noise emanating from the confectioner’s machinery. If the net value of (additional) medical services exceeds that of (additional) candy, the rights are in the correct (wealth-maximizing) hands. And, if the doctor so requests, a court will issue an injunction enjoining the confectioner to close down the nuisance. But if the net value of (additional) candy exceeds that of (additional) medical services, then the rights are not in the correct (wealth-maximizing) hands. The confectioner, it follows, can and will purchase from the physician the physician’s right to quiet in the neighborhood of his clinic. The same kind of analysis applies if we reverse the initial allocation of rights. In any and all cases of nuisances—competing uses of resources—rights remain with or flow to their highest valued use, provided the three assumptions of the Coase theorem are met.

Three aspects of the Coase theorem, and especially conditions that violate its three assumptions, deserve mention. First, the prevailing legal rights must be clear and plainly enforceable. Without such rights the parties do not have a starting point for bargaining, making dispute-resolution costs higher than necessary. Higher dispute-resolution costs, in turn, reduce the wealth-increasing opportunities for exchange of rights. Specifically, if the parties first must make legal arguments over poorly defined or enforced rights, the cost of conflict resolution, including the cost of delay, increases, again reducing the wealth-increasing opportunities for exchange of rights. The absence of clearly defined rights also lowers the value of all rights (including possession itself) to underlying properties. And, this absence of clearly defined rights similarly gives judges

---

3 Coase posits a world of zero transaction costs. But all transactions have costs, including those over rights to use a resource in a way that competes with an alternative use. Hence, we may modify the Coase theorem to say that transaction costs remain inframarginal, meaning that they do not affect the possibility for gains from trade.

4 Coase allows for the possibility that the parties will bargain to a result that allows some level of each activity to continue. The railroad may operate fewer trains at lower speeds. The rancher may reduce the number of cattle. And, the confectioner may reduce his factory’s hours of operation.
excessive discretion in legal disputes that may come before them. So, a judge may decide cases to maximize his own utility on ideological or pecuniary dimensions, with no connection to wealth-maximizing rules. Accordingly, judges or legislators afforded the opportunity to adopt different structures of rights should prefer those structures that make initial rights clear.

Second, alienability of rights is a necessary condition for wealth-regarding transactions in rights to occur. One could interpret labor law, for example, by using the Coase theorem. Suppose that the law makes it difficult or impossible (on public policy grounds) to discharge workers—a condition prevailing in many Egyptian enterprises—and that workers under existing law cannot alienate this right by contract. But a worker might prefer a higher salary to being guaranteed employment, and his or her employer might also prefer the same contract. Such exchanges cannot occur where workers’ rights remain inalienable. Where courts or legislatures have a choice of rules that affect alienability, therefore, they should look more favorably on rules that enhance the right to alienate rights themselves.

Third, the wealth-regarding rearrangements of rights that the Coase theorem contemplates cannot take place without the maintenance of low transaction costs, relative to the value of the affected exchanges. One way to increase transaction costs is to divide ownership rights to property in ever more but ever smaller pieces, with no one having clear and effective control of rights over the underlying asset. If the interests of the owners are not clearly aligned, one with the other, or as the number of (fractional) owners grows, then so too do the costs of transacting with other owners and other parties to resolve conflicts arising from competing resource uses. The Egyptian rules of inheritance, insofar as they fractionalize property ownership, raise transaction costs. Hence, these rules place a barrier before the efficient allocation of rights to resources.

Even in cases where nuisances are not involved, and where a simple and complete exchange of all property rights (including possession) for money would create wealth, it is difficult to bargain with hundreds of fractional owners, each with different

---

5 This hypothetical example says nothing about the legal rules giving strong guarantees of job tenure. For reasons that Fawzy (1998), Sachs (1996), and others explore, such rules are devastating to the efficient and competitive operation of firms, and therefore to the ability of firms to create wealth. The problem of making (workers’) rights inalienable reinforces the nation’s inability to achieve international competitiveness and economic growth. On the inalienability of rights, see Haddock and Hall 1984. Bentley (id.) argues persuasively that because these labor rules in Egypt apply principally to Egyptians, they lead employers, ceteris paribus, to prefer hiring non-Egyptians. These rules also lead employers disproportionately to adopt capital intensive (labor saving) processes. See Part III, 3.

6 This is not an argument against Shariah rules of inheritance. There may be several beneficial owners of a resource as a consequence of these rules. But this multiplicity need not increase transaction costs if the parties enjoy a method to place decision making rights in a few hands. My reading suggests that many Egyptians informally provide for such methods “in the shadow of the law.” Part V refers briefly to the problem of integrating religious and civil law rules. The present situation in Egypt appears to parallel that found in the United States concerning covenants in titles of residential neighborhoods. A developer, say, wishes to use the land for office buildings. The neighborhood covenant commonly requires a super majority to approve of the aggregated sale.
expectations. To engage in bargaining on behalf of oneself and all other claimants is to attempt to produce for them a collective good. But as the number of claimants grows larger, each can free ride on the efforts of the others. A sub-optimal amount of bargaining then occurs, as does the creation of real barriers to efficient allocations of resources (Olson 1965).

Brown (1997:187-188) provides an apt example. A Cairene learned in 1961 that he shared an endowment, in the form of urban real estate, with 800 to 900 other people. The estate had a value of $8 million. The consent of all beneficiaries was required to sell the estate. But each time the matter came to court, it was found that several beneficiaries had died, requiring the approval of yet more people—heirs of each deceased. In the end, it became “virtually an actuarial impossibility” (id.) to dispose of the estate. Even with the intervention of a minister of justice (also a beneficial owner of the trust), by 1997 the matter was still tied up over the trustees’ demand for payment before distributing each share. This is an unfortunate case of (practical) inalienability and high transaction costs. The corpus of the estate cannot move to its highest valued use while the “cloud on the title” persists. Hence, courts or legislatures faced with an appropriate choice should adopt those rules that reduce transaction costs.

The Coase theorem, in sum, implies clear wealth-maximizing rules for courts. First, in their rulings they must make plain for each class of dispute who owns what, who enjoys what rights and obligations. Second, they must protect alienability of rights (which is itself an important property right) to the greatest extent possible. This is a problem under Egyptian law, because of its occasional antipathy toward the use of foreign courts and legal systems. Third, they must adopt rules that reduce, or at least do not raise, transaction costs. Because, under the Coase theorem, the initial allocation of rights does not matter for the final allocation (which is wealth maximizing), in a world of perfect information almost any clear statement of rights will do. But in the real world one finds imperfect information, with costs attendant to contract making, bargaining, performance monitoring, and enforcement. Under these circumstances courts should adopt (default) rules that embrace the modal patterns of contracting and then allow parties to bargain away from those patterns if they so choose. If different modal patterns emerge, then courts should adopt those patterns for the governance of contracts that otherwise remain silent on the matter in dispute.

But what if transaction costs are high, perhaps because of the large number of parties involved or even because of ethnic antipathies? For most large-scale pollution

---

7 As Bentley (id.) and others observe, an efficient, modern system of ownership recordation is a necessary condition for clarity.

8 Specifying the forum and source of law that the parties would use in the event of a conflict over the terms of a contract is an important part of most commercial contracts. Antipathy toward the use of foreign courts and legal systems, as well as mediation and arbitration, is a recurring feature of the Egyptian legal landscape. (Brown 1997: 229, passim.) For an analysis of the development of “private” private law through arbitration and mediation, as applied to Russia and Eastern Europe, see Rubin 1994. Part III, 3 returns to this issue.
problems, for example, it seems impractical to consult all those whom a legal decision or policy change would affect. Coase argues that under high transaction cost conditions, courts themselves must make the economic calculation. That is, judges or legislatures must decide which of two or more competing uses of a resource has a higher net value. So, in trying to arrive at efficient outcomes, courts must decide what to do about widespread externalities must act like legislatures. Another way to state the same proposition is that courts must adopt the rule that they believe the multiple parties would have adopted had transaction costs remained insignificant. The parties cannot contract away from the rule, of course, precisely because the transaction costs are too high for them to do so, and there remains the possibility that they might bargain to mutually contradictory results.

2. Rubin’s tort law model. Is there any guarantee that courts will “get it right” in such circumstances? I argue elsewhere (Aranson 1992) that the task is daunting, not unlike the activity of central economic planning itself. But Rubin (1977) shows that in some circumstances the legal process will tend toward the adoption of efficient rules. In particular, suppose that an accident has occurred in which A drove his automobile into that of B. Can B collect damages from A? The problem is to adopt and apply a set of rules that gives A and all future A’s the incentive to take the correct (wealth-maximizing) level of care, resulting in an “optimal” number of accidents. Accident avoidance is not costless. We experience fewer and fewer accidents as we increase our level of care while driving. But the resulting level of safety increases at a decreasing rate. At the same time we must use more and more resources to achieve safer and safer driving conditions. An efficient rule would give drivers incentives to adopt safer driving methods until the cost of the last unit of safety purchased is exactly equal to the value of that unit of safety, as measured by the cost of accidents avoided.

Rubin’s analysis, which I do not repeat here, shows that the common law process can generate such rules. Rubin explores expected costs and benefits of litigation, based on the underlying costs and benefits of future accidents and safety. He then shows that if the prevailing legal rule is efficient, wealth maximizing, then potential defendants in accident cases will accept their liability and bargain with the plaintiff to an out-of-court settlement. They will also adopt the wealth-maximizing level of precautions—minimizing the sum of accident costs and accident avoidance costs. But if the rule is inefficient, requiring too high or too low a level of precaution, then one party or the other will be more likely to litigate. Because each challenge to an inefficient rule brings with it the chance that a judge will adopt another rule, the law evolves until only wealth-maximizing rules remain, which no one challenges given positive litigation costs.10

9 Rubin’s model relies on some subsidiary assumptions for efficiency to emerge. In particular, the parties must have some future interest in precedent, litigation costs must be positive, and judges must tend toward following precedent (stare decisis). Several other models of the common law process arrive at predictions of efficiency, though they use a different set of assumptions. (For a review, see Aranson 1986.) I do not argue here that the common law always arrives at efficient results, only that it can do so. That result appears fairly (though not wholly) robust to changes in the model’s underlying assumptions.
Rubin’s analysis describes an important and fairly extensive set of cases with high transaction costs between representative potential defendants A and representative potential plaintiffs B. To grasp the underlying structure of the problem, suppose that (before an accident occurs) all drivers could bargain with each other over the amount of care that each would take while driving. The situation, as noted earlier in the case of multiple owners of property, then resolves itself into a straightforward contracts case, covered by the Coase theorem. But transaction costs among (all) drivers simply remain too high for this kind of *ex ante* bargaining to occur. The common law process nonetheless provides a corrective in the form of the parties’ respective incentives to sue or settle. And the parties’ decisions in this matter drive the common law process toward the adoption of efficient liability rules. The parties tend to sue more when the underlying legal rule is inefficient, while they tend to settle more when it is efficient.

Notice that in both Coase’s and Rubin’s analyses, when the legal system comes to equilibrium, litigation ceases. Because the rules are clear, more people (or their lawyers) than otherwise know their rights and obligations, and they know that courts stand ready to enforce the actions that the rules prescribe. Because those actions are wealth maximizing, they are also “reasonable”—actions that add to the net value of a transaction or individual choice (Rubin 1982). One can find instances where the law is in flux. In such cases a flurry of litigation may result. But courts then experiment with different responses to the underlying changes that produced the legal uncertainty. Eventually, through an evolutionary process, some courts “get it right,” leading to a new equilibrium with no litigation.

Notice, also, that both Coase’s and Rubin’s analyses do not require judges to “know” economics or to apply economic theory to arrive at their rulings. Indeed, the economic theory of law is a recent development, and, some would argue, both common law and civil law were more potent sources of wealth creation 100 years ago than they remain today. In disputes arising from contracts, even where there is no governing common law precedent or civil law rule, the judge need only reason about the “legitimate expectations” that would have been embodied in contract terms, where a contract (or the law) remains silent. In tort cases the judge need only consult existing practice and the ordinal difference in the sum of accident and accident avoidance costs, to arrive at a correct rule.12

---

10 In a thoughtful commentary on this paper, Charles Cadwell (1999) raises the possibility that aggregating interests to bring about legal change may be difficult or impossible to achieve. With respect to public policy, broadly considered at the legislative level, I agree with his argument. Indeed, while he cites a new paper by Dixit and Olson (1998), the point goes back to the analysis of “rational ignorance” (Downs 1957; Aranson 1989/1990) and rent-seeking. Olson (1982) had anticipated much the same point. I disagree, however, in the extension of this claim to common law courts. The extant models appear to harness the interests of individual litigants to perform a wealth-regarding purpose. Of course, to the extent the law or legal process changes only by legislative decree, then Cadwell’s observations remain wholly applicable.

11 Technological change is a constant source of legal change, as are new patterns of consumption.
II. The Traditional Common Law: Contracts, Torts, and Property

Traditional common law—judge-made law—falls into one of three categories: contracts, torts, and property. While I attend here most closely to contract law, it is helpful to put the other two categories into perspective. Contract law ordinarily involves rules governing disputes arising from conflicts among people who know each other. Even where a large number of persons is involved, as with shareholders of large, publicly held corporations, their agents, the corporate executives, ordinarily know the parties on the other side of a contract dispute. Hence, in most contract disputes transaction costs do not disable rearrangement of rights. While courts or legislatures should not be indifferent to getting contract law “right,” there is less concern on this count than would prevail if transaction costs were high. This much we know from the Coase theorem.

Tort law usually, though not always, involves people who do not know each other. Each party to a tort lawsuit only serendipitously will know the other party, and each party stands in the place of all other potential victims or tortfeasors, save for the unpredictable accident that has occurred. Tort law thus governs situations with high transaction costs between or among the disputants. One must rely, therefore, on a process such as Rubin describes to hypothesize that the rules courts or legislatures eventually adopt are the correct ones.

Property law cases cover the entire spectrum of transaction costs. Rules for the leasing, purchase, sale, or conveyance of property are interpretable under a contract theory. Rules governing the external costs that neighbors’ activities might impose on each other are similarly interpretable under a Coasean (low transaction cost) casting of a contract theory. Property rules governing larger, more pervasive external costs seem more likely to represent high transaction-cost situations, in which we may search in vain for a process that reveals preferences accurately. Widespread air and water pollution are good examples, because there likely are large numbers of tortfeasors and victims. But we may interpret trade restrictions and other forms of legislatively or judicially created entry barriers in a similar light.

---

12 Even though judges need not know the economic analysis involved, some do grasp the economic nature of the comparisons that various cases entail. See, e.g., Judge Learned Hand’s famous decision in United States v. Carrol Towing Co., 159 F.2d 169, 173 (2d Cir. 1947).

13 Exceptions include intentional torts, private nuisances, and some kinds of losses arising out of negligence under contract situations. See, e.g., Epstein (1992).

14 Revealing and registering preferences in such situations is equivalent to the problem of revealing preferences for a public good. Political institutions (e.g., voting) under some circumstances of narrowly defined assumptions can offer correct incentives to policymakers. But these institutions remain extremely fragile to small variations away from the underlying assumptions of the associated models. For a discussion of political problems in the context of Egypt, see Noll 1997
I attend here principally to contract law, because it is a central feature of a legal order that stands at the heart of economic development and national wealth. To pursue this issue, I discuss three different contract situations. The first situation arises in the English case of *Hadley v. Baxendale* (1854). In *Hadley* a miller’s drive shaft was broken, leading the miller to ship it to a foundry for use as a form in casting a replacement. The shipper whom the miller hired sent the shaft by ordinary means, causing the miller to lose business because of delays. Should the court hold the shipper liable for the miller’s consequential damages? The court held otherwise, thus placing the burden of informing the shipper of possible consequences (arising from loss or delayed delivery) on the miller and in the future on all similarly situated parties.

Why does the rule in *Hadley* make economic sense? How might a shipper or miller respond under the alternative rule, placing liability for consequential damages on the shipper? The shipper might take some average level of care, but this strategy seems inefficient compared with one that matches speed and reliability with the nature of the cargo. Under the alternative rule the sender, in this case the miller, has no incentive to reveal the nature of the cargo, because he pays a lower price for shipping and then collects any consequential damages. The rule in *Hadley*, by contrast, places the burden of producing information concerning value and time preferences where it is easiest to find: on the cargo’s owner. Resources used for shipping thus become allocated more efficiently. Overly speedy or safe transport methods are not employed to move cargoes of little value; inadequately speedy or safe transport methods are not employed to move (sometimes irreplaceable) cargoes of great value. All of this economizing and preservation of expectations happens because the court “got it right.” But even if it had not done so, if contract rights are alienable, the parties ordinarily will themselves choose the right contract terms.

The second example involves a change in the law. Before the turn of the century, if a rental contract remained silent on the point, landlords in the United States had no obligation to mitigate damages following a tenant’s failure to perform. So, if a tenant refused to occupy the premises and to pay the rent, the landlord could collect all of the rent contracted for, with no obligation to mitigate his damages by finding an alternative tenant. Then, somewhere around the turn of the century, and despite the rule to the contrary, leases (commercial leases, in particular) began to reflect a landlord’s obligation to find an alternative lessee, to mitigate the damages from the original tenant’s breach of contract.15 Eventually, several courts adopted this (default) rule.

What provoked this change? Before 1900 most leases were for agricultural property—farms—and many landlords expected payment (in practice or by contract) out

---

15 In most circumstances the landlord could retain the tenant’s deposit and some extra funds as a form of liquidated damages. But he would not be awarded the entire rent for the whole period. Hence, under the new rule the landlord would have an incentive to find a replacement tenant after a reasonable period. And, because of the liquidated damages feature of the contract, it would not be necessary for courts to inquire whether the landlord had used due diligence to mitigate his loss. I am grateful to my colleague, Professor Frank Alexander, Emory Law School, for discussions concerning the general history of mitigation of damages in real estate lease transactions.
of crop yields. But crops are seasonal and sensitively so. A tenant’s failure to perform would mean that the land would lie fallow. Mitigation of damages under this circumstance would be most difficult, and perhaps more costly than enforcing a rule that placed no such obligation on the landlord. After 1900, however, first contracts, and then the rule itself, changed to require a landlord to mitigate damages. Courts, that is, became hostile to landlords’ claims for the entire rent covering the whole rental period. Contracting parties, of course, could always bargain around the new rule, to maintain the old one. The new rule, like the old one it replaced, merely stated a “default” provision in the event the particular contract remained silent on this issue.

This change in rules occurred because rental contracts increasingly covered commercial and residential property, with no connection to farming. It would seem far simpler and less costly to replace a tenant who rents a commercial building, single-family home, or apartment than it would be to replace a tenant farmer, well into the planting season. Notice, however, that both rules flow from the same inherent economic logic. It is in the interest of the parties, and the nation at large, for fields not to go fallow. Hence, the original law placed an onerous burden on the tenant, giving him an incentive not to rent the farm unless he was serious about performing, and giving him an incentive actually to perform.

Commercial buildings and residential dwellings, in a similar vein, are not useful when vacant—they “provide” no business or housing services. But there is not the time-dependent feature with commercial and residential structures that one finds with agricultural land. Hence, the law restricts the residential landlord’s rights to damages following his tenant’s breach to a reasonable time, during which he has an incentive under the new rule to attempt to re-let the property. Both rules, it turns out, place the respective property in more intensive, and therefore higher valued uses than would their opposites.

The third example involves another, more complex change of law, also taken from a combination of contract and tort law, found in a landlord/tenant context (Goetz 1984). If a visitor injures himself because of a hazard in a rented residence, is the tenant or the landlord liable? In the United States before the 1920s, the rule of such cases held the tenant liable. Then actual leases began to change, as landlords and tenants partially contracted away from this rule. What prompted this change to landlord liability? It was the shift from leasing of single-family dwellings to leasing apartments within large tenement (apartment) buildings. The change in the rule affected common areas specifically.

The prior rule seems efficient in that it places liability on the person who is most likely to detect the hazard. At the same time it freed up the landlord’s time, so he need not spend hours each day inspecting his property. Stated differently, the tenant goes up and down the front steps at least once daily. So, he is more likely to detect a loose brick. The rule thereby economized on information costs. The new rule, by contrast, reflected the evident problem that, with respect to common areas in large apartment dwellings,
tenants have a free-rider problem (Olson 1965). So, the law began to require landlords to assume the burden of making conditions safe outside the walls of particular apartments.

Notice that each rule, covering its respective circumstance, tends to reduce the cost of detecting and repairing hazards, and thus of avoiding accidents. Furthermore, it becomes less costly to place rental property in the stream of commerce under the appropriate rule. So, there is more surplus in exchanges (contracts), and the parties jointly prefer the appropriate rule to apply to their situation.

A rule, or a change in a rule, also may favor one party or the other. So as courts adopt new rules or change existing ones, of necessity they shift costs from one party to another. But that is not the principal purpose of adjudication. Instead, it is to maximize the sum of benefits, net of costs, arising from transactions. Another way to state the same proposition is that well considered legal rules do not really favor one party or the other, per se. Instead, they favor contracts formed and executed, by enabling the parties to make those contracts in the first instance. As a consequence, more contracts will be formed, so that more shipping (Hadley) or more housing will be demanded and supplied. These increases, in turn, add to economic activity and wealth. The backdrop of efficient legal rules also makes more likely the formation of new contracts for presently unavailable goods and services.

III. Designing Legal Rules: Some Limitations

My purpose here is to offer some guidance in reforming legal systems in general, and the Egyptian legal system in particular. I am less interested in structural reform than in some deeper observations about judicial choice. Nor do I offer a high degree of certainty about legal change. Egypt, for example, with its code law, has a wealth-destroying litigation explosion. But so does the United States, with its common law. Continental nations and Japan have code law but no litigation explosion. Britain and Australia, common-law countries, likewise have no litigation explosion. So if increased litigation becomes a problem, we cannot find its source in the overall form the legal process adopts.

It is patent that no legal system “gets it right” all of the time, just as it is patent that we would not necessarily wish legal systems, in all matters, solely to incorporate economic values, narrowly defined. Nevertheless, we can identify certain outcomes of legal processes that give evidence of serious problems, problems that stifle the creation and expansion of wealth.

16 The litigants before the court may experience a change in wealth on account of the court's decision in their case. But if so, then all parties like them in the future will bargain to different terms, e.g., concerning rent. If the court gets the rule right, then there will be more surplus in transactions to divide between the contracting parties than prevailed under the old rule.

17 The annual increase in the number of attorneys in Egypt is also greater than the birth rate. See Brown (id.)
1. Limits of the legal process: redistribution. First, the judicial process is a terribly wasteful method to redistribute income or wealth. In none of the hypothetical or actual cases I cite earlier is there reference to a litigant’s wealth. The railroad is doubtless wealthier than the farmer, the rancher and farmer may be on indeterminate relative terms, as are the confectioner and physician. Landlords generally are wealthier than tenants, at least in the United States (Rabin 1984: 567). But these generalizations are of little consequence for deciding cases and adopting specific liability rules. Courts surely should not adopt a rule that the less wealthy litigant always wins the lawsuit.

What matters is not the relative wealth of the litigants but the judicial adoption of rules that (give people incentives to) allocate resources to their highest use. Generally, such rules will be cost reducing or surplus increasing, or both. As noted earlier, a legal rule that maximizes wealth will increase the net benefits of transactions (contracts) or lead parties to take the correct level of care (torts). Courts or legislatures, therefore, should attend to the allocative consequences of their decisions, not to the distributional consequences for the instant parties.

One gains the impression from accounts of the Egyptian legal system, however, that the wealth of litigants does matter. Part of this tendency remains from Egypt’s overtly socialist period (Bentley id.). But the tendency predates that period. Populist antipathy toward business appears long to have been a staple of Egyptian legislative and judicial life (although these tendencies come and go) (Brown 1997: ch. 8). But indulging in redistribution through the courts is a practice that no developing nation easily can afford, precisely because it stifles economic activity. This is not an argument against well designed programs of income support. It is, by contrast, an argument against courts inserting large inefficiencies in specific markets, to alleviate problems that legislators might wish to address nationally.

2. Managerial reforms. The use of an overt standard such as redistribution to decide cases holds some interesting implications for the rate of litigation. Rubin’s model implies that the rate of litigation declines with increasing court costs and with a greater certainty about the “rule of the case.” Where court costs are low, because lawyers do not charge much or because filing fees are low, there will be more litigation than otherwise. Where the “rule of the case” is absolutely certain and unchanging, there will be no litigation. But where the rule (or the choice of a rule) itself remains uncertain, the amount of litigation will increase.

Suppose, to pursue a previous example, that courts are willing to say with utter clarity that the rights of doctors always take precedence over those of confectioners, or that commercial and residential landlords always have an obligation to mitigate damages. Then the parties will either accept these rules or jointly and voluntarily contract away

---

18 The consensus appears to be (Bentley, id.) that in Egypt court fees are too great, especially for small enterprises. I would add that court fees for minor suits may be too low, leading to a "zero pricing" of, and greater than optimal demand for the services of judicial resources.
from them. In either case the transaction increases wealth by sending rights over resource use in the correct direction. But if, in the event of a dispute over such rights, courts first and dispositively inquire which is the wealthier or the poorer party, then no particular, certain rule will cover all circumstances. Potential litigants, then, will know that courts are a lottery, leading to far more litigation than would occur under a greater certainty in judicial rules. More important, under a redistributational judicial regime, the resources used to pursue litigation produce no benefits; they only produce sterile transfers. The cost of the legal process then becomes pure waste. Worse, it stifles enterprise by increasing the costs of contracting and production.

Rubin’s model also provides a note of caution concerning the robustness of proposed structural changes in the judiciary for ameliorating Egypt’s current litigation explosion. One proposal (see, e.g., Bentley, id.) is to adopt modern case management techniques, shorten periods for litigants and courts to act, and limit the cases and questions that appellate courts must review. The idea is to move litigation more rapidly through the courts, thus reducing the backlog of cases. While this collection of proposals is a good idea, notice what it does to litigation costs. These costs include attorneys’ fees, court fees, and the cost of waiting. That is, court services in Egypt, as in the United States, are at least partly “rationed by waiting,” since the total “price” of these services does not clear the market. Shortening the waiting time will reduce the price of court services, so more of those services will be demanded. A reduction in court fees, similarly, will increase litigation rates.

3. Legal and extra-legal remedies. When legal systems work poorly, or fail to work as expected, people begin to adopt a number of private artifices both within and without the system. In executing debt contracts, for example, Egyptian lenders often ask borrowers to pay with post-dated checks. This artifice arises because writing bad checks falls under the criminal law, which in Egypt works more surely, more rapidly, and with more dire effects for the obligor than do civil law remedies (Brown, id.: 224). When confronted with rules that make eviction difficult or impossible, to consider a second example, landlords begin to treat tenants as buyers. Rents rise, and the supply of rental housing shrinks. When confronted with rules that make layoffs of Egyptian citizens difficult, and sometimes impossible, to consider a third example, employers hire fewer Egyptians and adopt (inefficiently) more capital intensive forms of production. These two reactions then increase unemployment among Egyptians.

Because of the problems associated with Egypt’s present legal system, firms, especially those engaged in foreign commerce, turn increasingly to arbitration, using either domestic or foreign arbitrators (e.g., the Paris Chamber of Commerce) and deciding cases under domestic or foreign law. For the parties involved, the use of

---

19 Bentley (id., vol. 3: 53) identifies another source of uncertainty, judges’ lack of knowledge. Said one of Bentley’s respondents: “The judges are untrained and their judgments are based on nothing. Filing a lawsuit is nothing more than engaging in a legal lottery.”

20 The increase in litigation following weak and unclear precedents is a subsidiary implication of Rubin’s model. See, e.g., Adams 1977.
arbitration appears to be an unalloyed benefit. Arbitration appears to be speedy, reasonably priced, and fair. But there are drawbacks to these processes. Bentley (*id.*) notes that Egypt's socialist period created a twenty-year hiatus in the development of Egyptian commercial law. The present collection of Egyptian commercial rules, and especially contract rules, seems nearly complete. But it has not been updated. So, it has not confronted many of the problems that judges or legislatures in other legal systems have had to grapple with in the intervening years. A shift of important, high-valued commercial cases out of the Egyptian legal system and into alternative *fora*, while desirable in itself, nevertheless reduces the chances that the legal system can develop appropriate rules as quickly as it otherwise might. Of course, if Bentley is right, the Egyptian legal system today does not enjoy the requisite intellectual capital to modernize. So, the shift to alternative methods of dispute resolution would at least be a matter of indifference. For the improvement of foreign investment in Egypt and international trade generally, the availability of alternative dispute resolution methods remains absolutely crucial but perhaps a Faustian bargain.

4. Corruption. The final "extra-legal" practice considered here is corruption, the bribing of public officials for private gain, or public officials’ extortion of money from private persons, again for private gain. My concern is with the economic view of corruption, its causes and consequences. But corruption itself breeds disrespect for law and a more general social demoralization. It is to be avoided, therefore, apart from any distortions it creates in economic or judicial actions.

Here, I emphasize two aspects of corruption. First, except in cases of personal animus or simple theft, corruption cannot flourish unless the law prevents or overly burdens a transaction that the parties to it otherwise would make. If government controls set rents below the equilibrium level (where amount supplied equals amount demanded), for example, a shortage will occur (more housing units will be demanded than supplied). But there is also a large difference between the (maximum) value the "next" renter places on a housing unit and the (minimum) value the "next" landlord will charge in rents. Because the first value is larger than the second, there is a surplus to be divided between the parties. And, therefore, some kind of subterfuge to evade the rent control remains highly (and jointly) profitable.

As a general proposition, the promulgation and enforcement of laws that prevent or otherwise burden mutually beneficial transactions from occurring invite the formation of black markets and other forms of extra-legal transactions. Corruption of legal and other government personnel, then, follows from the substantial surplus that attaches to circumventing the laws. Stated differently, governmental and legal interference with market transactions provides the source of most forms of corruption. Because corruption can and does arise whenever the public sector limits or prohibits or otherwise burdens mutually agreeable exchanges, governments and courts must choose the targets of regulation with care. Deregulation, therefore, becomes a preferred technology for reducing the incidence of corruption. Deregulation, it follows, is also a potent method for reducing the disrespect for law and social demoralization that accompany corruption.
The second aspect of corruption to be emphasized concerns the actions of government and judicial personnel themselves. Imagine a legal system where some personnel do not receive sufficient compensation (including appropriate working conditions) to bring forth an adequate supply of services of the desired quality. If payment of bribes or extortionate extractions from litigants becomes possible, then the amounts paid add to the compensation of service suppliers and become part of the "order of things." The system becomes further corrupted as those who are willing to accept illegal payments bid judicial positions away from those who are not. The system, then, selects personnel for their dishonesty.

The principal method for addressing this problem is the official payment of not merely an appropriate, market clearing wage for the quality of work involved (as well as its honest and faithful execution), but of a quality-assuring wage premium as well (Klein and Leffler 1981). This strategy makes the threat of discharge for official corruption undesirable on the part of workers in the system, since the present value of the flow of future wages exceeds the present value of lower compensation levels, including bribes. This strategy also removes the incentives for the corrupt to replace the incorruptible.

Commentators in developed nations such as the United States and those of Western Europe sometimes regard official corruption as an essential feature of nations undergoing economic development. But this observation may reflect a false causation. More likely, it is the combination of over-regulation of the private economy and low pay for justice system workers that makes corruption possible in a legal system. This combination certainly explains much corruption in the United States itself, in Western Europe, and in former Soviet bloc nations.  

IV. Sources for New Law: A Cautionary Note with Reference to Competition Policy and Corporate Law

Suppose what is patently false, that a nation such as Egypt had no legal system. One rapid method for building a legal system might then be to adopt a complete legal system from another country. One would have the choice of a code law or common law system. But one would have to exercise care to match conditions between Egypt and the donor nation. For example, one would not want to import into an agricultural economy the landlord-tenant law of an industrialized nation, as our earlier discussion of landlords' duty to mitigate damages indicates. While an existing set of legal precedents is a powerful and valuable stock of intellectual capital, it may require careful choice and eventual customization.

Corruption also afflicts processes where governments allocate monopoly rights, explicitly or through the creation of favorable entry barriers, to private persons and firms. Corrupt payments thus dissipate part of the monopoly rents.
This cautionary note is especially appropriate for two areas of law, competition (antitrust) law and corporate (governance) law. A number of commentators have urged the adoption by developing nations in general, and Egypt in particular, of expansive competition law close to the European Union model and equally expansive corporate law, more extensive indeed than most developed nations have embraced. Among academic commentators, the desirability of these bodies of laws and regulations, on their own terms, remains highly conflicted. Many argue, moreover, that each will limit economic growth. So it is surprising to find advocates favoring the adoption of these laws by nations with emerging economies.

1. Competition Law. Bentley (id.) and others urge Egypt to adopt competition law in a manner that I interpret to be close to the European Union's version. Bentley is especially concerned with predatory pricing. It seems clear that in his brief passages on the subject, he has adopted the thrust of European Union law, to prevent the "abuse of dominant position." He is wisely cautionary, because competition law almost universally provokes over-regulation and stifles competition.

While I cannot review all competition law or antitrust law here, I offer two generalizations and then consider predatory pricing specifically. The first generalization is that "nature abhors positive economic profits." Economic competition ordinarily leads entrepreneurs to notice profitable opportunities and to enter the associated lines of business, thereby dissipating incumbent firms’ monopoly rents, reducing prices, and increasing output. The second generalization is that governments, by creating various forms of entry barriers, are the principal agents in establishing and maintaining monopoly positions against the forces of competition.

That laws against predatory pricing should be proposed for adoption by developing nations is at least controversial. We know these things about predatory pricing. First, as early as 1958, in his review of the Standard Oil case, McGee provided the reasoning behind the proposition that predation is not a rational business strategy. Second, Liebeler's (1986) review of most predatory pricing cases in the United States shows that in only one of dozens of cases was there "suggestive" evidence of below (total) cost pricing, an indicia of predation. Third, in many cases a weaker, higher cost producer initiates a price war against a stronger, lower cost competitor and then brings suit when the stronger firm matches the plaintiff’s prices. So, to the extent that predatory pricing lawsuits "work," they keep prices artificially high, as stronger competitors try to stay out of court and (in the United States) avoid treble damages. Fourth, while some game-theoretic models predict predation in repeated games (Kreps and Wilson 1982; Milgrom and Roberts 1982), the resulting games have multiple equilibria, which even include non-predation as an equilibrium, making predictions from these models inappropriate for judicial consideration. Fifth, in reaction to these game-theoretic

22 Antitrust law does have some common law roots, but the kinds of developments some propose for developing nations are plainly statutory creations. While such developments of law would have to come through the political or administrative process, courts would face the challenge of interpreting, applying, and enforcing the resulting rules. Therefore, it seems appropriate briefly to consider these proposals here.
models, Isaac and Smith (1985) have taken predatory pricing into the laboratory. Try as they might, they could not produce predatory actions on the part of their subjects. Laws against predation, in sum, burden or prohibit the voluntary exchange between willing sellers and willing buyers at low prices. For all of these reasons, the U.S. Supreme Court, in *Matsushita Electric Industrial Co., Ltd. v. Zenith Radio Corp., et al.* (1986) has declared that predatory pricing is rarely used and less frequently successful. The Court has made it far more difficult to bring such lawsuits in any federal court.

Laws against predatory pricing, in the form of "antidumping" regulations, are especially damaging for international trade. Indeed, my own research with Curran and Curran (1991) suggests that European Union cases against predation reconstruct the international barriers that the Union itself was designed to eliminate. Other research (Dick 1991) indicates that "apparently" below-cost pricing grows out of (anticipatory) learning by doing in such technologically based fields as the computer chip industry. Governmental or private law attempts to suppress trade through the operation of laws against predation remain exactly the kinds of policies that establish barriers to entry against both foreign and domestic competition.

What is true of predation remains true of other practices subject to legal attack: these practices are pro- not anti-competitive. Vertical integration, for example, far from being an attempt to abuse a dominant position, serves to eliminate the transaction costs of vertical contracting. Vertical integration thus may become economically important in nations whose contract laws are not fully developed or evenhandedly enforced, leading to contracting problems between upstream and downstream producers. Vertical restraints likewise suppress intrabrand competition to promote interbrand competition. The creation and exploitation of brand name identification, far from being anti-competitive, is a way for firms to invest in reputation; the possibility of losing a sunk investment in good will through the sale of poor quality or unsafe products disciplines firms to maintain quality. This mechanism, along with an appropriately designed tort law, is likely superior to product quality regulation by regulatory agency. Indeed, quality and safety regulations themselves can become potent barriers to entry.

Egypt should not embark upon the enactment of a competition policy without serious consideration of its anti-competitive consequences. As Noll (1997) and others have argued, a nation open to foreign trade need not fear market power or its alleged effects. Where local monopolies or cartels persist, they more likely arise from government regulation and the political construction of entry barriers than from normal market forces.

2. Corporate governance and company law. Equally questionable is the recommendation that developing nations, and Egypt in particular, reform company (corporate governance) laws to conform with the recommendations of the most activist reform proponents in the United States. Since Manne (1966), for example, commentators

---

23 This review also suggests that, compared with modern scholarship in industrial organization (antitrust economics), European Community competition law is about forty years out of date.
on corporate governance have known that insider trading may have efficiency properties, because it gives entrepreneurs in firms that have become bureaucratic the appropriate incentives to adopt efficiency-regarding innovations. Manne’s work remains controversial. But most industrialized nations have not until very recently adopted bans on insider trading. And these bans often are weakly and haphazardly enforced.

The "new learning" on insider trading points out that if insiders cannot trade on information private to the firm, the information itself does not simply disappear. Instead, the next people "in line" to use the information will do so. Ordinarily market investment professionals, including investment bankers and brokerage firms, stand next in line. The policy question, then, becomes: Who shall use the information (Haddock and Macey 1987), those who created it or those who discover it following its creation?

Considering the controversial nature of these restrictions, firms should be free to choose to contract with inside managers and external shareholders in any way that they jointly deem appropriate. Some firms may prefer to prohibit their insiders from trading in their shares, while others may allow them to trade on inside information. It seems a contradiction that a commentator such as Bentley, who is so supportive of freedom of contract, would advocate its opposite when it comes to the internal structure of firms and the composition, duties, and obligations of their officers and boards of directors. There is no reason to suppose that firms that compete in factor and product markets will fail to do so in their choices of organization forms. The evidence is to the contrary (Chandler 1962).

V. Conclusion

Three issues remain. First, except in its analysis of statutes (Part IV), this discussion treats code law systems by adverting to the properties of common law systems. I believe that the two kinds of systems are sufficiently similar to warrant this comparison. Burdens on, or prohibitions of contracts, for example, appear to take the same form, and originate or continue for the same reasons, wherever one finds them. But important differences between the two systems may persist, differences that limit the appropriateness of the comparison.

Some differences, however, arise less as the consequence of adopting a common law versus a civil law system, and more because a particular form of one system or the other is in place. Common law systems, for example, enjoy a rapid transmission of decentralized knowledge and preferences found in the economy to the precedents that courts adopt. Civil law systems, such as those in France and other European systems, enjoy a mechanism for judges to collect such information and pass it on the legislature. Egyptian lawyers consulted report that their legal system has no such mechanism. First, judges are too overwhelmed by their caseloads and poor working conditions to assemble the kind of information the legislature would need. Second, there is no formal mechanism for judicial-legislative consultations. Egyptian law, as a consequence, changes slowly if at all. The legislative and executive branches may change the law in
response to press-reported scandals. But the press only understands the distributive consequences of law (who gets what), not allocative efficiency.

The second issue is that, unlike the nations of the former Soviet bloc, Egypt has a fully developed legal system, one that several other Middle Eastern nations have adopted. It remains to be seen if it is possible to reform such a system. The task, doubtless, is different from that of creating a legal system ab initio. My conjecture is that reform under these circumstances is more difficult than the act of creating a system itself. People make investments of human and physical capital that are specific to the legal rules that apply. Hence, any reform is likely to be disruptive.\textsuperscript{24} Able scholars in public finance, for example, can offer guidance in the construction of efficient tax systems. But experienced practitioners in this field of economics understand that "there is no tax like an old tax." So, there may be no legal system like an old legal system, one that provides a background for all of a population’s plans and investments, broadly construed.

Finally, there remains the problem of developing legal reforms against the background of religious law, in this case Shariah law. The preceding discussion offers an example in the problem of rules of inheritance. I have considerable sympathy for the view that the rules inherent in such laws may have purposes that modern commentators do not fully understand, and that it is hubris to propose circumventing or eliminating these rules. I also have considerable sympathy for the view that this body of rules undergirds the entire civilization and gives it its unique identity. So the challenge is not to make Egypt more like the United States, or Germany, or England. Instead, the challenge is to use these legal materials in a way that fosters Egyptian national identity while improving the well being of its people.

\textsuperscript{24} See, e.g., Olson 1982. The claim is oft repeated that successful economic and legal reform is more likely in nations whose interest group infrastructure has been eliminated (e.g., postwar Germany and Japan), or which maintains a political dictatorship (e.g., Chile and China). Where people rely on the status quo and enjoy an ongoing political capacity, serious proposals for reform appear to have reduced chances of successful adoption.
Bibliography


Cadwell, C. (1999) "Comments on Peter Aranson's 'Wealth Increasing Law, with Applications to Egypt.'" University of Maryland, IRIS Center.


