

## REPUTATION AND THE EFFICIENCY OF LEGAL RULES

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Policy recommendations frequently are based on efficiency arguments that are unfounded or misleading. The application of economics to law offers some excellent examples: scholars repeatedly have failed to state the precise conditions (e.g., all consumers have identical preferences) that describe the world being analyzed, the empirical evidence (if any) that supports these conditions, and the value judgments (e.g., Pareto criteria) that provide the benchmark for the efficiency comparisons. The resulting policy recommendations are flawed and have occasioned a great deal of confusion and controversy.<sup>1</sup>

The discussions concerning the relative efficiency of alternative breach and product liability rules illustrate the issues. Some scholars have urged the adoption of strict product liability, arguing that it is more efficient than either *caveat emptor* or a rule of negligence because producers are better informed than their customers about product characteristics. If producers can form more accurate expectations regarding the probability of an accident and the harm that it causes, then strict product liability supposedly presents customers with prices that reflect more accurately the full costs of the products; as a result, resources are allocated more efficiently (e.g., Shavell 1980).<sup>2</sup> Similarly, other scholars have argued that, in some situations, breaching

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<sup>1</sup>For example, see the 285-page "Symposium on Efficiency as a Legal Concern" and its 161-page sequel, "A Response to the Efficiency Symposium," in the *Hofstra Law Review* (1980). In such debates, positive economics often is faulted for conclusions generated by normative judgments and questionable antecedent conditions.

<sup>2</sup>Among other flaws, this argument ignores that customers are better informed about their own individual circumstances, including how, when, and where they use a product.

a contract may enhance efficiency. If circumstances change and transaction costs inhibit recontracting, then permitting a promisor to breach and pay damages instead of fulfilling the contract supposedly allows resources to flow to higher-valued uses (e.g., Polinsky 1983: 25–36).

In addition to other limitations (De Alessi 1992), these analyses neglect the role of trademark (reputational) capital in conveying information and assuring performance.<sup>3</sup> Trademarks offset, wholly or in part, the effects of positive transaction costs, including those arising from asymmetric information. Accordingly, policy recommendations supported by efficiency arguments that rest on the existence of costly information but ignore trademarks are flawed within their own frame of reference.

The present paper reviews the role of trademarks in providing information and assuring performance. It then examines the effect of trademarks on the arguments that a rule of strict product liability is more efficient than either *caveat emptor* or a rule of negligence and that, under some circumstances, it is efficient to breach a contract. To round out the analysis, the paper notes some of the value judgments implicit in many efficiency comparisons and offers a few concluding remarks.

## Trademark Capital

Suppose that customers cannot establish the quality of a commodity before they purchase it. Then it seems that a firm has incentive to produce, and customers have incentive to buy, only the lowest quality viable (Akerlof 1970). But Benjamin Klein and Keith Leffler (1981) have shown that some firms engaging in repeat transactions can gain if they raise quality above this minimum, charge a price higher than salvageable costs of production, and invest the premium in reputational (trademark) capital. Trademarks allow customers, whether consumers or business firms, to form more accurate expectations about the quality of a product before they purchase it. If the sellers then fail to provide the quality promised, they forfeit at least some of their trademark capital. According to this analysis, trademarks assure quality.

Trademark capital, however, assures more than just quality. It assures *specific* performance, protecting customers from expectation losses in case of breach (De Alessi and Staaf 1994).<sup>4</sup> Although a customer who is harmed can always seek legal remedy, the suit may

<sup>3</sup>“Trademark” includes service marks and trade names. It is also described as reputation or goodwill.

<sup>4</sup>“Specific performance” is the performance of a contract according to the precise terms agreed upon. Legally, expectation losses include foregone gains from trade and reliance as

not be successful or, if it is, the damages awarded may not provide full compensation (De Alessi and Staaf 1989). Damages are calculated by a judge, jury, or other outside observers who rely on market prices. Because market prices at best measure value only at the margin (cf. Buchanan 1969), damages typically underestimate actual losses. For example, damages exclude the gains that a customer forgoes on the inframarginal units. If damages are not fully compensatory and the courts do not enforce penalty and other clauses designed to yield specific performance, then promisees demand other assurances. Firms invest in trademark capital to establish a bond that provides these assurances by guaranteeing specific performance directly as well as by guaranteeing all other warranties and promises (e.g., money back if not satisfied).

Trademarks inform users. Customers' demand for trademarks is derived from their demand for information (and assurances) about product quality, warranties, post purchase service, and other performance characteristics. Producers' supply of trademarks provides that information (and assurances). Since Phillip Nelson's (1974) seminal paper, an extensive theoretical and empirical literature has supported the informational role of advertising and trademarks. Accordingly, efficiency arguments based on the assumption (antecedent condition) that users lack adequate information are fundamentally flawed unless they back that assumption with appropriate empirical evidence. Given the absence of any supporting evidence, it is useful to reappraise these efficiency arguments taking trademarks into account.

## Efficient Product Liability Standards

The notion of efficient standards of liability in tort, where transactions in principle are involuntary, initially centered on the Learned Hand rule. According to this rule, a party is liable if the cost of taking precautions is less than the cost of the harm times the probability of the event.<sup>5</sup> John Brown (1973) noted the ambiguity of the rule and opened the way for a more rigorous analysis of the problem. More recently, Lewis Kornhauser (1986), Steven Shavell (1987), and others have pointed out that a truly efficient rule has to be particularized to each event. For example, an individual with a higher opportunity cost of time could drive faster without being found negligent in case of an accident than an individual with a lower opportunity cost of time.

Product liability typically arises from voluntary exchanges, say between producers of automobiles and their customers. If transaction

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well as any reasonable expenditures. See Friedman (1981: 4–9) and Polinsky (1983: 25–30).

<sup>5</sup>Following Judge Learned Hand in *U.S. v. Carroll Towing Co.* (1947), let  $P$  be the probability of injury,  $L$  the gravity of the injury, and  $B$  the burden of adequate precautions. Then a defendant is negligent and liable for  $L$  only if  $B < PL$ .

costs are negligible, the analysis pioneered by Ronald Coase (1960) implies that the legal rule of liability—neglecting wealth effects, whose size and direction are unpredictable—does not affect the final allocation of resources. Liability is allocated to the same least-cost avoiders by negotiating warranties under *caveat emptor* or disclaimers under strict liability. High transaction costs, as discussed below, inhibit these exchanges and raise additional issues, including some relating to the role of trademarks.

The standard analysis of product liability rules begins with the following assumptions (e.g., Shavell 1980; Polinsky 1983). Information and transaction costs are zero; sellers are wealth-maximizing price takers in both input and output markets;  $c(x)$  is the U-shaped average production cost curve for commodity  $x$ ;  $r$  is the probability of an accident to a customer;  $d$  is the loss per unit of output if the accident occurs;  $m = rd$  is the expected damage per unit of output;  $m' = r'd'$  reflects the values of  $r$ ,  $d$ , and  $m$  perceived by the customer; insurance is fair and costs the same whether it is purchased by a producer or its customers, so that full cost =  $c(x) + m$ ; the market price of the product includes the insurance premium for the liability incurred by the producer; all parties take the behavior of others as given; and all parties accept the rule of liability (they have no incentive to contract around it).

These assumptions yield the following implications. Producers choose the quantity of output that minimizes average production cost and, in equilibrium, marginal production cost is equal to average production cost. If all customers are identical and face the same expected damage  $m$ , then both customers and producers look at the same prices and Pareto efficiency conditions hold. Given that the true and the perceived expected damages are the same ( $m = m'$ ) by assumption, the full price that customers pay is equal to the full price that they perceive and both are equal to full cost.

Under these conditions, the rule of liability merely determines the extent to which the producer acts as an intermediary in the insurance transaction. This conclusion follows because the full price that consumers pay is equal to the full price that they perceive at the time of purchase; both prices are independent of the rule of liability and are equal to full cost.

New possibilities arise if information costs are positive and differ between buyers and sellers. Continuing the standard analysis, suppose that producers have full information but that customers underestimate  $r$ ,  $d$ , or both, so that  $m' < m$ . The full price *paid* by consumers, as in the previous example, is still equal to full cost.

The full price *perceived* by consumers, however, depends on the rule of liability. Under *caveat emptor* or a rule of negligence, the

assumption that  $m' < m$  implies that the full price perceived by customers is less than full cost. Accordingly, customers purchase “too” much  $x$ .

Under a rule of strict liability, producers must take into account the costs of all defects. Producers include the insurance premium  $m$  in the prices of their products and internalize the costs of all defects, regardless of who is negligent.<sup>6</sup> Because producers are said to be better informed than their customers, the market price  $p$  is equal to the full cost and customers do not underestimate the full price that they pay:  $p = c(x) + m$ . Producers and their customers look at the same prices, and Pareto optimality reigns: resources are allocated to their highest-valued use. Consequently, strict product liability is said to be more efficient than either *caveat emptor* or a rule of negligence.<sup>7</sup>

In a world of positive information costs, however, firms have incentive to provide product information and assurances by investing in trademark capital.<sup>8</sup> Thus, the market price of a product already includes a premium  $s$  that customers pay to obtain specific performance:  $p = c(x) + s$ .<sup>9</sup>

Because the premium associated with a trademark performs the same function as the premium associated with strict liability, *under the conditions assumed* the shift to a rule of strict product liability has effect only to the extent that  $m$  exceeds  $s$ . Trademarks offset the supposed lack of product information by customers. Thus, the existence of trademarks reduces, if it does not eliminate, the efficiency case for strict liability.

In practice, a shift to strict product liability can have substantial effects. For example, the rule may require a firm to provide more insurance than informed customers want to buy, encourage customers to engage in opportunistic behavior, and create greater uncertainty about the nature of the liability as different jurisdictions grope toward

<sup>6</sup>Under a rule of negligence, a firm is liable only if the court finds that it failed to exercise due care. Under a rule of strict liability, a firm may be liable even though it exercised due care.

<sup>7</sup>The shift to strict liability is akin to a Pigouvian tax and is open to all the criticisms that Coase (1960) levied at the latter.

<sup>8</sup>For present purposes, competition and monopolistic competition do not differ (Demsetz 1959, 1968).

<sup>9</sup>To provide specific performance, at the margin firms have incentive to take avoidance measures rather than insure. That is, firms have incentive to design and produce goods that are more likely to perform as promised and yield smaller expectation losses when they fail to do so, shielding buyers from damages even if the burden of adequate precautions is greater than the probability of loss times the value of the loss measured by a third party. Producers with trademark capital at risk have incentive to undertake avoidance expenditures greater than those predicted by the Learned Hand formula. Note that insurance, like damages, relies on measurements by third parties; thus, it is not fully compensatory.

new standards. These costs occasion a premium  $u$  in addition to that required to provide specific performance. The market price of trademark goods and, therefore, the full price that customers perceive, may well exceed the “efficient” price.

Similarly, other conditions underlying the standard analysis do not hold. For example, the fact that consumers are not identical implies that—under strict product liability—those with expected losses greater (smaller) than the average premium pay “too” little (“too” much); Pareto efficiency conditions do not hold. More fundamentally, the assumption that producers systematically are better informed than their customers lacks empirical substance. Leaving trademarks aside, there is evidence that consumers are well informed about the products they buy.<sup>10</sup> Moreover, consumers typically purchase commodities from expert buyers, such as department stores, thereby reducing their demand for information about the characteristics of specific products. And even if producers are better informed about some product characteristics, their customers surely are better informed about how, when, and where they are going to use the products. Efficiency comparisons based on asymmetric product information are even weaker when the producers have trademark capital at risk and when the customers are other firms, which frequently have substantial wealth at stake and are well motivated to acquire and use information. One could argue just as cogently that *caveat emptor* is more efficient than strict product liability because customers are better informed than producers.

According to the efficiency rationale used to compare liability rules, under a regime of strict product liability the full prices of trademark products may actually be too high, discouraging consumption. Thus, too few rather than too many resources are devoted to these products.

Event studies by Sam Peltzman (1981) and others (see summary in De Alessi and Staaf 1994) indicate that deceptive advertising, product recalls, and fraud result in a substantial loss of trademark capital. This empirical evidence buttresses the quality assurance/specific performance hypotheses (De Alessi and Staaf 1994). Because the wealth losses observed are a multiple of any possible direct costs involved, the price premium that assures performance appears to exceed by a substantial amount the price premium associated with a shift to strict liability. Accordingly, the efficiency argument for strict liability is greatly weakened in the case of trademark goods: Producers of these

<sup>10</sup>For example, consumers have not used the Federal Trade Commission’s “Cooling-Off” Rule, which was intended to protect them from door-to-door salesmen (McChesney 1984). Similarly, consumers’ behavior under the FTC’s Funeral Rule suggests that they are well informed (McChesney 1990).

goods already undertake additional avoidance measures to protect their trademark capital, reducing the residual risk, if any, that would be insured against under strict liability.

At least in the case of trademark commodities, the case for strict product liability is flawed. This conclusion does not imply that *caveat emptor* or a rule of negligence is preferable. The answer depends on the value judgments used for the comparison.

## Efficient Breach

Suppose that the courts require a promisor to provide specific performance even though circumstances have changed. Perhaps a lower-cost alternative has become available, the cost of performance to the promisor has increased, or the value of performance to the promisee has decreased. Then, it is argued, too many resources are allocated to fulfilling the contract and efficiency considerations indicate that the promisor be allowed to breach and pay damages.

This conclusion rests on several assumptions that are unwarranted. For example, an outside observer must be able to identify and measure values, the law must be particularized to each event, the redistribution of wealth must not matter, and transaction costs must be prohibitive—if they are not, the Coase theorem implies that the parties renegotiate and resources flow to their highest-valued use (De Alessi and Staaf 1989, De Alessi 1992). Moreover, trademarks do not exist.

The case for an efficient breach focuses on a particular contract as an isolated event and ignores the trademark capital of the parties involved. If damages are not compensatory, if the promisor breaches more frequently than the promisee had anticipated, and if other actual and potential promisees know about these events, then the promisor can negotiate future contracts only at a lower price; its trademark capital falls. Specific capital is equivalent to a legal penalty clause that assures specific performance. Like all self-enforcing contracts, it helps solve the problem of high transaction costs.

Instead of investing in trademark capital, a seller could simply offer to pay some multiple of the damages assessed by a third party. Some promisees, however, would behave opportunistically and seek to induce a breach; this possibility has been used to explain why penalty clauses are not enforced (Clarkson, et al. 1978).<sup>11</sup> One alternative is to pay damages to a third party. Although such contracts are difficult to draw, Charles Knoeber (1983) has shown that they exist. Trademark capital enjoys a similar advantage. Because the loss in trademark

<sup>11</sup>For a different view, see Goetz and Scott (1977).



capital does not accrue to those supposedly harmed by the breach, it does not encourage them to spend resources on opportunistic (breach-inducing) behavior.

Strictly interpreted, criteria for evaluating the efficiency of legal rules require an array of standards that, in the limit, equal the number of transactions. Competing firms who provide a broad spectrum of trademark capital assure a wide range of quality and performance tailored to individual circumstances. Trademark capital represents a response not only to the inability of third-party observers to calculate fully compensatory damages and the reluctance of the courts to enforce contracts, but to the inability of the legal system to particularize rules to individual circumstances. Common law doctrines in tort and contract are “common” principles that permit little variation (De Alessi and Staaf 1991). Differences in trademarks provide variations in assurances and allow a broader array of standards.

Once again, the analysis merely indicates that the argument for efficient breach is flawed. It does not indicate which rule is preferable.

## Some Value Judgments Implicit in Efficiency Comparisons

To demonstrate the relative efficiency of alternative legal rules, economists frequently make assumptions about values and states of the world that are debatable or unwarranted (De Alessi 1990, 1992). Some of these assumptions are implicit, and analysts may not even realize that they are making them. Other assumptions, even if explicit, are so frequently and widely used (e.g., Pareto criteria) that they have become commonplace and their significance is overlooked. As a result, conclusions that are strictly subjective are cloaked with the appearance of objectivity.

Many studies assume, often implicitly, that all individuals have identical preferences and even identical endowments. These assumptions lack any empirical bases and yield implications that are inapplicable to the real world. For example, contractual and institutional arrangements formed precisely because people are different—and this is true for most, if not all, contracts—would be inefficient. The assumptions of identical preferences and endowments also mask some strong value judgments. In the case of strict liability, some customers are more likely than others to have an accident or to incur larger losses if an accident occurs. As a result, customers whose expected losses are above the average premium included in the market price gain wealth at the expense of those whose expected losses are below



the premium.<sup>12</sup> In the case of an “efficient” breach, the party breaching typically gains wealth at the expense of the promisee, who receives damages instead of specific performance. The assumption that individuals are identical helps to mask the value judgment that the wealth redistribution associated with different rules does not matter.

Most efficiency comparisons also contain the implicit assumption that an outside observer can estimate true values using market data. As James Buchanan (1969), Armen Alchian (1968), and others have emphasized, market prices at best measure value at the margin. They do not reveal the value that the chooser attaches to the inframarginal units acquired and to those foregone. As a result, an outside observer typically underestimates the full costs at issue; damages are not fully compensatory (De Alessi and Staaf 1989).

The efficient breach argument also contains the implicit assumption that a promisor is entitled to breach by paying damages (the price). But even ignoring moral considerations (e.g., “Is it acceptable to commit a crime if the perpetrator is willing and able to pay the price if caught?”) and supposing that damages are fully compensatory (i.e., all gains from trade and reliance as well as all relevant costs are included), the party who breaches is able to capture all gains from the subsequent trade (Friedmann 1989). Thus, damages and specific performance entail different distributions of wealth; they are not perfect substitutes.

Finally, the choice of Pareto efficiency criteria as a benchmark is purely arbitrary. The value judgments underlying Pareto criteria need not be universally accepted and the compensations necessary to fulfill Pareto efficiency conditions certainly cannot be implemented (De Alessi 1992).

## Conclusion

The efficiency arguments used to establish the superiority of a rule of strict liability over rules of *caveat emptor* and negligence and to justify the breach of some contracts do not hold even within their own frame of reference. Strict liability is said to be superior because the resulting price premium compensates for customers’ tendency to underestimate the cost of a product’s defects. But the price premium that customers pay for trademark goods to obtain assurance of specific performance already performs that function. This and other considerations discussed in the paper suggest that strict liability may result in

<sup>12</sup>Customers whose expected losses are greater (less) than the average premium would use “too” little (“too” much) of the product.

a price that is “too” high rather than “too” low, negating the rule’s efficiency claims. Similarly, some contractual breaches are said to be efficient because, in the presence of substantial transaction costs, they facilitate the flow of resources to their highest-valued uses. In addition to other flaws, this conclusion ignores the role of trademarks. Trademarks, like other self-enforcing contracts, help solve the problem posed by high transaction costs. They also inhibit opportunistic breaches, substituting for the inability of third-party observers to calculate damages that are fully compensatory, the reluctance of the courts to enforce contractual provisions (for example, penalty clauses and specific performance) that discourage breaches, and the inability of the legal system to particularize rules to individual circumstances.

More generally, efficiency comparisons typically rest on conditions that are empirically unfounded and value judgments that are unjustified. Economic theory simply does not provide an answer to the question: Which rule is preferable? Policy recommendations based on efficiency considerations are inherently suspect. Indeed, as Buchanan (1960: 87–88) noted, “By the very nature of free markets, . . . the only entity required to compare two social alternatives when a choice is actually made is the individual. . . . It [the market] will choose what the market will choose.”

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# THE ASSAULT ON THE FIRST AMENDMENT: PUBLIC CHOICE AND POLITICAL CORRECTNESS

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It is possible to radically change the meaning of the Constitution without changing one word of the document. This has happened, for example, with respect to the Takings Clause of the Fifth Amendment (Epstein 1985, Rowley 1992) and the Contracts Clause. The words in both of these clauses remain unchanged in the Constitution, but both have greatly reduced force today relative to, say, the pre-New Deal world. Moreover, the Supreme Court in recent years has established interpretations of the Constitution that agree with the mainstream of American constitutional jurisprudence (Farber and Frickey 1991: chap. 3; Horwitz 1992). As a result, most constitutional scholars do not point out that the Constitution has been radically reinterpreted.<sup>1</sup>

The courts have already substantially reinterpreted the Constitution to reduce protection of economic liberties. Thus, scholars interested in constitutional protection of freedom must act as historians, and must attempt to determine what forces caused existing constitutional changes. Although there are sudden changes in constitutional jurisprudence (e.g., the 1937 “Switch in Time”), the detailed working out of the implications of these reinterpretations takes some time. This is

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<sup>1</sup>Daniel Farber and Phillip Frickey write from a public choice perspective, but essentially reject most of the normative conclusions of most public choice scholars. Their discussion of *Lochner* is instructive. They indicate that the Supreme Court in *Lochner* “considered maximum hours legislation to be a violation of the rights of bakers and their employees” (Farber and Frickey 1991: 67). They do not argue with this view, which is of course correct on its face. Rather, they argue against what they claim to be the public choice defense of *Lochner*, that “it protects freedom of contract for instrumental reasons, not because it views this freedom as an intrinsically important value” (1991: 68). By this rhetorical twist, Farber and Frickey are able to avoid discussing the merits of contractual freedom.