Fairness in a Liberal Society

Richard A Epstein

NEW ZEALAND BUSINESS ROUNDTABLE

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Contents

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His books include *Free Markets Under Siege: Cartels, Politics and Social Welfare* (New Zealand Business Roundtable and Institute of Public Affairs, 2004), *Skepticism and Freedom: A Modern Case for Classical Liberalism* (University of Chicago, 2003), *Cases and Materials on Torts* (Aspen Law and Business, 8th edition 2000), *Torts* (Aspen Law and Business, 1999), *Principles for a Free Society: Reconciling Individual Liberty with the Common Good* (Perseus Books, 1998), *Mortal Peril: Our Inalienable Right to Health Care* (Addison Wesley, 1997), *Simple Rules for a Complex World* (Harvard, 1995), *Bargaining with the State* (Princeton, 1993), *Forbidden Grounds: The Case Against Employment Discrimination Laws* (Harvard, 1992), *Takings: Private Property and the Power of Eminent Domain* (Harvard, 1985) and *Modern Products Liability Law* (Greenwood Press, 1980).

Professor Epstein has written numerous articles on a wide range of legal and interdisciplinary subjects. He has taught courses in civil procedure,

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Fairness in a Liberal Society

Two notions of fairness

The concept of fairness is both elusive on the one hand and well-nigh indispensable on the other. On particular occasions, I devoutly wish that the word would be eliminated from the English lexicon, which is a bit like hoping to hold back the tides with a wave of the hand. On other occasions I have been tempted to treat the notion of fairness (or its close cousin, justice) as an intellectual trump card that sweeps all opposition aside.

To frame this lecture, therefore, I shall begin by looking back at two moments from what could be called 'The intellectual odyssey of Richard Epstein'. Twenty-five years ago I was having lunch with the late George Stigler, the Nobel laureate in economics, known to all as the quickest wit in economics. I was criticising some body of thought and I finished with a grand flourish by saying, "This person does not have the slightest idea of what is meant by fairness". Without so much as a pause, Stigler added, "either".

Stigler's point was that if I were depending on an idea of fairness to advance my argument, then my comments were of little more worth than those of the person I was criticising. After all, Stigler was a relentless efficiency-oriented economist who thought that introducing fairness into any argument was a sign that the basic position was morally weak and problematical. He believed that arguments about social welfare needed to rest on tighter, more operational concepts and definitions. I was suitably chastened by this amusing one-word refutation to rein in some of my early enthusiasms.

The second event, perhaps a decade later, took place at a conference on liberal ideas sponsored by the Liberty Fund. At one meal, I sat next to an English professor from Wofford College, whose name, alas, I cannot

remember. By that time, I had become more economically inclined in my own thinking and I recited a number of economic arguments to him about the efficiency of contracts when measured against the Paretian criterion (situation A is better than situation B if everyone in A is at least as well off as in B, and at least one person is better off). He listened and looked at me oddly. I do not think he disagreed with the propositions that I was defending but he clearly objected to my style of presentation, because he said, "Young man, if I played a videotape of your arguments to any jury in the United States, I could have you civilly committed". His point was that a relentless economic parsing of social issues was offensive to the moral sense of ordinary individuals, and tended to undercut the very social objectives I sought to achieve. He said human beings do not operate like that. The only thing they understand when they interact with one another, he maintained, is a core concept of fairness.

There is a strong lesson that can be extracted from these two vignettes. Many operational and descriptive ways of dealing with economic issues are powerful and useful. There are also strong moral intuitions associated with and bundled around the use of the term fairness. Sometimes, to have a complete and compelling understanding of a problem, we must take economic conceptions of efficiency, translate them into notions of social welfare, and then express them in terms of fairness that laypeople can understand. We could say that both George Stigler and the English professor from Wofford College are wrong, at least in part, but they are also right, at least in part.

The references made earlier to the Pareto criterion are capable of this transformation. When comparing two potential states of the world, economists will prefer the second state to the first if no person is worse off in the second than in the first state and at least one person is better off in the second. That is a so-called Pareto improvement. When there are circumstances in which nobody loses from a change, we do not want to call the first state fair and the second state unfair. We do not want fairness to be invoked to reduce the potential satisfaction, happiness and well-being of individuals. In this case, we have to avoid lumping people all together into some anonymous mass. Each person, in a nice Kantian fashion, counts as an end in themselves, and the cleverness of this criterion is that we rely on productive gains to make

sure that no one is forced to sacrifice their welfare for the benefit of others. Armed with this conceptual test, we can then see how concrete cases play out under different legal rules, after which we can assess how any rule works in terms of the welfare of the individuals making up the group. If all do at least well as before, then we can make statements about the whole that respect the individual dignity of each person. Then the gap between moral intuitions – no individual should be sacrificed for the benefit of the whole – and economic theory can be successfully bridged.

To achieve this within the framework of classical liberal theory, it is useful to use as headings the four hot topics that arise in any consideration of this theory. The first is the question of fairness with respect to individual rights to self-ownership and ownership of property. The second is how fairness relates to the voluntary transfer of property or services between individuals. The third concerns the protection of individual entitlements against the aggressive actions of others. The fourth is how to decide whether the distributions that result are fair or unfair.

In effect, I shall start from the beginning by figuring out how anybody acquires rights to anything. Then we can slowly work through the process of exchanging and modifying these rights until we reach a larger judgment about the social distribution of resources that is amenable to analysis under the banner of fairness.

Individual rights

The classical liberal approach to fairness in initial entitlement was summed up by John Locke, who famously said that, "Every man has a property in his own person. This nobody has a right to, but himself. The labour of his body and the work of his hands we may say are properly his". Note that there is a certain equivocation as to whether we call these elements private property in the sense of a book or a house, but it does little good to delve into the philosophical conundrums that arise in trying to explicate the notion of self-ownership. The key features of exclusivity and use of one's labour are what matters, not whether we call this an autonomy or a self-ownership claim. The key point for these purposes is that Locke believed that the particular endowments we

receive at birth belong to us as individuals, and we are each entitled to their exclusive use. This concept of fairness has an enormous appeal to people who believe in self-ownership and self-determination.

However, this position has not escaped all challenge. Most notably, we must consider the rival conception of John Rawls, who believed the uneven distribution of such natural attributes should not be celebrated, but first criticised and then altered. Some people are born smarter and healthier than others. Because such endowments are not allocated in accordance with any human-generated central plan or intelligible moral principle, Rawls believed any system of law based on these natural accidents of birth was morally arbitrary.

Both of these conceptions of fairness have enormous contemporary influence. How do we decide between them?

We cannot examine the nature of rights that people have against other individuals solely at an abstract level; we have to consider the more concrete inquiry of what legal regime could be used to enforce and defend individual entitlements. Thus, we discover that Locke's conception is much more practical than that of Rawls. Under the Lockean approach, individuals own their labour, so it is simple to work out who may transact with whom. If you want to hire the labour of X, then go to X. There are no third-party claimants who can say, "You cannot enter into this transaction because you are disrupting an entitlement of mine".

If we adopt Rawls's attitude that it is unfair to allow luck to dominate, or indeed to have any role in determining human entitlements, we need a principle of rectification to guide us in our costly efforts to eliminate the morally arbitrary consequences of nature's allocation. But what is that principle? Answering this question requires a very different concept of justice from that of corrective justice, which, dating back to Aristotle, invokes the sensible notion that when you commit a wrong against me, I am entitled to redress against you. One person is not allowed to change the balance of entitlements of another individual unilaterally. The original distribution of rights in a Lockean world confers autonomy. Physical invasion or the coercive alteration of rights upsets that balance. The person who takes (or destroys) can be asked to compensate for the injury to person or property. Most people

understand this notion fairly well, and it tracks well any sensible global conception of economic efficiency or social welfare in the sense that it is hard to see some social misallocation of resources that arises if the principles of corrective justice are consistently and properly applied.

But this simple system of rectification breaks down within the Rawlsian moral universe. When it comes to the endowments that occur at birth, there is no wrongdoing, so it is unclear against whom disadvantaged individuals have a claim. There is no one person who stands out, so that the form of redress must be collective. But how is that collectivity defined? People in the immediate vicinity? Everybody in the world who is better off? If two people are relatively unfortunate but in the same group, should the less unfortunate pay something to the more unfortunate, even though both may be entitled to collect something from a third party more fortunate than either? A huge number of transactions would be required to unravel the consequences of bad luck, leaving members of a society little or no time to engage in productive activities. The first order of business becomes redistribution, which is almost always a mistake if you do not produce anything worth taking. I have made the point when speaking about flat taxes that a society should worry about production first and redistribution last.[1] Rawls gets this the wrong way around.

However, the classical liberal position does not conclude uncritically that Locke is 100 percent correct. Locke's prescription is relevant as a matter of law, but the classical liberal position carefully draws a distinction between legal duties and moral duties. There is nothing to stop individuals who are advantaged in the natural lottery of birth from giving something to people less fortunate in ways that help advance some fraction of the Rawlsian agenda. These acts of assistance are not legally enforceable; nor, however, are they left as a matter of whim and taste. The classical liberal position is that this moral duty fits into a category known as 'imperfect obligations' whereby everybody who is fortunate has an obligation to help people who are less fortunate.

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1 See Richard A Epstein (2005) *The Case for a Flat Tax*, New Zealand Business Roundtable, Wellington.

Imperfect obligations are enforced by conscience and social convention, not by legal rules. People can discriminate and pick the individuals or charity of their choice, but they must do something to remain in the good graces of their fellow citizens.

A sceptical response is that everybody likes to talk about a 'moral duty' but nobody does much to discharge it. However, if you look at the great philanthropic institutions of the United States and elsewhere, you see that most were formed in the late nineteenth century by people who took imperfect obligations extremely seriously, for moral and religious reasons. Names like Rockefeller, Stanford, Carnegie, Sloan and, today, Hewlett, Packard and Gates, are not only associated with huge financial success, but also with thriving charitable institutions. With such a high degree of compliance with so-called imperfect obligations, this category cannot be dismissed as devoid of meaning. We should encourage a system that allows people to generate huge amounts of wealth but also provides the means to secure a better distribution of it. The Rawlsian conception should not be simply dismissed, but the redistribution of natural entitlements should be through social rather than legal means. In respect of legal rights and duties, the Lockean concept of individual entitlement is the only one that allows the work-a-day business of the world to proceed.

Voluntary transfer

Justice in transfer is extremely important in any society because, unless trade is allowed, individuals will not be able to get the benefits of cooperation or the division of labour. The feasible level of production in such an autarkic universe is far lower than when cooperation and voluntary exchanges are facilitated.

The concept of fairness that arises in an exchange economy is one based on the proposition that if the pedigree of a particular title is secure then subsequent entitlements created by voluntary exchanges are just as valid as the original set of entitlements established under our first heading. If I own my labour or a particular piece of property and I enter into a bargain with you, you thereby acquire rights that I had. My rights were good against the rest of

the world (which is the force of the test of exclusion); yours therefore are every bit as good, for we do not want any transfer between A and B to have the unfortunate consequence of reducing the sticks that are otherwise contained in the transferred bundle of rights. Given the preservation of rights through transfer, one good deed begets another, because people can combine voluntary transactions in any endless sequence. On average, these transactions will be win-win for their participants so, over time, and across persons, a very high level of productivity will be encouraged. Classical theories of property rights always use notions like 'prior in time, higher in right', which is essentially a way of saying that interlopers cannot upset a pre-existing title. In so doing they reinforce the point that voluntary transfers are fair as between the parties in ways that dispossession and misappropriation are not. No liberal social order can function unless it jealously guards this view of the world.

There are several ways in which the critics of classical liberalism attack this concept of property rights. One approach is to ask what counts as a voluntary exchange. Within the classical liberal tradition, transactions tainted by fraud, duress, or incompetence may all be set aside on the grounds that the presumptions of mutual gain are not likely to be satisfied: people are better off yielding to threats than succumbing to violence, but they are better off still if they never have to face these threats in the first place. There are huge bodies of law governing the details of defective contracts. All I want to do here is to note the legitimacy of this broad collection of rules that may override contracts, not to explore their many intricacies.

But what of the situation where someone who wants to enter into a voluntary transaction is faced with a monopoly on the other side? The situation is surely not as perilous as one where force and deceit are used. Nevertheless, the presence of a single seller is not likely to create a situation that makes for a fair exchange. Although antitrust is an enormously complicated field, generally the classical liberal position is to accept some restrictions on bargains when there is just one supplier, otherwise bargains entered into in distress situations could be extortionate. The most famous cases involve admiralty salvage of sinking ships. Here, the salvager has the whip hand, yet the nearly universal practice is to limit the gain to some multiple of

costs plus reasonable profits, taking into account the down time of potential rescuers. Nor do these cases stand alone once this chink in the theory of voluntary exchanges has been recognised. Yet the moral is clear. Figuring out the ideal terms of exchange with single sellers is tricky business. The best way to avoid expropriation is to create a set of initial conditions in which people have alternatives so that monopoly power is quickly undermined.

Another way in which people try to attack voluntary exchange is to insist that the same problem of arbitrariness associated with initial entitlements also applies to subsequent transactions. If I buy one share of stock from Company X and you buy one share of stock from Company Y, each of us may bear the same risk at the time of purchase. However, my share price goes through the roof, whereas yours falls through the floor. The argument is made that my gain was just dumb luck and that something should be done to redress the imbalance of fortune when equally prudent voluntary transactions do not turn out 'fairly'.

This is a dangerous line of argument. If we examine the case on a transaction-by-transaction basis, imbalances of this sort will always arise, so that the security of transactions is undermined in a surging sea of regret. If you look at a set of transactions, fortune will always have a bearing on whether a stock goes up, a job works out, or a marriage is successful. It is nearly impossible to figure out how to separate merit from luck in each case; attempting to do so would dissipate an enormous amount of work and effort. Therefore, in individual cases we should not be concerned that the outcomes are not necessarily those that the parties themselves wanted or expected. Instead, the parties taking risks should try to diversify them so their luck is not wholly tied to a single transaction. In financial terms, the rule would be to buy a mutual fund if you are not in a good position to bear risk, not a parcel of shares in a single company. Self-help beats legal redress every time.

Some make a further argument. While they accept that individual transactions cannot and should not be unravelled, they suggest we look at results periodically, say at the end of each tax period, and compensate individuals for their lack of luck. That can be done more easily through the tax system, it is argued, than on a transactional basis. The point is true enough, but it is hardly reason to go down this particular path, for although

the task is easier, the basic approach is still misguided, because it undermines a sensible flat tax that is desirable on so many grounds. Even when a range of transactions is examined, you cannot completely attribute differences in wealth to luck. Some may be a result of superior skill and acumen. It is impossible to disentangle the relevant factors. There may be a case for overall income redistribution but I think the effort to redistribute luck will fail, whether on a transactional or a periodic basis. The classical liberal position remains the same: the person who has enjoyed good fortune and acquired wealth is the person most subject to imperfect obligations to make voluntary transfers. Coercion is not justified to that same end.

Protection of entitlements

When we come to the protection of entitlements, it is important to recognise that the word fairness can be used in multiple ways. Some of them bear on the same issue of the relationship between luck on the one hand and the rules of the game on the other.

A wrongdoing in tort law arises because someone encroaches on the person or property of another. We can understand the role of luck in this situation by thinking of it in terms of an ordinary sporting contest – say, baseball. In this game a fair ball is one that is in play and a foul ball is one that is out of play. Boundary lines, easily observable, separate fair from foul. Suppose somebody makes a tremendously skilful hit but the ball goes foul by just one centimetre. Should the umpire say, "the player made a wonderful effort and it was very unlucky that the ball went foul, so we will rule it to be fair"? Obviously, the game could not be played if the observed outcomes were tampered with in that way. Either everybody follows the outcome-based rules or they abandon the entire game. This implicit conception of fairness negates any appeal to luck. In all cases, the umpires should call a ball outside the boundary lines a 'foul'. There is a strong sense of integrity associated with fairness in this situation.

We can use exactly the same approach when it comes to tort law. If you happen to harm somebody, despite taking all the efforts in the world to avoid doing so, you still must pay. If you are extremely careless but by luck happen

not to hurt anybody, you do not have to pay. These strong and relatively clear principles of boundary crossings can be administered in a sensible way. Incentives to take care will not be distorted because they are determined by the *ex ante* probabilities of harm occurring. In general, risky behaviour will produce harmful outcomes, so that people have the right incentives to take care before they know the roll of the dice in the particular case.

Fairness in boundary crossings does not just apply to physical injuries to an individual but also arises in competitive settings. Here, two rivals are trying to get the custom of a third party. The question is, what counts as unfair competition?[2] The first problem one has to confront is whether the word 'fairness' in this setting is simply as vapid and open-ended as George Stigler might have postulated. I think it is not. Within the common law tradition, the idea of unfair competition has a precise meaning that is perfectly consistent with classical liberal theory.

Misinformation that reduces the effectiveness of consumer choice is a wrongful activity. If you and I are both selling products and I say your product is inferior to mine when it is just as good, this is a form of misrepresentation designed to induce third parties to do business with me when, if fully informed, they would be equally willing to do business with you. Consumers may sue me on the grounds that they were misled, but often the loss will not be large enough for them to make a fuss, given the high cost of a law suit. Therefore, the competitor who has been prejudiced by my wrongful statements is often in the best position to sue me as the party responsible for them. In terms of classical liberal theory, which invokes state action to punish force and fraud, such matters count as fraud in the context of competitive industries. After all, this misrepresentation is not the same as my offering my own goods at a lower price or on more favourable terms.

The same is true of a passing-off situation where I pretend that my goods are your goods. I am still misrepresenting something that matters both to consumers and my competitor. As the competitor whose goods have been

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2 Richard Epstein deals with these issues at more length in his book, *Free Markets Under Siege: Cartels, Politics and Social Welfare*, New Zealand Business Roundtable, 2004.

misappropriated, you should be entitled to stop me from doing so. The notion of unfair competition obviously has a perfectly coherent foundation even in market settings. The real question is, should it be extended further?

One of the greatest dangers to civil liberties in the world is the idea that a competitor can maintain that a rival is engaged in unfair competition solely because the rival's prices are lower. That definition of unfair – or worse, ruinous – competition has been used in countless cases. The potential expansion of the scope of liability is enormous because every successful competitor could be subject to an unfair competition charge.

To see that this is a groundless cause of action we must distinguish between two types of impact. From the point of view of a consumer, misinformation and passing-off cases reduce options, whereas the newer breed of 'unfair competition' cases actually expand them. The buyer has the choice of two products, one at a reduced price. (One should never talk about this kind of harm as though it were a real, actionable injury.) Competition keeps the economic world going round. It cannot become the paradigmatic wrong solely because there is always a disappointed competitor licking their wounds.

How much further can we take the idea of unfairness in market transactions? Suppose two sellers get together and agree to raise their prices. Is that unfair? In fact, the issue is more one of economic efficiency than equity. When monopolies are formed, prices are raised and output is reduced – it is not just a transfer of wealth from one group to another but a diminution in the overall wealth of society. The hard question is administrative: is the problem so great that a huge body of antitrust law is required to deal with it? Does the possibility of allocative losses justify the costs and risks of regulatory interventions, including the potential loss of dynamic efficiency? I do not propose to resolve that issue here, but simply to note it as a major conundrum.

Distribution

For the purposes of wealth creation, the classical liberal model works fairly well. Acquisition of property rights is well defined. There is a strong set of rules on voluntary transfers. Competitors cannot elbow one another aside unlawfully. This brings us to the question of how to think about distribution.

Let me start by talking about unfairness in distribution in a way that seems to me thoroughly consistent with the classical liberal tradition and has an enormous amount of traction, at least in ordinary discourse. Suppose you are in a position of power and you have relationships with multiple persons in a like position – they could be your children in a family context, your employees in a business context, or your shareholders in a corporate context. The fairness question is whether it is fair or unfair to engage in differential treatment of people who have the same relationship to you. If a corporation has two shareholders – to take the simplest case – and declares a dividend to one but not to the other, then it is engaging in unfair conduct. Treating like cases alike is an important aspect of fairness. In the case of shares, we focus on people in their role as shareholders and ignore all their other characteristics.

Why do we have such a powerful intuition in this case? I think the answer is that the moment you have unfair treatment between people in identical positions, it can rightly be regarded as a taking. If two people have shares worth $100 and the company pays $50 in dividends to the first and not to the other, in effect, that is a taking of $25 from the second person: one person now has a total value of $125 and the other of $75. When you allow one person to take from another, you distort the entire investment process. Investors will not put money in when they think the game is rigged.

There is a powerful heuristic that says equal treatment for shareholders in the same class is a strong method of guarding against illicit transfers within a firm. Perhaps half the body of corporate law is nothing more than an effort to make sure that such situations are avoided in corporate reorganisations, takeovers and going-private transactions. This notion of fairness has enormous attraction, precisely because it corresponds to the sort of efficiency justifications associated with private property.

When you move from the company setting to employment relationships, the arguments become trickier. Let me recount a story I heard on a visit to a German university. An eminent economist and psychologist were talking about the complicated problem of relative preferences – the issue of whether, when one person gets richer and another does not, the poorer person feels even poorer because the gap between them has grown larger. Their conversation had

nothing whatsoever to do with that conception in the abstract. They were complaining because a newcomer to the university, who had not written half the number of papers that either had written, had joined the university and was being paid more than either of them.

People get indignant in such circumstances because they see themselves as victims of the kind of implicit wealth transfers that can occur between shareholders. Incentives are ruined if those who contribute more to a common enterprise get less. In such cases, people will either exit, or be resentful until the situation is fixed. The concern with inequity is tied to the illicit transfer of wealth in a setting where contribution and reward were out of step with each other.

The question that arises is whether to give legal protection to this intuition of fairness under the maxim of 'equal pay for work of equal value'. I think the motivation is valid but that to resort to legal remedies would be unwise. Corporate shares may be perfectly fungible but people are not. A judicial or administrative system that attempts to make a judgment about whether employee A is overpaid relative to employee B will face a series of comparisons that no neutral body can possibly evaluate. The sensible approach is to understand that in a flexible labour market the situation will be handled in one of two ways: either the firm will make adjustments, or people will quit. The threat of staff leaving will generally be an effective way to control against such problems.

Academics tend to be more preoccupied about relative incomes than other people. But all too often they miss the fairness claims that resonate in the rest of society. It is instructive that a university secretary may get extremely upset if another with a comparable workload is being paid more, but the secretaries as a whole are not particularly upset that the professors – to take my line of business – receive higher incomes for a rather different line of work. They understand the nature of pay scales. When they see the large pay gap between secretaries and professors they do not see any implicit danger of illicit income redistribution or cross-subsidy among people in the institution. They do not know whether it is the ideal gap, or whether it should be larger or smaller, but they do not have the same sense of unfairness that arises when there is a gap between what they earn and a co-worker in the same position earns. Indeed,

far from generating a feeling of resentment, these kinds of disparities create the opposite attitude in many cases. If you happen to be in a firm with a dynamic leader who is creating enormous value for the firm, you will want and expect that leader to get richer because you will benefit too, even if the gap between your income and that of your leader gets larger. In these settings envy turns out to be a losing emotion, and it seems unwise to set up political arrangements that seek to legitimate it.

Yet, for every liberal concept there is an alternative concept of fairness. One such alternative is based on the idea that differences in wealth, no matter how they come about, are at least suspect, because the marginal dollar is worth less to the rich person than to the poor person. The classical liberal theory of fairness produces tension because, although people might accept its premises in respect of the acquisition of original rights, transfer, protection, and distribution within the firm, when they see the ultimate outcomes they may want to shrink from their own theories. The great question that I will leave unresolved is whether the theory of imperfect obligation is strong enough to handle systematic wealth differences, or whether some social mechanism of forced redistribution is called for in a civilised society to underwrite a certain minimum living standard. I think this last claim is intuitively strong when considered in the abstract but much weaker when looked at in its institutional context. When you have strong moral intuitions of fairness that you cannot effectively translate into legal rules, is it better to rely on voluntary compassion or to invoke the machinery of forced redistribution? Neither approach, nor some combination of them, is perfect. Deciding on whether to give expression to concepts of fairness through private or public welfare is one of the thorniest problems in contemporary social policy.

Questions

The notion that fairness requires some sort of settlement when relationships break up is very resilient. Unfair dismissal laws have emerged even where the classical liberal tradition would view employment as a matter of contract and frown on outside adjudication of the fairness of dismissals. There is another area where, in New Zealand at least, there has been substantial outside interference, with little pressure to change the law, and that is in marital break-up or property settlements. No-fault divorce came in a long time ago and now we have nearly automatic 50:50 division of property. Yet everyone knows that in many marriages there is a gross imbalance in terms of what has been put in and taken out, not to mention responsibility for the marriage break-up. How should we understand the concept of fairness in these situations?

I think there are some very important differences between the employment case and the marriage case. Marriage, at least at the time of divorce, is a bilateral monopoly whereas labour markets are competitive. The reason I am deeply suspicious of efforts to make *ex post* readjustments in labour markets is that it is enormously difficult to determine whether the dismissal is just. The moment a government makes dismissals complicated and costly, employers become unwilling to hire high-risk people and you hurt the very group of people you are trying to benefit.

On the marriage question, there is a great piece of work in the 1987 *Journal of Legal Studies* by a friend of mine, Lloyd Cohen, called 'Marriage, Divorce, and Quasi Rents; Or "I Gave Him the Best Years of My Life"'. (Clearly the first part of the title would appeal to Stigler, and the second to my friend from Wofford College.) Cohen takes the typical marriage (as of the 1980s) and

assumes that the greatest inputs in the early years are made by women as they put their husbands through higher education. If he dumps her for someone younger when he starts earning money, his actions might be regarded as a form of misappropriation of her labour for his own advantage.

If we do not know exactly what the inputs are but we are pretty confident that there is some kind of sequential apportionment, it is better to adopt the simple 50:50 rule than make endless inquiries into fairness. An analogy in the labour market, even under common law rules, is the case of a commission salesperson who has drummed up some business. If the person is fired before the payment is received (and is thus deprived of the commission), the courts will grant redress in the form of a remedy equal to the value of services rendered, usually measured by the standard commission scale within the firm. This, too, is a case of sequential performance where the first to perform has to be protected against the default of their trading partner.

Sequential performance is not the right principle in all marriage relationships. There are cases in which the paradigm does not work at all, particularly with second marriages or in cases of first marriages where one or both parties come with enormous amounts of wealth. Often in such situations there are pre-nuptial agreements to avoid the problems of bargaining breakdown in the event of divorce. As one might expect in so sensitive an area, there is some *ex post* willingness on the part of courts to undo pre-nuptial agreements on the grounds that they are not fair after the fact. Divorce lawyers hate that. They tend to the view that in these cases contracting works fairly well and *ex post* readjustment does not normally make sense. There are other grounds for departures from a 50:50 rule. A common illustration involves a party who owns property that was separate before the marriage, which was kept separate during the marriage, and then left out of the settlement on the grounds that it belongs to the original owner rather than the joint enterprise. There seems no reason to override on divorce the consistent judgment to keep the property separate during marriage.

The basic problem in all these divorce and dissolution cases is that only two parties are involved in the break-up, so there are tensions. Relationship property is created in very uncertain proportions and through non-market

transactions, so it is very difficult to determine fair divisions. I think the 50:50 rule is not a bad one. The truly disastrous alternative is the old (orthodox) Jewish rule that break-up requires mutual consent. The rule means that if one party desperately wants out of the marriage, they can be held to ransom. The 50:50 rule avoids the blockade problem. It may create a misallocation, but that is sometimes inevitable with bilateral monopolies. There is no rule that does not involve breaking some china in particular cases and my judgment is that the even-split rule does a better job on simplicity and fairness grounds than its alternatives.

I wonder if you would care to comment on historical justice. You talked about the establishment of property rights and how they open up a series of voluntary trades, but in New Zealand we have the situation where a dislocation can occur as a result of Treaty of Waitangi claims. We do have a statute of limitations in our general law. This is an arbitrary date that in effect says, "let us forget about wrongs that may have occurred before then because to go back further would create problems that we do not have the knowledge to overcome, and if we allowed such actions, no property rights would be secure". But is it not hard for classical liberals to run that line of argument if there was a wrongful taking some time ago?

I alluded to this when I brought up the old common law maxim that 'prior in time is higher in right'. The situation becomes complicated when you have multiple claimants. Under classical theory, the earlier (aboriginal) title will always win over later titles. Therefore, within the Lockean framework, there is an extremely powerful claim with respect to Maori rights, at least where the rudiments of possession are satisfied. 'Aboriginal' could indeed be replaced by 'original' so that the right to claim title is not restricted to select groups. This highlights the affiliation between Lockean theory and indigenous rights.

Apart from inter-racial or inter-ethnic conflicts, a problem arises in any case of adverse possession (possession in breach of some property right of a prior holder). If you have valid titles and no statute of limitations you open up every title to an attack, so that over time you will harm more good titles than you will correct injustices. The further the rival claims go back in time, the greater the likelihood that they will be both unsound and difficult to prove. There

is good reason to force people to make an early declaration of rights claims so that they can be contested when the evidence is fresh.

What makes matters even more difficult is that the doctrine of prescription – which recognised the validity of claims founded on long use – is subject to the exception known as tolling, that is, a suspension of the statute of limitations because of some disability of the claimant. An example of this is where we judge it unjust to have a cut-off date because the person out of possession was a child and could not have asserted their rights until they became older. However, this process cannot go on for ever, and there is an American, English and (I think) New Zealand rule that independent grounds for tolling claims cannot be stacked on top of each other. So, if I am first too young to make my claim and then I become insane, I get the benefit of the youth exception but not that of insanity.

I think the best thing a country can do under these circumstances is figure out what the general policy should be, and then stick to it. You will run up against the argument that it is not possible to settle on a general policy because there are wildly varying arguments about the proper scope of a statute of limitations. I recommend looking at a legal system elsewhere that has had to handle this problem, examine what its periods of limitations are, and use them to guide domestic policy. That way you know the period of limitation is not opportunistic. Using this approach, the applicable maximum periods tend to be 20–30 years. Over time they have, in some cases, come down to 10–15 years, because the security of transactions has grown.

My attitude on the Maori claims issue is ambivalent. I admire the framework adopted by the Waitangi Tribunal in its report on the foreshore and seabed when it argued that holders of property rights should not be deprived of them without consent or compensation. That is a classical liberal principle. However, I consider the Tribunal extremely loose on the question of whether these property rights had been created at all. Maintaining that Maori thought they owned all of New Zealand is not a sufficient basis for a claim, for it takes more to show ownership of a particular parcel than sovereignty over the whole. To make out the latter, you have to show continuous possession and actual use of something. I suspect many Maori claims do not satisfy that test.

I think the answer is to apply conceptions of prescription that have been applied elsewhere on the grounds that every issue of justice is tempered in real-world circumstances by the difficulties of administration. Remember the two definitions of fairness that I referred to earlier – fairness in the abstract as a moral matter (the Rawlsian idea) and fairness as an institutional matter. I think the moral conceptions leave too much running room and would have adverse consequences, of which the most conspicuous would be a complete reversal of the original intention of the Treaty of Waitangi, which was to protect vested rights of all New Zealanders and create a unified society. You run the risk of creating a permanent problem of separatism by allowing old claims to be constantly re-adjudicated as if they had never been settled and were instinctively valid. The principle of *res judicata* has to apply to adverse possession and prescription claims as much as it does everywhere else.

You talked about two investors in a business putting in equal amounts of money and receiving equal rewards. But is it fair that the investors might take out more than the people producing the wealth? Should the salesperson who produces most of the wealth perhaps get paid more than the investors who put the money into the business? And why is it fair that the secretary in a university is paid considerably less than a professor if it could be argued that the secretary is worth more than a professor in terms of the business of the university?

This is a profound question because there are issues not only of investment contracts but of sequential contracts that are made by the firm after original investments are made.

The first point I made about the two investors was the presumption of parity. I should add that in any partnership or company, that presumption can be modified so as to give unequal stakes, and, in fact, sophisticated capital structures are designed to take asymmetry into account, especially when there are in-kind contributions of property and labour.

The pair of investors in effect enter into a contract with the salesperson (perhaps through executive management) and the issue the contract raises is how to overcome the problem of agency costs. A salesperson is putting in the effort to make a particular sale. If the individual gets all the benefits from the

sale, no firm will exist. Hence, the salesperson must receive a reward large enough to induce effort but small enough to leave a residual for the firm.

At that point it is a straightforward matter of contract between the firm and the salesperson. Compensation scales can take many different forms. A common method is for the salesperson to receive a base wage and a commission. The wage element is designed to protect the salesperson against a slow period and the commission is to provide incentives to perform.

Does the salesperson or the firm receive more? Knowing the structure of the arrangement does not answer the question. If the firm loses 50 percent of its capital value, the salesperson will still receive a fixed wage and commissions, and the investors will lose 50 percent of their money. The whole point is that the risk-return profiles for investors will differ from those for employees because the investors can put their capital elsewhere and diversify their risk, whereas workers, for the most part, find it harder to diversify their human capital.

My comment about secretaries was only half the story. If you look at universities, the biggest complaint that you hear from large numbers of faculty members is about the so-called 'star' system. There are a few professors who have such stellar reputations that universities will fall over themselves to hire them and offer lighter teaching loads, simply to say that they are on the faculty. This will help the university to raise money from alumni, attract students and so forth. The universities that pay these high salaries see themselves as having won something, not lost, even though they might pay somebody 50 percent more for doing half the amount of teaching.

This suggests that in the professorial business some high-profile faculty have a drawing power for which there are few, if any, substitutes anywhere in the market. In the secretarial business, on the other hand, an advertisement for a vacancy at existing salary levels might net 20 applications the next day. When the number of close substitutes available for a particular job is numerous it keeps wage levels lower than they might otherwise be, which is an essential signalling device in a well-functioning labour market. Ignore that signal and you end up with unemployment and an inefficient economy.

The really strong contribution of the classical liberal theory in employment markets is that it provides a principle for allocating a scarce economic resource. If we dropped that market mechanism for a principle of pay equity or comparable worth, any contract could be overturned if the terms were not in accord with somebody's – we never quite know whose – view of what they should be. The instability created would destroy the labour market's operations.

The genius of the market system – I think that term is more accurate than capitalism, because multiple sources of wealth creation, not just capital, are involved – is that it provides a way to organise inputs voluntarily so as to maximise the output of the economy. Certainty in contracting is a prerequisite for encouraging investment. We would be unwise to upset that in the hope of getting some higher distributional gains.

Even people who believe in a vision of minimum entitlements for everybody want to have the wealth creation game run its course, and then subsequently look at redistribution through the tax or welfare system. That is the sensible, smart, social democratic view – Bill Clinton, Laurence Summers and Robert Rubin are all from that particular school. The debate on that issue is much closer than it is on the prior question of facilitating secure transactions. In the end, I am in favour of lower taxes and less redistribution than the social democratic school, but it is a real issue that requires argument. However, I am sure that examining and modifying each transaction individually through a redistributionist lens is the road to administrative and social chaos.

Vote of Thanks

Roger Kerr

I asked Richard Epstein to deliver this lecture because I believe we do not articulate issues of fairness well in this country. I am a strong supporter of fairness in the sense that New Zealanders on the whole relate to it. The idea of a 'fair go' is one that we all consider very important, and rightly so. However, we have not been in the habit of thinking rigorously about what fairness means for policy. In many debates over the past 20 years, those who have opposed moves to a freer, more open and competitive economy have sometimes grudgingly accepted that such an economy would improve material standards of living, but have complained of some 'fairness deficit'. I believe that they have been on the wrong side of fairness arguments too. Things like the introduction of fees for higher education can be justified on many criteria but one of the most obvious is that it is fair. Those who typically come from more privileged backgrounds and go on to earn higher incomes in later life should pay a decent share of the costs of their tuition, instead of having taxpayers, some of whom are on much lower incomes, fund it for them.

Another of Richard's lectures was about the case for a flat tax. We all know the arguments for a single rate of tax based on the efficiency and administrative simplicity of such a regime. However, fairness arguments for a flat tax can be invoked as well. It turns out that the arguments for progressive taxation are motivated by envy, not any justifiable concept of fairness. Advocates of moves towards a lower, flatter tax scale should be on the front foot using fairness arguments too.

The New Zealand Business Roundtable's initial contact with Richard was in the context of the arcane structure of regulation that had grown up around our labour market. Of course, that had produced a less efficient and productive economy, but it also fenced many unemployed and marginal workers out of the labour market – whether through regulated wages or rules about dismissals that made employers risk-averse in hiring. In other words, the employment regime was profoundly unfair.

These arguments about fairness led the Business Roundtable to commission two very competent academics, one Australian and one American, to write a book about equity as a social goal.[3] We have followed that initiative up in various ways, including by asking Richard to address the topic of fairness today. He has provided us with another set of arguments to use in the debate.

This might be the last opportunity on this visit of Richard's for me to say how enormously grateful we are for all the help, advice, insights and time he has so generously given to us and others in New Zealand since our first contact. Without question, Richard is among the line of pre-eminent scholars who have made immense contributions to the case for a liberal society over the last 200 years. I believe his books will be read in 100 years' time. Today, we have been in the presence of one of the most outstanding thinkers of our time from anywhere in the world. It has been wonderful that Richard's wife Eileen and their children have accompanied him at different times on his visits. We have had a wonderful family relationship – and I use family in a very broad New Zealand sense – because so many people in this country have had the gift of the association with the Epsteins through these visits.

Richard, I want to thank you for another highly informative lecture. We certainly hope to see you again.

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[3] See Cathy Buchanan and Peter Hartley (2000) *Equity as a Social Goal*, New Zealand Business Roundtable, Wellington.