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## COOPERATIVE SURPLUS: THE EFFICIENCY JUSTIFICATION FOR ACTIVE GOVERNMENT

CHARLES H. KOCH, JR.\*

In his paper here and in several other recent works, Professor Epstein has argued for strong constitutional protection for economic liberties. Economic liberties are as important to him as other liberties protected by the Constitution and, as discussed in his paper, implicate those other liberties.<sup>1</sup> Government infringement on economic liberties may infringe also on fundamental freedoms, here religious freedoms.

I find that Epstein's zeal for economic freedom ignores the very purpose of our joining together into a cooperative society. We, as a people, entered into what eighteenth century political philosophers called the "social contract"; or, more realistically, each of us accedes to being governed, if we have any sense, because joining a society creates a "cooperative surplus" from which we all may benefit.<sup>2</sup> A necessary condition for gaining that surplus is that we relinquish some individual freedom.<sup>3</sup> Both economic and noneconomic freedoms are implicated, but accepting restraints on economic freedom may pay larger dividends for society *and* the individual.

We must recognize at the outset that one cannot attack Epstein's zealous defense of economic liberties for improper motives. Any survey of his publications, or personal conversations for that matter, establish impeccably humane motives behind his view. For him, protection of economic liberties, as with other liberties, expands the value of our society for all classes or groups. Infringement of those liberties as well as others on behalf of a current ex-

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1. Epstein, *Religious Liberty in the Welfare State*, 31 WM. & MARY L. REV. 375, *passim* (1990).

2. See generally T. HOBBS, *LEVIATHAN* (E.P. Dutton & Co. ed. 1950); J. LOCKE, *THE SECOND TREATISE OF GOVERNMENT* (J.W. Gough 3d ed. 1976).

3. See *supra* note 2.

pedience harms everyone, even when the social goals of such action are ones with which he would agree.

In short, Epstein advocates the social value of the economist's sense of efficiency. Efficiency makes the pie bigger and we all potentially benefit. President Kennedy offered a more folksy expression of the same principle: A rising tide raises all boats. Even Marx recognized that capitalist efficiency increases wealth throughout the various classes.<sup>4</sup> Thus a commitment to this sense of efficiency is a commitment to improving the position of all economic groups.

Economists, in general, caution against short run expediencies that adversely affect efficiency. Nonetheless, even a fairly strong market economist might accept government intervention that regulates "externalities." "Externalities" are costs or benefits accruing to those outside the transaction and hence not included in the "price" of the good.<sup>5</sup>

Economists might approach the justification for confining fundamental liberties, such as religion, in the same way as economic liberties. As Posner expressed it: "Government may not regulate these [first amendment] markets beyond what is necessary to correct externalities and other impediments to the efficient allocation of resources."<sup>6</sup> The exercise of religious liberties, for example, may adversely affect others. For example, the noise of a church bell early Sunday morning may annoy late risers. For those who enjoy the sound, the church has bestowed positive externalities. Yet Posner is referring to the regulation of negative externalities. In the case of the church bell, the negative externalities are *de minimis*. If these externalities are too great, however, such as with human sacrifice, we feel we can regulate even religion.

Epstein would, I think, find even this motivation for active government suspect. He would contend that, although this seems sound in theory, we often make the judgment to regulate poorly. Hence, in our attempts to constrain the negative aspects of the exercise of a freedom, we in fact diminish the aggregate value of that

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4. R. WOLFF & S. RESNICK, *ECONOMICS: MARXIAN VERSUS NEOCLASSICAL* 128-29 (1987). Of course, he also contended that as this greater wealth was spread to the working class it became a means of increasing exploitation. For him, a more equal, but "poorer" society, is more just. *Id.* at 183.

5. See R. POSNER, *ECONOMIC ANALYSIS OF LAW* 62 (3d ed. 1986).

6. Posner, *The Law and Economics Movement*, 77 *AM. ECON. REV.* 1, 12 (1987).

freedom. In questioning our ability to regulate all liberties, he suggests that we have the same problem evaluating the effects of externalities when we are controlling economic liberties as we do with respect to first amendment liberties. Government manipulation diminishes our aggregate economic welfare, and probably results in a uniform lessening of all welfare, including our spiritual, political or social welfare.<sup>7</sup>

On the other hand, the argument for active government has strong moral and humane overtones. Government action that affects economic liberties works "transfers," either indirectly by regulation or directly by welfare benefits. In economics, a "transfer" is a redistribution of wealth that has no productive purpose.<sup>8</sup> In contrast, an exchange that moves goods to the highest valued user is distributionally efficient and increases aggregate wealth.<sup>9</sup> A productive exchange motivates productive activity and is efficient. A transfer, however, merely moves wealth around with no benefit to society and with significant potential to actually diminish aggregate wealth.<sup>10</sup>

The purpose of government-compelled transfers is the movement of wealth from advantaged segments of society to disadvantaged ones. In addition to the humanitarian justification for such transfers, one can advance an efficiency sounding argument: The transfers do not increase aggregate wealth, but they do increase aggregate utility. Assuming a diminishing marginal utility of money,<sup>11</sup> a transfer to one with less money will make that money "worth" more in the hands of the disadvantaged. For example, if government takes \$25,000 from a millionaire and uses it to provide food and housing for five people, the value of the food and housing is greater than the value of the second BMW the millionaire would have purchased with that money.

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7. Today, the relative state of planned economies versus free market economies and the people served by those economies provides impressive evidence supporting economic freedom.

8. See R. POSNER, *supra* note 5, at 7.

9. *Id.* at 10-12.

10. A. POLINSKY, *AN INTRODUCTION TO LAW AND ECONOMICS* 7 (1st ed. 1989).

11. This is a debatable proposition. Rich people may in fact value money more than poor people.

Again, Epstein would doubt the government's ability to undertake these transfers in a way that would in fact increase even utility. Political considerations are likely to distort our judgments on these transfers. Perhaps more importantly, the administrative costs of transfer programs divert wealth to politicians and bureaucrats in a way that diminishes society's aggregate wealth so much that utility cannot be increased sufficiently to compensate for these losses.

These arguments against active government are strong and caution against precipitous government interference in natural market processes. Depending on one's findings as to the costs and benefits of each government program, one may take several positions on the advisability of active government. One may even take Epstein's extreme position without appearing insensitive to human values. However, these arguments about the advisability of active government are not relevant to the question of whether government should be *constitutionally* prohibited from engaging in such activities.

No matter how sympathetic one is to the pragmatic arguments against active government, it is difficult to accept what I see as Epstein's working principle that any government-compelled transfer is an unconstitutional taking of what Locke called "the product of our labor" in violation of the social contract represented by the Constitution.<sup>12</sup> The phrase "product of our labor" connotes our basic entitlement from participating in the economy—that property we earned and hence most surely deserve to hold. Epstein is justifiably concerned that government takings from the product of our labor diminish the social benefits envisioned by the Constitution.

In order to raise these arguments to a constitutional dimension, however, one must demonstrate that government infringements on economic liberties are fundamentally detrimental to our basic concept of society. My view is that not only is this not the case, but that some infringements on economic freedom are in fact fundamental to joining together as a society. This analysis hinges on what economists call "cooperative surplus."

Resort to the "prisoners' dilemma" game can help explain this theory. As you may know, if the two prisoners cooperate between

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12. See Epstein, *supra* note 1, at 388-96.

themselves in this game both will be better off. Together they will serve much less jail time, which is the cooperative surplus. Correspondingly, absent cooperation, the prisoners will be better off if an authority forces cooperation. Indeed, they would be better off paying some of their surplus to a third party who forces them to cooperate. To a large extent, that is the efficiency justification for government: It forces cooperation and creates cooperative surplus.<sup>13</sup> Understanding that government intervention creates surplus by limiting individual conduct is the beginning of an efficiency justification for an active government and the reason, I believe, strict enforcement of limitations based on economic liberties has not emerged in our constitutional law.

Let me explain by way of an example. Suppose that I work as a lawyer and am willing to do all the work I can for \$100,000 per year. Suppose, however, that my clients are willing to pay me \$150,000 per year. We each have a "threat value," or point at which we are willing to walk away from the deal: for me, less than \$100,000 and for my clients, more than \$150,000. So long as we bargain within that range, however, we will act efficiently. Economics, so far as I know, has no disciplined way of allocating the surplus and often, for theoretical purposes, assumes that the surplus will be divided equally. In reality, the surplus is divided according to such things as bargaining power.<sup>14</sup>

Assuming for now that the value of a surplus can be determined, if a third party takes the surplus, or part of the surplus, there is no efficiency loss. Say, for example, that a third party charges a fee for providing a site for the bargain. If the fee is less than the surplus,

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13. Professor Epstein recognized this point. See R. EPSTEIN, *TAKINGS: PRIVATE PROPERTY AND THE POWER OF EMINENT DOMAIN* 8 (1985). His only quarrel with the cooperative surplus theory is that the state expropriates the surplus. This is not a problem, however, if the state uses the surplus to serve the people or to generate more surplus. His dissatisfaction, then, is with the political process that allocates the surplus, not with the active government that created the surplus.

14. An efficiency reason for allowing bargaining exists, however. The bargaining process communicates each side's value, and there is rarely a better way of finding that value. We *know*, and do not even need to assume, that if the deal takes place, it takes place within the bargaining space and it allocates surplus. The bargain is distributionally efficient because the deal shifts the resource to a higher valuing user. Often missed is the fact that the deal brings about productive efficiency as well. Johnsen, *Wealth Is Value*, 15 J. LEGAL STUD. 263, 270-77 (1986). We know much less if the deal does not go through.

then the efficient bargain will still take place; the allocation of surplus between the parties will simply be smaller.

Suppose the third party is the government. At the first level, the government's taking of surplus is at worst efficiency neutral. If the government takes only the surplus, it has *not* created an inefficiency. Only when the government takes more than the cooperative surplus does it create an inefficiency. This cautions temperance and a limited concept of government intervention, but does not require absolute prohibition by making such action unconstitutional. So long as active government affects only surplus, under whatever justification,<sup>15</sup> one cannot challenge such activity on efficiency grounds.<sup>16</sup>

As Epstein suggests, the philosophical underpinning of the Constitution's efficiency aspects are rooted in eighteenth century "social contract" theory.<sup>17</sup> If you will remember my original example concerning the economics of a bargain, you will recall that the third party may gain some of the surplus because the third party creates the conditions that lead to the surplus. The social contract works much the same way.

We come together and allow others to govern us because we gain a cooperative surplus from doing so. We are rational maximizers at least in the limited sense that we will not intentionally hurt ourselves. Hence, we never accept government action that diminishes total wealth. Rather, we enter the contract to increase our total wealth by creating a cooperative surplus. Less theoretically, each of us in modern society accepts the contract and its constraints on individual liberty because we seek to participate in surplus-generating community action.

Evidence abounds that modern individuals accept limits on personal behavior in order to participate in activities having joint ben-

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15. Justification for active government may include protection of the bargaining process or enforcement of the bargain.

16. An economist finds it relatively easy to talk about this surplus as more than mere money. The cost for an economist is the "opportunity cost" or what you must give up to get what you want. If what you give up is worth more *to you* than what you want, you will not do it. The value of anything for an economist is not its dollar value.

17. See R. EPSTEIN, *supra* note 13, at 9-18.

efit.<sup>18</sup> This behavior is found even in an environment of competitive self-interest. For example, competing businesses join into cartels and agree to enforced cooperation. Indeed, antitrust laws attack this cooperation by attacking the enforcement devices.

Just as these cartels are a burden on other segments of an economy, enforced cooperation in the prisoners' dilemma interferes with law enforcement and hence is detrimental to society. Cooperation is not per se beneficial. Yet just because cooperation may have both a good and a bad impact on society is no justification for eliminating cooperation-seeking government activity altogether by constitutional prohibitions. The Constitution contemplates instead that we can trust the democratic process to search for cooperative activities that will benefit society. The fact that active government does not always achieve this result does not justify eliminating all such activity.

The cooperative surplus motivation for accepting the social contract, our voluntary participation in society, does, however, suggest a concept of economic liberties. Remember that economists may accept constraints on freedom that protect others from the external cost of our exercise of that freedom. The concept of cooperative surplus suggests another approach to the constitutional dimensions of economic liberties: The Constitution limits the government to actions that take the surplus its own enforced cooperation created.

Epstein suggests that the Constitution was intended to protect the product of our labor as defined by Locke.<sup>19</sup> Locke's influence on the drafters surely supports this view. However, the concept of cooperative surplus suggests that government action may be taking back only the surplus it created. If so, it is not affecting the product of our individual labor, but acquiring and allocating the product of our joint participation in society. So long as the government action affects only surplus, constitutional limitations on those actions are without support.

A boundary may exist at this point between a moderate view of economic liberties and a more politically liberal one. Under a more

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18. The value of cooperation is so great that even unilateral cooperation may optimize a participant's position if others are convinced thereby to cooperate also. Allman, *Nice Guys Finish First*, SCIENCE, Oct. 1984, at 24.

19. See Epstein, *supra* note 1.

liberal view of economic liberties, the Constitution might permit government action reaching even beyond the surplus. This view would find constitutionally permissible the taking of the product of our labor, our earned entitlement, for some social purposes. We may justify this broader government intervention because it is aimed at enhancing the cooperative surplus in the future. The government, in essence, takes in order to invest in the future. An even more liberal view might allow such taking on moral grounds alone.

Whenever the government reaches beyond the cooperative surplus, however, it jeopardizes efficiency values. If one believes that the Constitution protects efficiency values in some way, one would find a constitutional objection to such government action. Nonetheless, to say that such government action is unwise is easier than saying that it violates some fundamental principle incorporated in the Constitution.

The 50-year-old constitutional law that Epstein finds disagreeable does not define economic liberties so as to protect against government action that affects more than surplus. The boundaries of this law have not been tested, but at some point government action that affects our earned entitlement may be held unconstitutional. For example, the Constitution might not permit a communist economy in which all our earned entitlement is taken and distributed by government fiat.

We need not necessarily adopt this narrow view of economic liberties, however, to approve active government. Active government creates a surplus, and so long as it affects only that surplus, the government does not compromise efficiency values. Therefore, even if one finds that the Constitution incorporates efficiency values, one cannot use that concept against the constitutionality of government action that stays within the surplus. The constitutional questions then become who we take the surplus from and how we allocate this surplus. At this point, we move to more subtle and controversial levels of analysis—those outside the concept of economic liberty. To me, however, the Constitution tells us several things about the taking and allocating of surplus.

For one thing, the Constitution requires that we take or allocate surplus through a certain type of decisionmaking: a republican form and due process. Because I hope good government is a fundamental constitutional principle, I believe that this is the evolved

constitutional concept of economic liberty. Once within the area of acceptable process and motivation, the debate must center on whether a particular transfer will enhance future surplus. This is a political debate within the boundaries of the social contract.

The decisions to take and to allocate surplus may have many constitutionally acceptable motivations. Some of these decisions are distributional justice decisions aimed at allocating the surplus to those who need it most. Decisions about allocating the surplus are aimed also at enhancing surplus. Some of the surplus goes to maintaining the cooperative environment and preventing destructive conduct. Often the justifications for welfare payments, for example, include considerations such as preventing crime or limiting burdens on productive members of society. Transfer of surplus may involve government intervention that prevents wealth loss from monopolistic or fraudulent business practices, or transfers that are in reality joint investments, such as investments in "human capital"—education, health care, training the handicapped—involving a payoff that will accrue to society in the long run.

Contrary to Epstein, therefore, I do not believe that the scope of economic liberties necessarily implicates other liberties. Nonetheless, the Constitution limits our economic decisions. It tells us that we cannot take or allocate surplus according to certain prohibited considerations such as religion or race. A link is not necessarily established, however, between economic liberties and other constitutional liberties simply because the latter affect government decisions about taking and allocating surplus.

I admit I have approached this question somewhat differently than Epstein. I start, not with the private constitutional litigant, but with the government action. In deciding the constitutionality of a government action, I would go down the list of potential constitutional rights. I am saying only that economic liberties are not violated if the government action affects a surplus. The violation of other liberties may, however, prevent the action.

Economic liberties and the other liberties, however, overlap as well. Even under a fairly expansive view of economic liberties, the Constitution prevents only the taking of more than the cooperative surplus. Where the economic liberty leaves off, however, other liberties may continue. For example, the government cannot take or

transfer either surplus or the product of our labor under religious motivations, whereas economic liberties might protect only the latter. The Constitution might protect the product of our labor, however, even if the decisions did not involve religious considerations.

Indeed, religion gives a fairly complete example of this interaction. The first amendment says that government can neither giveth nor taketh away. Without violating the first amendment, active government can create surplus that accrues to the benefit of religion. It maintains roads for people to travel to church, educates the population so that people can read religious materials, provides an open society, enforces contracts, and so on. Still, the Constitution does not allow the government to take back that surplus on religious grounds. The free exercise clause provides that protection. Nor does the Constitution allow the government to allocate other surplus to religion. The establishment clause prohibits that action also. As long as government stays within the surplus, however, economic liberties remain irrelevant to the constitutionality of the government action. The Constitution does not prevent government from affecting surplus in a way that benefits religion, among other interests.

One of the cases cited by Epstein serves as an example of the disjunction of economic liberties from the other liberties. In *Estate of Thornton v. Caldor, Inc.*,<sup>20</sup> the Supreme Court held that a Connecticut statute violated the establishment clause by providing employees with an absolute and unqualified right not to work on their chosen Sabbath. As Epstein observes, this may be a correct holding, but the correctness of the holding has nothing to do with economic liberties.<sup>21</sup>

If the Connecticut action infringed only economic liberties, it should have been held constitutional. Nonreligious employees were not hurt by the statute because if Sunday workers became scarce, the nonreligious employees could bid up their wage price. Employers were not hurt because they were merely required to pay the true cost of hiring people to work on Sundays. If workers had a greater taste for working on Wednesday, for example, rather than Sunday, then hiring Sunday workers *should* be costlier. Employers

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20. 472 U.S. 703 (1985).

21. See Epstein, *supra* note 1, at 406.

and thereby consumers should pay for indulging their taste for shopping on Sundays. Neither religious nor nonreligious workers are hurt; they are simply paying for their taste in days on which to work. Under an efficiency measure, the Connecticut law does not fail. It may fail because any law that takes into account a taste or distaste for religion violates the first amendment, but not because of the concept of economic liberties.

Of course the problem is: How do we find the boundary of the surplus created by our joining into a cooperative society?<sup>22</sup> Courts have been very lenient in controlling government action in this regard. I am less worried about this than Epstein is because I see the work of constitutional interpretation here, as others are apt to see the work of the common law process in general, with its basis in sound economic principles.<sup>23</sup>

This optimistic theory of the evolution of the law is based on a sort of legal Darwinism: Inefficient laws will not survive over time.<sup>24</sup> A large part of the process behind the emergence of efficient laws is the tendency for inefficient principles to be challenged much more often than efficient ones, with the result that inefficient principles evolve, however slowly, into efficient principles.

Although some doubt exists that the law in general evolves this way, law directly related to efficiency values surely must. Because economic liberties focus so intently on efficiency, one would expect the law regarding these liberties to be particularly sensitive to efficiency values. At the least, one would expect the law to evolve towards, not away from, efficient solutions. I believe this "natural" process has brought constitutional law regarding economic liberties to its current point of operating at an efficient level of economic liberties.<sup>25</sup>

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22. The surplus involves regulation of business, health, safety, and so on, as well as direct transfer (e.g. welfare payments).

23. R. POSNER, *supra* note 5, at 229-30.

24. Rubin, *Why Is the Common Law Efficient?*, 6 J. LEGAL STUD. 51 (1977). *But see* R. COOTER & T. ULEN, *LAW AND ECONOMICS* 494 (1988) (expressing some doubt that inefficient laws are challenged more often); Cooter & Kornhauser, *Can Litigation Improve the Law Without the Help of Judges?*, 9 J. LEGAL STUD. 139 (1980).

25. Other liberties are much less focused on efficiency, even when efficiency is defined as aggregate total utility, and hence one would expect a different evolutionary pattern. The efficiency basis for economic liberties, appropriately absent with regard to other liberties,

This concept of legal Darwinism suggests that our economy has not been living with 50-year-old inefficient constitutional principles. Instead constitutional law concerning economic liberties may have evolved to its optimal point fifty years ago.<sup>26</sup> True, this law developed a very narrow view of economic liberties, but because economic liberties focus so intently on efficiency values and other liberties do not, one should not find surprising the fact that the different liberties have evolved in different ways.

Arguments for the acceptance of limited economic liberties are not arguments for blind acceptance of all the current surplus-seeking or allocating government activities. The advisability of such programs should be constantly evaluated. Over time, good ideas fail to prove themselves in practice, and circumstances change so that an idea for one time is not appropriate for another. A truly liberal public policy approach has the flexibility to adjust or discard concepts and to develop new ideas while remaining committed to humane goals. This need for flexibility itself, however, argues against an expansive interpretation of economic liberties.

### CONCLUSION

An open minded survey of Epstein's writings makes difficult a challenge based on his goals. What is suggested here, instead, is that he has ignored an important mechanism in our economic system. Active government is necessary to create the cooperative surplus on which we all thrive. Because man lacks the altruistic instincts of bees and ants, we can only achieve the cooperative surplus by accepting compelled cooperation. In a complicated society, government necessarily performs this function.

The debate, then, should not center on constitutional principles, but on the advisability of particular efforts to take, allocate, or generate cooperative surplus. Constitutional principles that protect economic liberties only in extreme situations seem optimum. Nonetheless, I do not contend that Epstein and others cannot find

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has naturally created the separation Epstein sees between the protection of economic liberties and that of other liberties, in this case those relating to religion.

26. Imagine, for example, a pareto optimal state in which no one can be made better off by correcting the law about economic liberties without making someone else worse off.

a superior economic state; I assert only that they have to look elsewhere than the Constitution.