David Friedman's Model of Privatized Justice

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Abstract. David Friedman employs mainstream economic tools to argue for a non-mainstream economic conclusion: the law and the legal system can and should be privatized. First we circumscribe Friedman's model of privatized justice within the map of the anarchist schools of thought. Second, we present how the model would purportedly work in practice. Third, we describe the assumptions of the model. Since the normative force of the model depends on their limitations, when deemed suitable, we point out ways to support them. We sketch a normative defense that owes to Richard Posner, we show why a system of justice focused on efficiency peacefully corrects initial errors and suggest why a system of justice focused of revealed preferences only, gives an unbiased treatment to agents. Fourth, we call in Harold Berman and Stringham and Zywicki's contribution to interpreting the early history of the Anglo-Saxon legal system and North, Wallis and Weingasts' framework for understanding social order. An application of their framework is double-edged. One the one hand it adds weight to Tyler Cowen's objection against the stability of the Friedman model. On the other, it makes a certain reading of history more plausible, namely, that according to which the dynamics of power between the Church and the state allowed for a system of privatized justice, albeit limited and non-transparent. If this reading is right, David Friedman's model proves less utopian than we think.

Key words: David Friedman, privatized justice, market anarchism, anarcho-capitalism.

I. THE MODEL CIRCUMSCRIBED

1.1. Privatized justice

Phrases such as "privatization of justice," "privatization of the law," and "liberalization of the market for law" only make sense if we eliminate the notion of state authority from the definition of law[1]. "Law" and "justice" are part of an effort to subject human conduct to rules (Fuller 1963, 96; Benson 1990, 11), especially under the threat of physical coercion[2]. This effort takes place in three stages: the production of law, the interpretation of law, the enforcement of law. Human efforts directed towards these aims can be conceptualised as economic services: they are "goods" - insofar as they are both desired and scarce. The "privatization of the law" or the "liberalization of the law" designates the privatization or liberalization of these three "protective services" – of producing, interpreting and enforcing the law. The anarcho-capitalist order represents an order of free enterprise and free exchange for this class of services.

2] The requirement of physical coercion delineates the administration of justice from that of other moral rules.

The freedom of contract for protection entails the freedom to choose not to enter a contract with any agency, no matter which. One requirement to understanding anarchism in general, notjust anarcho-capitalism, is to discard the assumption of hierarchy. Imagine three people in a triangle, where each of them is appointed to be their judge by the other two. Or think of families. Sometimes two members ask a third who is in the wrong. Each appointed judge can judge slightly differently. The assumption of legal uniformity over a territory or domain is also discarded. Individual I1 can stay under legal code A when interacting with individual I2 and under law B when intercting with individual I3. Different solutions can coexist for the same kind conflict over different pears of individuals, and for different domains of application.

1.2. The intellectual map of the anarchist schools of thought

Building on Peter Boettke's classification (2005, 207), we place David Friedman within the analytic anarchism research program, as distinguished from the utopian and the revolutionary research programs.

Utopian anarchism works with assumptions poorly justified by social and human science, about a post-scarcity world dominated by altruism. It is also impregnated with a double aversion to political power and economic inequality. The first modern anarchist William Godwin (2011) and Josiah Warren (2011), publisher of the first American journal of anarchism, sample that thinking[3].

Although revolutionary anarchism in the tradition of Mikhail Bakunin (2011) does not rely to an equal extent on the assumptions of post-scarcity and altruism, it is guided by the same double aversion. It recommends an upsetting of the system of private property *and* political power by violent means.

Another tradition, ignored by Boettke, is manifest in the moral philosophy of political obligation. We may call this "ethical anarchism" and have in mind anarchist-individualists such as Robert Paul Wolff (1998) and John Simmons (1979).

Analytic anarchism employs economic analysis of institutions, an effort to identify the effects of legal rules with the help of rational choice theory. Besides David Friedman, important examples here are Murray Rothbard (1998), Randy Barnett (1998) and Roderick Long (see Long and Machan 1998), while their common precursor is Gustave de Molinari (2011). The terms "market anarchism" (Long) and "anarcho-capitalism" (Friedman) are largely interchangeable. It is analytic anarchism that caught the attention of Robert Nozick (1992) and James Buchanan (2001). The latter formulated different arguments against the anarchist position and they were largely followed by political philosophers and economists. To this day, analytic anarchism is still a marginal research program.

3] See Doherty 2007 for an evaluation of a large number anarchist-leaning authors made from a libertarian perspective.

1.3. Intellectual sources of analytic anarchism

We can distinguish a number of different intellectual sources put to work in the analytic anarchism research program, though none of the original sources are themselves anarchistic proper.

The rejection of the idea of large-scale monocentric legislation, for reasons that have to do with an understanding of equality before the law. Alfred Venn Dicey (2005) praises the universal subjection of all classes to one law administered by the ordinary Courts.

The rejection, from an evolutionary perspective of the idea of large-scale monocentric legislation. Hayekian arguments (1945; 1973; 1988) according to which a law fit for the complexity of human interaction must benefit from local dispersed knowledge can be used in favor of anarchism (Stringham and Zywicki 2011).

The epistemic arguments of the Austrian School regarding the impossibility of rational central planning in the supply of any services (Mises 1991). Absent private property and free exchange, there are no real exchange rates; without real exchange rates, we don't know people's relative valuations of services; missing the knowledge of people's relative valuations, relative prices of centrally planned production and allocation are bound to be arbitrary. The argument could be extended to cover legal services (Solcan 2003).

The Chicago School, which is a mix of neoclassical economics and "the property rights paradigm" rooted in Ronald Coase (1991). If at zero transaction costs, property rights go to he who values them the most, then we have an argument in favor of free exchange of property rights. The argument can be used at a deeper level to argue for a free market for more fundamental legal rules, and in fact this accounts for a large part of what David Friedman is doing.

The Virginia School starting with Buchanan and Tullock (1995) and Tullock (1967). Firstly, it shows the reasons why the alternative to anarchism, the supply of legal services by the state, is inefficient – thus, the appeal of anarchism increases indirectly. Secondly, it reinforces arguments against economic objections formulated against anarchists by people in favor of a more-than-minimal state, within discussions in political science and political philosophy.

Robert Nozick. With the tools of analytical philosophy, Nozick (1992) reevaluates political philosophy from the perspective of negative individual rights and inviolability of individuals.

What sets David Friedman apart within the intellectual family of analytic anarchism? David Friedman makes less use of specific Austrian ideas, today a rather marginal methodology. A most noteworthy feature of Friedmanian anarchism is that he is employing mainstream methods to the benefit of non-mainstream conclusions. Friedman is using Coasian analysis of property rights, economic analysis of law, and neoclassical economics. As a neoclassical economist, Fredman sees economics as a study of human behaviour. He answers questions about the value of goods on the basis of their marginal utility to the consumer and relative demand. Once we base our theory of value on goods

that can actually make the object of choice at certain points in time, then we tie value to marginal (additional) units of goods, thus exploding comparisons between the totality of bread in the world and the totality of diamonds in the world. Classical intuitions that tie value to labor or to the costs of production also disappear.

<center>II. THE MECHANICS OF THE MODEL</center>

In order to see what the system would look like in practice, we need to employ economic analysis of law. Essentially, David Friedman identifies and estimates costs and, on the basis of rational choice theory, he makes institutional predictions.

Following a functional division of labor, the production and interpretation of a legal protocol will constitute the province of legal courts (Friedman calls them "arbitration agencies"). The legal protocol's administration and application will constitute the province of "protection agencies".

Insofar as legal services are protocols of interaction, they only make sense if produced for and consumed by pairs of individuals. Pairs of customers choose their justice providers. This does not mean that these protocols cannot be asymmetric (or bad); they can, even to the point of slavery. What it does mean, is that 'domestic' production and enforcement of law (as in 'each person with their own law') makes as much sense as using a 'private language.' The terms of a legal insurance bought by an individual form a legal code, and that legal code applies to that individual paired with others.

Pairing is the key to the Friedman model. Justice providers sell legal codes together with services of interpretation or arbitration to protection agencies and, after enhancing them with enforcement services, the latter further sell them to pairs of customers. Courts also sell the codes to pairs of protection agencies – only to be resold to pairs of customers of the two respective agencies.

In a free market for justice we can foresee three general characteristics of the model. First, we can expect more peaceful agreements than violent conflicts since the latter are more costly relative to peaceful agreements. In the case of agencies, the conflict is particularly costly, since it chases away clients towards those agencies that prove able to successfully solve comparable problems more cheaply.

Second, we can expect that the applicable codes will become tolerably similar due to pressures for cutting on bargaining costs. In the first instance, the formal realm of legal possibilities is large: it will reflect the diversity of human preferences. There are at least as many possible codes as individual pairs can think of times two, where the multiplication by two reflects the possibility of legal codes asymmetrically applied between individuals. Because of the costs of diversity, the result will nevertheless be tolerable uniformity, due to the costs of negotiation. These are costs of negotiating separately with each individual with whom one could find oneself in conflict. The costs of contracting differently with each new group of people are larger if the clauses that are applicable to the old group could not be applied to those in the new group.

Third, we should expect widespread pre-existing bilateral agreements, as pre-existing agreement reduces bargaining costs. Ad hoc bargains are costly relatively to legal insurances. Practically, protection services get to be protection services against *the eventuality* of conflict.

III. ON THE NORMATIVE CHARACTER OF THE MODEL

3.1. The prima facie case for efficiency

The attractive feature of the model of privatized justice is the efficiency of the output. The rules produced by the system are claimed to be efficient. But why would we be interested in a legal system that maximizes efficiency? Allocating rights and producing distributions of rights for those who pays the most for them on an open market is desirable for two reasons. First, the right to decide whether a particular change occurs goes to the one for whom it matters the most. Second, market allocation reveals an important information to third parties. Rates of exchanges, prices, or information about relative valuations, can only emerge out of rich networks of transactions. Third parties can use the information revealed in other transactions when setting and following their own objectives.

3.2. Value maximization

Friedman uses Alfred Marshall's method of measuring and aggregating preferences, according to which the intensity of preferences is measured by the number of monetary units that agents are willing to give up for the sake of some change in the states of affairs (money reprepresenting the value to them of some other changes). The efficient outcome is the outcome that produces the greatest net positive effect. If John would rather lose 2 dollars than confront some change C, and Mary would pay 3 dollars in order for that change to take place, the change is efficient.

This description seems burdened with the idea of interpersonal comparisons of utility. However, two things can be said to prevent objections against utilitarian suppositions. First, utility must be interpreted in a formal sense. Talk about utility is not necessarily committed to a metaphysical notion of units of happiness. If people behave consistently, their behavior can be modelled as though maximizing the expected value of something, whether they are intending to or not, whether they feel anything or not. Whatever this may mean or involve for anyone in particular context, we can call it utility without being committed to its actual existence (Binmore 2005, 65). Second, at zero transaction costs, compensations take place. At zero transaction costs the difference between a metaphysical commitment to interpersonal comparisons of utility and the methodological decision to only look at revealed preferences fades anyway: there is nothing to prevent preferences from being reaveled. Under certain assumptions (among which zero transaction costs,

uniform valuations of the dollar across participants and an ability to pay[4]) a money market reveals quantitave information about "intensities of preferences" across agents. It measures, in dollars, how much people want something rather than something else.

A system of privatized justice founded on the ideal of value maximization or wealth maximization would focus in practice on the satisfaction of preferences registered in a market. But the concept of market is here more inclusive than it would appear. It includes both barter markets and hypothetical markets. The value of services exchanged in a barter market could be estimated by looking at the monetary price of substitutes. What are hypothetical markets and why are they included? We must remember that our normative ideal describes a zero transaction costs market. Since the real world manifests transaction costs, a court of justice set to maximize wealth would employ hypothetic market analysis and distribute rights according to their speculations on potential market transactions freed from transaction costs (Posner 1981, 61).

If courts are forced to make entrepreneurial judgements on hypothetical transactions, then we have another argument in favor of an aspect of privatized justice: free enterprise. Do we really have a discovery procedure of efficient rules better than competition? In a recent article Stringham and Zywicki (2011) make a case for a Hayekian anarchism.

3.3. Zero transaction costs

Neoclassical economists usually employ the model of perfect competition to demonstrate that some particular arrangement leads to an efficient outcome. The model of perfect competition shows why on a market with sufficiently many suppliers, competitive pressure is forcing each supplier to reduce the price close to the cost of production. The legal market has, nevertheless, a peculiarity: legal suppliers buy a set of individual agreements or consents for a particular code, which applies to those individuals paired with other individuals. The situation is that of a rich texture of bilateral monopolies. By hypothesis, in a free market for law no one can supply my agreement but myself. In the absence of competition, I will sell my agreement more dearly than it would cost me to 'produce' it. Consequently, concludes Friedman, the model of perfect competition is of little use.

Friedman then appeals to the Coasian model of bargaining for property rights (Coase 1991). The model shows that only legal changes with a net benefit take place at zero transaction costs (Friedman 1994; 1996). In the absence of costs of acquiring information about what and how strongly others desire people identify and exploit the possibilities of improving their legal insurance, and in the absence of costs of negotiation they will exploit these possibilities. These can be either changes that are in the interest of both parties, or changes that are in the interest of one but against the interest of the other party, provided the interest of the party who favors change is stronger than that of the one who prefers the status-quo. Compensations can take place for Pareto improvements.

4] There are hidden assumptions that limit the normative character of efficiency and Friedman admits to them (Friedman 2001, 22). We shall discuss them in what follows.

Imagine two agencies representing their respective litigant clients. One agency is for the death penalty, the other is against it. A transaction between the two agencies occurs starting from an initial distributional point. At zero transaction costs, regardless of whether the initial distributional point specified death or no death the concrete result will be efficient. If the initial distributional point is was so that interagency conflict was solved in a pro-death manner, but now the antideath agency is able to pay enough to compensate the pro-death agency, then the efficient result (no-death) occurs. If the distributional point was already anti-death, then the result stays anti-death. The efficient result occurs regardless of the initial distribution provided that point is specified is some way so that the deal can start off.

3.4. Uniform valuation of the dollar

Maximization of efficiency is an imperfect proxy for the maximization of utility. One reason is that Marshallian aggregation, or interpersonal comparisons of utility made by means of market exchange at zero transaction costs still assume that dollars are valued uniformly by all. It might seem that the dollar has a lower marginal utility for the rich.

How could that be shown empirically, by looking at people's choices? Recall our formal analysis of utility. If we do not commit to a metaphyscal dimension of utility, then my valuing X makes sense only by comparison to my valuation of a Y. As long as there are values that are not registered in a market, it follows that the richer I get, the more worthy non-marketable values get for me by comparison to the set of values that can be bought for money. Evidence would require systematic observation of rich persons increasingly making choices of values that are not registered in a market, not even in the inclusive sense of market. This seems difficult to show.

But assmuning it is possible, Friedman's partial defense here is that when we aggregate large amounts of costs and benefits across large sets of people, the differences in valuations average out. The Marshallian method works well in evaluating legal changes that affect large classes of individuals, such that the group which does want it and the group which would rather do without it do not overlap with the rich and the poor. The objection does not have teeth in situations in which there are as many deviations in the valuation of a dollar on each side (Friedman 2001, 22). The Marshallian method still is appropriate in evaluating what Hayek called general rules.

3.5. Ability to pay

Second, the model assumes away the possibility that at some point some people can value something more than they are able to pay.

How could *that* be shown empirically? Someone might choose to spend an amount of time in jail set to be equal with a $ 10,000 fine for stealing a $3000 necklace for is wife (Posner 1981, 63-65).

If this scenario is possible, then efficiency does not have enough normative force. Efficiency or wealth maximization again fails to approximate utility maximization.

How could the criterion of wealth maximization be defended against these objections? One defense is that we cannot base a system of justice on speculations about utilities. Although these scenarios are possible, we cannot know *when* they are true. These scenarios are burdened with an element of speculation.

From a methodological point of view, if individuals are separate opaque worlds (I can't feel your pain), we refrain from speculating on their interior. From a normative point of view, we refrain from violating these worlds through unwanted interventions for redistributive (deliberately inefficient) purposes. Limiting the purpose of justice to efficiency is the consequence of accepting these normative and methodological contraints. In traditional analysis of happiness, or in traditional talk about utility maximization, what matters is the passive, subjective experience. Analysis of wealth anchors valuation in intersubjectivity. Methodologically, we can easily observe transactions. A focus on exchange is a focus on the interesction between manifest preferences (Posner 1981, 66). Normatively, what matters is the active character of producing wealth. Successfully offered services are let out freely from an opaque world and are freely received in another.

Of course, we cannot hope for a philosophical settlement here. But the advantage of a legal system that concentrates on minimizing transaction costs weakens the objection from the ability to pay: such a system encourages the creation of kinds of services that build upon services. An vast array of possible labor niches for everyone facilitates inclusion in the network of exchanges enabling everyone to pay.

3.6. Two aspects of transaction costs

Transaction costs hinder an efficient output. There are two aspects of transaction costs that the model would confront in practice. The first side is that given a distributional starting point, the cost of a rectifying trasaction is naturally positive. This adds friction to the mechanics of the model. The other side is that the initial distributional point may be itself unstable, unclear or under dispute. This difficulty is more like one that does not allow the mechanical process to start off.

Regarding the first problem, a reasonable claim is that transaction costs have a better chance to be overcome if bilateral bargains are allowed, and that is what privatizing justice means. Private law is efficient because given any distribution between two agencies, if agencies realize any efficient possible change, they will make it happen, with the winner compensating the loser (Friedman 1994). If pairing is the key to understanding the mechanics of the Friedman model, the key to understanding why the output of that model tends to be efficent is that at zero transaction costs, if pairs imagine an improvement, they will realize that improvement.

Bilateral bargains with resolutions that have zero external net effect (especially those that hardly affect third parties at all) will have a real chance of producing an efficient outcome.

Bilateral bargains whose resolutions have a non-zero effect on third parties will have lesser chance of producing an efficient outcome. The more widespread the externalities, the larger the transaction costs and the lesser the chances that the outcome will be efficient.

To understand this, let us take intellectual property rights as an example (Friedman 1996). An efficient fully privatized market for intellectual property law has to deal with three relevant costs. On the one hand, there is the cost of a decrease in intellectual production. Let's say the perspective of such a cost pressures in favor of a rule of intellectual property. On the other, there is the cost of not using sufficiently that which has already been produced plus the increase in the cost of law enforcement. In the anarcho-capitalist model, if John agrees to pay Mary for her intellectual product (their relationship will be governed by the rule of intellectual property), then Mary will produce as long as she is paid. If the products are beneficial to third parties who do not pay, the outcome will probably be inefficient because it does not take into account the valuations of third parties. An efficient rule would have to minimize the sum of all these costs. Why so? Let us presume that the cost to Mary to produce an extra work is over 2 dollars. The work in question would be valued by John and other two people at 1 dollar each. But if only John is a party to the transaction the work is not being produced.

The second side of transaction costs is "the baseline problem" (Friedman 1996). Theoretically, agencies could return at any time to that initial distributional point – a result of a bilateral monopoly bargaining process which includes mutual threats of refusal to agree on any arbitrator. The claim is however that changing the status-quo with aggressive means is relatively costly.

3.7. Levels of rules

A market for legal rules assumes mutual recognition of the baseline and since that baseline is itself describing a rule, we arrive at the idea of several levels of rules.

In an attempt to clarify the idea of privatized justice let us distinguish at least three levels of rules. Transacting rules (or rights) at the first, surface level is not unfamiliar. Let's say according to the official, formal distribution given by the judicial system I have the right to phonically pollute my neighbor but I am selling that right to her, as I am currently in need of cash and she is conducting lucrative sessions of psychotherapy in her apartment. This surface allocative level is today privatized, since my neighbor and I really can choose to re-allocate differently such rights set for us in our initial distributional point. The freedom of transacting at the allocative level is obviously conducive to efficiency. In most cases today, starting from the distributional points offered by the current legal system, parties reach agreements outside courts and reach efficient solutions (Friedman 1996).

We have distinguished two levels of rules, the first, the allocative level, and the second, the formal distributional level. According to this second layer, in my example, I am the one holding the right to decide when I make noise. The official distributional point is fixed today but we can imagine that my neighbor and I could choose among different providers of default distributional points. Choosing legal codes on a market for justice means choosing formal distributions of rights that form starting points in subsequent allocative transactions. Today this level is not privatized but we can imagine it could be. In Shasta County the official distribution by state law defining whether the *range* is open or closed (whether ranchers' cattle can move freely in neighboring farms) is immaterial (Ellickson 1991). Neighbors have created and are following a different distributional level. Ellickson claims the farmers from Shasta County manage to reach a more efficient agreement than through state law.

However, transactions of legal codes at the second level presuppose a more fundamental recognition of rights, they presuppose yet a more fundamental distributional point that describes the terms allowing for that business. Actors operating on the free market for justice must themselves operate within some framework of mutually recognized rules. Thus, a third level must stand as a baseline responsible with maintaining and formulating the second level. This most fundamental (often informal) distributional level represents the power distribution that defines the initial bargaining positions of the very actors operating on the free market for justice.

3.8. The initial bargaining position can incorporate inefficiencies

Recall that example of the disputed property right to decide when your silence can be broken by my singing. If the initial distribution entitles you to silence and you value silence more than I value my own singing next to you, the concrete result will be efficient – silence. If in the initial distribution, I have the right to pollute you with noise, but you value silence more than I value my own singing next to you, the concrete result will be efficient – silence– since at zero transaction costs we exchange property rights accordingly. There will be silence whenever silence has a social value (aggregate value) greater than my singing, regardless of initial distribution of property rights over silence and my own singing).

Let us assume that in the initial (second level) distribution the right to decide lies with the singers, that the social preference lies with silence, and that real world transaction costs are positive. Then the outcome itself (at the first level) is inefficient, since the efficient allocation of property rights is hindered.

To be sure, the number of transactions that might be avoided should be the main factor in the selection of an efficient initial distribution, at any level. But to the extent that the initial distribution and initial bargaining positions are the result of relative force and

rectifying transactions are costly, then inefficiencies at the base level plague the entire legal edifice.

Moreover, the initial bargaining position at the second level incorporates inefficiencies to the extent to which the second level is inevitably the outcome of a balance of power (the outcome of a credible threat game), which is not necessarily the outcome of valuations manifest in market exchange.

3.9. A privatized system of justice corrects in time initial inefficiencies

Should we then go back to the fundamental distributional level and make forceful reparations? The problem with that proposal is that in the absence of a market we lack a method of determining what a reparation is. How can we recognize an overlapping between power and valuations? Imposition of force would exclude the market. The new power elites would be incapable of showing rationally that the new fundamental distribution represents a more exact overlap with valuations. This is a problem not only for any anarchist radical revisionism but indeed, for radical revisionism of any kind.

An authentic correction of initial inefficiencies can take place under an institutional arrangement arrangement that, starting from the status-quo, would reduce transaction costs for all legal transactions, at the first two levels. The market would correct in time the inefficiencies embedded in the fundamental level.

The first reason why we should expect corrections is that favorable but inefficient rules that some obtain for themselves are generating litigation after litigation until the rule is being corrected. The first is that favorable but inefficient rules which are obtained in some way or another generate a series of litigations, to the point that the rule corrects itself (Friedman 2001, Ch.1). If the rule is inefficient at the outset, those who stood to lose had more to lose than those who gained had to gain. The rule corrects itself because the resources of former losers come into play, and given the assumption of the ability to pay, these resources are larger by definition.

The second reason is that a rule which is favorable to John but inefficient will shortly generate corrections, by increasing the price of transactions between John and the disenfranchised actors in other parts of the economic system. If, for instance, I should be so lucky as to obtain a rule that permits me to kick my tenant out sooner than in common practice, the price my tenants will be willing to pay should reflect this risk and be lower than the average market price. If, on the contrary, I am a tenant and I obtain a favorable rule, according to which the owner is required to allow me more time than it is commonly the case in the free market, soon the prices at which owners would be offering me accommodation will turn higher than the average market price. In a tolerably free market, the boomerang effect gets to discourage efforts to secure favorable but inefficient arrangements.

4.1. Tyler Cowen's objection from instability

In 1992 Tyler Cowen (2007) formulated an invisible hand objection against the stability of the model. His conclusion is that incentives in the legal sector push (back) towards cartelization.

According to David Friedman all protection agencies get to have contractual agreements with other agencies that establish the terms in which potential conflict of interest between their clients are to be adjudicated. From the customer's perspective, the more worked out the pre-arrangement, the better.

But once an infrastructure for transactions is established between all operating firms, asks Cowen, what could prevent the members of such a network to constitute into a cartel with the intention of dividing the market into exclusive territories, raise prices and even institute taxation? Each firm belonging to the network would agree not to deal with upstart firms, or with firms that violated the common agreement to monopolize. Could they do it? Cowen does think so because of the following constructive dilemma.

First, brute force allows them: if members of a network can act collectively to such an extent that they can use force to put down outlaw agencies that do not accept their higher-order arbitration, then they are also able to put down agencies that do not adhere to a collusive agreement and thus enforce their cartel. If we assume a functional system of privatized justice, then we assume that competitive market forces prevent an outlaw firm from increasing its business by promising not to turn over its guilty customers for imprisonment or trial. But then, the infrastructure for collective action is already provided for, regardless of the number of agencies operating at one point. If the members of a network have sufficient resources to collectively force a truly outlaw agency (illegitimate by more largely shared standards of legitimacy) to turn over their outlaw clients to some adjudication then why don't they have sufficient resources to impose the terms of a cartel to outside agencies? Won't the majority of the network members also have the power to close that network, enforce the cartel terms on renegade agencies - rebel agencies that initially used to be a part of the network? The network can enforce compliance, as the network could threaten to cut off all relations with the renegades. Nonconforming firms will lose market share and go out of business because they cannot promise peaceful adjudication to customers.

Second, economic forces allow them too: the special network-nature of their industry makes it hard for new entrants and renegade colluders to obtain market share, if the cartel refuses them access to its arbitration network. Think of mobile telephone companies and the fact that intra-network conversations are cheaper. The more users a network has, the more useful it becomes. The larger network N1 and the smaller N2, the more costly it is for potential customers of N2.

Cowen's conclusion is that the network develops the attributes of a state: finance through taxation, claim of sovereignty, ultimate decision-making, authority, prohibitions on competitive entry (2007, 268).

Friedman's answer comes in two parts. First, members of the cartel may compete on the kind of service provided for intra-network clients, so there is some small room for competition. Or, at the very least, special insurance packages can be enforced by the cartel over different pairs of customers, which means we don't have uniform law codes across the cartel.

Second, as in any industry, members of a cartel can secretly sell more at a lower price (chisel on the cartel price) and thus serve unsatisfied left-out demand (Friedman 1994). Sometimes they could find it in their interest to settle some of the issues in ways prescribed by the non-member agency. This can happen when the non-member agency is willing to secretly pay for the change in a way in which both litigants are satisfied with the result.

We may add a third defense. If more or less incognito, out-of-network firms exist at all, they can also provide legal services between out-of-network members. The out-of network firms can establish terms of agreement with one another and thus start to form themselves a new network, perhaps incurring lower costs of production. The larger this second network the more incentives for customers of agencies who are part of the original cartel to give up on the all-inclusive package and to start buying parts of their protection services from agencies who are not members of the original cartel. Some people choose to have two or even three mobile phones and thus be members of different networks.

The first defense does not seem strong; after all, it does allow for quality collusion. The second defense seems stronger but it only secures a rather unofficial competiton, where firms operate more or less incognito. Competition depends on the degree to which firms feel pressured to conceal their dealings. The third argument also seems to revolve around the optimal degree of transparency of unofficial "renegade" dealings. Can we determine the optimal degree using economic analysis of law?

4.2. The actual foundations of the model rest with the distribution of power

What is the degree of transparency that agencies unabiding to the terms of the cartel can afford? This level depends on the relationships with peers and on the relationships with potential clients. The relationship with peers is characterized by such things as the risk of fewer transactions with peers and the risk of confronting their withdrawal of support in various collective actions. The relationship with potential clients depends on the transaction costs that unabiding agencies confront in reaching and concluding dealings with potential customers. Direct routes between competitors and clients may be hindered by other powerful agencies who seek to maintain monopoly. Potential customers' ability to pay may be low. If with anything, the utopian character of the model rests with these aspects. If we inquire into the utopian aspect of the model, we must inquire into possible

changes in these two factors continuously affecting the definition of the initial distributional points between agencies, and between agencies and their clients.

Let us pause the analysis of the factors that determine the fundamental distributional level for a methodological observation about our inquiry. As we can see, economic analysis is useful in determining that optimal degree of concealment. However, we were forced to go deeper than Coasian analysis can take us, since Coasian analysis only applies to transactions, and transactions always start off from some given initial distributional point. It is this precise point that is now in question. Indeed, the economic approach we entered goes in the direction of an institutionalism belonging to a family of authors like Mancur Olson (1993) and North, Wallis and Weingast (2009) who focus on the role of organizations more than on the role of transactions.

Coming back to the main line of inquiry, we said that the formal distributional point at the second level assumes the existence of some distributional point at the third (and fundamental) level. Could we also infer something substantial about the third level from data describing the second level? One conjecture is that if we observe a functional set of more than one independently operating protection agencies on a free market for justice, we can correlate the existence of that set with a balanced distribution of power between independent actors at the third and fundamental level. The argument for that correlation is not difficult. We have seen in the section on zero transaction costs that if the distributional level is mutually recognized, rectifying trasactions occur for an efficient result. In real life however agencies can actively obscure property rights and pretend that the distributional point was in their favor. They can do that because real options include violence besides just paying when prompted and the costs of violence for the two respective agencies may be different. If when calculating the relative costs of conflict, one agency repeatedly realizes that it is much weaker than the other, the other simply prompts and collects payment in all cases. After enough such repeated interactions weak agencies would disappear. The argument also works if formulated form the perspective of customers. Assuming the existence of a single center of power, freedom of enterprise in law offers escape routes to pairs of customers. But as the flow of rents towards that center weakens, so is the power necessary to sustain it.

The idea of correlating a certain freedom of legal choice with polycentricity of power finds an illustration and an empirical support in the first centuries of the Anglo-Saxon system of common law.

According to a strand of research on the development of common law, local courts of justice, manorial courts, mercantile courts, universities' courts and above all ecclesiastical courts, were independent from the king's courts. Officially, from the 12th century on, each of them was limited to a domain. However, for at least some legal areas such as contract law, these providers of justice were able to circumvent their limitations to effectively compete for customers (Berman 1983; Stringham and Zywicki 2010).

Even under an official cartelization between the Church and the Emperor (think of the Concordat of Worms in 1122 which established that the jurisdiction of the ecclesiasti-

cal courts should be limited to matters concerning the soul), competition between the ecclesiastical and the king's courts still stayed in place.

This was because in practice, it was the power to interpret the official limits that determined real jurisdictions; the power to interpret was continuously and silently disputed as a consequence of a larger dynamic. The justice providers (courts and systems of courts) could claim jurisdiction over domains with an unclear interpretation by making use of procedural fictions (Stringham și Zywicki 2010, 11). Pairs of customers seeking legal insurance or adjudication of potential disputes from ecclesiastical courts could effectively choose that if they both swore an oath to God. A breach of contract could have been interpreted as an impiety against God. Impieties against God would fall under the jurisdiction of the Church. A set of such legal fictions came to constitute an unwritten basis of private justice. These customs endure until the 17th and 18th century, when the king's courts absorb all other courts and effectively take over the whole legal sector (Strigham and Zywicki 2010, 9, 11).

On the one hand, the availability of legal fictions is crucially important in determining whether the legal system was indeed privatized. The practical availability of legal fictions to common folk meant that customers were practically free to choose their legal provider. To the extent to which choice belonged to customers, justice was privatized.

On the other hand, the un-written, unofficial, or 'fictional' character of legal fictions is important in determining how transparent legal competition was. The number and complexity of functional legal fictions capable to help common people evade formal jurisdictional limitations, depended on the two factors mentioned above: the power support enjoyed by each of the legal courts or networks, and the transaction costs with customers.

North, Wallis and Weingast's (2009) and Wallis and North's (2010) idea that individuals use organizations as tools (sometimes organizations that they themselves did not create) in their confrontation with other powerful organizations offers a conceptual framework of interpretating connections between formal distributions of rights and fundamental distributions of power. It throws light on the reason why the power distribution (the third level of rules) is important for the practicability of privatized justice (i.e. the freedom to provide second-level distributional points plus the freedom to choose among providers). Courts in the ecclesiastical network stand in a client-patron relationship with the ecclesiastical political organization that forms and supports them. They can use it as a tool in their confrontation with powerful organizations such as the secular state. If the distribution of power between the two elite organizations, the Church and the state, is balanced, then pairs of customers are able to choose an ecclesiastical court as a legal provider. This is because, at the other end of the transaction, there is a powerful actor. The ecclesiastical political organization, which, as a matter of fact is able to choose them as customers, backs up by force its ability to deal with them.

At this point we can make another methodological observation about the usefulness of the Olson – North, Wallis, Weingast institutional economics for our inquiry in the stability of the Friedman model. In the chapter about stability in the *Machinery of Freedom*,

judging from the efficient size and number of present-day police forces, Friedman takes the guess that the number of protection agencies in the United States would be closer to 10,000 than to 3. He conjectures that if the legal system was privatized, a protection agency protecting as many as one million people would be far above the optimum size. The guess implicitly assumes that the transaction costs confronted by independent operating firms and their customers would be the same as the transaction costs confronted by present day police stations and citizens spread throughout the US[5].

Police stations today don't have the possibility to hinder other police stations' transactions with new clients for the purpose of extracting rents, since they do not compete. They are all units dependent on a central power elite. Independent economic agents would have, on the other hand, the incentive to hinder competitors' transactions with customers. This is clearly happening in all domains of activity in all history. Appealing to power resources (such as lobbying the state legislature) with the purpose of extracting rents is ubiquitous. Even if not transparent, rent seeking activities are effective, and this always shows on the number of independently operating firms. In the historical example we gave there were indeed many courts across England but they were not independent. They were caught in small number of operating networks. The number of those independent networks was actually closer to 3 than to 10,000.

At this point one might think the mechanics of power is reduced to a clear number of patron-client vertical networks: an ecclesiastical power elite with a set of client-courts and a secular power elite with its set of client courts. This would mean that the number of operating networks is 2. But if we look closely, that number was closer to 3 than to 2. There were also other legal networks. One of them was the network of merchant courts operating Law Merchant. Common people's access to merchant courts was granted as usual by a set of customary legal fictions. For example parties entering a contract who wished their future matters to be adjudicated in merchant courts, would, instead of giving an oath to God, "wet the bargain" by having a drink together at the moment of contract (Stringham and Zywicki 2010, 2, 14). The existence of a third independent network is curious because we cannot readily find the supporting patron.

Merchant courts are examples of organizations that emerge under the shelter of competition between the two power elite organizations, the Church and the State. The independence of the merchant legal network is explained by the closely balanced character of the distribution of power thereof. The close competition for power between the two main dominant coalitions forces each of them to bid for the support of third parties. Less powerful agents who formed Merchant Courts grew their freedom to form them as a consequence of a continuous bidding process for their support.

5] The size of the firm, or the existence of organizations, is explained by appeal to how costly market transactions would be by comparison to intra-firm relationships. This may be misleading for activities for which there are no preexisting market transactions at all and such no price tags to compare (Solcan 2002). This is the case with the provision of law: power elites have by and large prevented the existence of market transactions.

To conclude the section, if the historical data provided by Berman and Stringham and Zywicki is correct, then none other than Western history offers a lesson on the non-utopian character of private justice. Using the frame inspired by North, Wallis and Weingast, we can impute commoners's freedom of choice for legal distributional points to a particular power distribution at the fundamental distributional level. A fundamental distributional point characterized by a consistent balance of power between independent power elite organizations operating in the same territory stands at the origins of Western history. The difference between the actual history of legal competition in the first centuries of Anglo-Saxon common law and the David Friedman model of privatized justice is one of degree, not of nature. The difference rests in how limited, how unofficial and how opaque was freedom of legal choice, but nevertheless, the choice was there.

Although the Anglo-Saxon precedent based system of law is commonly defined as law applied by the king's courts (Hogue 1986), the content of the doctrines was, and to a certain extent still is, the result of a competitional dynamics (Strigham și Zywicki 2010, 23). On the one hand, there was an incentive for the production of legal fictions in order to attract cases from other competitor-courts, and on the other, each of these alternative legal systems had the incentive to adopt the other system's successful legal innovations. The evolution of these concepts reflects the evolution of the legal system as a whole. Richard Posner (1992) discovers that the legal output of the Anglo-Saxon precedent based system is more efficient than the output of legislatures. If there is indeed a tendency of privatized justice to produce efficient rules, then one conjecture is that the present Western status quo contains fossilised efficiencies to the extent that it is itself the result of a private market for justice.

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