

# The Uses and Limits of Constitutional Arrangements

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Richard A Epstein

NEW ZEALAND BUSINESS ROUNDTABLE

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# Contents

Richard A Epstein v

The Uses and Limits of Constitutional  
Arrangements - Richard Epstein 1

Questions 15



# Richard A Epstein

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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).

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vi      **The Uses and Limits of Constitutional Arrangements**

communications, constitutional law, contracts, corporations, patents, individual, estate and corporate taxation, Roman law, criminal law, health law and policy, legal history, labour law, property, real estate development and finance, jurisprudence, land use planning, torts and workers' compensation.

# The Uses and Limits of Constitutional Arrangements

## **A risky comparison**

The study of constitutional law often begins with a dispute between two different versions of the relationship of the individual to the state. There are those who think that atomistic individuals come together by a set of voluntary contracts, and those who think that societies should be treated as though they are complex organisms that cannot be understood simply as the sum of their parts. In general, I think that these organic arguments can lead to heavily collective institutions whose operations and ambitions I discuss. However, in this case I want to examine the problem of the constitution as though it were a study in social biology. I hope therefore to draw out comparisons of the organisation of the human body on the one hand with those of the state on the other. There are always dangers in making this transition, but the insights that are garnered should be useful enough to make the risk worth bearing. I begin with an account of the distribution of functions in the human body in order to provide a template for understanding the organisation of other types of system. From there, it is a simple progression to consider the workings of a family, a business and, finally, a state.

## **The human body**

It is commonplace in biology to note that in the human body two systems operate concurrently. The subconscious part of the mind acts as a constant, permanent autopilot that ensures basic functions are maintained, while the conscious mind allows individuals to exercise discretion over their lives as



## 2 The Uses and Limits of Constitutional Arrangements

circumstances change. In abstract terms a constitution represents a similar division of labour. Durable structural limitations form the legal analogue to the subconscious. Simultaneously, a full range of other issues that cannot be handled with the same automatic response are assigned to legislatures and courts which, by analogy to the conscious mind, can address them on a particular ad hoc basis.

Historically, it was an article of faith of Lockean empiricism that everything that occurred in the mind had existed previously in the senses. In other words, everything one knew about the world had been gained through learned behaviour. It was believed that the brain consisted of an undifferentiated mass of cells. Information was stored away in various places – the exact location was unimportant. Consistent with this radical form of sensory empiricism, Locke used the metaphor of *tabula rasa* or blank slate to describe the human mind.

One indisputable finding of modern psychology is that this simplistic explanation of the mind's organisation is wrong. Physiologically it is now known that there is considerable localisation of mental functions inside the brain. Specialists can trace where particular capacities are held, including where we learn to organise and store memory, speak, discover balance and recognise spaces. This means specialisation is not just something that is learned. Indeed, the only reason any of us can learn from our interactions with the environment is that we do not have an undifferentiated mass of cells. Instead, we each have specialised knowledge and a predisposition for certain activities.

How then are functions of the body divided between those that are pre-committed structurally (the constitutional metaphor) and those that are decided on a discretionary basis (the governance side of the system)? The answer is in the same manner as a computer maker who must decide which components should be hard-wired and which should be provided as software. The computer maker reacts to low-variance environmental features of a computer with a hardware response, which provides reliable performance over a limited set of tasks. In contrast, there are features of a computer with a high degree of variation that make built-in protection unsuitable. For these, a greater level of flexibility is required: the software response.

The analogy we may draw is simple. When we find constant, standard features in the environment we should respond with an entrenched constitutional provision. But for matters likely to appear in strange and diverse ways, we must instead develop institutions that allow for discretion and flexibility.

Let us return to the human body. The subconscious autopilot is more reliable than conscious mental control. It performs many vital functions such as breathing. In an area where one lapse would result in death, the constancy of the subconscious is important. Breathing is an example of a function that our body carries out in the background, to use a most appropriate computing term. What occurs in the background takes place regardless of what we are doing on a conscious level.

On the other hand, it would not be feasible to rely on such hard-wired intuitions when it comes to getting from one location to another. Therefore, people are not pre-programmed with a map of the Inca trail or the Queen Charlotte walkway in their mind. Instead, individuals must consciously organise their perceptions to provide them with reliable information and discretion.

This recognition of hard-wired elements in the human psyche does not mean everything is built into one's fundamental constitution at the moment of birth. The level of developmental psychology in forming an internal constitution continues to evolve along fairly predetermined lines. When we reflect about who we are, it is important to consider how much of our behaviour is habit and how much is automation.

### **The organisation of a family**

Leaving behind our examination of the human body, we may proceed by noting that one of the most important features of institutions that people form is the mechanism of cooperation between individuals. Within a body there is no conflict between nerves and organs: each part will moderate itself in order to maximise the chances of survival of the organism as a whole. However, in organisations of people, conflicts of interest and coordination and relationship problems occur. The primary question is: what enduring features

#### 4 The Uses and Limits of Constitutional Arrangements

of the social environment create a need for a permanent organisational structure? Such structures, I might add, are not easy to create and sustain. Often, social institutions fail. Looking around, we see only examples that have succeeded. But it turns out that these successful models contain common elements.

The primary way many human beings organise themselves is within a family. There are relationships between the spouses, between parents and children, and between siblings. Logic dictates that we should expect to see a strong maternal or paternal instinct in parents, efforts by infants to make themselves appealing to their mothers and fathers, and a robust bonding mechanism within the family. Sure enough, we find exactly those forms of dependency in all higher species. One could say these relationships are subject to familial constitutional arrangements, where the relevant unit was, at least for historical purposes, biologically defined, as is still the case largely today.

We can push the argument still further. Generally speaking – and in common with many organisations – the family has an internal and an external dimension. The external dimension is the way the family interacts as a unit with the rest of the world. Let us look at a two-parent, two-child family as an illustration. In a modern society the parents will own the family home and the children will have their own rooms. In more traditional societies the father is the only person with legal ownership while the wife is subordinate. In both situations the children do not have independent status. If somebody wants to buy the family house they do not need to deal with the children individually, or figure out how the family has allocated the property among its members. Instead, the prospective buyer deals with the parents. The purchaser is bound and entitled to treat the head or heads of the family as sole property owners. Any claims from the children against the parents are sorted out through informal means – if, for example, they do not receive a similar or better room in a similar or better house, they will become unhappy!

When a formal arrangement is entered into between strangers, it will be an ‘arm’s length deal’. The meaning is clear: outsiders are kept at a distance as a protective mechanism. (People at arm’s length cannot stab you, for example.) Inside the family, however, the love between parents, and the genetic commonality between parents and children, is usually strong enough to

overcome potential conflicts of interest. Because there is a high level of common interest among the family members, intuition tells us that on average a very low level of formal structure is needed to protect one family member from another.

By the same token, there is considerable variation among families. In some cases, children are badly treated. In others, parents make excessive sacrifices for the benefit of their children. The general attitude is that the state need only intervene in the internal affairs of the family in extreme cases, where there is abuse or neglect (and the latter term is, out of sheer necessity, construed in a limited fashion). Instead of having an internal constitution, the family functions through a series of ad hoc internal adjustments. The organisation of a family contrasts rather vividly with the way a business is run.

This does change subtly if we consider situations more complicated than the traditional, nuclear family. Consider a marriage between two individuals of vastly different wealth. The son of a rich oil magnate may fall for a penniless bride. The groom's parents could insist on a pre-nuptial agreement that will allow the wife an allowance in return for the protection of family assets against her claims on divorce or death. (This is not a sex-specific rule; rich daughters get exactly parallel treatment against amorous suitors). The heightened level of distrust and scope for opportunism mean various formal arrangements become necessary.

Another situation with a similar result is a second marriage. The bride may be a widow with three or four children by a first marriage. No natural bonds link the second husband to the children of the widow's first spouse. Rather than waiting for wills to take effect, the only way to ensure assets will be disposed of in a pre-appointed fashion is to provide an explicit protection to both parties. This is required because there is no commonality of interest.

These sorts of arrangements require a greater degree of structural permanence than the simple case of a traditional, nuclear family.

## **The structure of a business**

An even greater degree of structure is required with a family business. Let us imagine that two siblings form a business partnership. There are some natural bonds of affection but there is also enough money at stake and enough

## 6 The Uses and Limits of Constitutional Arrangements

potential for conflicts of interest that informal mechanisms no longer suffice to keep self-interest under control. Slowly and surely more formal mechanisms and agreements will be created that act as a constitution for this particular firm. These will indicate the contributions made by each sibling, what each stands to gain, and the protection each has against acts of misappropriation by the other. The pervasive fear of self-interest and opportunism lead to higher structural safeguards.

Put yourself in the position of somebody forming a partnership with a stranger. This partnership is designed to be in business for the long haul, not just for a single transaction. Neither you nor your partner will invest in the business unless you each believe that your gain from the business will be greater than the amount you put in. Both of you will take into account the capital, labour and administrative costs you must incur to keep the arrangement going. If you had no protections against opportunism, the amount you put in on day one could be expropriated by your partner on day two. Your rate of return would become minus 100 percent; this is not a deal that either of you would undertake, given the reciprocal risks. However, if you could safeguard yourself with a mechanism like a joint cheque-signing requirement, you will be willing to commit *ex ante* because the diversion of resources becomes less likely. The risk cannot be completely removed. However, it can be made low enough that when the expected rates of return are balanced against the potential of a worst-case scenario, both parties will be willing to proceed.

In business associations there is a powerful correspondence between the degree of formality and the nature of the underlying venture. There are two related features to note. One is that the risk of expropriation will grow as the size of the stakes and the riskiness of the venture rise, so investing partners will utilise more numerous structural protections. Secondly, the greater the number of people involved, the greater the opportunity for factions and coalitions, and the more infrastructure will be created to protect against such situations.

Because this pattern is generic – it can be observed in gated communities, business partnerships, religious organisations and other associations – it is pertinent to consider what structural protections look like and why we have them at all. Let us start with the question of how business is organised.

Virtually every business owner has two types of decisions to make. On the one hand, there are the small, rapid judgments – for example, which telephone to install, which employee to hire, or which contract to sign. Then there are the longer-term, larger decisions – these concern the business model, major acquisitions or divestments, or perhaps whether to liquidate or merge the firm.

Almost every business responds to this division of responsibilities by creating two kinds of decision-making arrangements. For the high-frequency, low-value transactions a single executive officer is put in charge. This person's behaviour will be reviewed and evaluated. This will not occur transaction-by-transaction – it would be infeasible to review a million transactions – but at regular intervals, perhaps annually.

For major structural decisions, however, a board will be used because the risk that one person will make a mistake is too high. Having an executive and a board requires further decisions. The first is whether the executive will be part of the board. If an organisation believes in the separation of powers, it will adopt a business approach similar to the English business model: the chief operating officer will not be a member of the board, and the chair of the board will not be the chief executive officer. Although this provides some protection against misappropriation, it is inefficient. An alternative is the American business model where a single person typically occupies the offices of chair of the board and chief executive officer. Incidentally, I believe this division helps to explain why the US Constitution mandates a strong separation of powers in which the entrenched executive – the president – has nothing whatsoever to do with the elected Congress, whereas in the English system, the prime minister is part of the board of directors (the Cabinet) but does not have powers equal to that of the American president, except maybe in times of war.

The pressing demand to deal with the self-interest problem – a constant feature of human nature – shapes many organisational arrangements. At the board level a collective decision is required, quite rightly, because a single individual is not trusted with issues of such moment. But what rules should govern the board? There needs to be regulations regarding access to information. Somebody must decide who has a right to speak and who has a right to examine papers. This takes us well into the realm of the rules of natural

## 8 The Uses and Limits of Constitutional Arrangements

justice (to use the constitutional language of England and New Zealand) concerning the procedures, especially those relating to notice, and the right to be heard, that must be followed before various decisions can be made. A voting rule is required. If the board consists of five people, do three constitute a majority? Or does the risk of factions justify a requirement for a super-majority? The trade-offs are sufficiently ambiguous that even though everybody is committed to the idea of having a board, there will be no uniformity across boards – nor should there be – on the question of whether majority or super-majority devices are better.

If you look at the US Constitution you will see that in some cases simple majorities are required – for example, for the Senate to confirm a presidential nomination for the Supreme Court – but a super-majority (of two-thirds) of both houses of Congress is needed to override the presidential veto of ordinary legislation. Choosing between a majority and a super-majority is an inherent problem with constitutional issues. One useful way to understand what is going on in a political constitution is to study how a voluntary organisation arranges its affairs in dealing with similar problems. Why is this the case? Because the members of that organisation have strong incentives to adopt those complex arrangements that work, and avoid those that do not. They do not make right decisions in all cases, but the common set of institutional arrangements, with divided power and clear procedures, is a feature that anyone dealing with political constitutions ignores at their peril.

### **Constitutional protection of individual rights**

So far we have concentrated on governance. However, the same insights carry over elsewhere. In the case of permanent constitutions, we must also examine protected individual rights. If a company has 100 shareholders and a five-member board, it will not do to have a set of rules that allows board members to declare a huge dividend to stockholders A–N while not giving a cent to stockholders O–Z. The protection of shareholder rights is the obvious analogy to the protection of individual rights under a national constitution. At some level, every constitution deals with both structural decision making and individual rights.

In business, it is generally straightforward to quantify the nature of an individual's interest given the limited nature of the commitments. If I invest twice as much as you in a corporation at the same time then I get twice as many shares as you do. To protect against misappropriation there will be a rule that says that when paying a dividend, a business must treat all the shares within the same class of stock in the same way. This is a cross between a property protection and an equal treatment protection: the non-discrimination provision will make it harder to shift wealth from A to B in an illicit fashion. This principle of equality and non-discrimination not only works with respect to the shares of corporations but also plays a powerful role in political settings.

However, there is a need for a little more sophistication than first appears because, in addition to avoiding discrimination, there is also a need to discourage wholesale expropriation. Meeting this challenge requires further limitations. For example, suppose I have a controlling interest in a corporation whose constitution provides for equal distributions according to the number of shares held. If I sell the assets of the company for one-tenth of their value to a corporation in which only 20 percent of my fellow shareholders have an interest, I have engaged in expropriation from the majority of the first corporation to all the shareholders of the second corporation, including that 20 percent minority from the first corporation. In the corporate framework, therefore, all sorts of doctrines have evolved to guard against fraudulent transfers of one form or another, all because simple equality guarantees can be overridden by circuitous transactions. There are parallel protections within a political constitution. If the state cannot confiscate an individual's property, it should not be allowed to re-zone it until it is worth much less and then pay the individual the residual value if it takes it by eminent domain after the imposition of regulations. Extensive constitutional safeguards must be applied to prevent any of the basic norms on equal treatment being circumvented.

Generally, businesses have three features that make them easier to operate than political societies governed by standard constitutions. The first is that people become members of a firm by dint of a voluntary transaction. There is not a massive degree of heterogeneity in a business because all those who invest in it found the investment congenial. Even if they grow apart later, they



are still likely to share many more common sentiments than any large array of individuals chosen by residence only. Secondly, businesses do not deal with diffuse issues of citizenship where all sorts of powerful rights and duties are involved. Corporations do not fight wars; they do not have explicit redistributive goals. Instead, the focus is on the money committed to the venture, so that the differences among investors tend to be about the best means to profit from the firm's assets. Only in very small businesses where people also contribute labour to the firm will the range of issues become broader to include such matters as working conditions and chain of command. Finally, exit rights are easier to specify in business charters than in political constitutions. If I do not like the way a business is run and the shares are alienable, I do not have to sue or kill the board of directors. I can sell my shares to somebody else and get out of the business. My buyer is more likely to agree with the policy of the board, and thus can support its direction. Therefore, the resale mechanism allows people to reassess the way a business has evolved after its formation. The clean exit of the dissenters helps restore the needed homogeneity of the enterprise. In the case of a political constitution, the exit right is always encumbered, for it can only be exercised if you leave the country, thereby abandoning your friends, home, associations and employment.

There is no question that every person who considers constitutions in a serious way will be struck by the parallels, however imperfect, that exist between the charters for voluntary organisations and the constitutions created for political entities. By any standard, the political constitution is harder to frame. Because a state is defined by its monopoly over a particular territory, the population is much less homogenous than the members of a voluntary organisation. There are many cases of strange bedfellows, often with fierce ethnic animosities that make it hard to cooperate in a spirit of trust. It is not as likely that a governance decision will commend itself to everybody simply because it commends itself to anybody. In many cases the stakes will be higher, for example, lives and fortunes may be put at risk over questions of war and peace. Because the exit option is less effective, internal protections require greater precision and heft than they do in a business arrangement. Whether a constitution is informal like that of New Zealand or formal like that of the

United States, there will be a constant effort to ratchet up such protections, whether by provisions on separation of powers or through conventions on cabinet protocol designed to prevent the centralisation of power in a single individual. Often the constitution will contain a bill of rights that deals not just with property but also with things such as freedom of religion that for the most part ought to be kept outside the state's ambit. Yet even here it is easy to go astray and include in the constitution a set of unenforceable commands, by guaranteeing a list of entitlements to things like housing, education and health care, which the state has no comparative advantage in providing. It is not enough to entrench individual rights in a constitution. It is necessary to entrench the right set of (negative) rights, that guard against the aggrandisement of government power.

This last point highlights the difficulty within a political setting of getting agreement today on the key provisions of an ideal constitution. When I think about a constitution my preferred model is constructed along classical liberal lines. I believe the function of a government is to protect autonomy: to figure out how to protect rights, to make sure that voluntary exchanges can take place, and to provide a social infrastructure. One of the advantages of this type of constitution, as opposed to the more modern form, is that limiting the range of government functions reduces the risks of expropriation or manipulation: the fewer the number of tasks performed by the state, the fewer opportunities for official misconduct. However, my model is different from any modern constitution in the world today. Look at the US Constitution, for example. There are massive wealth transfers through taxation and regulation in the United States, and all sorts of positive entitlements not created by the Constitution but nonetheless enacted, including a social security system, a medicare system, a public housing system, a farm subsidy system, and more. When property rights are indefinite and massive wealth transfers are routinely tolerated, it is extremely difficult to figure out how to prevent the democratic machinery from becoming dysfunctional. The current American travails over Social Security are a direct outgrowth of the initial decision to place all funds into an amorphous trust account that severed any tight connection between what people put into the fund and what they took out. The vaunted phrase

‘social insurance’ has it precisely backward. The huge set of implicit cross-subsidies increases the level of social uncertainty.

### **Achieving balance**

In the light of these challenges, then, every constitution faces the same dilemma: how to achieve balance. The goal is to prevent illicit expropriation that could mean wrongful imprisonment or even death for individuals. Strong controls are required to regulate the behaviour of elected officials. Because so much damage can be done by those with coercive powers, a lot of thought must be given to worst-case scenarios. But in a well-meaning attempt to constrain harmful transactions, it is easy to suppress actions that governments need and ought to take. Therefore, there has to be a constant attempt to separate the activities that ought to be prohibited from the activities that ought to be tolerated, or indeed encouraged.

I have done a lot of work and writing examining the ways in which the government should be restrained when it takes property from individuals to give to other individuals, and how the government should bargain with its citizens through contracts. From this experience, I believe the purpose of this body of law must be to make sure that there is enough flexibility for the government to do the things that must be done, but only in such a way that those whose property must be surrendered for the common good do not get crushed in the process. It may well be, for example, that in the frontier towns of the United States a family farm can be compulsorily acquired to build a crucial defence installation – but if the government does so, it must pay the family just compensation, which should include not only the market value of the land, but something to cover the loss of subjective value, the indignity of forcible displacement, the costs of relocation and the like. Sadly, that higher standard is frequently and systematically ignored. The upshot is an excessive use of the eminent domain power by states that are not asked to internalise the full costs of their decisions.

In practice, a government seems to have two kinds of mechanisms to deal with the recurrent danger of oppression. It often has super-majority rules that reduce the likelihood that one faction will commandeer the whole situation.

But these are not the whole answer. Let a nation have a 10 percent minority that the majority despises, and no super-majority rule will afford it adequate protection. The rules on legislative process must therefore be supplemented with substantive rules that allow the state to take property for public use without the consent of owners, but if it singles out a person or group from the population, it must provide just compensation for their losses along the lines indicated above.

These provisions have a direct application to some of the most contentious issues that face New Zealand today. If you read, for example, the Waitangi Tribunal's analysis of the foreshore and seabed cases, the essential argument in favour of Maori rights goes right back to this vision of a Lockean constitution, which attaches great weight to the original possession of natural resources. Therefore, the issues here are as relevant to New Zealand as they are anywhere else. The point of a constitution is, in effect, to constrain the ways in which political abuses happen. But the limits to what can be laid down in a constitution mean there is no way to eliminate the need for executive discretion in undertaking particular tasks. Trying to reconcile the need for both constraints and discretion is not simply the work of a lifetime, but that of many lifetimes for many individuals.



# Questions

*You discussed the importance of correctly calibrating constitutional arrangements. My question concerns their recalibration. Can political imperatives ever be reconciled with the classical liberal view of a limited state? Could the constitution be used to limit the state, given the incentives for politicians to spend other people's money? For example, could it limit the government's spending to, say, no more than 20 percent of gross domestic product to fund its proper tasks?*

That is a terrific question. Let me reply by first looking at the way the US Constitution tried to deal with the size of government. It did not get into the numbers game, but took a more structural approach. In the original Constitution there was a distinction between direct and indirect taxes. The aim was to ensure rich states would not have to pay more for the provision of national public goods than poor states. If the average Virginian's income were twice that of a citizen of South Carolina, for example, the rate of direct tax for a Virginian would be half that of a South Carolinian. This provision was included to make sure there was no wealth transfer between states. It was eliminated by the Sixteenth Amendment to the Constitution in 1913 because the salience of state citizenship grew weaker over time, and the individual, not their home state, was regarded as the proper unit of taxation.

A second attempt at limiting the size of the state was a so-called uniformity provision for taxation. This safeguard meant differential rates could not be imposed in different places. In the 1970s, when a windfall profits tax was being debated, Alaskan senators convinced Congress to make oil from that state exempt from taxation. The Supreme Court found that this was acceptable

because the tax was uniform everywhere except Alaska. I am not joking – I was involved on the losing side of the windfall profits tax case.

The uniformity provision became a weak presumption to be overridden in the case of serious national necessity. Alaskan oil wells were considered a ‘serious national necessity’ because they were near Russia. I suspect that if the oil had been discovered in the South, the result would have been the same, except the argument would have been that the subsidy was needed because the resource was near Cuba. There is an endless set of excuses to bypass this provision, so it seems to have failed. It is one of the great dangers of constitutionalism. Provisions that current governments find unpleasant can be watered down to the point of ridicule under the misleading ‘rational basis’ test.

Progressive taxation is another way redistribution occurs, and one that could be stopped. Yet, by 1915 the chance of constraining progressive taxes in the United States had effectively been lost. They could be increased until they were confiscatory, right up to 100 percent of income. It remains to be seen whether current advocates of a flat or proportional tax will have more success. But wholly as a political matter, there is a far greater reluctance now than historically to push income taxes up to high levels. The nominal 91 percent rate that applied in the United States in the 1950s will not return.

Experience on the spending side has been no more encouraging. A proposed statutory scheme to limit spending was struck down on constitutional grounds: the umpire who was to limit spending was not inside the executive or congressional branches. The momentum for tax and expenditure limits at the federal level has waned, although some US states have implemented them with varying degrees of success.

This record of experience with structural limitations is not particularly encouraging. Yet, in another way, they have been a great success in the United States. One of the single most important features of American government has been the judicial creation of a common market, notwithstanding the different regimes of state regulation affecting interstate transactions. In the Constitution there is very little explicit, textual warrant for an open market. Under the so-called Dormant Congress Clause, however, the courts said that interstate trade

must be subject to the same treatment as goods and services produced and consumed within a state, unless there is a classical liberal justification for an alternative treatment. This is basically the internal version of the national treatment principle of the World Trade Organisation.

One might assume that weak justifications for bypassing this provision would have been put forward, as occurred with the windfall profits tax. However, this never happened. The only justifications allowed by the courts are the justifications that a classical liberal would advocate. If a state wants to keep a good out, it must show that it would be damaging environmentally or in some other way. Any lesser justification fails, because naked (and badly disguised) economic protectionism never counts as a valid reason for government action. To date, state efforts to keep out milk from other states simply on the grounds that it is inferior have failed. Nor can the state of Wisconsin, say, impose a requirement that milk sold in Wisconsin must be pasteurised inside the state.

With a few exceptions, it appears Supreme Court judges understand the gains from having free trade inside the United States. Because they care about it, they gravitate to the only intellectual framework that motivates free trade: classical liberalism. Yet, when you ask them if they care about property rights on the grounds that they create competition and free trade among individuals, which maximises welfare, their unthinking answer is no. They believe every bargain is essentially exploitative if the legislature says so. What lesson can we draw? I think the moral is that if you win the intellectual battle, the classical liberal restraints can survive. If you lose this battle, then, no matter what a constitution says, somebody will find a way of ripping it to shreds.

Let me give you one final example on this point. We have a freedom of speech provision in the US Constitution. In the past, judges understood that its purpose was to allow citizens to criticise their government, and they resisted attempts to suppress individual dissent on the grounds that restrictions were needed to preserve national unity in time of war. It was a classical liberal idea. However, when people started to believe that the provision protected not just individuals speaking up in the town square but powerful business and media



interests as well, things changed. This is why regulations placing limits on campaign financing, which heavily limit free speech, have been upheld by a court that has been more deferential to Congress than it should be.

*In the first part of your talk you discussed hard-wired versus voluntary behaviour, and in response to the last question you mentioned constitutional protections for things other than property. What has been happening in this area in the United States, particularly in the light of the terror attacks of September 11, 2001?*

First, let me say that my view of property goes beyond economic property. I regard it as including the full set of rights people have to organise their personal lives – this embraces religious and personal freedoms.

I take the same position on issues like same-sex marriage as I do on economic property rights. In my academic writing I have strongly advocated against having personal affairs subject to extensive regulation as was the case in the United States before 1937, or property interests subject to extensive regulation as has been the case since 1937. I tend to be libertarian on both sorts of issues. If you want my intellectual orientation, I believe in the maxim that property is the guardian of every other right.

Regarding September 11, I believe libertarians have won an important intellectual debate. This may be a surprising statement, so allow me to explain it. Before the terror attacks, the United States had reasonably open borders. For the most part, no real external threat was perceived. The loss of 3,000 people and many hundreds of billions of dollars from the economy clearly changed the prevailing views. Pro-rata taxes and pro-rata restrictions were imposed on individuals, although generally these did not include any kind of wealth transfer across groups. There was a high level of willingness to submit to these impositions because people could see an improvement in security. Although they believed things were worse than they had been before the attack, they accepted that life was better with the new restrictions given the increased possibility of being harmed. People conformed to the classic Lockean trade-off: I will surrender liberty to the extent that it is necessary to gain security for life and property.

So why do I say libertarians have largely won? Because there is a fairly strong coalition between the civil liberties advocates associated with the American Civil

Liberties Union and those associated with, say, the libertarian Cato Institute. Each says the government justification for impositions must be scrutinised with scepticism, even given the events of September 11. When libertarians saw long-term incarceration without trial, as occurred at Guantanamo Bay, they became worried. The pressure on this issue has been enormous. Remember, the Supreme Court struck down the government's efforts to detain people without trial. It rejected arguments, which were supported by social conservatives like the *Wall Street Journal*, that the practice was justified because the inmates had combatant status, that the due process clause had not run out, and that Guantanamo Bay was leased and not sovereign territory. Compare this with the reaction after 1918 during the so-called 'red-scares' under Attorney-General Palmerston, or the inexcusable World War II incarcerations of American Japanese, or even the willingness to suppress demonstrations during the Vietnam War. In comparison with these events there have been fewer incursions on personal liberties. Even Attorney-General John Ashcroft has been relatively light-handed. The consensus reached in the so-called Brandenburg case in 1971 that individuals can say whatever negative things they like about a government policy without fear of retribution has become rock solid. As I mentioned earlier, the First Amendment is essentially classical liberal until arguments concerning a concentration of wealth (in media organisations or other businesses) are added. Nobody considers matters associated with September 11 as being in the same category as media issues.

In summary, I believe the United States has come through this period rather well. I do not think this outcome has been wholly dependent on the First Amendment to the Constitution. Rather, the way in which the written and the unwritten constitutions interact has been vital. The unwritten constitutional culture in the United States is every bit as important as the written Constitution, and more extensive. It contains two elements. The first is the standard of scrutiny brought to any particular clause, and this is not laid down in the Constitution. The second element, driven by the first, is what police power justification is put forward. The term 'police power' is to be found nowhere in the text of the Constitution, yet it dominates constitutional adjudication and state relationships, including interstate commerce. It dominates issues of property (including restraints of nuisances), speech and

religion. Questions like whether an abuse of children justifies the state's intervention arise under it. Regarding September 11, we have seen a presumption of distrust of government behaviour that translates into a narrow reading of the police power.

New Zealand does not have a written constitution. The two things that are part of the unwritten US Constitution operate in this country through the political process. Yet there is much more convergence between the two systems than might be supposed. In the end, the way the populace views an issue will affect the outcome. I have no doubt that if the United States suffered another terror attack or catastrophe you would see strong popular support for more ratcheting up of taxation and incursions on civil liberties.

Everybody hopes that what the US government has so far done is right, yet it is impossible to know. Recently, half of New York City was shut down on the basis of information that turned out to be three years old. It is wrong to blame those who acted on outdated information. When a mistake is made, it should be reversed. I think the American public has been remarkably tolerant and resilient in these matters. The present administration has made a mess of many things – same-sex marriage is one example – but on the security/liberty trade-off we get an A-. That is well short of an A+, because of all the irregularities with various noncombatants. But take that into account, and overall it is certainly not a C or a D.

*The first question concerned top-down limitations on the scope of government with respect to spending. A more logical way to achieve this outcome might be bottom-up, constraining government to its proper functions. In the light of the enumerated powers doctrine in the Constitution that essentially aimed for this approach, what are your views on the American experience with it at the federal and other government levels.*

The American experience has been one of failure rather than success. The broadest grant of federal power in the original Constitution conferred on Congress the authority “to regulate commerce with foreign nations, among the several states, and with the Indian tribes”. That is the entire provision – there is no mention of Congress having the power to pass whatever

legislation is necessary for the well-being of the United States. It is a very constrained power.

The question is, what does it mean? Until 1936, Supreme Court decisions in the United States took the view that the reference to commerce between the states encompassed network industries that crossed more than one state (such as telephone lines across state boundaries, railroads and roads), along with cross-border transactions involving goods and the movement of individuals. The theory was that the role of Congress was to keep these networks open, while local regulation by the states in competition with one another would produce a sensible set of rules for commerce. In my view, this theory was correct.

However, the difficulty with this theory is that it allowed competition to occur when some wanted to create state monopolies. For example, in the agricultural sector in the 1930s there was a desperate desire to prop up prices by creating all sorts of acreage limitations, cartels and pooling arrangements as part of the New Deal. These practices found their way to New Zealand, so you know their consequences.

If the federal government were only able to control interstate commerce, implementing such policies would not be possible. It would not have the ability to implement uniform prices nationwide if in-state transactions were outside its scope. However, despite its talk about a free trade zone under the Dormant Commerce Clause, the Supreme Court seemed to think that these cartels were a good thing. Therefore, in the 1942 case of *Wickard v Filburn* it found that in-state transactions should be considered as though they were interstate. Newcomers to American constitutional law find this difficult to fathom. How could a farmer feeding his own corn to his own cattle possibly be considered to be engaged in an interstate transaction? This was the effect of the Supreme Court ruling. It was bizarre, yet no ruling on economic regulation has ever been more tenaciously defended by American academics. I essentially lost my place in the respectable branch of academia when I pointed out - more than once I might add - that this emperor had no clothes: the decision is absolutely wrong-headed and serves an ignoble end. It is impossible to make a plausible argument for the cartelisation of industries.

## 22 The Uses and Limits of Constitutional Arrangements

For further reading on this topic, I recommend the 2003 Wincott Lecture that I gave in the United Kingdom with the title *Free Markets Under Siege: Cartels, Politics and Social Welfare*.<sup>1</sup> This traces the evolution of the US Constitution from an institution that preserved competition to a cartel-maintaining institution in the 1930s.

Thus, the doctrine of enumerated powers has largely failed in the United States as a restriction on the growth of the state. One redeeming factor is that the federal government only regulates local industries to the extent that it believes it can preserve national or worldwide cartels for the benefit of American farmers and unions. Despite exactly the same dynamic being at work, the federal government does not get involved in areas such as land-use planning where enterprises can gain substantially through the exclusion of rivals. Why? Because there is no comparative advantage to rigging such a monopoly from Washington. The monopoly creation may as well be undertaken by the state government or at a local level. Despite Congress having the unquestioned jurisdiction to decide what supermarket will go on any street corner in any city, these zoning decisions have remained local.

Whenever there has been an effort by the federal administration to get involved, state agencies essentially tell it to back off. Enumerated powers have failed where multi-state cartels are involved, but continue to be upheld where there are no cartel rents to be had.

This is the opposite of what I would desire. I believe the federal government should not use the commerce power to create national and state cartels, and the Fourteenth Amendment was designed to stop local governments from exercising control over individual rights. However, the present situation arises because of the way the Constitution has been interpreted. The great achievement of the New Deal was to make the world safe for cartels at the national and state level. As an American, that is not something that I am particularly proud of.

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<sup>1</sup> Reprinted as Richard A Epstein, *Free Markets Under Siege: Cartels, Politics and Social Welfare*, New Zealand Business Roundtable and Institute of Public Affairs, 2004.